

SENIOR MANAGERS' PERCEPTIONS OF AUDIT COMMITTEE COMPOSITION AND EFFECTIVENESS: SOME EVIDENCES FROM MALAYSIA

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ABSTRACT

The aim of this study is to investigate the perceptions of corporate management of audit committee composition and effectiveness. Issues examined include status of audit committee members, members' knowledge of financial matters, status of the chairman of audit committee, and characteristics of an effective audit committee. It has been found that the effectiveness of the audit committee would be enhanced if the committee comprised a majority of non-executive directors. The respondents also believed that the effectiveness of the audit committee would be enhanced if the majority of the audit committee members were knowledgeable in financial matters and the non-executive director assumed the chairmanship of the committee. It is also found that a characteristic of a good audit committee is its members have a good knowledge and understanding of the company's business activities.

INTRODUCTION

The corporate failures that have been reported in academic and professional journals and news media have led to major suggestions from the public of the corporate governance practices safeguarding shareholders' interests. Indeed, good corporate governance practice is the key factor for credible and reliable financial reporting

(Krishnan, 2005). In addition, good corporate governance practices would enhance investors' confidence and subsequently increase the marketability of corporate shares (Solomon and Solomon, 2004). Investors' trust and confidence in capital markets depend on the credibility of the financial information which is prepared by management, audited by external auditors and verified by an independent audit committee of the Board of Directors.

Malaysia experienced a prosperous economic climate for many years during the 1990s; however, the Asian Financial Crisis experienced by many countries in the region during 1997/1998 affected the country. The 1997/1998 Asian Financial Crisis in Malaysia was a product of weak legal institutions or legal mechanisms which failed to prevent the expropriation of the minority shareholders' interests, weak enforcement of shareholders' rights, ownership concentration, and weak corporate governance practices (Shleifer and Vishny, 1997; Claessens *et al.*, 1999). The crisis has severely affected many corporations listed on the Bursa Malaysia Berhad (BMB) (formerly known as the Kuala Lumpur Stock Exchange), and prompted the regulators to review and undertake appropriate measures to rectify the weaknesses (A-Kadir, 2000a, b; Abdullah, 2004).

As a result of the crisis, the Malaysian government established a high level Finance

Committee on Corporate Governance (FCCG) in March 1998 to identify corrective action taken to improve corporate governance practices. The FCCG (1999, p. 43) argued that weak corporate governance had resulted in investors losing confidence in the Malaysian capital market, and there was concern about the role of directors and regulators in safeguarding their interests. Furthermore, the FCCG (1999) highlighted the need for an effective audit committee, and noted, "We have very real experience in Malaysia in the form of audit committees, where companies merely comply in form by setting up such committees without giving heed to the spirit of the requirement by ensuring, for example, the quality of the people within the committee".

In addition, the chairman of the Malaysian Securities Commission, A-Kadir (2002a, b), noted that many boards and audit committees did not function as effective oversight mechanisms. Consistent with the above arguments, Mohamad *et al.* (2001) found that a large majority of companies listed on the BMB tended to comply with all regulations imposed on them but did not properly observe the spirit of such mechanisms.

Though corporate governance reforms in developed markets, such as in the US and UK, have led to an increase in investors' confidence in corporate reporting, there is a lack of research on this issue in the Malaysian context. Thus, it is timely to undertake this research to help identify current practices and to contribute toward improving the role of the audit committee in Malaysian corporations. It is anticipated that this research will contribute to the literature on audit committees from the perspective of developing countries. Thus, the objective of this study is to investigate the perceptions of corporate management i.e. senior managers of Malaysian public-listed companies concerning audit committee composition and its impact on the effectiveness of the audit committee.

LITERATURE REVIEW

An array of research efforts has been undertaken to study the relationships between audit committee effectiveness relating to composition, such as expertise, financial literacy, status of audit

committee members (i.e. executive and non-executive members) and chairman's status.

Criteria ensuring the independence of audit committees are important to the appearance of the committee (BRC, 1999; BMB, 2001). Indeed, the appearance of audit committee independence would enhance auditor independence and make the management and auditors more honest in financial reporting (Lam, 1976). This is because independent directors have a greater incentive to avoid activities that would damage their reputation than non-independent directors (Abbott and Parker, 2000; Abbott *et al.*, 2003). They would try to avoid any potential reputational damage, such as financial misstatement, because non-executive directors might view audit committee service as reputational capital enhancement (Abbott *et al.*, 2003).

The existence of a large number of non-executive directors on the audit committee board might indicate the level of protection against fraud, misstatement or negative behaviour of managers. Beasley (1996) found that firms with a significantly lower percentage of independent, outside directors commit a higher degree of financial statement fraud than matched firms with a higher percentage of independent directors. Klein (2002) showed that board independence is negatively associated with earnings management. Vicknair *et al.* (1993) argued that non-independent directors on the boards of audit committees could have a negative effect on the financial reporting process.

The existence of a large number of non-executive directors on the audit committee board was also found to have a positive impact on the financial reporting process. Abbott and Parker (2000) discovered that active and independent audit committees tend to hire industry specialist auditors. In addition, the literature has documented that audit committee members who are financially literate would contribute to their communication with the other monitoring agents. Raghunandan *et al.* (2001) revealed that audit committees that consist solely of independent directors and that have at least one member with accounting or finance credentials tend to have longer meetings and meet privately with the chief