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Impact of Audit Committee on the Association Between Financial Reporting Quality and Shareholder Value

Ahmad Ibrahim Karajeh[1]*, Mohd Yussoff B. Ibrahim[2]

[1]Department of Management and Humanities, Universiti Teknologi Petronas 32610, Seri Iskandar, Perak, Malaysia, [2]Department of Management and Humanities, Universiti Teknologi Petronas 32610, Seri Iskandar, Perak, Malaysia.
*Email: ahmad_kar1987@yahoo.com

ABSTRACT

Regulatory and governmental authorities in Malaysia provide substantial financial planning to help attract potential investors and improve value for shareholders. Companies are always encouraged to improve the quality of financial reporting. However, some managers tend to manipulate earnings' data to make it appear more attractive. Stakeholders rely on the audit committee to motivate managerial provision of accurate data for accounting processes. Hence, this study examines the impact of financial reporting quality on shareholder value and assesses impacts from the audit committee's influence and its relationship to financial reporting. The proposed study will use modified Jones model to evaluate the financial reporting quality. Also, the study proposes ordinary least square for identifying the impact of (i) independent audit committee, (ii) financial and accounting expertise, and (iii) audit committee size as proxies to investigate the effect of the audit committee on the relationship between financial reporting quality and shareholder value.

Keywords: Financial Reporting Quality, Shareholders' Value, Audit Committee
JEL Classifications: M41, M42, G1

1. INTRODUCTION

Regulatory authorities in various countries, including Malaysia, have established diversified financial plans to attract shareholder investment in attractive ventures. Inviting capital investments increases the productive power of industries in the economy, which then enhances steps towards optimizing resource allocations (Yamchi et al., 2013). For these reasons, regulatory authorities and governmental bodies have adopted suitable approaches to improve financial reporting quality.

Financial reporting quality is considered one of the most effective means to reflect a company's performance and shareholder value. Thus, all companies are expected to reflect shareholder value in the best of manners. However, some companies tend to make undesirable situations appear otherwise. Providing attractive information for all interested parties promotes investor decisions when making an investment (Hassan and Ahmed, 2012). Thus, one finds special attention placed on increasing shareholder value by improving the quality of financial reporting.

Nevertheless, data processing in financial reporting can be used in unjustifiable ways to inflate shareholder value and make an investment seem more attractive. In general, management tends to manipulate earnings (financial reporting) and thereby mislead interested parties who might find the information useful. They can abuse their positions and power to achieve personal gains at the expense of shareholders even though managers are expected to show the true status of earnings at all times to help shareholders predict future earnings (Bhattacharya et al., 2013).

There are potential weaknesses in the quality of financial reporting (Yamchi et al., 2013). Information processing in financial reporting depends on four factors: (i) Audit quality, (ii) audit committee experience, (iii) high quality accounting standards, and (iv) management attitude. Compromising any of these factors affects the quality of financial reporting and hence, can have an indirectly negative effect on shareholder value and earnings. Shareholders depend on financial analysts and audit committee assessments for the quality of reported earnings through which real earnings are determined. Moreover, predicted future earnings and estimated stock prices that affect stock returns also depend on the quality of reported earnings (Penman and Zhang, 2002; Yamchi et al., 2013). Penman and Zhang (2002) explicitly mentioned that any misuse of information (misleading or insufficient reporting) on the quality of earnings has an effect on long-term profitability and directly impacts stock returns.

Most previous research examined correlations between net income and stock prices. For example, Subramanyam (1996) and Janin (2000) found a relationship between net income and stock price. However, few studies have investigated the impact of financial reporting quality on shareholder value. Therefore, this study proposes to: (1) Examine the impact of financial reporting quality on Shareholders value, and (2) assess the impact of the audit committee on the relationship between financial reporting quality and the shareholder value, where the general aim of an effective audit committee is to reinforce the quality of financial information and to encourage investor confidence in the quality of financial reports.

The remaining sections of this paper are organized as follows. Section Two presents a literature review and the paper's theoretical framework. Section Three sheds light on the scope and methodology of the study. Finally, section four presents conclusions and the study's significance.

2. THEORETICAL FRAMEWORK AND LITERATURE REVIEW

Some managers may wish to show that their firm's position is better for reasons such as retaining the firm or reaping rewards (Yamchi et al., 2013). According to Healy and Wahlen (1999), earnings management (EM) exists when managements either "mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." Hence, it is possible for managers to manipulate financial reporting by making discretionary decisions in accruals to show positivity in the quality of earnings.

Accruals are considered an important component of earnings; however, this component of earnings depends on managerial discretion and is not reflected in current cash flow. As such, it is considered a tool that can be used to manipulate profit declarations (Bergstresser and Philippon, 2006). The quality of financial information in annual reports gives investors and other users indicators of reliability when making investment decisions. Therefore, management is likely to engage in the manipulation of accounting for earnings within standard and regulatory law limitations. Such accounting practices become more noticeable when management has interests related to earnings and the company's performance (Cornett et al., 2009).

EM affects earnings and performance and hence, can reduce shareholder value. Motivations arise to manipulate earnings and company performance reports when a conflict of interest exists between management and shareholders. The conflict usually occurs when shareholders lose control of the business, which then offers a chance for management to take decisions freely. Researchers noted that management can influence financial reporting by discretional accounting or operating decisions (Kang and Kim, 2011).

Past studies unambiguously mention incentives for earnings manipulations. A study by Bhat (1996) related income smoothing with management earnings to help explain management's motivation to maximize executive compensation and improve shareholder value. While Healy and Wahlen (1999) reported that managers have incentives to: (1) Increase compensation and job security, (2) increase regulatory benefit (reduce costs), and (3) avoid violating debt contracts.

Recently, Chang et al. (2008) asserted three major motivations for earnings manipulation. The first concerns the capital market, including seasoned equity offerings, initial public offerings and management plans to smooth and forecast earnings. The second concerns contracts that represent debt agreements and management compensation. The third can happen due the existence of poor regulations and laws, for instance: Poor quality antitrust, import and industrial regulations. Therefore, management can use discretionary accruals as a motivation to increase income (earnings) by attaining a level of performance that affects stock prices by enhancing manager value (Cornett et al., 2009).

According to the agency theory, audit committees are important bodies that ensure the companies' management is working to improve and increase the wealth of all shareholders (Al-Matari et al., 2016; Al-Matari et al., 2016). The role of the audit committee helps to minimize the information asymmetry, and consequently reduce and solve agency problems (Aldaoud, 2015; Boo and Sharma, 2008). Furthermore, Turley and Zaman (2004) elucidate that the effective observation of the audit committee protects the interests of shareholders in light of the annual financial reporting, external auditing efficiency and internal control.

The audit committee plays an important role in monitoring management practices in order to help protect the shareholder's value (Islam et al., 2010). This is done via the inspection of the integrity of the annual reports, enhancing the quality and credibility of annual audited financial reporting, and finally by guaranteeing the financial reporting, internal control and management risk reliability (DeZoort et al., 2002). Therefore, Global accounting and governmental bodies require the audit committees to be independent and highly competent whilst possessing a high level of integrity.

Audit committees, to be qualified and trustable, are required to hold some crucial features. Such features include independent and expert members with sufficient expertise and experience in relative fields. The committee size is required to be large and to hold frequent meetings in order to perform its duties more effectively (Aldaoud, 2015). An effective audit committee minimizes the errors in the financial statement and increases the probability of detecting management fraud (Goodwin and Seow, 2002). Prior studies explored how an audit committee's characteristics are linked with financial reporting and management earnings. Studies by Xie et al. (2003) explored the size of the board; Hassan and Ahmed (2012) studied audit committee meetings; Klein (2002) studied their composition and independence; Marrakchi et al. (2001) studied the financial incentives of independent directors.

Bédard and Gendron (2010) assert that the audit committee independence, size competency, and meetings have highest impact on financial reporting quality. In addition, Dellaportas et al. (2012) document that that corporations with big audit committees, more independence of committee memberships and further experienced members, are more likely to provide clear reports about the quality of financial information on time. This means that audit committees are expected to effectively monitor management practices, enhance the quality of annual financial reports, and discover any manipulation of earnings (Saleem et al., 2016). Furthermore, Felo and Solieri (2009) asserted that both of audit committee features (independent members and audit committee financial experts) are positively associated to aspects expected to improve the financial reporting procedure.

Financial and accounting experience holds more attention because it is considered a competence construct that plays a relevant role in monitoring the quality of financial reports (Hassan and Ahmed, 2012). Researchers such as Xie et al. (2003) investigated the impact of audit committees on EM and found that audit committee members with greater financial and corporate backgrounds and experience were related to a higher quality of reporting and a decrease in the manipulation of earnings. They found that members with financial experience who were independent and active on the committee were negatively related to discretionary accruals.

Few researchers studied the relationship between financial reporting quality and shareholder returns. Rajgopal and Venkatachalam (2011) focused on the variance of stock returns and variables affecting the quality of financial reporting. They found that deterioration in financial reporting quality was related to the rising volatility of stock returns over the past 40 years. Leuz and Verrecchia (2000) argued that an increase in the asymmetric component of information on the cost of capital was likely to increase stock return volatility.

Chan et al. (2001) found evidence suggesting that a broader set of information from financial statements can enrich a predictive power for stock returns. After this study, Penman and Zhang (2002) and Francis et al. (2005) asserted that there is a clear relationship between earnings quality (financial reporting quality) and expected returns.

Adeyemi and Fagbemi (2010), Felo and Solieri (2009), and Kibiya et al. (2016) reported that audit committee influence and improves the financial reporting quality. Moreover, Rad et al. (2016) argued that how the auditors protect the interest of shareholders against significant distortions and errors in the financial statement, where they documented as Chee et al. (2016) and Memis and Cetenak (2012) that the auditors have a significant effect on EM. On the other hand, Al-Matari et al. (2016) point out that there is a significant relationship between the three AC effectiveness characteristics and performance.

Overall, the preceding discussion explained how financial reporting quality tends to improve shareholder value while also suggesting that the audit committee affects the relationship between financial reporting quality and shareholder value. Hence, this study proposes to examine the impact of financial reporting quality on shareholder value and examine the impact of the audit committee on the relationship between the two (Figure 1).

3. SCOPE AND METHODOLOGY OF THE STUDY

3.1. Sample Selection

Planned sampling comprised all sectors of companies listed on bursa Malaysia but the proposed study excepted finance, insurance and service companies because they have different financial reporting characteristics. Therefore, the sample consisted of 300 listed companies from a population of 814 companies listed on bursa Malaysia. Data for the planned study was collected from the annual reports of the said companies from 2010 to 2015.

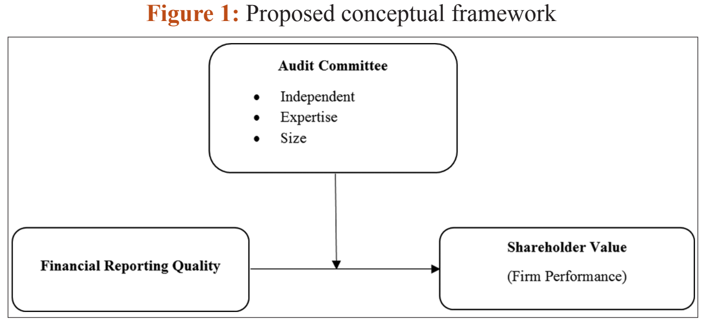
3.2. Measurement of Variables

3.2.1. Audit committee characteristics

An audit committee with independent members ensures the transparency and quality of the financial reporting process (Kibiya et al., 2016; Li et al., 2012; Madi et al., 2014; Saleem et al., 2016). Top-quality auditors execute more dynamic audits to provide audit report about annual financial statement (Schmidt and Wilkins, 2012). Independent members motivate managers to provide accurate information and accelerate information processing (Haniffa and Cooke, 2002; Dellaportas et al., 2012, Knechel and Sharma, 2012). In addition, financial and accounting expertise effectively enhances the monitoring of the corporate reporting process because members with expertise can understand and interpret financial report data (Dhaliwal et al., 2010; He, 2015; Dellaportas et al., 2012; Lee and Jahng, 2008).

Furthermore, a larger audit committee membership affords a more likely diversity of experience and skill to ensure more effective monitoring. Audit committee size is considered one of the important factors that adequately ensures the oversight of financial reporting practices. Therefore, the present study utilized (i) independent audit committee, (ii) financial and accounting expertise, and (iii) audit committee size as proxies to investigate the effect of the audit committee on the relationship between financial reporting quality and shareholder value. The independence of the audit committee was defined as the proportion of independent members to total

Figure 1: Proposed conceptual framework



audit members. Similarly, financial and accounting expertise was considered the proportion of financial and accounting expertise to the total number of audit members; and audit size was the total number of audit committee members.

3.2.2. Financial reporting quality

Prior research such as Memis and Cetenak (2012) used discretionary accruals as proxy to measure financial reporting quality or EM. Thus, they applied the modified Jones model (Chaney et al., 2008; Sun et al., 2010). Discretionary accruals depend on managerial preferences that are not reflected in current cash flow. Thus, the discretionary accruals ratio is a tool that measures the extent of management interference in financial reporting quality. Hence, the present study used the following modified Jones model:

$$TA_{it} = \delta_0/ASSETS_{it-1}+\delta_1(\Delta REVE_{it}-\Delta REC_{it})+\delta_2 PPE_{it}+\delta_3 ROA_{it-1}+\varepsilon_{it}$$

Where,
TA: The total accruals for company i at year t;
ASSETS: Total assets for company i at the end of year t−1;
ΔREVE: The change in net revenues in year t from year t−1;
ΔREC: The change in net receivables in year t from year t−1;
PPE: Gross property, plant and equipment for company i at year t; and
ROA: Return on assets for company i from year t−1.

In this model, total accruals were measured as the difference between net income and net cash flow from operating activities, according to Sun et al. (2010). The present study employed approaches by Bartov et al. (2000) Rad et al. (2016), and Sun et al. (2010) all of which used the absolute value of discretionary accruals.

3.2.3. Shareholders' value (firm performance)

Shareholder value is the value returned to shareholders as a result of management's ability to increase earnings, dividends and share price. Many researchers use stock returns (earnings per share) to measure a firm's performance Azeez (2015) and Penman and Zhang (2002). Therefore, the present study also used stock returns as proxy to measure shareholder value.

4. METHODS OF ANALYSE

The ordinary least square (OLS) statistic was used to determine the impact of financial reporting quality on shareholder value and the audit Committee's affect on the relationship between financial reporting quality and shareholder value. Therefore, the following model is used to estimate the impact of financial reporting quality on shareholder value:

$$SV_{it} = \beta_0+\beta_1 FRQ_{it}+\beta_2 ASSEST_{it}+\beta_3 BTMV_{it}+\beta_4 LEV_{it}+\beta_5 ROA_{it}+\varepsilon$$

Where,
SV_{it}: Shareholders value, stock returns of firm for each year t.
FRQ_{it}: Financial reporting quality, discretionary accruals of the firm measured by joins model for each year t.
$ASSEST_{it}$: Control variable, total assets of the firm for each year.
$BTMV_{it}$: Control variable, book to market value of the firm for each year.
LEV_{it}: Control variable, debt to equity ratio (leverage) of the firm for each year.
ROA_{it}: Control variable, return on assets of the firm for each year.

This model includes controls variables in order to control the company's characteristics that might have an impact on the relationship between the financial reporting quality and the shareholders' value. The company size is an important coefficient in this model because of its use in controlling the potential effects on the earnings (Lobo and Zhou, 2001). Kiattikulwattana (2014) asserts that the management in large corporations performs many complicated transactions which increases the difficulty of detecting the manipulation in earnings. This means that large corporations attend to have more motives to manipulate earnings compared to small corporations.

On the other hand, leverage can be considered as a great motive to manipulate earnings. Many studies point out that managements try to manipulate discretionary accruals in order to satisfy the debt covenant criteria (Frankel, 2002; Lobo and Zhou, 2001). Corporations with high leverage tend to have more incentives to manipulate earnings compared to corporations with poor leverage. Thus, this model includes the leverage coefficient. Since the return on assets and book to market value reflects the corporations' performance and growth ratio (Francis et al., 2008; Hong and Andersen, 2011), thereby both of them also necessary to include them within the model.

Interaction variables between the audit committee and financial reporting quality were measured by OLS as coefficients to determine the audit committee's relationship between financial reporting quality and shareholder value. Therefore, the following model is used to investigate the audit committee's affect as a moderating variable on the relationship between financial reporting quality and shareholder value:

$$SV_{it} = \beta_0+\beta_1 FRQ_{it}+\beta_2 IAC*FRQ_{it}+\beta_3 FAE*FRQ_{it}+\beta_4 ACS*FRQ_{it}+\beta_5 ASSEST_{it}+\beta_6 BTMV_{it}+\beta_7 LEV_{it}+\beta_8 ROA_{it}+\varepsilon$$

Where,
$IAC*FRQ_{it}$: Interaction variable between independent audit committee and financial reporting quality of the firm for each year.
$FAE*FRQ_{it}$: Interaction variable between financial and accounting expertise and financial reporting quality of the firm for each year.
$ACS*FRQ_{it}$: Interaction variable between audit committee size and financial reporting quality of the firm for each year.

5. CONCLUSIONS AND SIGNIFICANT OF THE STUDY

Financial reporting quality is one of the most effective ways to improve shareholder value. Thus, management can improvise desirable or undesirable situations and conditions to make things appear more attractive. To assess the veracity and quality of an earnings' report, shareholders depend on the audit committee to discover such manipulations. Hence, based on literature review of this study, the writers recommend that (i) the independence of the audit committee along with (ii) financial and accounting expertise and (iii) larger audit committee size should be linked to financial reporting quality at all times. This will maximize the veracity and reliability of pertinent variables and thus increase the monitoring capacity of the corporate reporting process and EM.

Limited empirical studies that have investigated the relationship between financial reporting quality and the shareholder value, therefore, the planed study will fill the gap in literature by using OLS to (1) examine the impact of financial reporting quality on Shareholders value, and (2) assess the impact of the audit committee on the relationship between financial reporting quality and the shareholder value.

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