THE EFFECT OF AUDIT COMMITTEE AND EXTERNAL AUDITOR CHARACTERISTICS ON FINANCIAL REPORTING QUALITY

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MASTER OF SCIENCE (INTERNATIONAL ACCOUNTING)

UNIVERSITI UTARA MALAYSIA

2015

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Thesis submitted to

Othman Yeop Abdullah Graduate School of Business,

Universiti Utara Malaysia,

In Partial Fulfillment of the Requirement for the Master of Science

(International Accounting)

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ABSTRAK

Kajian ini adalah untuk mengenalpasti hubungan di antara ciri-ciri jawatankuasa audit dan ciri-ciri juruaudit luar (pembolehubah bebas) dan kualiti pelaporan kewangan (pembolehubah bersandar). Kajian lepas yang berkaitan dengan kualiti pelaporan kewangan mempunyai skop yang terhad dengan latar belakang Malaysia. Pembaharuan penyelidikan ini adalah ia menyumbang kepada dua dimensi ciri-ciri audit yang berbeza iaitu ciri-ciri jawatankuasa audit dan ciri-ciri juruaudit luar yang dikaji dalam skema yang sama. Kajian ini telah mengunakan sampel daripada Bursa Malaysia, tentunya 100 syarikat tersenarai teratas mengikut saham Bursa Malaysia.

Analisis laporan tahunan telah membuktikan bahawa jawatankuasa audit (berdikari, kepakaran, kerajinan) mempunyai keupayaan ramalan kepada kualiti pelaporan kewangan. Walaupun keputusan menunjukkan pemimpin industri didapati signifikan ke atas kualiti pelaporan kewangan tetapi pada sudut lain, firma audit yang besar tidak signifikan ke atas kualiti pelaporan kewangan. Kajian ini telah menambahkan pemahaman mengenai amalan jawatankuasa audit dan prosedur literatur perakaunan dalam konteks di Malaysia. Kajian ini tidak boleh dibuat kesimpulan umum kerana kajian mengambil 100 syarikat tersenarai teratas dari Malaysia. Keputusan kajian ini mungkin berubah jika kajian akan datang mengambil koleksi sampel yang berbeza.

Kata kunci: Jawatankuasa Audit, Juruaudit Luar, Kualiti Laporan Kewangan

ABSTRACT

This study aims to examine the relationship between audit committee characteristics and external auditors' characteristics (independent variables) and financial reporting quality (dependent variable). Past studies related to the financial reporting quality has limited scope with regard to Malaysian background. The novelty of this research, therefore, is that it accounts for two different dimensions of audits characteristics i.e. audit committee characteristics and external auditors' characteristics that are examined in the same schema. The study used the sample firms from the Bursa Malaysia, explicitly top 100 performing firms according to the Bursa Malaysia stock exchange.

The analysis of annual reports has proven that audit committee (independence, expertise, and diligence) has the prediction capability to financial reporting quality. Although results indicate that industry leader has significant impact on financial reporting quality, but on other side, large audit firms do not have any significant effect on financial reporting quality. This study adds the knowledge of audit committee practices and procedures in accounting literature regarding Malaysian context. The results of this study cannot be generalized because study used top 100 performing firms from Malaysia. The results of this study might be changed if future researches use different set of sample firms.

Keywords: Audit Committee, External Auditor, Financial Reporting Quality

ACKNOWLEDGEMENT

First and foremost, I am extremely thankful to almighty Allah, who helped me to complete my study.

I want to express my thanks and gratitude to my supervisor Dr. Kamarul Bahrain Bin Abdul Manaf, for his patience, support, guidance and for sharing his wisdom and experience with me during my academic career. Specifically, special thanks go to him for his contributions to the success of the research and his continued encouragement also without his support this work could not accomplished.

I am grateful to my father "Jawhar" who is always the real builder in our family, also when I need his kindness, support, encourage and precious guidance provide me to overcome problems in my life. Also I am eternally grateful to my father in law "Ali" for his encouragement and support during my studies.

Moreover, I want to express my sincere thanks to my dear wife Zainab. She has the courage to achieve my study and come true our dreams, also I hope succeed in her master of civil engineering. Thank you so much to be in my life and take care my two lovely kids Aland and Blnd "All my love to them for finding me the light wherever it was far away".

My mother Ateya and grandmother Fatma, they always gave me pray for me that I would get everything which is good in my life. Really thankful to my brothers, Hemn, Headi, Ahmed and lovely sister Zainab, being supportive to me during the course. I would like to deepest thank to my real and dear friend, Sangar Yousif Alqasab.

Aram Jawhar Mohammad

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LIST OF ABBREVIATION

MCCG	Malaysian Code of Corporate Governance
IFRS	International Financial Reporting Standard
FRQ	Financial Reporting quality
ACI	Audit Committee Independence
ACE	Audit Committee Expertise
ACD	Audit Committee Diligence
EALAF	External Auditor Large Audit Firm
EAIL	External Auditor Industry Leader
TAC	Total Accrual
REV	Revenue
REC	Receivable
PPE	Property, Plant and Equipment
ROA	Return on Assets
DAC	Discretionary accrual
NDAC	Non - Discretionary accrual

APENDIX

CHAPTER ONE

INTRODUCTION

It is generally believed that fundamental pillar of capital markets is financial reporting quality as efficient resource allocation is determined by such information. When the true performance of a firm is neither disclosed in the annual reports nor reflected in the reported earnings then economy, different companies, individual employees and investors face huge losses (Pergola & Verreault, 2009). Similarly, the evidences of Schipper and Vincent (2003) claim that stakeholders are very much concerned in financial reporting quality disclosed in annual reports as this information highly influence their decision making, specifically information related to investments and contracting.

It is generally argued that information about low and poor financial reporting quality leads to unintended transfer of wealth. The most important role that corporate governance system plays closely monitor financial reporting and earnings quality of a firm (Cohen, Krishnamoorthy, & Wright, 2004). However, significant relation between poor financial reporting quality and different mechanisms of corporate governance is revealed by past studies that particularly discuss hot issues like manipulation, earnings management, flaws in internal control system and financial statement frauds (Beasley, Carcello, Hermanson, & Lapides, 2000; Beasley, 1996; Carcello & Neal, 2000; Dechow & Skinner, 2000; Klein, 2002; Krishnan, 2001). Four major stakeholders watch over corporate governance of a firm which includes external auditors, internal audit, governing board, including audit committee, management and internal audit. The remarkable number of studies was carried out to address the issues pertaining to external auditors, audit or board committee and the effect of management on financial reporting quality, whereas, several audit committed role in this respect is still an empirical questions.

Agency theory addresses the conflict of interest between owners of the firm (principals) and firm managers (agents). Firm owners want to maximize their wealth as they have high stake in the firm, whereas, on the other side shareholders also want high dividend and value maximization of their shares. These two objectives are opposite to each other and give rise to agency problem. Davis, Schoorman and Donaldson (1997) and Hamid, Othman, and Rahim (2015) argued that ineffective communication leads to agency problem, also referred as information asymmetry between shareholders and managers. In contrast, some argued (e.g. Jensen and Meckling, 1976) that abusive use of powers by managers give rise to agency problem because most of the managers in firms try to take decisions in favor of their own interests instead of all stakeholders. In line with the arguments of past studies (such as Bharath, Sunder, and Sunder, 2008; Dhaliwal, Naiker, and Navissi, 2010) 'accrual quality' is used as a proxy of financial reporting quality.

1.1 Background of Study

A vast number of empirical studies provide evidence that the quality of financial reporting system is highly depend on the mechanism of corporate governance such as effectiveness of audit committee, financial expertise and board structure (Abbott, Parker, & Peters, 2004; Beasley, 1996; Farber, 2005; Klein, 2002; Jayanthi Krishnan, 2005; Vafeas, 2005). However, the mechanism of internal monitoring, i.e. the internal audit function, and external audit, receive little attention by previous studies.

The listing requirements of stock exchange particularly support the establishment of audit committee and the guidelines of several governance regulatory authorities give significant attention to audit committee. Some of the audit reforms, for example, initiated by United States (US) which include, section 404 on disclosure of material weakness of the Sarbanes-Oxley Act 2002 expanded audit activities. To maintain an audit committee is a legal requirement of New York Stock Exchange from all listed firms (NYSE, 2009). Recently in the USA, the Public Company Accounting Oversight Body (PCAOB) highlights a significant weakness and deficiency in large and complex firms which do not have an effective audit committee. Nonetheless, the mere presence of an audit committee in organization is considered as inadequate function and being increasingly criticized, whereas the audit committee is more critical in achieving desire goals (Abbott, Parker, & Peters, 2012; Carcello, Hermanson, & Ye, 2011). Contrary to aforesaid arguments, this study being a significant internal control mechanism, provides empirical evidence on the role of audit committee in emerging economy, which has not been well addressed by past studies and the assessment of the external financial reporting system of a firm is still an empirical question and with background under auditing standard (PCAOB, 2007). External auditors can relay their work on internal auditors. These issues deteriorate quality of financial reporting and adversely affect on firm's reputation, therefore the relation between shareholders and mangers should be scrutinized effectively (Zaitul, 2010). As discussed earlier, that the relationship between financial reporting , audit committee and external auditors is mainly reported on US firms, whereas this study extend this scope by using firm level data of developing countries.

Over the times, the role of audit is continuously evolved which traditionally starts from assurance and goes till value addition (Bou-Raad, 2000; Krogstad, Ridley, & Rittenberg, 1999). Based on international standards on auditing – 610 and in external audit perspective, the work associated with audit committee can be used by external auditors subject to some conditions that must be fulfilled.

Discussion about the audit committee and external auditor also necessary in assuring the independent credibility of financial statements issues examined by the stakeholders benchmarked for make conclusive decisions. If financial accounts are prepared with utmost care to avoid any misstatement and material bias then, accordingly, independent opinions can be got from external auditors on financial statements of the firms. Therefore, the audit committee and external auditor have the incentive to issue high quality reports. In addition, the audit committee and external auditor are also expected to perform high quality audit work in order to maintain reputation, audit market and avoid legal liability. Prawitt et al., (2009) mentioned the insignificance of both variables audit committee effectiveness and governance index, and therefore, they argued that, instead of other corporate governance aspects, external audit quality significantly contributes effects on financial reporting quality.

On the subject of reliance of audit committee and external auditors on the financial reporting quality, Bame-Aldred et al., (2012) argued that there are limited numbers of studies that address the impact of reliance on financial reporting quality by external auditors to assure external audit quality.

Moreover, for the Spanish banks Gras-Gil, Marin-Hernandez and Garcia-Perez de Lema (2012) used different methodology and found better cooperation between external auditors during annual audit for those banks that have high quality of financial reporting. Particularly, during the review of financial reporting process, they found high level of participation and cooperation of external auditors which ultimately bring improvement in financial reporting quality.

1.2 Problem Statement

Previously, most of the empirical studies discussed the role of audit committee in relation to quality of financial reporting or earnings management which is insufficient and limited to the US or other developed economies. Based on previous experimental studies and surveys, Gramling, Maletta, Schneider and Church (2004) argued that audit committee greatly influence the firm performance, quality of corporate governance and quality of financial reporting. However, the relationship between financial reporting quality and audit is concerned, there are limited studies in literature who explore this relation in developing economy context (Davidson et al., 2005) which calls for a research.

The reasons of selecting Malaysian economy are several. Although the importance of audit committee and external audit is not a new concept for policy makers of

Malaysian regulators, however, Malaysian economy is greatly different from US and other developed economies with regard to capital market maturity and economic development. The East Asian Financial Crisis 1997 becomes a cause of great attention and scrutiny by Malaysian public listed firms. Malaysian firms are required to establish audit controls and maintain strong and effective system on internal controls in compliance of instructions given by Malaysian Code of Corporate Governance (MCCG) in year 2000. In case of nonexistence of audit controls boards will explain how regular and sufficient review and assurance would be undertaken on internal controls. Moreover, during 2001, and industry task force is established by securities commission of Malaysia in order to formulate instructions and guidelines for the establishment of audit compliance. Due to increase in corporate irregularities especially after Asian Financial Crisis (such as Nasion Com Holding, Takaful Bhd, Megan Media Holdings, Transmile Group Bhd, and Southern Bank Bhd), the MCCG was revised twice, once in 2007 and second in 2012.

On the subject of financial reporting quality, most of the studies that were conducted on Malaysian economy used survey design semi-structured interviews (for example Ali, Gloeck, Ali, Ahmi & Sahdan, 2007; Cooper, Leung, & Mathews, 1996; Ernst & Young,2004; Hanim Fadzil, Haron, & Jantan, 2005; Leung, Cooper, Cooper, Leung, & Wong, 2006; Mathews, Cooper, & Leung, 1994) and found that Malaysian CEOs (Chief Executive Officer), being responsible for the efficiency and effectiveness of business operations, are more positive in their perceptions of audit. But no empirical study yet explores this relationship particularly in Malaysia which is a big gap in literature which this study intends to fill in.

A gap exists in regarding the predictors of financial reporting quality in relation to audit committee and auditor characteristics. But none of the study became successful in examining the audit committee and external auditor characteristics at same schema in relation to financial reporting quality with Malaysia background. Several reforms undertook by Malaysian government regarding the improvement of audit system in corporate sector and these reforms undoubtedly highlight the confidence and substantial interest over audit committee characteristics in Malaysia for enhancing and monitoring the quality of financial reporting. The audit committee and external auditor characteristics is still found the scare literature in Malaysian background. Therefore, this study fills this gap by undertaking a comprehensive analysis on developing countries, i.e. Malaysia in this case. This study examined the effect of audit committee and external auditor characteristics on the quality of financial reporting mechanism.

1.3 Research Questions

Specifically, this study seeks to find answers for the following research questions:

1. What is the relationship between audit committee independence, expertise and diligence on the financial reporting quality?
2. What is the relationship between external auditor Large audit firms and industry leader on the financial reporting quality?

1.4 Research objectives

1. To examine the relationship between audit committee independence, expertise and diligence on the financial reporting quality.
2. To examine the relationship between external auditor large audit firms and industry leader on the financial reporting quality.

1.5 Significance of Study

This study is important from both aspects theoretical and practical which is discussed below.

1.5.1 Theoretical

As mentioned earlier that audit committee has been extensively discussed in literature but the characteristics of external auditors are under-researched. This study is theoretically significant in this regard that it discuss the relationship between audit committee and external auditors with financial reporting quality in single framework that past studies cannot do before.

On the basis of theoretical debate this study aligns the two different approaches in the same theoretical scheme, on the other hand, examination of their relationship adds the body of knowledge in literature in relation to financial reporting quality. And in the last, present study will examine differentiate audit committee and external auditor characteristics in the Malaysian background.

1.5.2 Practical

The current study has the great practical importance in the context of Malaysia. Malaysia has introduced the IFRS system to support enhance the financial reporting system and because imitating the new system. This study focuses the audit committee and external auditor characteristics and makes comparison with past studies in the same context and, simultaneously, observed the variability of results. The Malaysia introduced several measures after the crises of 1997 to improve the financial reporting quality such as the Malaysian Code and Corporate Governance (MCCG) in year 2000 and Security Commission Report 2001. In the context of Malaysia, this study contains the practical significant of the audit committee and external auditors of Malaysia and provides transparent picture of Malaysian business environment.

1.6 Scope of the Study

This study is conducted in Malaysia. The sample is confined to Malaysia firms listed in Kuala Lumpur Stock Exchange (Bursa Malaysia). Top 100 firms are selected for this study. Data is collected manually from annual audited reports for the year 2014 available on Bursa Malaysia website. Sample firms represent a number of industrial sectors such as electronics, food products, industrial products, telecommunication etc.

1.7 Organization of the Study

This chapter briefly describes the introduction of topic which is audit committee and external auditor characteristics of Malaysian based companies. In introduction, the debate is about the necessity of financial reporting quality. The background provides glimpse of financial reporting quality standard and at same time some studies conducted in different parts of the world are discussed. Problems statement describes the importance of the study and lack of understanding in the same schema of audit committee and external auditor characteristics which is into deluge in same framework. Research questions have derived from the problems statement and practical and theoretical significance also briefly discussed.

CHAPTER TWO

LITERATURE REVIEW

2.1 Financial Reporting Quality

The quality of accounting information, has turned an important issue owing above all, to the evolutionary modern technological changes and business practices witnessed worldwide (Afify, 2009). A major remarkable factor affecting the quality of information consist in corporate annual reporting punctuality and accuracy, considered a critical factors affecting information usefulness as put at the disposal of external users. In fact, the latter often require a comprehensive, transparent and timely published information likely to help further promote and enhance the decision-making process and reduce the capital market-related information asymmetry in the capital market (Owusu-Ansah & Leventis, 2006) in which financial statements prove to be the exclusively reliable source of information available to the market.

Financial information quality has been approached empirically since the late 1960s. Studies have focused on ascertaining whether the data provided by companies are beneficial to accounting users. In the beginning, some studies investigated the content of the information (Ball & Brown, 1968). However, to focus on information relevancy, a new orientation was emerged in the late 1980s which uses robust regression models to explore the relationship between the market profitability and financial information (Ou & Penman, 1989). These models exhibit the phenomena that financial information of corporate organizations has to face certain changes, particularly introduction of International accounting practices.

2.1.1 Financial Reporting Quality and Audit Committee Characteristics

So far, several studies have empirically examined the audit committee in relation with financial reporting quality. Bases on previous experimental and survey based studies, Gramling et al. (2004) suggest that audit committee is able to influence firm performance, corporate governance quality and financial reporting quality. However, to date the relationship between financial reporting quality and audit committee is not well addressed by past studies with the exception of Prawitt particularly board of directors play significant role in ensuring financial reporting quality. Previous studies state that effectiveness, expertise and knowledge, independence and composition are those attribute of the board that significantly affect financial reporting quality such as fraud, earnings quality and earning manipulation, (Abbott et al., 2004; Farber, 2005; Jayanthi Krishnan, 2005).

Many studies highlight different aspects, while discussing financial information quality, which open the avenues of new research lines. In result of utilitarian paradigm, research on accounting took a new path in the late 1960s and leads to the adoption of new accounting methodology which consider accounting as an information system. Accordingly, the line of capital markets research has started to emerge. The focus of this approach is on the performance of accounting information for investors.

In this research approach, Ball and Brown (1968); Beaver (1968) are deemed as pioneers. Two fields in this approach can be easily distinguished:

1. The investigation of the measurements of accounting results.
2. To conduct research for study information, content and relevance.

One perspective of examining information is associated with the contents of information. To be precise, in relation to publications of earning announcements, market response is vastly investigated. Different authors indicate that, in relation to earnings announcements, market prices have positive reaction (Barth & So, 2014). In the study of Korean firms Bae, Cheon, and Kang (2008) found that value of market shares are positive or negative influenced by the increase or decrease in earnings announcements; but some studies provide contradictory results (Demerjian, Lev, Lewis, & McVay, 2012).

2.1.2 Financial Reporting Quality and External Audit Characteristics

International Financial Reporting Standard (IFRS) to prepare consolidated financial accounts of listed companies (Larson, Herz, & Kenny, 2011). To bring harmonization and introduce some changes in accounting, several measures were taken for the transparency of information disclosure which is deemed as a key factor of producing quality accounting information (Epstein & Epstein, 2009). Thus, in explaining true economic condition of a company, financial information quality plays significant role, while several empirical studies provide evidence that quality of external financial reporting is particularly associated with corporate governance factors such as effectiveness of audit committee, financial expertise, board size, CEO duality and board structure (Klein, 2002; Vafeas, 2005).

2.1.3 Empirical Studies of Financial Reporting Quality

Many past studies examined financial reporting quality effects with both: (i) volume of operations, (ii) prices. A sample of Hong Kong firms, for example, was analyzed by Cheung and Sami (2000) in context of earnings announcements over the period of 1992 to 1995. Their results revealed that, after the announcement of earnings, volume of operations and prices are significantly reacted. While, on the other side, the comparative analysis between negotiations without online trade from 1992 to 1995 and negotiations with online trade from 1996 to 1999, was made by (Jamal, 2003). Their results demonstrate that during the period of online negotiations, three months earnings announcements affect both volume of operations and share prices.

Some studies examined the relationship between financial reporting quality and negotiation volume. For example, Choi, Jeon, and Park (2004) argued that when three months earnings announcements made, operations volume is reacted accordingly. Some factors, such as information asymmetry Lalonde and Adler (2015) or investors agreement degree Huang and Thakor (2013) are significantly influence the negotiation volume. After post earnings announcements drift, many authors analyzed delayed reactions in the market. Due to problems of earning predictions, PEAD announcements were made. Bernard and Thomas (1989) classified PEAD incorrect measures in two subgroups, false risk measures and other incorrect measures. In this regard, Zhang (2008) claimed that prediction sensibility of analysts is correlated with benefits and costs of predictions.

It is worthwhile to discuss studies that discuss market reactions produced due to accounting changes. Some studies did not find any effect of accounting changes on the market (Carson, Simnett, Soo, & Wright, 2012). In the meantime, many studies provide evidence that market is highly affected by accounting changes e.g. adoption of international financial reporting standard (Baumeister & Peersman, 2013). The relation between changes in market prices and investor's performance is emphasized by various studies. Investor performance, for example, of Danish corporate firms was analyzed by Rose and Mejer (2003) and got significant abnormal results after few days of presenting information. While, contrary to that Chewning, Coller, and Tuttle (2004) argued that in the use of accounting information, both sophisticated investors and unsophisticated investors have advanced their skills and abilities. As a consequence, the subsequent effect of their performance is explicitly reflected on stock prices.

Past studies related to prices anticipation are largely emphasized on time extension for profitability calculation. By using earnings regression and price, for instance (Bradshaw, Drake, Myers, & Myers, 2012), examined future earnings expectations over different periods of time. On the other hand Schleicher, Hussainey and Walker (2007) financial reporting quality for two years period in their regression model. Different studies found different results while investigating the relationship of profitability and results. Das and Shroff (2002) for example, demonstrate the relationship between different level of results and profitability, while on the other side, some studies exhibit relationship between level of results and changes (Ibrahim, 2015).

2.2 Audit Committee Characteristics

2.2.1 Audit Committee Independence

From different perspective notions, an argument can be drawn that independence of audit committee is highly significant and independent board of directors are deemed as effective and close monitors of corporate organizational matters (Fama & Jensen, 1983). Carcello and Neal (2003); Mangena and Pike(2005) argued that from management influences, independent audit committee should be free and out of any undue influence. In this way the credibility and quality of reporting system and process can be ensured and ultimately information asymmetry can be reduced. Activities related to share valuation of the stock market are significantly affected by IC (Intellectual Capital) information (Holland, 2003; Too, Wan Yusoff, & Chase, 2015), and for enhancing the privileges of investors, such important needy information can be provided through independent audit committee.

According to the guidelines provided by UK Code (2010), for small organizations there must be at least two members in audit committee and minimum three in large organizations and the members should be independent directors. Goddard and Masters (2000) suggested that further more refined measures of independence, expertise and diligence of audit committee members could be developed and used in future studies. Further, the research models do not indicate causality between the variables tested. By considering business relationships, investment holdings and family relationships, audit committee must ensures that firm's independence should be properly reported and evaluated by the internal auditors. The condition of independence should be applied to the firm as a whole to public companies, local offices of the firms and to the engagement teams. In all necessary areas, audit procedures can be formulated, executed and properly implemented through appropriate level of independence and provide full supportive suggestions and recommendations to the members of audit committee, firm's management or full board members. Guidelines of COSO (Committee Of Sponsoring Organizations) regarding monitoring and improving internal control systems suggest some useful recommendations vis-à-vis objectivity of the board. It may seem strange to consider audit clients as participants in the audit process, as auditors are required to maintain independence from their audit clients and perform their own procedures to reach their own conclusions.

The audit client involvement has required in the examination of performance and assurance services because the clients playing the important role in the audit procedure (Fontaine & Pilote, 2011). Similarly, it can be concluded that auditor considered client as the solely responsible to provide source of indication (Rennie, Kopp, & Lemon, 2010). For example close relationship can be express that way and most common observation the traditional business approach of client such as the seller and buyer , in that case some financial transaction cannot be record or noted in the financial statement . This all transaction is the routine between the investor and creditor and clients has to be worked closely with audit firms to insure and avoid any audit in discrepancy. Background of the unrecorded public client transaction Sarbanes–Oxley Act (SOX) guide the auditor must charge some non-audit fees to facilitate avoid the business of auditor independence and quality of audit should not compromise.

The rules regarding ethics of public accountants and professional conduct given by Malaysian Institute of Accountants (MIA) are referred as MIA By-Laws (MBL) which exemplifies different situations regarding independence of auditors. The diversity of domestic culture of Malaysia is neglected by MBL while addressing issues regarding independence. Auditing behavior and financial reporting structure is highly influenced by cultural environment of a country as evident by many studies (Agacer, n.d.; Amernic, Kanungo & Aranya, 1983; H. L. Jensen & Yiu, 1995; Singhvi, 1968).

Auditor's judgment and objectivity might be potentially influenced by variety of ethnic obligations, feelings and most importantly professed threat given by different ethnic groups. The behavior of auditors may be compromised by high fees which is the major concerned of all regulators, researchers and users of financial statements (Ashbaugh, LaFond, & Mayhew, 2003). It is suggested by auditor independence theory that the fees of clients contain significant proportion of total fee revenues of the firm then it is deemed that auditor independence is at stake and compromised by this fee contribution (Chung & Kallapur, 2003). The key threat and danger to the independence of auditors is the economic bond between auditors and clients (Ashbaugh et al., 2003). According to agency theory, effectiveness of audit committee is dependent on the characteristics of audit committee (Dellaportas, Leung, Cooper, Rochmah Ika, & Mohd Ghazali, 2012; García, Barbadillo, & Pérez, 2012). For the achievement of actual functions of audit committee the number of members should be large (Ismail & Abidin, 2009). In order to minimize the chances of fraudulent reporting, majority of the members of audit committee should be independent (J. W. Lin, Li, & Yang, 2006).

Several empirical studies have highlighted the need for independent audit committee. Decreased earning quality portrayed by discretionary accruals are strongly connected with independent audit committee (Klein, 2002). Likewise, Yang and Krishnan (2005) highlighted the relationship between less discretionary accruals in relation with independence of audit committee. On the other hand few researchers also argue that higher earning quality is strongly linked with independence of audit committee (Bradbury, Mak, & Tan, 2006; Gras-Gil et al., 2012) and quality of financial reporting (Agrawal & Chadha, 2005; Siagian & Tresnaningsih, 2011). Several researchers have also highlighted the relationship between independence of audit committee and quality of accruals (Baxter & Cotter, 2009), earning in formativeness and discretionary accruals (Adiguzel, 2013). Several researchers have highlighted a negative relationship between earnings management and independence of audit committee in Malaysia (Mansor, Che-Ahmad, Ahmad-Zaluki, & Osman, 2013), but on the other hand a positive relationship has also been found (Ahmad-Zaluki & Nordin Wan-Hussin, 2010). It is also considerably important that some researchers have not found any relationship between independence of audit committee and quality of earnings (Ismail & Abidin, 2009).

Cadbury (1992) strongly recommend the formation of oversight committee. It also include that audit committee should appoint directors and financial auditor which is supported by agency theory. Board committees should consider additional control mechanism which improves accountability, which consequently ensures the safeguard of interest of shareholders. For independent review the audit committee should consist independent directors (Cadbury, 1992). Decision of executive directors should be ensured by the outside directors, so that these decisions may be in the best interest of the shareholders and other stakeholders. Good audit committee ensures good accounting practices which ensures organizational effectiveness (Carcello et al., 2011). Here the term good audit committee means independence and financial expertise of members of audit committee. The term good accounting practices means absence of fraudulent reporting. Thus, it would be right to say that independence is the backbone of auditors and a prerequisite or fair financial reporting in order to enhance effectiveness of financial statements (Ye, Carson, & Simnett, 2011). The strong audit committee has a great role in internal control and audit process (Brown-Liburd & Wright, 2011). Independence has a dominant role in ensuring reliability of financial reporting (Efendi, Smith, & Wong, 2011) because managers tends towards accounts manipulation for their vested interest and on the other hand, independent audit committee assure fairness and transparency of financial reporting.

Researches in the Malaysia have highlighted a significant impact of independent audit committee on performance of companies. The core function of the audit committee is to review the financial statements and internal control systems by meeting and reviewing the audit procedures. This implication has reduced the problems of agency by releasing timely financial information of the organization for the stakeholders, as it reduces the issue of information asymmetry. Investors ensure existence of audit committee at the time of investing in stock market.

There is an undue influence of composition of audit committee of the performance of firm (Efendi et al., 2011). They conclude that Malaysian firms should form audit committee which should be fully independent from management and possess three qualities: frequent meetings, accounting knowledge of committee members and independence. These qualities enhance effective and monitoring of the committee. In Malaysia subcommittees have more non-executive directors. For the development of unprejudiced reports members of audit committee should be in a position to perform their duties independently to avoid conflict of interest between managers and the auditors (Klein, 2002). Usually the conflict is the consequence of choosing an alternative procedure of accounting. Malpractices and frauds are usually not seen in firms where the audit committee performs its function effectively (Beasley et al., 2000).

Diverse background and expertise of auditors usually enhance the value of firm as it ensures good performance and improvement of decision making process. Non-executive directors are independent and are concerned about their reputation in the labor market so are in a better position as compared to executive directors in fulfilling their responsibilities (Fama & Jensen, 1983). Thus, positive association between proportion of non-executive directors in audit committee and performance of firms is guaranteed. Researchers have shown a significant difference between the performance of firms having executive and independent members in their audit committee (Ameer, Ramli, & Zakaria, 2010). Thus, it would be right to say that firms with more non-executive directors perform better than firms with more executive directors in their committee.

By empowering the powers of independent directors performance of firms can be enhanced as they would be in a position to perform their jobs in a better way (Walsh & Seward, 1990). Likewise, Chouchene (2010) highlighted the importance of audit committee composition in accordance with independent directors. Stock market respond in a better way for the firms that have higher proportion of independent directors. On the other hand reported that there is a negative relationship between the proportion of non-executive directors and firm performance, this argument is supported by (Aggarwal, Erel, Stulz, & Williamson, 2007). Carcello et al., (2011) reported a negative relationship between audit committee and fraud in their study that was a meta-analysis of 250 previous researches. Likewise there are significant evidences regarding negative relationship between outside directors in audit committee and performance of firms (De Jong, Roosenboom, DeJong, & Mertens, 2005). But P. Dechow, Ge and Schrand (2010) claimed that firms without audit committee and minority outside directors are more likely to involve in fraudulent activities. By summarizing all the studies it can be claimed that corporate governance claim is correct that there should be a proper mechanism regarding the presence of adequate number of non-executive directors in the audit committee.

2.2.2 Audit Committee Expertise

In the auditing research this has proven by the several research that the performance of the audit committee members increased if they have enough authority and resources to fulfill their principle obligation (DeFond & Francis, 2005). The expertise in the audit committee board has the more capable to minimize the problems of the financial reporting process because expertise has the extensive experience to dealt that problems (Bedard, Chtourou, & Courteau, 2004). Thus, transparent and adequate financial reporting is being influent by the expertise of audit committee board (Klein, 2002). Contrary, it is also observed that embargo of the free auditor has evolved and people presumably visualize that responsibility must be shift (Karamanou & Vafeas, 2005).

In contrast to that the large expertise of audit committee usually face diffusion of responsibility and loss of procedures (Karamanou & Vafeas, 2005). In the light of the recommendations given by Smith Report (2003), minimum three non-executive directors should be expertise there in the audit committee. Empirical evidence has shown mixed results regarding the audit committee expertise and quality of financial reporting as per the recommendations given by (Smith Report, 2003). Research has found a significant relationship between lower earnings management and expertise of audit committee (Cornett, McNutt, & Tehranian, 2009). Whereas, on the other hand, other studies failed to find strong relationship between same (Bedard et al., 2004). While some studies also cannot find any relation with voluntary disclosure in interim reports (Mangena & Pike, 2005).

The main concern of Blue Ribbon Panel (1998) mainly lies on expertise and knowledge of audit committee as these variables have a high influence over effectiveness. For the prevention of financial frauds, the panel argues that financial expertise of the members is compulsory. Effectiveness of financial literacy is more influential where mandatory audit committees are established with diversified members (Yoon et al., 2012). It clarifies the term of financial literacy which is helpful in understanding financial background as compared to expertise of finance.

Potential investors also value the importance of financial expertise of audit committee (Carcello et al., 2011).

According to the code of corporate governance of Malaysia adequate level of understanding of financial matters is mandatory for the members of audit committee. Bursa Malaysia listing require at least one member from Malaysian Institute of Accountants (MIA) in the audit committee, or at least one member should have professional experience of minimum three years. McDaniel, Martin and Maines (2002) argued that the quality of financial reporting is dependent on the financial expertise of the members of audit committee, because financial matters can be handled in a better way when the audit committee members are financial literate (Xie, Davidson, & DaDalt, 2003). Likewise, positive association is highlighted between performance of firms and financial literacy of members of audit committee (Mir & Souad, 2008).

Yet there is a contrary debate between earnings management and audit committee. Members of audit committee can only conduct good monitoring in mitigating earnings management when they have the experience of financial institutions (Haniffa, Abdul Rahman, & Haneem Mohamed Ali, 2006). In addition this study argues that companies listed in stock markets of Malaysia still need to improve their monitoring level.

Code of corporate governance of Malaysia are in line with the listing requirements of Bursa Malaysia, as they also claim that there should be minimum of three directors in audit committee. In such a scenario the intentions of the firm to manipulate the accounting statements would minimize as they would know that audit committee has financial experts. Quality of financial reporting is improved with the presence of financial experts in the audit committee. The basic reason behind that, the members of audit committee have a good understanding of earnings management. In addition to that, because of the fact that firm performance is influenced by the size of audit committee, thus, the current study also inculcate the size of audit committee. The Malaysian Code on Corporate Governance (MCCG 2000) highlighted the numbers of audit committee at least three members in the committee but, in contrast (Mohd Saleh, Mohd Iskandar, & Mohid Rahmat, 2007) object the effective monitoring of committee with large size.

Majority of the studies have confirmed a positive relationship between board size and firm performance. Monitoring procedure of the board and board size positively influence the performance of firms (Dalton, Daily, Johnson, & Ellstrand, 1999), whereas, Mohd Saleh et al., (2007) highlighted that firm performance is dependent on knowledge, expertise and diversified skills of the board members, this argument is also supported by (Mir & Souad, 2008). In contrast Raghunandan and Rama (2007) highlighted that large size of audit committee conducts more meetings which ensures better performance by providing effective monitoring. Likewise, Vafeas (1999) argued that conducting more meeting because of large size of audit committee increases the administrative expenses, which leads to inefficient governance. Thus on the basis of the above mentioned arguments, it would be right to say that expertise audit committee and firm performance have a positive relationship.

2.2.3 Audit Committee Diligence

Several studies claim that there is a tradeoff between expertise or and independence of committee members and audit committee diligence. High frequency of meetings for example, may compensate the deficiency of members regarding expertise of formal accounting, especially if audit member is present in those meetings or for executive presence in audit committees. Therefore, Sharma's (2003) finding holds for larger and more varied sample of companies. However, because the relationships between the three audit committee variables are likely to be complex, the explore possibility of interaction effects without predicting a direction.

Some of these companies may have trouble appointing independent directors with appropriate experience to be audit committee members. Consequently, there is a huge possibility that diligence of audit committee play a significant role in large companies. Thus, more refined measures for independence, expertise and diligence of members of audit committee should be used in further research.

Furthermore, the characteristics of audit committee explained by the Blue Ribbon Committee (BRC) for the improvement and effectiveness of corporate audit committee have been addressed in the current study. The characteristics of audit include independence of audit committee, expertise of audit committee and diligence of audit committee. It is suggested by the BRC (1999) that independence, diligence, expertise, and large size of audit committee have a better influence over evaluation of managerial accounting and reporting practices. Such characteristics of audit committee contribute to product of improved and reliable financial reports. On the basis of risk based approach in the provision of audit services, these audit committee characteristics are more likely to minimize the inherent risk of firm and the same with the control risk in financial statements (Anderson, Mansi, & Reeb, 2004).

This study has the explaining of variables variation in the certain way, in this research corporate governance has taken observation to keen consideration. The argument has prevailed that board diligence likely has to perform well if the board is diligent and efficient. The concentration of audit committee is always required to perform audit functions in the organizations predominately when the financial reporting procedure has adopted. Similarly Vafeas (1999) exploring in this research audit committee effect can be improved if the audit committee member engaged in the more time scheduled. Therefore it is understood that if the audit committee provide more time to board, they can provide the better supervisory role to examine the financial reporting process of firms. As the conclusion, there is negative relationship is expected from the diligence and financial reporting process.

Several companies now adapting the risk base approach to avoid the certain threat on the organization, for that sake the companies making the risk management committee which also providing the supervisory role to the audit committee board and previous findings prevent that diligence and awareness of these member is consider important in the financial reporting procedure (the COSO of the tread way commission, 1992, 2004; Herman son, 2003).

As the stringent action has required in the audit process that influence and impact on the financial reporting quality. In the same it can be conclude that extensive diligence board of audit committee are able to enhance efficiency of internal governance and environment in the financial reporting process. The core of this study to examine the audit committee diligence and its effect on the procedure of financial reporting quality.

This study is using the proxies of audit committee per year to examine the audit committee diligence. Abbott et al., (2003) found the positive relationship between audit committee diligence and financial reporting quality. This finding is proving argument that audit committee diligence must be increased with financial reporting quality.

2.3 External Auditor Characteristics

2.3.1 Large Audit firms

Several researchers have argued that the brand name of auditor and the size of audit firms tend to have better strength of monitoring which enables the auditor to produce quality and credible information in the financial reporting (Davidson & Neu, 1993; DeAngelo, 1981). On the other hand it has been observed that investors respond positively to the decision of the company regarding changing its auditor from large firm to small firm (Chang, Cheng, & Reichelt, 2010). Detection of material misstatement is dependent on the competence of auditor, but the disclosure of misstatement is the function of independence of auditor (Khurana & Raman, 2004).

Level of competence of auditor varies from firm to firm, it is because of the many audit firms spend time and money on the training and formal education of their auditors, as a result they have better capacity and capability. Likewise, level of independence varies across different audit firms. Small firms usually do not disclose material misstatements for retention of the client and relationship with the client (DeAngelo, 1981). On the other hand, for large firms reputation has more importance than retaining a client, so they can not sacrifice independence and integrity. A hypothesis testing the relation between reputation and big firms proved that previous clients of big audit firms involved in lesser earnings, whereas earnings are measured by cross sectional Jones model (1991), (Becker, DeFond, Jiambalvo, & Subramanyam, 1998). On a sample of 10,379 samples of big audit firms and 2,179 samples of small audit firm of United States, they argue that average discretionary accruals are 1.5 to 2.1% less for previous clients of big audit firms. The studies on quality and reputation of auditor show that brand name of auditor has a high influence on monitoring, quality and credibility of financial statements (Davidson & Neu, 1993; DeAngelo, 1981). Otherwise, investors have a positive response towards the shift of auditor from big firm to small firm (Chang et al., 2010).

Essence from the prior research concluded that audit quality has been observed on satisfaction level in the large relative to the small firms. This phenomenon can be understood that larger audit firms have the vast number of clients, the reason is dependency, diverse and disperse (Makarem, 2011). Additionally large audit firms have able to better audit quality and the stake on the reputation and name.

On the other side of the picture, it is evident from the past research, illegal and unethical practices have been observed by the explicitly from the renown and famous companies. Similarly Francis (2004) endorsed that fact, it's not in the proven that large audit firms have higher quality than the smaller firms.

The past studies discussed about size of audit firms have expanded the relationship of audit committee characteristics i.e. the interest point of audit client have been always size (Simunic 1984). There are several ways to explain that phenomena first the reputation is the main concerned for the large audit firms; these audit company characteristics enforce companies to avoid the coercive decisions (DeAngelo, 1981). Second the large audit firm has the more resources compare to small firm such as the financial resource to invest in the technology and training to their staff for the efficiency (Ashbaugh-Skaife et al., 2007). Third litigation risk and lawsuits expectancy also have been the factors to provide the higher quality of audit from the large audit firms.

On the perspective of the perception about the large audit firms have the ability to provide the services and better quality of audit for the big and large companies respect to the small audit firms, moreover the investor keep in the concerned about the large audit firms have more probability to provide the higher quality of audit. Some believe enhanced transparency of audit firms may improve the availability and delivery of audit services to larger public companies by allowing other audit firms to compete with larger audit firms.

Guedhami et al., (2009) examined the selection character for the audit selection firm and concluded that the big companies likely to choose the large audit firm rather than small audit firms Lawrence, Minutti-Meza, and Zhang (2011) also found the same facts about size of audit company which is the main constraint of selection decision of big4 companies and main reason of dominance in the audit market (GAO 2003). These two studies provide the simple selection of audit firms which cannot be generalize but contrary proved the small scared amount of the information about large audit firms.

Lennox and Park (2007) reported by detailed examination of the audit firm selection from the management side that large audit companies is considering first choice of the high management executives. Dhaliwal et al., (2014) similar findings had observed that Lennox and Park (2007) that management venture with audit firms have the greater in the audit selection.

In the conclusion, the results of past studies were consistent from survey that size, perception on investor and litigation risk about audit firms as the consider in the audit from selection (Cohen, Krishnamoorthy & Wright 2010; Fiolleau, Hoang, Jamal & Sunder 2013). They conclude that companies choose large audit firms to provide the high quality of audit. The reason of large audit firms or industry firms has the greater ability to provide the higher quality of financial reporting (Balsam et al., 2003).

2.3.2 Industry Leader

Reporting quality can be increased by enhancing the experience of auditors in companies because they would be able to focus on highly risk areas of a firm during audit. Similarly, misstatement and frauds can better discovered by industry specialized auditors as they have more bargaining power with their clients and can adjust accounts and stop manipulation before final disclosure. Previous studies showed that premium in remuneration was paid to industry-specialized auditors over non-specialized ones (Craswell, Francis, & Taylor, 1995), which implies that in case of ineffective audit, industry specialists are more likely to lose their market reputation and good will. Industry leaders are more likely to enforce management to disclose ICDs (Intellectual Capital Disclosure) if same incentive for accurate and error-free reporting exists for internal control because the quality of financial reporting influenced by internal control quality.

The measure of audit quality is an indicator variable equal to one if the company's auditor was an industry leader in 2003 and zero otherwise (Nathaniel M. Stephens, 2011). Industry leaders should be associated with companies reporting weaknesses in their controls during the section 302 regime for the following reasons: auditors that have specialized knowledge in a particular industry and are familiar with common problem areas in that industry are likely to be better able to identify weaknesses in internal controls. Prior research provided evidence that the clients of industry-specialized auditors had higher financial reporting quality (Balsam et al., 2003). Empirical evidences provided by past studies supported longer relationship between auditor and client which in turn improve reporting quality.

The past studies proved that competitive factors may lead firms to select the industry leader in the audit market to grab the situations in which a company switches from a nonmarket-industry leader audit firm to the market-industry leader audit firm (Christensen, Omer, Shelley & Wong, 2015). However, past studies had great contribution they are focusing on the industry expertise and big4 model, its effect on the audit quality and financial reporting quality. On the contrary this study has taken Price Waterhouse Copper (PWC) as the industry leader in the Malaysian audit market (i.e. the out of 30 top performing in Malaysia, 14 are audited by the Price Waterhouse Copper).

The predictors of audit quality have identified by several studies, but this study has chosen the variation on variable to see any significant difference of proposed relationship between variables. Audit quality is affected by industry leader in major audit industry client, the stock market has shown the fully anticipation that company choose audit firms as the industry leader.

The empirical findings of the past studies had concluded in the certain way such as Palmrose (1986) measured industry expertise as a dichotomous (i.e. industry leader or not) market share measure, the criteria of which vary with industry. The analysis found consistent relation between the two variables audit firms size (industry leader) and the audit quality. The same examination had observed by the Ettredge and Greenberg (1990), whether audit firm industry market share (industry leader) is associated with audit quality and the findings has endorsing that fact if the company has high industry market share then the client receive the high quality of audit, because the industry leading company charging the high price or premium from the client company.

2.4 Underpinning Theories

2.4.1 Stakeholder Theory

Stakeholder theory is concerned with the various stakeholders approval over an organization's activities. Guthrie, Petty and Ricceri (2006) stated that:

"According to stakeholder theory, an organization's management is expected to undertake activities deemed important by their stakeholders and to report on those activities back to the stakeholders… stakeholder theory highlights organizational accountability beyond simple economic and financial performance".

This study also follows the line of thinking which explains that accountability of organization is not limited to maximize the wealth of shareholders (as suggested in agency theory). Rather, the organization must also be able to meet and account for the multiple goals of diverse stakeholders. Gray, Kouhy and Lavers (1995) remarked that the continued existence of organizations largely depends on approval by surrounding stakeholders and the more powerful of the stakeholders, more organization must adapt their activities to comply with those stakeholders. The groups that can affect and be affected by an organization's activities apart from shareholders are employees, customers, suppliers, lenders, the government and society (Riahi-Belkaoui, 2003). The organization has an obligation to provide information about how its activities affect the stakeholders (Deegan, 2000; Vergauwen & Van Alem, 2005). In this regard, social and environmental disclosure has been found to be part of mechanism for organizations to dialogue with stakeholders (Gray et al., 1995).

Stakeholder theory has two branches; i) an ethical (moral) branch; and ii) a positive (moral) branch, each of them demonstrate a different discharge of accountability to various stakeholders (Guthrie et al., 2006). The ethical branch states that each class of stakeholders must be treated fairly and the organization must engage in activities that could satisfy the demand of all stakeholders equally (Deegan, 2000). Meanwhile, instead of discharging accountability equally as suggested in the first branch, the positive branch on the other hand attempts to identify which group of stakeholders have significant or powerful influence over the survival of an organization. The most powerful stakeholders are deemed to have a critical influence over the control of an organization's resources such as supply of labor, material, finance, access to media and customers, which in turn determine the long term success of the organizations (Guthrie et al., 2006).

Meanwhile, Guthrie et al., (2006) contended that the positive branch of the theory can be used to determine whether companies show a different way of communicating with diverse stakeholders that have different types of control over the company. Likewise, more powerful of the stakeholders and more information about stakeholders is disclosed in annual reports. Previous studies have showed that significantly different volumes of capital information (Bozzolan, Favotto, & Ricceri, 2003; Campbell & Rahman, 2010; Yi & Davey, 2010) and this may be explained by the positive branch of stakeholder theory.

2.4.2 Signaling Theory

Signaling theory is useful in informing capital market behavior particularly with regard to corporate disclosure (Nurunnabi, Hossain, & Hossain, 2011). The theory of signaling purports that information asymmetry exists when companies have relevant information those investors does not. The disparity of ownership information may cause an imperfect situation in capital markets likely to increase perceived risk and cost of capital (Sengupta, 1998). In order to narrow the information asymmetry, companies will signal information explicitly to outsiders, which eventually gains more economic benefit and reputation than other companies that fail to do so (Watson et al., 2002).

A greater signal is also capable of distinguishing between the higher and lower quality companies (Nurunnabi et al., 2011). A higher quality company has a stronger motivation than a lower quality company to signal their strengths and attract more investors. The costs of a failure to signal the strength is deemed to be greater in a high quality company than a lower quality company (An Yi et al., 2011). In achieving this benefit, the companies typically use annual reports to disclose a wider range of information that is not required by mandate. However, Williams (2001) suggested that some companies may be reluctant to make their information more visible to the public because of the strategic nature of the information which may in turn harm the competitive advantages of the company. Meanwhile, the risk of litigation resulting from a misrepresentation of information may also cause the low level of information signaling activities (Pave and Epstein, 1993).

The transformation from traditional economy to knowledge economy has intensified the level of information asymmetry between capital market players and managers due to the limited account of knowledge assets in traditional financial reporting

(Yeoh, 2010). Consequently, the real economic value of knowledge-based companies has been undervalued (Edvinsson & Malone, 1997). Those companies with high levels of financial reporting quality may signal the internal and external strength of the company by conveying information about its knowledge assets such as technology, R&D activities, corporate culture, employee skills, brand, customers, and business partners, etc. Thus distinguishing them from other less knowledge based on companies. Therefore, in examining signaling theory, this study argues that the increasing important of knowledge assets in value creation over time has strongly motivated companies to increasingly signal positive information about annual reports in order to ensure they have not been undervalued.

Hasseldine, Salama and Toms (2005) argued that an information signal will have high quality when it is costly and difficult to replicate. In other words, a low quality information signal is usually associated with cheaper production, is easy to be produced and replicated, and is disclosed in large volume without intellectual commitment. A low information signal quality implies a low quality of reporting company which eventually may fail to convince the investors. Consistent with this argument, Watson et al., (2002) stated that to achieve signal quality, the signal content (information disclosure) must be credible and verifiable. If a company falsely signals that they are high quality, while if the fallacy is discovered, no subsequent disclosure will be deemed credible by users. Therefore, the quality of the signal relies not merely on the information presence but also on its quality.

2.4.3 Agency Theory

The agency is considering grounded theory to explain the existing relationship between variable of investigation such as the audit committee characteristics and financial reporting quality. The agency has developed by Jensen and Meckling (1976), and argued that agency problem can be reduced if audit will provide quality service more auditing played the major role to reduce the agency problem.

Recent empirical studies in the emerging economies provide support to theories with origins in the economically developed Western countries. Agency theory is among a number of theoretical perspectives that were found to be applicable to corporate governance and disclosure practices of firms in the developing economies (MohdGhazali & Weetman, 2006; Mustapha & Ahmad, 2011; Chu et al., 2013).

The agency theory is a way to see the world which is bounded by the social values and capable of influencing on the perception of people on the organization can visualize by the annual capital reporting procedure (Cormier & Gordon, 2001; Magness, 2006). The capital reporting has the two prolonged effect in the social responsibilities and shaping the stakeholders perception on the organization (Gray et al., 1995). On that note several past studies social concerned also played the greater role in the availability and issuing of the annual reports.

Prior research such as the Guthrie et al., (2006); Whiting and Woodcock (2011) showed agency theory has the direct and indirect link to the transparency of financial reporting quality which would be main resource to present the financial performance of any organization. This is also consistent that past researcher helps and understands the relationship between the employee, customers and companies and this would not capable in public acceptance and public image but explore the more competitive advantages of liquidity.

2.5 Summary of the Chapter

This chapter briefly describes literature review about the background of financial reporting quality and all related studies that are related to our subject. It provides detailed discussion about the dimension that are used to measure dependent and independent variables from literature. Then it discussed about the audit committee and external auditor characteristics and, finally, how variables, i.e. financial reporting quality, independent audit committee and external auditor characteristics, connect into the same framework which is supported by the underpinning theory.

CHAPTER THREE

HYPOTHESIS DEVELOPMENT AND METHODOLOGY

3.1 Introduction

Research designed provides the glue that holds the research project together. A design is used to structure the research, to show how all of the major parts of the research project the samples or groups, measures, treatments or programs, and methods of assignment work together to try address the central research questions. Here, after a brief introduction to research design, classify the major types of designs. There is major distinction between the experimental designs that use random assignment to groups or programs and the quasi-experimental designs that do not use random assignment. People often confuse what is meant by random selection with the idea of random assignment. One should make distinction between random selection and random assignment. Understanding the relationships among designs is important in making design choices and thinking about the strengths and weaknesses of different designs.

In contrast to primary data, which originate with a researcher for the specific purpose of the problem hand, secondary data is data originally collected for other purposes. Secondary data can be obtained quickly and is relatively inexpensive. However, they have limitations and should be carefully evaluated to determine the appropriateness. The current study conducted in a single stage in which an exploratory investigation conducted in Malaysia using a sample of 100 most profitable companies' data during 2014.

Following section demonstrate the methodology used by the study. First subsection depicts the theoretical framework of the study illustrating the relationship between variables. Next subsection explains the hypothesis developed by the study. These hypotheses would be further tested in chapter four. Subsequently, research process of the study is described in which sampling method was explained that how sample is selected out of total population. Then computation of variables and their operational definitions was explained. Statistical and data processing techniques used by the study were demonstrated in next section.

3.2 Research Framework

This study is an attempt to examine the relationship between audit committee characteristics namely, independence, expertise, diligence, and external auditor characteristics namely, large audit firms, industry leader, and financial reporting quality for the listed companies in Malaysia. The underpinning theory used in this study is signaling theory.

This study contains two different approaches to examine, predictors of financial reporting quality in the form of audit committee and external auditor characteristics. As it suggested by the signaling theory that strong signal of company has deluge from the annual reports which is prime responsibility of company to issue every year

(Krishnan & Krishnan, 1997). In search of transparency and Independency every company has appointed audit committee and independent external auditors to examine these reports carefully. On that conclusion, the role of auditor directly or indirectly effect on the quality of annual reports, disclosure, audit quality and high quality of information.

Watson et al., (2002) stated that to achieve signal quality, the signal content (annual reports) must be credible and verifiable. In other words, quality of the signal relies not merely on the information presence but also on its quality. Firth and Smith (1992) supported the signaling theory with their evidence showed that companies are likely to choose quality-differentiated auditors to add credibility to the new issue. Various other studies focus on factors associated with quality independent issues (Chow and Rice, 1982; Williams, 1988). Most of the continuous audit literature focuses on continuous audit from the internal auditors' perspective, although more recent studies explore in some detail the relationship between the frequency of the audit and external auditor or management decision making (Glover et al., 2008). The prior research has proven that variability in the nature of audit committee and external auditor has the positive impact on the financial reporting quality (Hunton et al. 2008).

This study underpins background of signaling theory and predicts relationship auditors' characteristics (audit committee and external auditors) and financial reporting quality.

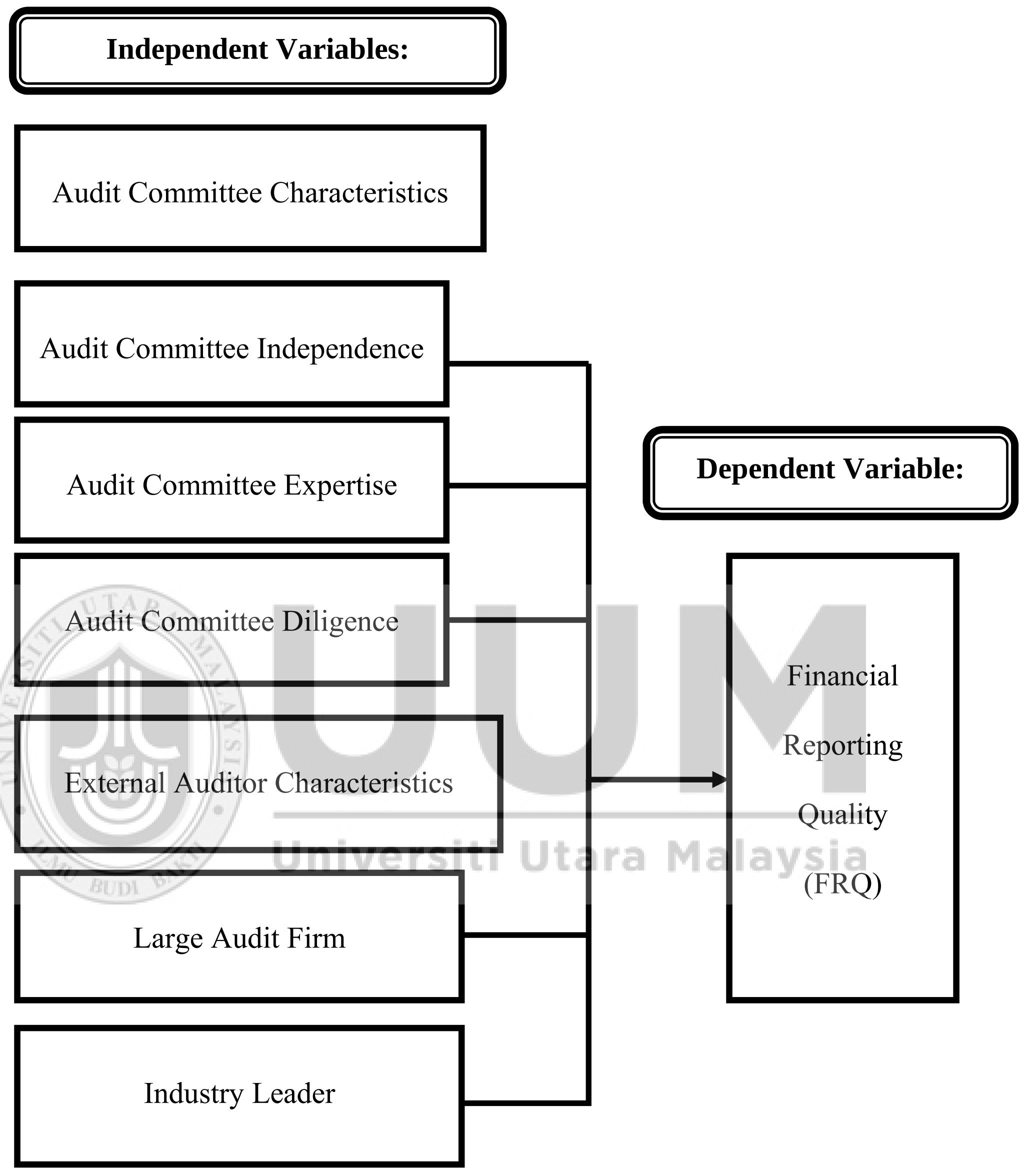

Figure 3.1 Framework of the study

3.3 Hypothesis Development

This section provides the hypothesized relationship between financial reporting quality as the dependent variable with the independent variables, audit committee characteristics namely, independence, expertise, diligence, and external auditor characteristics namely, large audit firm and industry leader.

3.3.1 Audit Committee Independence and Financial Reporting Quality

Agrawal and Chadha (2005); Yang and Krishnan (2005) argued that there is significant relationship between independence of audit committee and quality of financial reporting. Similarly, Sharma and Iselin (2012) also claimed same fact that there is positive relationship between independent audit committee and quality of financial reporting. It is assumed that financial reporting quality is positively influenced by independent audit committees to the extent managers are effectively monitored by independent directors. In this regard, it can be hypothesized that this study is likely to generate results which would be of greater interest for policy makers and in consistent with worldwide efforts regarding improvement of audit committee effectiveness (Committee, 1999; Smith, 2003). The examination of the relationship between the characteristics of audit committee (such as meeting frequency, expertise and independence of audit committee members) and audit fees has become the main subject of earlier studies (Abbott, Parker, Peters, & Raghunandan, 2003; Carcello, Hermanson, Neal, & Riley, 2002; Sharma, 2004). However, some studies predict that higher audit quality should be demanded by audit committee (Abbott et al., 2003). On the basis of mixed results in the literature and the importance of audit committee, the current study is conducting on the relationship between independent audit committee and quality of financial reporting and supposes that there is a positive associated between them.

H1: *There is a relationship between audit committee independence and financial reporting quality.*

3.3.2 Audit Committee Expertise and Financial Reporting Quality

This argument has prevailed that, strong governance is compulsory for enhancing the wealth of shareholders (DeFond & Francis, 2005). Financial expertise of the members of audit committee is mandatory because the responsibility of fair financial reporting lies on the shoulders of audit committee members (Jaime & Micheal, 2012). With the help of financial expertise significant value can be offered to the clients as they can easily detect any fraud or manipulation because of their knowledge and expertise. Majority of the studies have highlighted the positive influence of financial and accounting knowledge on the members of audit committee and the quality of financial reporting (Krishnan &Vivanathan, 2008). High level of expertise on the members of the audit committee ensure less misreporting because of effective monitoring (Raghunandan & Rama, 2007). Directors with independence and high level of expertise in the field of accounting and financial reporting consequently bring reliability and quality in financial reporting (DeZoort, 1998). Aforesaid arguments provide justification to develop another hypothesis in relation to the relationship between audit committee expertise and quality of financial reporting and suppose that there is a positive associated between them.

H2: *There is a relationship between audit committee expertise and financial reporting quality.*

3.3.3 Audit Committee Diligence and Financial Reporting Quality

Abbott et al., (2004) argued that good governance practices depend on diligence of audit committees in carrying out their duties. Generally, studies in this area use the most common proxy for audit committee diligence, which is the number of audit committee meetings held annually. Prior research also suggested the audit committee that arranged their meetings frequently can reduce the incidence of financial reporting problems. By meeting and communicating frequently, for instance, with the external auditor, the audit committee can alert the auditor on a particular auditing issue requiring greater attention from the auditor (Scarbrough, Rama, & Raghunandan, 1998). Consistent with the risk based approach, therefore, it is expected that a more diligent audit committee is likely to reduce financial reporting problems, leading to lower external audit fees. Overall, audit committee structures that are consistent with the Blue Ribbon Committee's (1999) recommendations helped strengthen audit committee effectiveness in their oversight functions. This is likely to result in less substantive testing, leading to lower external audit fees. The following hypothesis is tested audit committee diligence.

H3: *There is a relationship between audit committee diligence and financial reporting quality.*

3.3.4 Large Audit Firm and Financial Reporting Quality

Chen and Lin (2012) argued that fact large audit companies have more concerned about brand reputation. Similarly Li, (2009) supported that because of companies height litigation brand reputation, big4 audit firms are more prudent to the client companies. After the Posta Anderson Scenario, several companies has the reiteration to hire large audit companies avoiding the irregularities in financial discloser and moreover investor showing the interest in examining the reputation of audit company. Moreover, big firms are more conservative that is the reason, it is observed that increase in accrual causes legal problems, therefore, big firm prefer to audit firms with lower accruals (Becker et al., 1998; Francis & Krishnan, 1999).

The size and age of audit firms are those characteristics which affect the financial reporting quality (Boubaker, Mensi, & Nguyen, 2008). Francis et al., (2013) similarly endorsed that auditor size or large audit companies have the better audit quality. Michael and Elizabeth (2014) found that the big4 audit firms are more prudent than non big4 firms in the term of better quality of audit and procedure.

The current study investigate the influence of characteristics of external auditor firms in terms of size of audit firm over client firm value which will be checked in terms of big4 brand effects on the financial reporting quality for that the following hypothesis is relationship between large audit firms and financial reporting qualities.

H4: *There is a relationship between external auditor large audit firms and financial reporting quality.*

3.3.5 Industry Leader and Financial Reporting Quality

Some studies have provided the significant relationship between industry leaders with quality of financial reporting. Prior research provided evidence that the clients of industry-specialized auditors have higher financial reporting quality (Balsam et al., 2003).

Thornton and Seidman (2003) studied on the companies are audited by industry leaders in 2002 and found the significant relationship between industry leader and financial reporting quality. Francis and Mnchis (2012) supported that industry leadership is based on each audit firm's market share of audit fees. In Price Waterhouse Cooper (PWC) has the biggest share in the Malaysian audit industry and it is also supported by several reports that out of 30 big companies of Malaysia, PWC is the client of 14 companies. Due to this reason this study has chosen Price Warehouse Copper to examine the variable of industry leader. Thus this study has hypothesize following hypothesis.

H5: *There is a relationship between external auditor industry leader and financial reporting quality.*

3.4 Data Collection

This study used content analysis for examining corporate annual reports with the aim of providing an overview of auditor's characteristics for the year 2014. Data is collected from annual reports of the companies available on the websites of Bursa Malaysia or firm's own website downloaded in pdf form.

This study incorporates stratified random sampling procedure, hence 'market' is the first stratum where sample is constructed by listed companies and therefore, several criteria can be applied. As data is collected from annual reports of the companies, therefore, according to Campbell (2000) they are frequently and regularly produced document and most broadly dispersed item of the organization.

3.5 Data Collection Procedures

The data required for this study is related to audit committee characteristics, external auditor characteristics and financial reporting quality and this were retrieved from the annual reports of the listed companies on Kuala Lumpur Stock Exchange known as Bursa Malaysia. Data for the independent variables (such as audit committee and external auditor characteristics) were collected from audit committee reports section inside the annual report. Similarly, data about dependent variable (financial reporting quality) was gathered manually from annual reports specifically from the financial statement of companies provided in Bursa Malaysia website.

3.6 Model Specification and Ordinary Least Square Regressions

The ordinary least squares (OLS) regression method is used to examine the relationship between the financial reporting quality and audit committee independence, expertise, diligence, external auditor large audit firm, and industry leader. It is also used for single response variable which has the interval scale. This model can be applied if the variables are coded in the several assumptions. This study is also recording the responses from the annual report in the form of coding which can be further analyzed in the regression model to explain the relationship between the variables.

The estimated regression model is as follows;

$$FRQ_{it} = \beta_{0it} + \beta_1 ACIit + \beta_2 ACE_{it} + \beta_3 ACD_{it} + \beta_4 EALAF_{it} + \beta_5 EAIL_{it} + \varepsilon_{it}$$

Where;

FRQ represents financial reporting quality, ACI represents audit committee independence, ACE represents audit committee expertise, ACD represents audit committee diligence, EALAF represents external auditor large audit firm, EAIL represents external auditor industry leader and Ɛ represents error term.

3.7 Measurement of the Variables

This variable can be computed by formula of basic calculation and then this variable can regress in the regression technique to find out differentiation between two independent variables.

3.7.1 Dependent Variable

Financial reporting quality is measured by using absolute value of discretionary accruals, to estimate the discretionary accruals, modified-jones model (1999) has adapted which is specified followed by Kothari, Leone and Wasley (2005).

$$TAC_{ijt} / A_{ijt-1} = a_j(1/A_{ijt-1}) + \beta_{1j}[(\Delta REV_{ijt} - \Delta REC_{ijt}) / A_{ijt-1}]$$

$$+ \beta_{2j}(PPE_{ijt} / A_{ijt}) + ROA_{t-1} + \varepsilon_{ijt-1} \quad (1)$$

Where;

TAC_{ijt} = Total accruals for firm *i* in industry *j* in the current year *t*;

A_{ijt-1} = Total assets for firm *i* in industry *j* at the end of the previous year;

ΔREV_{ijt} = Change in revenue for firm *i* in industry *j* between the current year and last year;

ΔREC_{ijt} = Change in receivables for firm *i* in industry *j* between the current year and last year;

PPE_{ijt} = Gross property, plant and equipment for firm *i* in the current year; and

ROA_{t-1} = Return on assets at the end of the previous year.

Total accrual (TAC) are calculated as the difference between operating income (EARN) obtained from the financial statement and operating cash flow (CFO) obtained from the statement of cash flow.

$$TAC_{ijt} = EARN_{ijt} - CFO_{ijt} \quad (2)$$

The predicate value from equation (1) is non-discretionary accruals (NDAC), and the difference (residuals) between total accruals (TAC) and NDAC is discretionary accruals (DAC) (Kothari et al., 2005).

$$DAC_{ijt} = TAC_{ijt} - NDAC_{ijt} \quad (3)$$

3.7.2 Independent Variables

ACI: The percentage of total number of independent audit committee members divided by the total number of audit committee members (Abdul Rahman & Ali, 2006; Mohamad et al., 2012).

ACE: The percentage of audit committee members with finance or accounting degree to total member of audit committee (Saleh et al., 2007,Goh 2009; Zaman et al., 2011).

ACD: The number of audit committee meetings held during the financial year (Puan, Pamela & Clarkson, 2006)

EALAF: The “big4” is equal to one if a “big4” auditor was engaged by the company and zero otherwise (Abdul Rahman & Ali, 2006; Davidson et al., 2005).

EAIL: The variable equal to one if the company’s auditor was an industry leader in 2014 and zero otherwise, in this case PWC is market leader in the Malaysian audit market (Nathaniel M. Stephens, 2011).

3.7.3 Unit of Analysis

This study used the descriptive statistics and univariate test results for the variables, classified as per above discussion. The sample size consists of the 2014 annual report from the Kuala Lumpur Stock Exchange Malaysia. It contains the 100 annual reports observations of the top 100 performing companies in the Malaysia. These three variables of audit committee characteristics and two variables of external auditor characteristics need to be examined and estimated by using the following OLS regression analysis.

3.7.4 Statistical Technique

E-view V.8 was used to compute to all parameters of bond performance and analysis for above mentioned data and framework. Then all results transferred to E-view V8 program. For further clarification and validation of research (t) test used to make analysis difference in two independent variable and all parameters are carefully examined in the Eview-8 program. This gives the visual comparison and show the difference between variables. Regression analysis is a technique used for the modeling and analysis of numerical data consisting of values of dependent variable financial reporting quality and of one or more independent variables (audit committee and external auditor characteristics). The dependent variable in the regression equation is modeled as a function of the independent variables, corresponding parameters "constants" and an error term. The error term is treated as a random variable. It represents unexplained variation in the dependent variable. The parameters are estimated so as to give a "best fit" of the data. Most commonly the best fit is evaluated by using the least squares method, but other criteria have also been used.

3.7.5 Correlation of Variables

Correlation, often called as measured as a correlation coefficient, indicates the strength and direction of a linear relationship between two random variables. Therefore, in this research, the dependent variable i.e. financial reporting quality is correlated with another parameter so in general statistical usage, correlation or co-relation refers to the departure of two variables from independence. In a broad sense there are several coefficients, measuring the degree of correlation, adapted to the nature of data.

3.7.6 Regression of Variables

Regression analysis is concerned with the study of dependency of one variable on one or more than one explanatory variables with an objective to predict the average value of the dependent variable on the basis of given known values of the independent variables involved in the regression model. There are many forms of regression model. This study used classical linear regression model, as this model is appropriate for the present study. For the purpose of estimation, two regression models are estimated. The first model is the auxiliary regression that focuses on the estimation of NDAC while the second regression model investigates the impact of various explanatory variables on FRQ.

3.8 Summary for the Chapter

This chapter highlighted the research methodology which has been used to examine relationship between dependent variable and independent variables. The introduction has given indication about the research methodology. Then research process describe, understanding of research process, selection of companies, sampling technique and statistical used of E-view V.8.

CHAPTER FOUR

FINDINGS AND DISCUSSION

4.1 Introduction

This chapter outlines the results on the basis of descriptive analysis of the collected data. The descriptive analysis is followed by the correlation analysis that shows the linear association among various variables of interest. After that, regression analysis is presented in two separate models as the first model offers the calculation of non-discretionary accruals (NDAC) by the company which is used to calculate the discretionary accruals (DAC) by subtracting that NDAC from total accruals (TAC). Next, regression results are presented in order to examine the relationship between financial reporting quality and selected explanatory variables.

4.2 Descriptive Analysis

Descriptive statistics are calculated for all the independent variables and dependent variable. Descriptive variables include mean and standard deviation of each variable for the entire data set. For the matter of examining if there is any missing value, number of observations are also calculated i.e. N. In order to examine the range of the data, maximum and minimum values for the entire data set for all variables are also computed. Descriptive statistics for the dependent variable, i.e. log natural of absolute values of DAC (discretionary accruals), absolute values of DAC, and original values of DAC and all independent variables included in the regression model are given in the following table:

Table 4.1 *Descriptive Statistics*

	N	Mean	Standard Deviation	Maximum	Minimum
FRQ	100	5.0007	1.5824	9.2637	1.2508
ACI	100	0.8114	0.1779	1	0.34
ACE	100	0.4627	0.193	0.8	0
ACD	100	5.798	2.5434	18	2
EALAF	100	0.92	0.2727	1	0
EAIL	100	0.28	0.4513	1	0

FRQ: Financial Reporting Quality ACI: Audit Committee Independence, ACE: Audit Committee Expertise, ACD: Audit Committee Diligence, EALAF: External Auditor Large Audit Firm and EAIL: External Auditor Industry leader

Table 4.1 above represents the descriptive statistics (N, mean, standard deviation, maximum and minimum values) for the dependent variable financial reporting quality (FRQ), audit committee independence (ACI), audit committee expertise (ACE), audit committee diligence (ACD), external auditor large audit firm (EALAF) and external audit industry leader (EAIL) in the regression model of financial reporting quality. N represents the number of observation for each variable. It is clear from the table that the mean value of dependent variable is 5.0007 with a standard deviation of 1.5824 and range of 8.019 (maximum value – minimum value) and the data for dependent variable is complete for 100 companies. There is no missing data for any variable as number of observations is 100 for all variables. The mean values for ACI, ACE, ACD, EALAF and EAIL are 0.8114, 0.4627, 5.798, 0.92 and 0.28 respectively.

Descriptive analysis indicates that audit committee characteristics directly effect on the financial reporting quality which is proven by the detailed analysis while discretionary accrual is main proxy to understand the relationship of dependent and independent variables. This study extends the debate on auditor independence as prior researches have also found the significant relationship between these two variables (Myers, Myers & Omer 2003; Abbott Daugherty, Parker & Peters, 2015).

Moreover, the analysis also revealed that mean is 0.8114 for the auditor committee independent in the top 100 performing companies in the Bursa Malaysia which concludes that around 81% concentration has found independency in the audit committee structure in the form of independent executive directors at the top 100 performing companies in the Bursa Malaysia. Moreover, this study also concluded that, consistent with all annual reports, out of 4 in the audit committee members 3 has found independent audit committee members in all companies. The standard variation also found 17% which also significant evidence that Malaysian top 100 performing companies are readily focusing the independency of audit committee.

At the relationship between the audit committee expertise and financial reporting quality by detailed examination discretionary accrual this study has found significant results which are concluded that expertise in the audit committee significant on the firms of 100 top performing companies in the Bursa Malaysia. The findings of this study is parallel to several past studies with regard to financial reporting quality (Cohen, Hoitash, Krishnamoorthy & Wright, A. M., 2013; Li, Mangena & Pike, 2012).

The descriptive analysis has provided more detailed about the expertise in the top 100 performing companies is constituent 0.4627, means 46%. This descriptive analysis extract that top 100 companies also depend on the audit committee expertise in the organization structure that's the reason half on the independent directors they have taken in the audit committee to ensure that they will surveillance better audit quality in terms of financial reporting quality. The standard deviation is 0.193 means the less or more half of the audit committee have the sufficient knowledge of finance or finance background which is considering prominent factor to indulge in the audit committee board.

The study has proven in the literature review that diligence required in the audit committee if they want achieve the effective financial reporting quality. This is also examined by several past researchers that audit committee diligence has effect on the financial reporting quality (Campbell, Hansen, Simon & Smith 2014; Jubb & Lin 2012). Consistent with in this study has proven that diligent audit committee member is effecting on the financial reporting quality.

The average mean in the top 100 Companies found that around the year, at least six meeting were held and findings at banking sector, audit committee were involve rigid practices of audit and some sampling concluded that more 15 meeting in the year, which is proven that banking sector of Malaysia is more conscious about diligences of audit committee board. The standard deviation is 2.5434 which concluded that top 100 companies of Malaysia conducted at least 3 to 6 meetings per year. At it is noted that diligence of audit committee examined by the meeting per year proxy. The descriptive analysis has proven the strong relationship between the audit committee diligence and financial reporting quality.

The reason might be observed from the analysis, that the variability of variable near to be 90% constant, this might concluded due to linear variation of independent variable, i.e. its proven by the analysis that more than 90% of the companies using the big4 companies for the audit of annual performance of organization. But for the better understanding about the big4 role in Malaysian companies more detailed research is required.

The descriptive studies has shown the statistics results that average mean is found in the top 100 performing companies is 0.90 that's concluded that more 90% companies are relaying on the big4 companies to audit an maintain financial standards. This strong support for the argument the companies use big audit companies to audit the financial resource in terms of proving that the financial standards are transparent. The only variable in the model that has less variation is 0.10. Malaysian companies are focusing on the big4 companies to audit their annual accounts.

The industry leader variable which is also significant in the model is leading audit companies in the top 100 performing companies. The leading company or industry leader in the audit world is Price Waterhouse Cooper Berhad. The myth exists that top 100 performing companies always use that the best audit firms of the market but in this case top 100 performing companies are reluctant in the choosing Price Waterhouse Cooper Berhad. For the audit, out of 100 companies only 28 companies choosing the Price Waterhouse Cooper Berhad. For the audit services other companies choose the other big4 companies for the first choice. As per researcher's knowledge, market visited Price Waterhouse cooper Berhad charging the highest price (almost double in respect of other big4 companies) in the form of audit fees that's the reason companies reluctant to hire Price Waterhouse Cooper Berhad.

4.3 Correlation Analysis

Correlation analysis is concerned for examining the mutual linear association among variables. If association is observed between two variables only, then simple coefficient of correlation is used while for examining the linear association among more than two variables, multiple correlation coefficients is used. The range of correlation coefficient is between -1 and +1. Minus 1 show perfect negative linear association between two or more variables and +1 demonstrates perfect positive linear association while a value of zero shows no association among variables. Following tables shows the coefficient of correlation for selected variables.

Table 4.2 *Correlation Matrix*

	FRQ	ACI	ACE	ACD	EALAF	EAIL
FRQ	1.000000					
ACI	0.037518*	1.000000				
ACE	0.171121**	-0.085417	1.000000			
ACD	0.161318*	-0.074910	0.019517**	1.000000		
EALAF	-0.045044	-0.174527	0.019466*	0.151181*	1.000000	
EAIL	0.177612*	-0.074439	-0.076014	0.070898*	0.186201	1.000000

FRQ: Financial Reporting Quality ACI: Audit Committee Independence, ACE: Audit Committee Expertise, ACD: Audit Committee Diligence, EALAF: External Auditor Large Audit Firm and EAIL: External Auditor Industry leader
* shows significance at 10 percent level of significance
** represents 5 percent level of significance

Table 4.2 presents the correlation matrix i.e. the coefficient of correlation among log natural of the absolute values of DAC named as Financial Reporting Quality (FRQ) and ACI, ACE, ACD, EALAF and EAIL. The relationship between FRQ and ACI, ACE, ACD and EAIL is significant while the relationship between FRQ with EALAF is insignificant. The coefficient of correlation among all these variables is also presented in this table for explained information.

4.4 Regression Analysis

Following table provides estimation of auxiliary regression along with variable, coefficients, standard error, *t* and *p* values in estimating non-discretionary accruals. These results are based on hundred sample firms including hundred observations. Ordinary least square is used for estimation.

Table 4.3 *Estimates of auxiliary regression estimating NDAC*

Dependent Variable: TAC_A
Method: Least Squares
Sample: 1 100
Included observations: 100

Variable	Coefficient	Std. Error	t-Statistic	P-Val
C	0.036914	0.042916	0.860141	0.3919
1/A	-129.4372	64.90928	-1.994124	0.0490
(ΔREV- ΔREC)/A	-2.999668	0.217593	-13.78571	0.0000
PPE/A	0.080234	0.034085	2.353967	0.0206
ROA_{t-1}	-0.032929	0.038352	-0.858598	0.3927

R-squared	0.814180	Mean dependent var	-0.157127
Adjusted R-squared	0.806356	S.D. dependent var	0.812997
S.E. of regression	0.357759	Akaike info criterion	0.830793
Sum squared resid	12.15920	Schwarz criterion	0.961051
Log likelihood	-36.53965	Hannan-Quinn criter.	0.883511
F-statistic	104.0621	Durbin-Watson stat	1.709231
Prob(F-statistic)	0.000000		

NDAC: Non-discretionary Accruals TAC: Total Accrual, A: Total Assets, ΔREV: Change in Receivables, ΔREC: Change in Receivables, PPE: Gross Property, Plant and Equipment, ROA: Return on Assets, Ɛ: Error Term

The value of R-squared in Table 4.3 shows the goodness of fit of the regression model. Its value ranges between zero and 1. Zero means perfectly poor fitness of regression line while 1 means perfect fit. The value of R-squared is 0.8141 in present model which shows that 81 percent of the variations in the dependent variable are predicted by included explanatory variables in the regression model. In other words, more than 81 percent of the variations in non-discretionary accrual are explained by included independent variables in the model. The value of adjusted R-squared also shows the goodness of fit of the regression model after adjusting the effect of increased number of explanatory variables. Its value i.e. 0.8064 also is revealing the same conclusion as that of R-squared that more than 80 percent of the variations in the dependent variable are explained by included predictors in the model.

The 'C' is the constant in the regression analysis. This is the intercept of the regression line when observed graphically. While statistically, its interpretation is not necessary. The values of the parameters show the direction and magnitude of relationship between dependent and explanatory variables. This is evident from the estimation results that $1/A_i$ (at 1 percent significance level), $(\Delta REV- \Delta REC) /A_i$ (at 5 percent significance level) and PPE/A_i (at 1 percent significance level) are significant predictors of NDAC but, return on assets in one year lag is not posing significant impact on dependent variable i.e. non-discretionary accrual. Once can say that reciprocal of assets of a company, difference between change in revenue and receivables with a ratio of total assets of the company and gross property, plant and equipment are the significant predictors of the non-discretionary accrual of a company, but return on assets with a lag of one year is not significant.

The overall model significance can also be observed by the value and significance of F-statistic (a good measure of the overall significance of the regression model). The overall significance of the model is obvious by the p-value of F-statistic (0.0000) i.e. this is also significant at 1 percent level of significance.

The Durbin-Watson statistic is used to examine the presence of autocorrelation in a time series data and the presence of specification bias in the regression model. Here, in present study, this statistic is used to examine the problem of specification bias. The value of the Durbin Watson d statistic ranges between zero and 4. The closer the value of d statistic to 2, the more evidence is there of an absence of specification bias. The value of the Durbin Watson statistic in this auxiliary regression is 1.7092 which when compared to its corresponding table values shows the absence of any specification bias in the regression model which further supports our model in estimating the non-discretionary accrual.

Total accrual (TAC) are calculated as the difference between operating income (EARN) obtained from the financial statement and operating cash flow (CFO) obtained from the statement of cash flow.

$$TAC_{ijt} = EARN_{ijt} - CFO_{ijt} \quad (4.1)$$

The difference between actual total accruals (TAC) and NDAC is discretionary accruals (DAC) as stated by Kothari et al. (2005).

$$DAC_{i} = TAC_{i} - NDAC_{i} \quad (4.2)$$

After estimating DAC from Eq. (4.3), absolute values of DAC and the resultant is taken as a proxy measure for the financial reporting quality. The FRQ depends upon audit committee independence, audit committee expertise, audit committee diligence, external auditor large audit firm and external auditor industrial leader and ε_i is the residual term fulfilling the CLRM assumptions.

The regression model in the estimated as follows;

$$FRQ_i = \beta_{0i} + \beta_1 ACIi + \beta_2 ACE_i + \beta_3 ACD_i + \beta_4 EALAF_i + \beta_5 EAIL_i + \varepsilon_i \qquad (4.3)$$

The estimation of above stated model in Eq. (4.4) is as follows:

Table 4.4 *Estimates of regression estimating FRQ*

Dependent Variable: FRQ
Method: Least Squares
Sample: 1 100
Included observations: 97

Variable	Coefficient	Std. Error	t-Statistic	P-Val
C	3.542951	1.141442	3.103927	0.0025
ACI	0.573362	0.265214	2.161884	0.0316
ACE	1.588973	0.833253	1.906953	0.0597
ACD	0.102271	0.063167	1.619058	0.0989
EALAF	-0.581905	0.600070	-0.969728	0.3348
EAIL	0.726537	0.362106	2.006423	0.0478

R-squared	0.802096	Mean dependent var	5.008395
Adjusted R-squared	0.770980	S.D. dependent var	1.604713
S.E. of regression	1.561807	Akaike info criterion	3.789423
Sum squared resid	221.9708	Schwarz criterion	3.948684
Log likelihood	-177.7870	Hannan-Quinn criter.	3.853820
F-statistic	3.069435	Durbin-Watson stat	1.920615
Prob(F-statistic)	0.026403		

FRQ: Financial Reporting Quality, C: Constant, ACI: Audit Committee Independence, ACE: Audit Committee Expertise, ACD: Audit Committee Diligence, EALAF: External Auditor Large Audit Firm and EAIL: External Auditor Industry leader

Table 4.4 above represents the estimation of regression model given in Eq.(4.3), where, FRQ is the dependent variable, C is the constant in the equation while ACI, ACE, ACD, EALAF, EAIL are the explanatory variables included in the model. This can explain model same as it is explained in case of auxiliary regression.

As explained earlier that the value of R-squared shows the goodness of fit of the regression model and the range of its values is between zero and 1. So, the value of R-squared in this regression model is 0.8021 which shows that more than 80 percent of the variations in the dependent variable FRQ are predicted by included explanatory variables in the regression model. In other words, more than 80 percent FRQ variations are explained by ACI, ACE, ACD, EALAF and EAIL. The value of adjusted R-squared also shows the goodness of fit of the regression model after adjusting the effect of increased number of explanatory variables. Its value in this mode is 0.771 which also shows that more than 77 percent of the variations in FRQ are explained by included predictors in the model. The result of R-squared is consistent with the findings of Madawaki (2012) who conducted same research on Nigeria and found that around 85% of variations in dependent variable (financial reporting quality) are explained by independent variables.

The values of the parameters show the direction and magnitude of relationship between dependent and explanatory variables. This is evident from the estimation results that ACI and EAIL are significant at 5 percent significance level as it is clear from the p-value named as Prob. the last column of the table, ACE and ACD are significant at 10 percent level of significance but the influence of EALAF on FRQ is insignificant as shown by the p-value in the table above. It can be concluded that ACI, ACE, ACD and EAIL contribute to explain the variation in FRQ of a company, but, the contribution of EALAF in explaining the variation of FRQ is insignificant. The audit committee independence, audit committee expertise, audit committee diligence and external auditor industry leader can be used to observe the variations in financial reporting quality. The parameter of the EALAF found insignificant in the statistical analysis. Although prior research suggested that, significant relationship between the auditor (large audit firm, size, and characteristics) with financial statements (Becker et al., 1998). On the other hand some of the studies were not found any relationship (Wallace et al., 1994), which is parallel with this study. Moreover, that variation of each of the company characteristics different in country to another country that might be affected on findings.

The overall model significance can also be observed by the value and significance of F-statistic (a good measure of the overall significance of the regression model). The overall significance of the model is obvious by the p-value of F-statistic (0.0264) i.e. this is also significant at 5 percent level of significance and it can be concluded that overall this model is fit for examining the variations in FRQ.

As already stated that the Durbin-Watson statistic is used to examine the presence of autocorrelation in a time series data and the presence of specification bias in the regression model. Similarly, in this model, this statistic is used to examine the problem of specification bias. The value of the Durbin-Watson d statistic ranges between zero and 4. The closer value of d statistic to 2, the more evidence is there of an absence of specification bias. The value of the Durbin-Watson d statistic in this auxiliary regression is 1.9206 which when compared to its corresponding Table 4.4 values shows the absence of any specification bias in the regression model which further supports our model in estimating the FRQ

4.5 Summary of the Chapter

This chapter offers the results of analysis of the selected 100 companies. Descriptive analysis is followed by graphical analysis and then inferential statistics are given. Inferential statistics comprise of correlation matrix and regression analysis. It can be concluded that financial reporting quality (FRQ) depends on ACI, ACE, ACD and EAIL.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The purpose of this research is to examine the relationship between financial reporting quality (a dependent variable) and audit committee independence, audit committee expertise, audit committee diligence, large audit firms and industry leader (the independent variables). This chapter discussed the results and findings obtained from the analysis conducted in previous chapter. Subsequently, some limitations that this study possesses are discussed in detail. In result, study also provides the avenue for future research that how authors can address those limitations effectively. In the end, all discussion is summarized in conclusion section.

5.2 Discussion of the Results

The first objective of this study is to examine the relationship between audit committee independence, expertise and diligence on the financial reporting quality. Results indicate that all these independent variables (mentioned above) have strong and significant influence on financial reporting quality. In other words according to result the financial reporting quality is significantly affected by all these variables.

Likewise, the second objective of this study is to examine the relationship between external auditors large audit firm and industry leader on the financial reporting quality. Findings of this study suggest that the impact of external auditor industry leader is strong and significant on financial reporting quality. But, in contrast, results show that large audit firm has insignificant relationship with financial reporting quality.

The examination of top 100 performing Malaysian companies from Bursa Malaysia has provides very interesting results in nature. This study provides mixed results. With respect to variables, like audit committee independence and expertise in the audit committee in relation with financial reporting quality, obtained results are consistent with several past studies (such as Bedar, Chtourou & Courteau, 2004; Ashbaugh, LaFond & Mayhew 2003). It is also proven that out of five, four variables (audit committee independence, expertise, diligence, and industry leader) has found the significant relation with financial reporting quality and except one variable, large audit firm had not found inconsistencies with previous studies' findings.

The study has unique and novelty in the form of variable's selection. Past studies have provided the evidence on the relationship between audit committee characteristics and financial reporting quality. In contrast, this study has taken the external role of auditors to support the argument the external auditors' role also influence the financial reporting quality. The observation of large audit firms has concluded by the detailed examination of discretionary accruals which was the proxy of financial reporting quality. As per findings of previous researches, big4 audit firms found the significant relationship with financial reporting quality (Hope, Thomas & Vyas, 2013; Kim, Park & Wier, B., 2012).

The value of R-squared is 0.8020 in present model which shows that 80 percent of the variations in the dependent variable are predicted by included explanatory variables in the regression model. In other words, more than 80 percent of the variations in non-discretionary accruals are explained by included independent variables in the model. Its value i.e. 0.7709 also revealing the same conclusion as that of adjusted R-squared that more than 77 percent of the variations in the dependent variable are explained by included predictors in the model.

The overall model significance can also be observed by the value and significance of F-statistic (a good measure of the overall significance of the regression model). The overall significance of the model is obvious by the p-value of F-statistic (0.0000) i.e. this is also significant at 1 percent level of significance.

The value of the Durbin-Watson statistic in this auxiliary regression is 1.7092 which when compared to its corresponding table values shows the absence of any specification bias in the regression model which further supports our model in estimating the non-discretionary accrual.

This is evident from the estimation results that audit committee independence and external auditor industry leader are significant at 5 percent significance level as it is clear from the p-value named as Prob. audit committee expertise and audit committee diligence are significant at 10 percent level of significance but the influence of external auditor large audit firm on financial reporting quality is insignificant. It can be concluded that audit committee independence, audit committee expertise, audit committee diligence and external auditor industry leader contribute to explain the variation in financial reporting quality of a company, but, the contribution of external auditor large audit firm in explaining the variation of financial reporting quality is insignificant. The audit committee independence, audit committee expertise, audit committee diligence and external auditor industry leader can be used to observe the variations in financial reporting quality.

The overall model significance can also be observed by the value and significance of F-statistic (a good measure of the overall significance of the regression model). The overall significance of the model is obvious by the p-value of F-statistic (0.0264) i.e. this is also significant at 5 percent level of significance and it can be concluded that overall this model is fit for examining the variations in financial reporting quality.

5.3 Limitations and Recommendations for Future Research

Along with different contributions of this study, there are number of limitations attached with it. Based on the results and findings, this study suggests that future research need to overcome its limitations and provides more insight to the relationship between dependent and independent variables of this study.

The present study tested the effect of some factors on financial reporting quality hence, future studies are suggested to incorporate more factors to provide deeper insights into how effectively additional factors influence financial reporting quality in Malaysian context. Similarly, this study solely focusing on the Malaysia which is developing country and circumstances of PEST (Political Social .Economic and Technological) are not same as the previous research focusing in the western world with different aspect. Therefore, it is suggested that same methodology can be used by future studies for other countries where this relationship is yet not tested. It is also suggested that future research can extend these findings by increasing the number of sample companies if more annual reports are available.

Future study can also adopt different models of measuring and estimating the influence on financial reporting quality or combine the use of models as in other studies with will allow comparison of the present results. Additionally, the future study might focus on the other variable to examine size of the audit committee and in the external auditors audit committee tenure might be consider in the future research with relation to financial reporting quality.

The study not focusing in the one industry but chose top 100 performing companies which was the mix of different sectors; it might provide the disparity in the results due mix selection of different industries in the one study. This study has the limitation using the discretionary accrual, Kothari (2005) model which is only focusing on the discretionary accrual and using of different formula might be influence in the different way. Therefore, this same relation can applied in the different discretionary accrual model to observe any conclusive difference in proposed relationship. This study can be applied in the different geographical portions to see the difference with financial reporting quality.

5.4 Conclusion

This chapter summarized the findings and results discussed in chapter four with complete detail. The purpose of this study is to find how financial reporting quality is influenced by audit committee and external auditor characteristics. This study used three dimensions of audit committee characteristics i.e. independence, expertise and diligence. Similarly, two dimensions are used for external auditor characteristics i.e. large audit firms and industry leader. Results indicate that all three dimensions of audit committee characteristics have strong and significant relationship with financial reporting quality. Likewise, industry leader has strong influence on financial reporting quality, but week and insignificant relationship was reported between large audit firms and financial reporting quality. Similarly, there are several limitations of this study with regard to sample size, applicability of the results which limits the results to be generalized. Therefore, this chapter also provides directions to future research that how they can address this study limitations and fill the gap in literature.

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