Presence of Quality of Audit Committee and Organization's Monetary Data: An In-depth Analysis

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Abstract

All financial regulatory institutions legally bound their listed companies to disclose the information regarding the formulation of their audit committees. This study quantitatively investigates whether the quality of the audit committees affects the quality of a firm's financial information. Using the data of publicly listed non-financial companies of Pakistan Stock Exchange, this research found a positive association between audit committee quality measures and the firm's quality of reported earnings. This study extends the understanding of measures for audit committee quality to stabilize the financial reporting process as it relates to the ongoing discussion by researchers and financial regulators. Additionally, the study also increases the understanding of the concept of external audit quality for various parties which are involved in deliverance of good corporate governance practices; for example, audit committees, external auditors, corporate boards, and top-management team. The study also explores the influencing factors, internal as well as external, in the audit process by constructing its meaning and explaining its practical importance. This detailed exploration and investigation into the procedures of audit quality are vital because auditing is the process through which numbers in financial reports are checked and re-evaluated for any potential clerical errors and omissions.

Keywords: Corporate Law; Corporate Governance; Minority Protections; Agency Cost; Pakistan.

1. Introduction

At the end of the 21st century, many corporate scandals broke out in the United States (US) and Europe. For example; HealthSouth Tyco Enron Paramalat, WorldCom, and Xerox. In the wake of these sudden and immediate financial scandals, financial regulators around the world recognized the need for a robust system capable of keeping high-quality corporate financial reports (Krishnan, 2005). These financial crises around the world are causing financial supervisory authorities to change or formulate new regulatory requirements, particularly those that ensure the neutrality of the audit committee (AC) (Kim, Kwak, Lim, & Yu, 2015). Specifically, the Sarbanes-Oxley Act (SOX) and the New York Stock Exchange (NYSE) state that their publicly traded companies must hire knowledgeable members to strengthen their ACs. As a result, the code of corporate governance (CCG), internal control (IC) regulation, and

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audit regulation were globally strengthened. The supervisory authorities responsible for financial reforms see these adjustments as the best way to solve the agency problem (Giroud & Mueller, 2010).

Previous academic research (Klein, 2002b; Raghunandan & Rama, 2007), suggests that ACs are the most important part of an effective boardroom because they build confidence in the financial markets (Collier & Zaman, 2005). Section 2 of SOX (2002), detailed ACs as a committee (or equivalent body), established by and between the board of directors (BOD) of the issuer to oversee. Previous studies measure the ability of AC to effectively oversee financial reporting and its ability to manage earnings along three dimensions: its financial literacy (Dhaliwal, Naiker, & Navissi, 2010; Ghafran & O'Sullivan, 2017; Krishnan & Visvanathan, 2008), its independence (Abbott, Park, & Parker, 2000; Chan & Li, 2008; Klein, 2002; Krishnan, 2005; Wright & Cohen, 2002), and the frequency of its meetings (Abbott, Park, & Parker, 2000; Avison & Cowton, 2012; Bedard, Chtourou, & Courteau, 2004; Raghunandan & Rama, 2007). This study employs the accruals quality as a primary measure of FIQ (Francis, LaFond, Olsson, & Schipper, 2005).

During the research, this study faces certain research limitations; such as firstly discretionary accruals are being used as a proxy for financial information quality because of their extensive usage in quantifying abnormal accruals. But, prior researchers believe that this approach has the potential to contain measurement errors (Abbott et al., 2016). Second, it is hard to analyze the inward components of an authoritative climate, since it is hard to isolate different inside industry factors, for instance, interior capacity, AC, and upper echelon setup. Third, this examination depends on the data given by the association's yearly reports that contain the opportunity for administrative mistakes. Fourth, the primary impediment of this exploration is the accessibility of the company's yearly reports, because numerous organizations don't have their yearly reports either they have inadequate yearly reports on their sites.

2. Literature Review and Hypothesis Development

Agency problems between owners and managers due to the separation of owners have led to a demand for quality control (Fama & Jensen, 1983). The quality of audit is responsible for adjusting the financial statements of the company to reflect the actual financial position of the company. Therefore, quality auditing should limit intentional earnings management (EM) and reduce information risk (Lin & Hwang, 2010). Quality is defined as the likelihood that an auditor will discover and report a violation of accounting systems (DeAngelo, 1981), and the role of high-quality ACs remains important for financial regulators and professionals. This study focuses on the different properties of AC and its ability to effectively monitor the IC mechanism. The main responsibility of AC includes selecting independent external sound auditors, overseeing the internal processes, and ensuring a

higher financial information quality (FIQ) level (Chen, Moroney, & Houghton, 2005).

This study calculates the total number of AC members and predicts a positive relationship between AC, which includes at least 3 directors, and the company's FIQ. Resource dependence theory demonstrates that the efficiency of BOD and AC increases with their size (Hillman, Withers, & Collins, 2009). The independence of AC, the second proxy for AC quality, has been stated as the desire of AC members to investigate management and ask questions (Contessotto & -Moroney, 2014). Many prior researchers (Davidson et al., 2005; Xie et al., 2003), have linked independence of members with reduced EM. Independent AC's have also been shown to participate in high-quality indoor monitoring (Abbott & Parker, 2000). Xie et al., (2003), found evidence that a higher proportion of independent BOD members are associated with a lower level of EM. Davidson et al., (2005), examined the relationship between the internal management structure and EM in Australian companies and found empirical evidence that the low level of emerging markets is linked to the presence of independent directors on the board.

The financial expertise of AC members is marked by the US Securities and Exchange Commission (SEC) as member's experience in accounting, overseeing finance professionals, and company performance. However, there is a debate among researchers (Defond, Hann, & Xuesong, 2005; Grenier, Ballou, & Philip, 2012; Raghunandan & Rama, 2007), on whether this definition should include data include non-accounting financial experts who can understand complex financial statements, purely due to their work experience. The frequency of AC meetings is a measure of the calculation of AC activity. The frequency of AC meetings has an important effect on the institutional process of IC and the oversight mechanism (Smith, 2006). Therefore, it is generally accepted that a higher number of AC sessions indicate greater control efforts on the part of the AC. Thus from the above-detailed discussion, this study posits its hypothesis as;

H1: The presence of three and more members in AC is positively related to the firm's FIQ.
H2: Firms with a higher percentage of independent members in AC are positively related to firm's FIQ.
H3: The presence of an accounting qualified AC chairman is positively related to the firm's FIQ.
H4: Four or higher annual AC meetings are positively related to the firm's FIQ.

3 Research Methodology

3.1 Sample Selection

The sample for this examination is drawn from the 2015-2019 non-financial Pakistan Stock Exchange (PSX) companies listed on the stock exchange. Corporate governance information for 204 organizations is compiled from

their annual financial reports, which come directly from their websites. This study avoids the data from financial organizations because these types of organizations are subject to exceptional scrutiny by financial regulators, which limits the role of their management. Collected data were compared to reports from the State Bank of Pakistan (SBP) because they are used as the data validation standard by the Federal Government of Pakistan. To eliminate the effect of outliers on the reliability and robustness of the regression results, this study performs a quantitative tailing (winsorize) of 1% to 99% for all continuous variables that were ultimately included in the models of regression. The final sample consisted of 204 non-financial corporations with 1,020 observations representing 27 industrial sectors. In this study, Stata 14 statistical package is used for all experimental analyzes. Table 1 shows the details of sample selection, which likewise contains chosen industry areas.

Table 1 Sample Selection

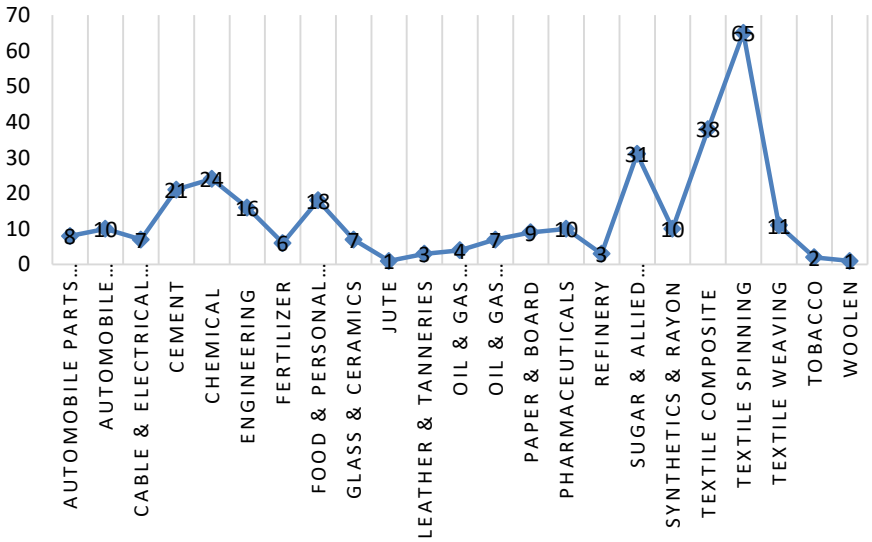

Table 2. Presents a description of all the variables used in this study.

3.2 Variables

3.2.1 Dependent Variable

Our dependent variable is FIQ and this research relies on the absolute negative value of accruals which are measured by using the Jones (1991) Model (Larcker et al., 2007). This research empirically examined how the characteristics of AC quality affect a firm's FIQ. This research will enhance the currently available literature on the quality characteristics of AC because it covers the uncharted avenues of quality characteristics of AC. Furthermore, this study expands the prior research on the quality characteristics of AC and their effects on firms' performance.

3.2.2 Independent Variables

This research used four independent variables to measure the quality of AC. First, Natural logarithm of total members of AC (ACSize) because number of members affect its performance, which is 1 when there are 3 or more members in AC, 0 otherwise. Second, the number of independent directors in AC because better corporate governance is associated with independence of AC, which is 1 when 75% of AC members are independent, 0 otherwise. Third, accounting qualification of AC chairman which is 1 when AC chairman is qualified Chartered Accountant (CA), 0 otherwise. Fourth, the number of meetings in a year, which is 1 when AC meets 4 or more times in a year, 0 otherwise.

3.2.3 Control Variables

We control for the log of total assets (LogTA) because accruals quality is positively related with log of total assets. Financial leverage (Lev) because leveraged firms engage in EM to avoid debt covenant default. Annual return on assets (ROA) because it is used to measure accounting performance. Market-to-Book ratio (MB) because it is used as an indicator for financial performance. The big external audit companies (Big4), which is 1 if external auditing firm includes in Big 4, 0 otherwise, and log of total sales (LogSAL) because it is an important determinant of equity incentives.

3.3 Regression Model

Initially, the study calculates total accruals (TA).

TACCit = EBXTit - OCFit ---------- (1)

Where,

EBXTit = Earnings before extraordinary items & discounted operations for period t.

OCFit = Change in current liabilities during period t.

This study estimates discretionary accruals (DACC), as the difference between total accruals (TACC), and non-discretionary accruals (NDACC).

$$\frac{TA}{\text{ATA}} = \beta 0 + \beta 1 \left(\frac{1}{\text{ATA}}\right) + \beta 2 \left(\frac{\Delta Sales - \Delta Rec}{\text{ATA}}\right) + \beta 3 \left(\frac{GPPE}{\text{ATA}}\right) + \varepsilon IJ \text{---------(2)}$$

TA = Total net accruals

ATA = Average total assets

ΔSales = Change in sales

ΔRec = Change in accounts receivable

GPPE = Gross PP&E

Where,

The regression model is:

$$Yij = \beta 0 + \beta 1\,(Xij) + \beta 2\,(Zij) + \varepsilon ij \text{ ----------(3)}$$

Where, i=123…….,1040 and j is a cross-section, Yij is a dependent variable, which is FIQ. Xij is the testing variable, which are characteristics of AC, such as ACInd, ACAExp, ACSize, and ACActive. Zij is controlled, which are Size, Lev, Age, ROA, Depre, Amort, Big4, and PP&E. Ɛ is an error of ith year and jth cross-section. We perform three sets of tests that involve real earnings management, accounting conservatism, and internal control quality. Table 2 contains the details of variables used in the study.

Table 2 Variable Definition

Variable	Description
FIQ	The absolute value of negative accruals.
ACInd	Independence of AC is 1 when 75% of AC members are independent, 0 otherwise.
ACAExp	Accounting expertise of AC, which is 1 if AC member has an accounting qualification, 0 otherwise.
ACSize	The number of AC members, which is 1 when there are 3 or more members in AC, 0 otherwise.
ACActive	Frequency of annual meetings of AC, which is 1 when AC meets 4 or more times in a year, 0 otherwise.
Size	Size of the firm, which is calculated from its total shareholdings.
LEV	Financial leverage. The ratio of total liabilities to total assets.
Age	Age of the firm, which is determined from the year of its inception.
ROA	Return on assets. Net profit after tax/Total assets.
Depre	Depreciation incurred in the company.
Amort	Total amortization of intangibles.
Big4	1 if the firm is audited by Big 4 & 0 otherwise.
PP&E	Gross property, plant & equipment.
MB	Market to Book ratio, which is the market value of the firm divided by the book value of total assets.
LogTA	Log of total assets.

4 Results

Table 3 reports descriptive statistics for our primary dependent and independent variables for quality measures of AC and firm's FIQ. In the sample, the average number of members in AC is 3.3 (ranging from 2 to 7). The average age of the firm is 36.2 years (ranging from -4% to 128%). Return on Assets is 6.8 (ranging from -26% to 46.4%), and the average size of the firm is 15.3 (ranging from 11.4% to 19.1%).

Table 3 Descriptive Statistics

Variables	Obs	Mean	Std. Dev	Min	Max
FIQ	1020	-.023	.115	-.486	.297
ACInd	1020	.918	.273	0	1
ACAExp	1020	.144	.351	0	1
ACSize	1020	3.311	.665	2	7
ACActive	1020	4.25	.713	2	12
Size	1020	15.364	1.553	11.449	19.195
Lev	1020	.600	.306	.101	1.962
Age	1015	36.704	18.473	-3	128
ROA	1020	7.363	12.808	-26	46.48
Depre	1020	3.91	8.93	0	8.85
Amort	1020	591	2.93	-425	4.15
Big4	1020	.542	.498	0	1
PP&E	1020	620	1.58	0	1.54
MB	1020	1.477	8.878	-155	164
LogTA	1020	1.71	4.32	524	4.96

Table 4 reports the matrix of correlations between dependent variables and independent variables. In regression results, FIQ is positively correlated with the AC independence (ACInd), accounting expertise of AC members (ACAExp), and size of AC (ACSize). As a result, the firm's size (Size) is also positively related to FIQ. A maximum of a correlation coefficient of 0.428 is found via a correlation between a firm's size and the size of AC. However, the activity level of AC is slightly negatively correlated with FIQ, which is insignificant.

	Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	**FIQ**	1.000														
2	**ACInd**	0.043	1.000													
3	**ACAEx**	0.024	0.101	1.000												
4	**ACSize**	-0.006	0.118	0.168	1.000											
5	**ACActive**	-0.061	-0.051	0.47	0.085	1.000										
6	**Size**	0.017	0.116	0.283	0.424	0.163	1.000									
7	**Lev**	-0.241	-0.085	-0.095	-0.073	0.074	-0.147	1.000								
8	**Age**	0.066	0.0061	0.110	0.066	-0.004	0.096	-013	1.000							
9	**ROA**	0.31	0.063	0.111	0.141	-0.010	0.124	-0.475	0.167	1.000						
10	**Depre**	-0.055	0.072	0.133	0.529	0.188	0.577	0.082	0.053	0.073	1.000					
11	**Amort**	-0.010	-0.021	0.019	0.186	0.033	0.248	-0.044	-0.057	0.020	0.352	1.000				
12	**Big4**	0.020	0.036	0.130	0.303	0.101	0.331	-0267	0.094	0.313	0.212	0.136	1.000			
13	**PP&E**	-0.093	0.060	0.065	0.403	0.241	0.562	0.122	0.022	-0.004	0.746	0.217	0.208	1.000		
14	**MB**	-0.063	0.031	0.003	0.022	-0.012	0.047	-0.021	0.166	0.162	0.007	-0.001	0.090	0.003	1.000	
15	**TA**	0.002	0.074	0.160	0.450	0.221	0.625	0.020	0.087	0.141	0.689	0.223	0.234	0.676	0.017	1.000

Table 5 Feasible Generalized Least Squares (FGLS) Regression

FIQ	Coef.	Std. Err.	t-value	p-value	Sig.
ACInd	-0.011	0.007	-1.60	0.109	*
ACAExpe	0.004	0.004	0.86	0.389	
ACSize	-0.009	0.002	-3.91	0.000	***
ACActive	-0.004	0.002	-1.65	0.100	*
Size	0.000	0.001	0.06	0.951	
Lev	-0.066	0.006	-10.43	0.000	***
Age	0.000	0.000	5.03	0.000	***
ROA	.003	.000	10.92	0.000	
Depre	-8.77	6.50	-1.35	0.177	
Amort	3.34	1.17	0.28	0.776	
Big4	-.018	.007	-254	0.011	
PPE&E	-4.27	3.47	-1.23	0.219	
MB	-.001	.000	-429	0.000	
TA	1.05	1.21	0.86	0.388	
_cons	-.076	.051	-1.48	0.139	
Mean dependent var			-0	SD dependent var	
Number of obs			1020	Chi-square	
Prob > chi2			1.000	Akaike crit. (AIC)	

*** p<0.01, ** p<0.05, * p<0.1

Table 5 shows the results of regression through FGLS method. Results show that the accounting qualification of AC members is positively related to the firm's FIQ. Results also show that in the presence of accounting experts in AC, other quality measures of AC also put their positive effect on FIQ, but that effect is insignificant. Besides, the age of the firm also plays a positive role in improving FIQ of the firm.

5. Conclusion

We find that when there is a presence of an accounting qualified person in AC then the quality of firms financial reporting will go up, which ultimately increases firm performance. We also concluded that activity level of AC, size

of AC, and independence of AC also play a vital role in enhancing a firm's performance, but their involvement is insignificant in the presence of accounting qualified person in AC. Also, our results show that higher firm size is also positively related to the firm's performance and firm's FIQ. Because larger firms try to gain the confidence of maximum shareholders by issuing higher quality financial reports which show the true financial picture of the firm.

The result of this study is important because it reflects the importance of hiring accounting qualified member in AC. These results are consistent with prior work (Ghafran & O'Sullivan, 2017; Hamdan, Mushtaha, & Al-Sartawi, 2013; Krishnan, 2005), which also shows that the presence of accounting qualified member in BOD will enhance firm performance. The presence of accounting qualified member also increases the confidence of outside shareholders. Accounting qualified board members are considered to be more resilient during the monitoring process because they have in-depth knowledge of all the stages of the accounting process which allows them to control the formulation process of financial reports. Our empirical results also help Pakistani financial regulatory institutions to make appropriate rules to legally bound all the registered companies to hire accounting qualified persons in their boards and AC because the effective and efficient formulation of financial reports is only possible in the presence of accounting qualified person in BOD and AC.

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