

# Audit Committees and Fraudulent Financial Reporting:

## A Descriptive Analysis

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**Abstract— The study examines the background of the audit committee from the aspect of professional affiliations, postgraduate qualifications and senior managerial experiences, in association with fraudulent financial reporting.**

**Keywords; audit committee; fraud; expertise.**

### I. INTRODUCTION

The study examines the background of the audit committee (AC) in association with fraudulent financial reporting (FFR). The study finds negative association between accounting affiliated ACs and fraud.

### II. THEORETICAL BACKGROUND

Three theories are utilised; the agency theory, resource dependence theory and behavioural decision theory, to form the basic framework of the study. Resource dependence theory (RDT) is related to audit committee expertise literature, while agency theory is the rationale for establishing the audit committee. The focus on director is stipulated on the three theories connected to it. Whereby, in the agency theory, the director or audit committee, acts as a monitoring mechanism on the preparers of financial statements (Shapiro, 2005). The RDT assumes, the director acts as a link between the firm and external resources, and functions as the provider of resources (Pfeffer, 1972). Hillman, Shropshire and Canella (2007) added that the board is also known as board capital, where directors as human capital providing expertise, experience and reputation to the organisation (Hillman and Dalziel, 2003). These expertise and experience are identified as criteria to be used to determine experts as explained by the behavioural decision theory (BDT).

The study includes two important criteria as the variables of interest, which describe the concept of human capital that measures the skills, abilities and knowledge, education and work experience as the most common dimensions of human capital. Subsequently, the study has three basic criteria for expertise as shown below:

#### A. Professional qualification.

The Blue Ribbon Committee (BRC) (1999), Sarbanes Oxley Act (SOA) (2002), Securities Exchange Commission (SEC) (2003), Smith Report (2003), Malaysian Code of Corporate Governance (MCCG) (2007), Defond, Hann and Hu

(2005), and Qin (2006), have outlined this as one of the criteria for a financial expert.

#### B. Academic qualification.

Bonner and Lewis (1990), Busch (1997), and Rose, Rose and McKay (2007), have noted that experts learned through formalised training, and specialised skills that will make directors more effective. Consistent with Kim, Aldrich and Keister (2006) who theorise that formal education allows individuals to gain knowledge and skills, and earn credentials valued by others in the business community.

#### C. Managerial experience.

Abdolmohammadi and Shantaeu (1992), Choo (1996), Defond, Hann and Hu (2005) and Carcello, Hollingsworth and Neal (2006), noted that repetition to exposure and extensive effects of experience increases the knowledge and skills of experts. In addition Perkins (1993) noted that experienced managers' cognitive structures appear to be organised by marketing functions, where in the marketing discipline, managerial knowledge is a critical element in many situations. Thus, gives support to the study's third variable of interest. Prior research show evidence of a strong positive relationship between the length of job experience and performance, where those managers with longer tenure achieved higher performance (McEnrue, 1988), supported by Kor (2003), that past managerial experience contributes to the competence of the top management team.

### III. HYPHOTHESES

#### A. Accounting Affiliated Audit Committee

The agency theory suggests that firms with higher agency costs will attempt to reduce the cost by showing good quality financial reporting, possibly by appointing an accounting financial expert (Krishnan and Lee, 2009). In addition, Sharma, Naiker and Lee (2009), reveal that accounting experts on audit committees and greater board independence demand more frequent audit committee meetings when management adopts more aggressive accounting practices, which suggests that accounting experts on audit committees and independent directors have important role in monitoring. Furthermore, Chen, Chang and Lee (2008) document that there is a positive association between professional training of assistants and financial performance in big sized firms when investigating the relationship between continuing professional education and firm's performance. Beasley, Carcello, Hermanson and

Neal (2009) found that accounting experts are more likely to state that their audit committee drives the content of information and discusses alternative accounting treatment under GAAP, as well as specific judgments, estimates and assumptions involved in implementing a new accounting policy. Hence the following hypothesis is conjectured.

H<sub>1</sub>: Firms with a higher proportion of audit committee members with professional accounting affiliations, are less likely to experience fraudulent financial reporting.

#### B. Audit Committee with Postgraduate Qualification

Formal education allows individuals to gain knowledge and skills, earn credentials valued by others in the business community (Kim, Aldrich and Keister, 2006), and the higher skill level in the workforce increases the production capacity, where one year's increase in average educational attainment of the workforce will lead to an increase in labour productivity growth of 0.3 percent point as documented by Canton (2007). Thus, lends support to earlier research by Singer and Bruhns (1991) which determined that higher academic qualifications can enhance a candidate's chance of success in a position, and conjectures the next hypotheses.

H<sub>2</sub>: Firms with a higher proportion of audit committee members with postgraduate qualification, are less likely to experience fraudulent financial reporting.

#### C. Audit Committee with Managerial Experience

There is a strong positive relationship between the length of job experience among early-career managers and their performance, whereby those with longer tenure in the role of manager achieve higher performance (McEnrue, 1988). Also, past managerial experience contributes to the competence of the top management team (Kor, 2003). Hence, the study expects that audit committee with previous experience in senior management positions such as Chief Financial Officer (CFO), group accountants or financial controllers, or relevant positions, will result in a lower occurrence of financial statement fraud, as documented in Dechow, Sloan and Sweeney (1996), and Beasley, Carcello, and Hermanson (1999). Thus, the following hypothesis is conjectured.

H<sub>3</sub>: Firms with audit committee members who have experiences in senior managerial positions, are less likely to experience fraudulent financial reporting.

### IV. RESEARCH DESIGN

#### A. Sample

The sample is limited to publicly traded firms because audit committees only exist in listed companies. Hence, the study has 28 fraud firms listed in Bursa Malaysia, to be matched with 84 nonfraud listed firms consistent with Lee, Yeh and Liu (2003), Owens-Jackson, Robinson and Shelton (2009), Zhao and Chen (2009), and Mustafa and Youssef (2010).

#### B. Fraud firms selection

To identify firms accused of fraud, the study searched the Securities Commission (SC) enforcement actions based on the offences as shown in **Table I**, consistent with Erickson, Hanlon and Maydew (2006), Zhao and Chen (2008) and Owens-Jackson, Robinson and Shelton (2009), the study compiles a matched sample of firms not accused of fraud. Lee, Yeh and Liu (2003) noted that the existing literature usually employs 1:1 or 1:2 matching sample. Where, for every financially distressed firm, one or two healthy firms are chosen as matching samples. However, in the real world financially distressed firms are far less than one half or one third. Thus, matching techniques may induce over sampling of financially distressed firms (Lee, Yeh and Liu, 2003).

Each of the fraud firms is matched with three nonfraud firms (1:3), consistent with Zhao and Chen (2008) and Erickson, Hanlon and Maydew (2006), creating a choice based sample of 28 fraud, and 84 no fraud firms. They are first matched by the industry or sectors to which they belong, and then by the closeness to the size measured by total assets, consistent with Zhao and Chen (2009). The number of firms in the sampling is consistent with Peyrefitte, Fadil and Thomas (2002) with a final sample of 87 and Mustafa and Youssef (2010) that examine 28 cases of misappropriation of assets. Data was hand collected from publicly available data.

TABLE I. SUMMARY OF OFFENCES

List of offences	Sections	Acts
Making a statement that is misleading in material particulars.	Section 176	Capital Market Securities Act 2007
Issued a prospectus contained misleading information.		
Submission of false information to Securities Commission.		
Making false statements in documents, which is used in the preparation of financial statements contained in annual report.		
False or misleading documents or information.	32B (Deleted) 33E	Securities Commission Act 1993
Disclosure of information to SC that is false or misleading, material omission; or misleading or deceptive.	152(2)	
False reports to Commission, stock exchange or recognized clearing house.	122B	Securities Industry Acts 1983
Criminal Breach of Trust		Penal Code

## V. ANALYSIS AND DISCUSSION

### A. Univariate Analysis

**Table II** shows univariate analysis on the descriptive of mean, standard deviation, median, minimum and maximum for whole sample. Results show that mean for audit committee members with senior managerial experience, EXP, is higher than those with accounting affiliations (ACC) and postgraduate qualifications (PG). Board size has a mean of 7.17. Audit committee independence (ACINDP) reached the required 2/3 majority of independence as proposed in the MCCG, and a mean of 0.6914.

For the t-test as in **Table II**, the ACINDP has a significant p value at 5 percent level, suggesting there is a difference between fraud and nonfraud firms where audit committees independence, is concerned. This is consistent with Abbott, Parker and Peter (2004), and Bronson, Carcello, Hollingsworth and Neal (2009) that show significant audit committee independence between going concern reports and clean reports firms.

MGTOWN is significant too, suggesting managerial ownership might have some influence to FFR which is consistent with Abbott, Parker and Peter (2004). The result shows a nonsignificant board size and firms' size between fraud and nonfraud firms' consistent with Carcello and Nagy (2004), suggesting that board's size has no influence on FFR.

### B. Correlation

**Table III**, shows the correlation matrix between fraud and other variables. From the table, ACC has a negative and

significant association with fraud, suggesting that audit committee with professional qualification is negatively associated with fraud, or the higher the number of accounting affiliated audit committees, the lower the incidence of fraud. However, ACC is positively significant with management ownership, suggesting as management ownership increases, the number of accounting affiliated audit committees increases too.

ACSIZE, is positive and significantly associated to board size, consistent with Baxter and Cotter (2009). This is because as the number of board size increases, the number of audit committee increases too since, audit committee members are also among the board members. MGTOWN has a negative and significant relationship with fraud, firms' size and age listed, consistent with Mitra, Hossain and Deis (2007) that managers with high ownership interest are less likely to misreport financial results. This may also suggest that, higher number of management ownership may help to reduce the likelihood of fraud and is consistent with the t-test shown in **Table II** earlier.

### C. Discussion

The univariate tests of the shows leverage, management ownership and audit committee independence, are significant to differentiate between the frauds and nonfraud firms. The correlation analysis supports the univariate analysis for management ownership where, it is found that management ownership is negative and significantly related to fraud. The

TABLE II. UNIVARIATE ANALYSIS

Variable	Mean	S.D	Min	Median	Max	Mean diff.	F tests	p value
<i>N=112</i>								
FRAUD	0.25	0.435	0	0	1			
ACC	0.3403	0.1674	0	0.3333	1	-0.089	1.148	0.286
EXP	0.8403	0.2279	0	1	1	0.064	1.909	0.170
PG	0.2699	0.2414	0	0.3333	1	0.028	3.319	0.071*
ACSIZE	3.24	0.651	2	3	5	-0.024	0.364	0.547
MGTOWN	16.9384	19.8225	0	8.002	88.76	-9.455	6.675	0.011**
BODSIZE	7.17	1.907	3	7	12	-0.369	0.005	0.944
ACINDP	0.6914	0.1177	0.33	0.6914	1	-0.009	6.446	0.013**
AGELIST	11.1339	10.864	0	9	51	-0.131	0.010	0.922
FIRMSIZE	11.9852	2.3871	0	11.9747	16.15	-0.887	1.514	0.221
LEV	0.5556	0.9195	0	0.3707	7.31	0.202	0.535	0.466

\*,\*\*significant at 5% level (2-tailed and 1% level (2-tailed)

Note : ACC=Proportion of AC members with professional accounting affiliations; EXP=Proportion of AC members with senior managerial experience; PG=Proportion of AC members with postgraduate qualifications. ACSIZE=Number of AC member; MGTOWN=Percentage of shares owned by directors; BODSIZE=Number of directors on board; ACINDP=Proportion of independent AC members to size of AC; AGELIST=Total number of years the company had been listed; FIRMSIZE=Natural log of firm' total assets; LEV=Total liabilities to total assets;

TABLE III. PEARSON CORRELATION

	FRAUD	ACSIZE	BODSIZE	ACINDP	AGELIST	LEV	FIRMSIZE	MGTOWN	ACC	EXP	PG
FRAUD	1	-0.016	-0.084	-0.037	-0.005	0.0096	-0.163	-0.207*	-0.233**	0.123	0.052
ACSIZE		1	0.417**	-0.067	0.324*	0.019	0.084	-0.127	-0.271**	-0.017	0.117
BODSIZE			1	0.154	0.026	-0.178	0.123	-0.003	-0.178	-0.143	0.043
ACINDP				1	0.079	0.068	-0.003	0.042	-0.079	0.111	0.172
AGELIST					1	0.022	0.180	-0.240*	-0.169	0.164	0.159
LEV						1	-0.017	-0.044	0.085	0.045	0.0094
FIRMSIZE							1	-0.209*	-0.002	-0.030	-0.136
MGTOWN								1	0.195*	0.117	-0.047
ACC									1	0.014	-0.169
EXP										1	0.308**
PG											1

\*, \*\*significant at 5% level (2-tailed and 1% level (2-tailed).

correlation also shows, audit committee directors with accounting affiliation is negative and significantly related to fraud, hence supports H<sub>1</sub>. Subsequently, the result conforms prior study by Sharma, Naiker and Lee (2009) that accounting experts on audit committee have an important role in monitoring, and gives better financial reporting quality (Jaggi and Leung, 2007).

In addition, Defond, Hann and Hu (2005) note that market would react favourably to the appointments of specialised skills possessed by accounting financial experts, since it makes directors more effective in executing the audit committee's primary responsibilities of ensuring high quality financial reporting. It is also supported by Krishnan and Visvanathan (2009), where accounting expertise contributes to greater monitoring by the audit committee, and also lends support to Gendron and Bedard (2006), that document the more professional accountants on audit committees, the more effective the audit committee when adhering to best practices.

The negative association between management ownership and fraud lends support to earlier research by Baek, Johnson and Kim (2009) that the level of managerial ownership influences the level of discretionary disclosure activities of the firm, and O'Connor, Priem, Coombs and Gilley (2006), where large Chief Executive Officer (CEO) stock option grants were sometimes associated with a lower incidence of fraudulent financial reporting. The results also lend support to prior studies such as O'Connor, Priem, Coombs and Gilley (2006) and Chen, Guo and Mande (2006).

## VI. CONCLUSION

The univariate tests of FFR, highlights the differences between fraud and nonfraud firms. It shows that management ownership, postgraduate qualifications and audit committee independence, have significant differences between the sample and the control firms. In addition, correlation also shows the

significant negative association between accounting affiliated audit committees and fraud. Hence support the RDT, that audit committee experts link the firms with external resources, such as expertise and experience (as identified from BDT), to reduce the likeliness of fraudulent reporting. Thus, the findings are consistent with the International Federation of Accountants (IFAC) Proposed Framework for International Education Standards for Professional Accountant, Exposure Draft 2009 (IFAC, 2009). Where the Framework is targeted to meet the needs of IFAC member bodies, but is relevant to a wide range of accounting education stakeholders, including, accounting faculty at universities, employers of professional accountants, professional accountants, prospective professional accountants, and anyone interested in the work of the International Accounting Education Standard Board (IAESB).

The study is without limitation that it has a small sample, and strict definition of fraudulent financial reporting that is consistent with prior literatures. However, for future research the area could be extended to examine further the managerial ownership, or ownership structure's impact on fraudulent financial reporting, and the background of audit committees.

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