

Accounting Body Membership of Audit Committee Member and Fraudulent Financial Reporting

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Abstract

Fraudulent financial reporting is a global phenomenon which has attracted attention of the business and financial community, regulatory bodies and the public. It is harmful in many ways. As a result, various mechanisms have been introduced to mitigate the occurrence of fraudulent financial reporting. One of them is the establishment of audit committee in an organization. Such a committee should possess certain characteristics in order for it to function effectively. From previous studies, it is apparent that not many empirical researches have been conducted pertaining the relationship of accounting body membership of audit committee member and fraudulent financial reporting. Hence, the purpose of this study is to examine the relationship between accounting body membership of audit committee member and the occurrence of fraudulent financial reporting.

Keywords: Fraudulent Financial Reporting, Audit committee, Accounting body membership, Public Listed Company, Malaysia.

Introduction

Fraudulent financial reporting becomes rampant phenomenon in the current economic and financial landscapes. It is of interest to regulators, standard-setters, accounting firms, and society at large. Association of Certified Fraud Examiners (ACFE) in its "2010 Report to the Nation on Occupational Fraud and Abuse" reported that even though the frequency of occurrence of fraudulent financial reporting is not as high as other type occupational frauds, yet it is the priciest. It can give rise to various devastating effects such as significant change in ownership, bankruptcy, termination or resignation of company executives (Beasley, Carcello, & Hermanson, 1999). The collapsed of Enron has caused the demised of once prominent audit firm, Arthur Anderson. Other harmful problems it has created include loss of job (Gilpin, 2001), investor loss, intense media and regulatory intervention (Carcello & Hermanson,

2008), reputation damage, potential fines, criminal actions and loss of investor confidence in the financial market (Ernst & Young, 2010).

According Albrecht and Albrecht (2002), fraudulent financial reporting is a global phenomenon which can be analogised as contagious disease. In the USA, among companies that were involved in fraudulent financial reporting are Enron, Global Crossing, Xerox and HealthSouth. The type of manipulation was through biasing of revenues. While the manipulation that took place in WorldCom was by understating expenses and reducing reserve account (Frieswick, 2003). Vivendi Universal a French mass media and telecommunications company committed fraud via violation of accounting principle (Badawi, 2005). In Switzerland, the executives of an employment services company, Adecco International executed fraud through falsification of revenues and current assets. Parmalat which was a dairy and food corporation in Italy engaged in fraudulent financial reporting via overstating revenues. In The Netherlands, a food retailer company, Ahold NV committed fraudulent financial reporting through fabricated rebates.

Fraudulent financial reporting is not new in Malaysia. Several cases involving Malaysian public listed companies have been reported over the past 20 years. Ganad Corporation Berhad was one of the earliest cases in the record of Securities Commission. The malpractice was committed by a director of Ganad 1995. A few more cases then arose towards the end of 1990's, involving companies for instance Westmont Industries Bhd, TCL Premier Holdings Bhd and Kiara Emas Asia Industries Bhd. Between 200-2004, among the companies that were involved are UCP Resources Bhd, Chin Foh Bhd and United U-Li Corporation Bhd. Two years later, companies such as Megan Media Holdings, Transmile Group Bhd and MEMs Technology were reported to involved in fraudulent financial reporting. The latest fraudulent financial reporting case in Malaysia occurred in 2011 involving Silver Bird Group Bhd (now known as High-5 Conglomerate Bhd), a bread manufacturing company. According to the record of Securities Commission, the litigation is still pending.

In order to mitigate the occurrence of fraudulent financial reporting cases, Malaysian regulatory authorities have designed various controls and reforms. The objectives are to restore the investors' confidence and to augment the integrity of the capital markets and. One of the reforms is the introduction of The Malaysian Code on Corporate Governance (MCCG) in March 2000. The Code specified the principles and best practices of good governance. It also described optimal corporate governance structures and internal processes. One of the best practices is the establishment of audit committee. The main goal behind the setting up of an audit committee is to heighten the quality of financial reporting and auditing (AlMatrooshi, Al-Sartawi, & Sanad, 2016). The role of the audit committee is to assist board of directors in monitoring management. Most importantly is in overseeing the accounting and financial reporting process of a company. An audit committee is considered effective if it can safeguard the interest of the shareholders and certify that the external audit process is working properly. As such, the researcher will look deeply on how audit committee will lead to the mitigation of the occurrence of fraudulent financial reporting in public listed companies in Malaysia.

Problem Statement

Fraudulent financial reporting is harmful in many ways as mentioned above. It will affect various groups of people including top executives, managers, auditors, accountants, employees and the investors. Various mechanisms have been introduced to mitigate the occurrence of fraudulent financial reporting. One of them is the requirement to establish audit committee in public listed companies. Despite audit committee being associated as part of best corporate governance practices, the effectiveness of audit committee in mitigating the occurrence of fraudulent financial reporting is questionable based on the number of fraudulent cases. This has led researchers to investigate the effectiveness of audit committee characteristics in relation to financial statement quality including alleged fraud cases, earnings management, restatements and fraudulent financial reporting.

Review of previous studies have indicated that among the audit committee characteristics being examined are the existence of audit committee (Beasley, 1996; Peasnell, Pope, & Young, 2005), independence (L. J. Abbott, Parker, Peters, Susan, & Gary F., 2004; Beasley, Carcello, Hermanson, & Lapedes, 2000b; Hasnan & Hussain, 2015; Klein, 2002; Lary & Taylor, 2012), size (Abbott, Parker, 2003; Adiguzel, 2013; Al-Rassas & Kamardin, 2015; Kent, Routledge, & Stewart, 2010), financial expertise (L. Abbott, Parker, & Peters, 2004; Al-Rassas & Kamardin, 2015; Lary & Taylor, 2012; Lo, Wong, & Firth, 2010; Mcdaniel, Martin, & Maines, 2002) and frequency of meeting (Al-Rassas & Kamardin, 2015; Kent et al., 2010). Most of the previous studies were conducted in various countries such as USA (L. Abbott et al., 2004; Beasley, 1996; Beasley, Carcello, Hermanson, & Lapedes, 2000a; Klein, 2002), UK (Peasnell et al., 2005), Australia (Kent et al., 2010)(Kent et al, 2010) and China (Lo et al., 2010).

However, not many researches have been conducted to examine the relationship between accounting body membership of audit committee member and fraudulent financial reporting. A study was conducted in the USA by McMullen and Raghunandan (1996) which showed that accounting body membership of audit committee is related to lower fraudulent cases. Another study in this area which was conducted in Canada by Gendron and Bédard (2006) also revealed the same result. This study, therefore attempts to examine the relationship between accounting body membership of audit committee member and fraudulent financial reporting in Malaysian public listed companies.

Literature Review

This section reviews the literature on the concept of fraudulent financial reporting, audit committee and accounting body membership.

Fraudulent Financial Reporting

Generally, fraudulent financial reporting can be defined as the intentional misrepresentation of a firm's financial statements with the aim to give investors a mistaken impression about the firm's operating performance and profitability. From the review of the literature, among the earliest definition of fraudulent financial reporting was by Elliot and Willingham (1980). He defined fraudulent financial reporting as a deliberate fraud committed by management that injures investors and creditors through misleading financial statement. Association of Certified Fraud Examiners (2008) defines fraudulent financial reporting as 'The intentional, deliberate, misstatement or omission of material facts, or accounting data to mislead and, when considered with all the information made available, would cause the reader to alter his or her judgment in making a decision, usually with regards to investments.

In practice, fraudulent financial reporting predominantly comprises of misrepresenting financial statements which consist of overstating assets, sales and profit, or understating liabilities, expenses, or losses. Most of the recommended definitions are based on the fact that it inhibits element of misleading and deliberate. In reality, fraudulent financial reporting can be viewed from the perspective of both the legislation and academic literature. Ball (2009) claimed that fraudulent financial reporting is a practice in earnings management in which managers knowingly fail to comply with the generally accepted accounting principles (GAAP) and breach the relevant securities laws. Even though there are a number of diverse definitions of fraudulent financial reporting, the existing study will define fraudulent financial reporting as encompassing offences as listed in the Table 1 below. The list of offences was based on the study by Nelson (2010).

Table 1

Summary of offences classified as fraudulent financial reporting

| List of offences |
|---|
| Making a statement that is misleading in material particulars. |
| Issued prospectus contained misleading information. |
| Disclosure of information to SC that is false or misleading, material omission, or misleading or deceptive. |
| Making false statement in documents, which is use in the preparation of financial statement. |
| False or misleading documents or information. |

Sources: (Nelson, 2010)

Audit committee

An audit committee is a committee established by and among the board of directors of a company. It is defined as committee of the board of directors which assumes some of the boards' responsibilities (Menon & Williams, 2004). The main role of audit committee is to assist board of directors in monitoring the financial reporting process. Among the fiduciary duties of audit committee as spelt out in MCCG are to monitor the financial reporting process, to monitor the internal control system, to oversee the external audit and internal audit function and to report findings to the board of directors. It is part of the governance structure of a company and is arguably the most important and challenging sub-committee of any company's board of directors (Ghafran, 2013). It is also seen as a guardian of a company's financial integrity (Rezaee, 2005). In addition, AlMatrooshi, Al-Sartawi and Sanad (2016) stated that an audit committee plays a crucial role in observing the degree of effectiveness of the internal control framework.

Accounting Body Membership

An accounting body is referred to an association of accountants in a specific jurisdiction. An individual is normally required to be a member of an accounting body in order to hold the post as an accountant in any jurisdiction. The local accounting bodies in Malaysia are the Malaysian Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants (MICPA). The Malaysian Code of Corporate Governance (MCCG) 2007 spells out that an audit committee should comprise of at least a member possessing an accounting body membership. Since MCCG has been mandated as part of Bursa Malaysia Berhad (BMB), the

Stock Exchange further clarifies in its requirement that at least one member on the audit committee must be a member of:

(i) the Malaysian Institute of Accountant; or
(ii) one of the associations of accountants specified in Part II of the First Schedule of the Accountants Act 1967. There are eleven associations namely:

- (a) Malaysian Association of Certified Public Accountants;
- (b) Institute of Chartered Accountants of Scotland;
- (c) Institute of Chartered Accountants in England and Wales;
- (d) Institute of Chartered Accountants in Ireland;
- (e) Association of Chartered Certified Accountants (United Kingdom);
- (f) Institute of Chartered Accountants in Australia;
- (g) Australian Society of Certified Practising Accountants;
- (h) New Zealand Chartered Accountants;
- (i) Canadian Institute of Chartered Accountants;
- (j) Institute of Chartered Accountants of India; and
- (k) Chartered Institute of Management Accountants (United Kingdom).

An audit committee member having accounting body membership is expected to be able to improve the credibility and accountability of financial information produced by listed companies (Abdul Rahman & Mohamed Ali, 2006). In other words, it is expected to help in preventing the occurrence of fraudulent financial reporting.

Empirical Studies that linked between accounting body membership of audit committee member and fraudulent financial reporting

A study by McMullen and Raghunandan (1996) revealed that the presence of audit committee member with an accounting body membership is associated with lower fraudulent financial reporting cases. Their study concealed that non-fraudulent companies had more CPAs on the audit committee. Precisely, 25% of non-fraudulent companies had audit committee with at least one CPA. Conversely, in fraudulent companies, only 6% had an audit committee with at least one CPA. Another study, Gendron and Bédard (2006) also obtained the same result stated that audit committee would be more effective in adhering to best practices when there were more certified accountants on audit committees.

The past literatures point out that very few researches have been carried out to examine the relationship between accounting body membership of audit committee member and the occurrence of fraudulent financial reporting. In addition, no research in Malaysia has been undertaken to investigate this issue. As a result, this research will be conducted with the objective to examine the relationship between accounting body membership of audit committee member and the occurrence of fraudulent financial reporting.

Methodology

The sample of the study only includes public listed companies. These companies are required to comply with Bursa Malaysia Listing Requirements. One of them is related to the establishment and the features of audit committee. The fraudulent companies are identified from the Securities Commission website (under Enforcement and News and Media) and Bursa

Malaysia website (under Media Releases). Under Enforcement tab of Securities Commission, they fall under subheading Actions and further narrowed down into Criminal Prosecution and Cases Compounded. Whilst under News and Media tab of Securities Commission, the fraudulent companies fall under category Media Releases/Statements. The Media Releases of Bursa Malaysia website can be found by clicking Media under Quick Links, then go to Media Centre. Media Releases is under Media Centre.

The number of fraudulent companies identifies based on the adapted offences of Nelson (2010) are 70 companies ranging from 1995 until 2011. The sample of these fraudulent companies will then be matched with non-fraudulent companies as applied by previous study such as Zhao and Chen (2009) and Nelson (2009). The data will be analysed using Statistical Package for the Social Sciences (SPSS) Version 24.

Conclusion

The objective of this study is to examine the relationship between accounting body membership of audit committee member and the occurrence of fraudulent financial reporting in the context of Malaysian market. The requirement that at least a member of audit committee should be a member of accounting association is spelt out in MCCG 2007. This requirement indicates that such characteristic has a role to play in enhancing the effectiveness of audit committee member in mitigating fraudulent financial reporting. It is hoped that this research will be insightful for the business community and regulator who are looking for ways to improve investors' confidence in the capital market.

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