

**Audit Committee Characteristics and Voluntary Disclosure:
Evidence from Malaysian Listed Firms**

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Abstract

Global economic crisis in 2008 has increased the focus on the role of audit committee in ensuring integrity and transparency in corporate reporting. Audit committee characteristics are crucial in determining the ability of audit committee in carrying out its responsibilities effectively. Hence, this study aims to investigate the contribution of audit committee characteristics; independence, accounting expertise, multiple directorship, size, and diligence to audit committee effectiveness over corporate voluntary disclosure by Malaysian listed firms. The study uses 146 firms listed on Bursa Malaysia for the year 2006. The empirical results have revealed that proportion of independent directors, and number of directors on audit committee is significantly associated with corporate voluntary disclosure, and hence enhances audit committee effectiveness. The study contributes to the understanding of the association between audit committee characteristics and such committee effectiveness in respect to voluntary disclosure practices.

Keywords: *Audit committee, Voluntary disclosure, Corporate reporting, Public listed companies*

1. INTRODUCTION

A corporate disclosure has been in the limelight recently, following continual economic crisis (PricewaterhouseCoopers, 2011; Mohd Ghazali, 2010). Given its significant impact, corporate disclosure practice has received considerable attention from researchers, policy makers, and regulatory bodies (PricewaterhouseCoopers, 2011, Mohd Ghazali, 2010; Akhtaruddin & Haron, 2010; Wan-Hussin, 2009; Haniffa & Cooke, 2005; Jiang *et al.*, 2010; Mohd Ghazali & Weetman, 2006; Allegrini & Greco, 2011). Corporate disclosure is crucially important for the growth and development of a firm in particular and equity market in general. Disclosures are considered to be an important mechanism in reducing information asymmetry between firm and outside investors (Jiang *et al.*, 2010), and hence improve corporate reporting transparency. It is also viewed that transparency and adequate disclosure are also important in order to ensure the protection of minority shareholder's rights. Investors would be able to make use of the information disclosed for decision making and for other investing activities (Chobpichien & Haron, 2007). Thus, the greater disclosure by company, the better the market efficiency is (Jiang *et al.*, 2010).

One of a major concern of corporate governance in emerging markets is corporate transparency (Filatotchev *et al.*, 2011), whereby Asian companies are experiencing a lack of transparency and information disclosure (Globerman *et al.*, 2011). In Malaysia, the inadequacy of high quality information results in inability of shareholders to assess the performance of concentrated shareholder listed firms (Rachagan, 2010). Accordingly, lack of corporate reporting transparency has resulted in a massive loss of investor's confidence in the integrity of corporate reporting (Hashim & Devi, 2009; PricewaterhouseCoopers, 2011). Thus, there is an urgent need to improve the corporate governance system to enhance the

integrity of corporate disclosures which leads to increase investors' confidence (Akhtaruddin *et al.*, 2009).

Audit committee is perceived as a key mechanism for improving corporate governance, and regarded as integral part of corporate reporting process (HassabElnaby *et al.*, 2007). The committee is a special operating committee of the board of directors, which is charged with oversight of financial reporting and disclosure. It is believed that individual audit committee characteristics influence the audit committee's oversight performance over financial reporting process (Bedard & Gendor, 2010; Lin & Hwang, 2010). Prior research suggest that audit committee with independent and capable members monitor the internal management disclosure process, leading to fewer internal control problems, more conservatism accounting, less earnings management, fewer incidents of financial reporting fraud and higher quality of voluntary disclosure (Allegrini & Greco, 2011; Dhaliwal *et al.*, 2010; Garcia-Meca & Sanchez-Ballesta, 2010; Naiker & Sharma, 2009; Owens-Jackson *et al.*, 2009; Persons, 2009). Accordingly, audit committee characteristics are critical in supporting the audit committee's ability to carry out its responsibilities effectively (Bedard & Gendor, 2010; Allegrini & Greco, 2011).

Prior research has largely examined association between voluntary disclosure levels and corporate governance structure such as, board of directors' characteristics, ownership structure and CEO duality (e.g Haniffa & Cooke, 2002; Chau & Gray, 2010; Garcia-Meca & Sanchez-Ballesta, 2010; Haniffa & Cooke, 2005; Huafang & Jianguo, 2007; Jiang *et al.*, 2010; Mohd Ghazali 2010; Mohd Ghazali & Weetman, 2006; Barako *et al.*, 2006). However, it is claimed that there is a limited empirical research that examine the impact of audit committee characteristics on corporate disclosures (Akhtaruddin *et al.*, 2009; Bedard & Gendron, 2010). Hence, this study is undertaken to address the gap in the existing literature and to extend the prior study of voluntary disclosure practices by investigating the influent of audit committee characteristics on such disclosure practice. Further, this study attempts to provide evidence that audit committee characteristics enhance audit committee effectiveness, and hence leading to better disclosure practices. This study attempts to contribute insights to the accounting literature by examining the effectiveness of audit committee structure in Malaysian firms and the outcome of this study would provide whether the existing structure of audit committee is effective in promoting corporate reporting. Thus, audit committee structure can be further improvised by regulators.

The remainder of this paper is organized as follows. Following section discusses the related literature and hypotheses development. This is followed by a section presenting research method. The results are presented and discussed in the subsequent section. Final section concludes the study.

2. LITERATURE REVIEW

2.1 Audit committee and voluntary disclosure

Demand for corporate voluntary disclosure has increased in the last few decades reflecting the dissatisfaction with mandatory disclosure from different parties who expect more comprehensive information from a firm about its activities (Chau & Gray, 2010). Outside investors mainly depend on corporate governance as a control mechanism that can influence corporate management to release additional financial information in their corporate reporting (Allegrini & Greco, 2011; Mohd Ghazali, 2010). Therefore, corporate voluntary disclosure practice is most important factor impacting investor's investment decision (Akhtaruddin *et al.*, 2009).

Audit committee is considered as the most essential mechanism as it is charged with the oversight of financial reporting and disclosure (Bedard & Gendron, 2010). The primary function of audit committee is to assist directors in ensuring transparency of financial reporting and corporate accountability. The members of the audit committee are delegated with the responsibility to exercise their expertise and skill with the aim of diligently ensuring the accuracy, completeness, transparency and timeliness of financial statements prepared by the management. Audit committee members support auditor independence and auditor's proposed adjustment (Lin & Hwang, 2010). Hence, it is natural to suggest that characteristics of an audit committee member influence the audit committees' ability to execute its oversight role effectively (Beasley *et al.*, 2009). Therefore, as audit committee effectiveness increases, corporate disclosure practices are expected to be improved. The audit committee characteristics investigated in this study are namely independence, accounting expertise, size, diligence and multiple directorships.

2.2 Audit committee characteristics

2.2.1 Audit committee independence

Agency theory argues that the audit committee comprising of a majority of independent directors provide an effective monitoring role that improves the quality of information and enhances the disclosures quality (Akhtaruddin & Haron, 2010; Barako *et al.*, 2006; Fama & Jensen, 1983). It is further argued that the inclusion of independent directors increases the audit committees' ability to monitor and control the opportunistic behavior of corporate management (Wan Hussin, 2009). Independent directors on audit committee are appointed to reduce managerial consumption of perquisites, act as a positive influence over directors' deliberations and decisions (Fama & Jensen, 1983; Haniffa & Cooke, 2002), and to exercise independent judgment in situations where there are conflicts of interests between internal managers and shareholders such as reviewing financial reporting statements (Beasley *et al.*, 2009).

Studies investigating the audit committee characteristics generally reveal that audit committee independence is a key factor for its effectiveness, as well as an essential element of achieving financial reporting quality (Bedard & Gendron, 2010; Lin & Hwang, 2010). It has been evidenced that independent directors on audit committee improve earnings quality (Dhaliwal *et al.*, 2010; Mohd Saleh *et al.*, 2007), and decrease the likelihood of financial reporting fraud (Owens-Jackson *et al.*, 2009). Similar results indicate in Bronson *et al.*, (2009) that the likelihood that firms receive a going concern opinion is influenced by the proportion of independent directors on audit committee. Concerning corporate disclosure, Akhtaruddin and Haron (2010) have found firms with more outside directors on audit committee are more probably to release more additional information. Indeed, audit committee independent provides an effective monitoring means of overseeing financial reporting process. Therefore, it is predicted that independent directors on audit committee would lead to higher level of voluntary disclosures.

2.2.2 Audit committee accounting expertise

Audit committee members need to have sufficient understanding of accounting, finance, or financial literacy to act as effective monitors of the integrity of company's financial reporting process and its disclosure practices (Emmerich *et al.*, 2005). Further, Dhaliwal *et al.* (2010) have argued that having audit committee members who are lack of accounting knowledge and experiences actually threatens the firm's overall financial reporting due to the inability to deal with issues affecting the firm's financial reporting.

Owens-Jackson *et al.*, (2009) have claimed that probability of financial fraud is lower when audit committee has accounting expertise. Dhaliwal *et al.* (2010) have documented that accounting expertise of audit committee members mitigates the earnings management.

Accounting expertise sitting on audit committee could ensure a good system of internal control and consequently contribute to reliable and relevant financial reporting and high quality financial statements (Naiker & Sharma, 2009). These studies indicate the importance of audit committee accounting in performing effective monitoring roles. It is therefore, expected that audit committee members with accounting knowledge and experiences are more likely induce firm to provide more voluntary disclosure information.

2.2.3 Multiple directorships of audit committee members

Directors with additional directorships might contribute to their effective function as he or she might bring more experience and it has stronger incentives to monitor because of higher reputational capital stake (Fama & Jensen, 1983). Multiple directorships expose directors to different management styles, monitoring behavior, and different management practices, and therefore directors are more capable of monitoring the management's financial reporting practices, which lead to enhance corporate disclosure practices and quality (Boo & Sharma, 2008; Razman & Mohd Iskandar, 2004; Ismail *et al.*, 2008). Moreover, multiple directorships is also found to have significant positive relationships with corporate social reporting practices (Haniffa & Cooke, 2005). Based on the above evidence, multiple directorships enhance the oversight role of audit committee over financial reporting process, and thus improve level of voluntary disclosure.

2.2.4 Audit committee size

A larger audit committee represents more divers skills, knowledge and talents to rely on in overseeing the financial reporting (Lin and Hwang, 2010). In addition, potential issues in corporate reporting disclosures are more likely to be uncovered and resolved with a higher number of audit committee members (Mohamad-Nor, *et al.*, 2010). Allegrini and Greco (2011) and Persons (2009) have found that audit committee size has a positive impact on the level of voluntary disclosure. Based on the above, higher number of directors in audit committee may benefit the committee as these directors have expertise, experiences, and greater networking with the environment, and hence enhance level of voluntary disclosure.

2.2.5 Audit committee diligence

A more diligent audit committee, i.e., one that meets frequently during the year, would provide its members with greater opportunities for discussing and evaluating the issues that are placed before concerning the company's financial reporting practices (Sharma *et al.*, 2009). Allegrini and Greco (2011) have argued that the frequency of audit committee meetings acts as a proxy of level of real monitoring and control. Therefore, higher levels of audit committee meetings indicate a more effective audit committee. Allegrini and Greco (2011) and Persons (2009) have found the audit committee diligent, measured by the frequency meeting of the audit committee, is positively associated with corporate voluntary disclosure. Prior research indicate that frequent meetings of audit committee would allow the members to express judgment and hence enhance their effectiveness in overseeing financial reporting process which in turn increases corporate voluntary disclosure practices.

3. RESEARCH METHOD

The data were collected from 2006 annual reports of top 146 companies listed on the main market of Bursa Malaysia based on market capitalization after excluding finance and unit trust sectors because they have different regulatory requirements. The voluntary disclosure checklist in this study is adapted from both Akhtaruddin and Haron, (2010) and Mohd Ghazali (2010). Both checklists are based on an extensive review of prior studies that have been used in several prior studies (Haniffa & Cooke, 2002; Mohd Ghazali & Weetman, 2006; Chobpichien & Haron, 2007; Akhtaruddin *et al.*, 2009). The combined checklist was then extensively examined, and similar items detected were eliminated. This resulted in a

voluntary disclosure checklist comprising 86-items. Scoring was based on the presence of each item, firm is awarded 1 if an item is disclosed and 0 if it is not disclosed. The level of voluntary disclosure is determined by number of items disclosed divided by the maximum possible items applicable to that firm. The study utilized the ordinary least squares (OLS) regression analysis to test the hypotheses. The following is the model of the study:

$$VD = \beta_0 + \beta_1 ACIND + \beta_2 ACACCTG + \beta_3 MDACMEM + \beta_4 ACSIZ + \beta_5 ACDILIG + \beta_6 FSIZ + \beta_7 LEVERG + \beta_8 ROA + \beta_9 BIG4 + \varepsilon \quad (1)$$

Where;

VD	=	Sum of all disclosure scores awarded divided by the maximum possible potential score
ACIND	=	Proportion of independent directors on audit committee
ACACCTG	=	Proportion of accounting expertise directors on audit committee
MDACMEM	=	Proportion of multiple directorships of audit committee members (at least three outside directorships)
ACSIZ	=	Total number of directors on the audit committee of the firm
ACDILIG	=	The number of audit committee meetings for the year
FSIZ	=	Natural log of total assets
LEVERG	=	Ratio of total liabilities to total assets
ROA	=	Ratio of net income after tax divided by total assets
BIG4	=	Coded 1, if the firm is audited by big4; 0 otherwise
β_0	=	The constant
ε	=	Error term

4. RESULTS AND DISCUSSION

Table 1 presents the descriptive statistics of all variables examined in this study. The average percentage of voluntary disclosure for the sample is 54.41%, ranging from 40.7% to 75.58%. The average disclosure index in this study is comparable to Akhtaruddin and Haron, (2010), but higher than reported by Mohd Ghazali (2010) who document an average voluntary disclosure of 40.94%. About, 73% of audit committee members are independent. Around 31% of audit committee directors have accounting and auditing experience. On average, 33% of audit committee members have at least three outside directorships. In term of the number of audit committee members, the average size of audit committee is 3.79 members. The average number of audit committee meeting held per year is about 4.9 meetings, which is slightly higher than Mohd Saleh *et al.* (2007) who show that the average number of audit committee meetings in 2001 is 4.2 meetings.

Table1: Descriptive statistics

Variable	Mean	Minimum	Maximum	SD
VD	54.41	40.70	75.58	8.47
ACIND	0.73	0.33	1.00	0.12
ACACCTG	0.31	0.14	0.75	0.16
MDACMEM	0.33	0.00	1.00	0.26
ACSIZ	3.79	3	8	0.85
ACDILIG	4.91	2.00	15.00	1.73
FSIZ	14.31	11.25	18.45	1.25
LEVERG	0.24	0.00	2.91	0.28
ROA	0.082	-0.21	0.45	0.07
BIG4	0.86	0.00	1.00	0.35

Table 2 reports the OLS regression results of level of voluntary disclosure on audit committee independence, accounting expertise, size, diligence and multiple directorships, controlling for firm size, leverage, return on assets and big 4 audit firm.

Table2: OLS regression results

Variable	Coefficient	t-test	Sig
(Constant)	0.156	1.77	0.078
ACIND	0.152	1.969	0.050*
ACACCTG	0.082	1.095	0.275
MDACMEM	0.139	1.790	0.076
ACSIZ	0.165	2.109	0.037*
ACDILIG	0.140	1.867	0.064
FSIZ	0.279	3.122	0.002*
LEVERG	0.058	0.684	0.495
ROA	0.292	3.683	0.000**
BIG4	-0.094	-1.256	0.211
R-squared	0.27		
Adj R-squared	0.22		
F-statistics	5.66		
Sig	0.000		

Note: ** significant at 0.05 and 0.01 respectively.

As reported in Table 2, coefficient of ACIND is significant and positive related to VD. This indicates that independent directors in audit committee effectively influence corporate manager to release more additional information. The insignificant association between audit committee accounting expertise and level of voluntary disclosure suggesting that accounting experience of audit committee members is not important in explaining the extent of voluntary disclosure. Audit committee with multiple directorships is insignificantly associated with extent of voluntary disclosure. The result suggests that the directorships in other firms do not appear beneficial to audit committee in overseeing voluntary disclosure practices. Audit committee size is found to have a positive and significant association with level of voluntary disclosure. The evidence indicates that larger audit committee efficiently monitors management's financial disclosure practices and thus enhances voluntary disclosure practices. The results however show that audit committee diligent is insignificant. This implies that the diligence of audit committee measured by frequency meeting does not enhance monitoring role of such committee in improving voluntary disclosure practices. In respect to control variables, the study has found a positive significant association between larger firms, firms with higher ROA and level of voluntary disclosure. However, audit firm, and leverage have no significant impact on voluntary disclosure.

5. CONCLUSION

Best practices in audit committee is regarded a key indicator of good corporate governance. Audit committee has a significant role on overseeing corporate reporting process. Being one of the key players in corporate reporting process, an effective audit committee would bring corporate reporting disclosure to a higher level of transparency and integrity. This study examines the impact of audit committee characteristics of Bursa Malaysia listed firms on corporate voluntary disclosures. Consistent with expectations, audit committee independence and size are significantly associated with level of voluntary disclosure. Results show that independent directors on audit committee perform effectively as monitoring mechanism because they are decision experts, and able to exercise independent judgment in reviewing financial reporting statements and consequently more ability to monitor and

evaluate management's disclosure practices which in turn reduces the asymmetric information and increases reporting transparency.

Moreover, larger number of audit committee members provides such committee with pool of expertise, rank of perspectives, and diverse skills that lead to improve firms' voluntary disclosure practices. However, the results have indicated that accounting expertise, multiple directorships of audit committee members, and audit committee diligence do not contribute to the extent of voluntary disclosure. This study provides an insight into the audit committee characteristics that are associated with such committee effectiveness in respect to voluntary disclosure practices of Malaysian listed firms. The empirical results provide support to the significant role of audit committee in improving corporate disclosure practices, and hence, enhance level of voluntary disclosure.

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