

## The Performance of Audit Committee Function in Malaysian Government Link Companies

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**Abstract:** Government-Linked Companies (GLC's) are defined as companies that have a primary commercial objective and in which the Malaysian Government has a controlling stake. Controlling stake refers to the Government's ability (not just percentage ownership) to appoint BOD members, senior management, make major decisions (e.g. contract awards, strategy, restructuring and financing, acquisitions and divestments etc.). GLCs represent a substantial portion of the economic structure of Malaysia to account for approximately RM260 billion in market capitalization (the market capitalization approximately 36% of Bursa Malaysia and 54% respectively of the benchmark Kuala Lumpur Composite Index). In addition, GLCs account for an approximated 5% of the national work force.

**Keywords:** GLC, Performance and Audit Committee Function

### I. Introduction

The Malaysian government continuously made an attempt towards gaining the "Capital Market Master Plan" as a comparable than markets of the developed nations in consonance with the dream to make Malaysia a developed country by the year 2020. One of the targets included in the master plan, was to help perk up the corporate administration of the corporate sector through an efficient national control system obligatory through audit committees to help increase confidence of international investors and also the economy. According to Simnet, *et al.*, (1993), three major benefits of receiving an audit committee are to improve or preserve the quality of the financial reporting process, to aid the actual and perceived independence of the internal and external auditors, and to improve the assurance of the financial statement users in the quality of financial accounts. The concept of audit committees has been in existence for decades yet; there is no consensus on the definition of what is an audit commission. For example, Collier (1997) indicates that it is a subcommittee of the main board (Cotter and Silvester, 2003); it is made up of a majority of non-executive directors (Abbott and Parker, 2000; Abbott *et al.*, 2003); and it plays a part in the recapitulation of the financial reporting process, passes with the auditors, and reviews internal controls (AISG, 1977; Walker, 2004). Common Organizational Chart Representing Audit Committee Position in GLC's is as per Table 1.

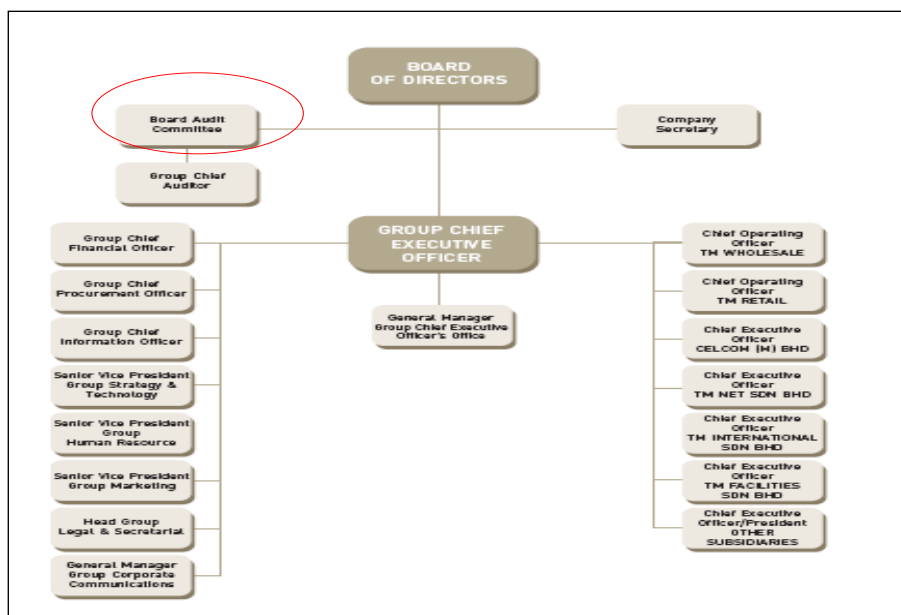


Table 1: Source Bursa Malaysia web: Annual Report of Telekom Malaysia for the Financial Year End 2006

## **II. Literature Review**

The effectiveness of an audit committee is further enhanced if members of audit committees possess accounting and financial expertise. Audit committee member's financial expertise allows better understanding of auditing issues and hazards, and the audit procedures proposed to address and observe these issues and risks (DeZoort and Salterio, 2001). The audit committee composition, literature involving member expertise developed initially with a number of studies and archival studies (e.g., Beasley and Salterio, 2001; DeZoort, 1997; GAO, 1991; Kalbers, 1992a, 1992b; Lee and Stone, 1997). The comparatively large number of subjects in this area indicates the heart of audit committee member expertise as an indispensable element of Audit Committee Effectiveness. The effects also indicate large deviation in expertise within and among audit committees, and that many members don't receive adequate experience and expertise in pertinent oversight areas. Bull and Sharp (1989) stressed the importance of financial knowledge of the audit commission. Knowledgeable audit committee members are in a better place to understand auditor judgments and discern the substance of disagreements between management and outside auditors. Furthermore, it will improve audit committee role in identifying and demanding questions that 'make management think harder and auditors dig deeper' (Levitt, 2000). Additionally, Knapp (1987) argues that if the audit committee does not have the knowledge necessary to understand technical auditing and financial reporting matters, its oversight role is likely to be ignored by the auditor and management. This would undermine the purpose of the audit committee in the financial reporting process. The Bursa Malaysia listing requirement stipulates, among others, that at least a member of the audit committee must have relevant skills, experience and qualified knowledge, such as being a member of the Malaysian Institute of Accountants (Rashidah, et al., 2006). Hence, an audit committee that has knowledge and accomplishments in fiscal coverage is more likely to raise the audit committee roles.

### **2.1 Problem Statement**

Financial reporting improprieties and business failures in companies such as the Enron in UK, Megan Media and Transmiles in Malaysia have brought audit committees of corporate boards of directors under increased enquiry. Enron has become an embodiment for "corporate recklessness. Therefore it creates a need for good corporate governance. Another example, Arthur Andersen, one of leading accounting firms, was closed down as a result of the scandal for be deficient in independence and conspiring to hide information from regulators.

These corporate misconducts have caused users to query, "where was the audit committee?" The rampant coverage by the media of these actions has gained the attention of the stock exchanges, regulatory bodies and the accounting profession worldwide. An audit committee is created by a company's board of directors and plays a crucial role in the corporate governance process, a process that is the cornerstone of shareholder protection. Levitt (2000) affirmed that, "...qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest". The need to address current and emerging issues is a fundamental requirement for effective management because the issues can have a direct or indirect impact on a company's control environment, financial reporting, and the audit process. Assessing how the organization responds to the challenge is at the core of an audit committee's responsibility. The existence of an audit committee could improve the monitoring of corporate financial reporting and internal control. The establishment of audit committee aimed to mitigate corporate fraudulent or creative accounting practices through internal control initiated by independent and effectively functioning non-executive members of audit committee. An effectively functioning audit committee helps to improve corporate governance practice of firms (Zulkarnain, et al., 2006).

The attributes of an effective audit committee Audit committee which has been defined differently in academic and professional literatures and in general it relates to the members and the expected functions of the committee. According to Collier (1997), most definitions include the following characteristics: (1) it is a subcommittee of the main board (Porter et al., 2003; Turpin and DeZoort, 1998); (2) it is comprised of a majority of nonexecutive directors (Abbott et al., 2003; BRC, 1999); (3) it plays a role in the review of financial reporting process, communicates with the auditors, and reviews internal controls (FCCG, 1999; NACD, 2000; Walker, 2004). Indeed, the objective of having an audit committee is to increase public confidence in the credibility and objectivity of published financial information, assist directors to meet responsibilities regarding financial reporting and strengthen the independence of external auditors through the ability to communicate to non-operational directors (Venables and Impey, 1988).

## 2.2 Research Objective

This work points to explore the following research objectives related to the Malaysian GLC as below:

- i. To investigate the performance of audit committee function on Malaysian GLC;
- ii. To investigate whether the execution of audit committee function varies across the types of company; listed and non-listed;
- iii. To explore whether audit committee functions are linked up with the financial literacy of Audit Committee directors.

## 2.3 Research Questions

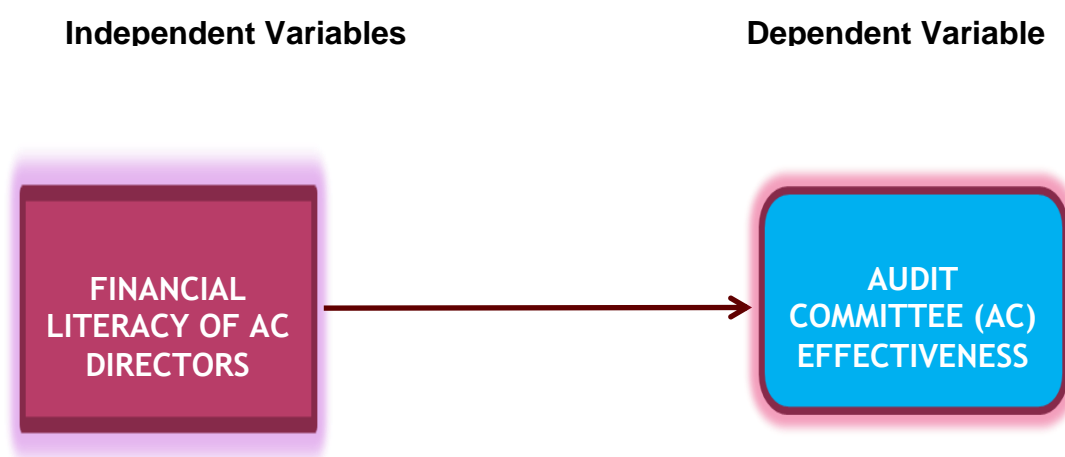
The current study explores and investigates the following research questions:-

**RQ1:** What is the frequency of performance of audit committee function Malaysian GLC?

**RQ2:** Does the performance of the role of the Audit Committee of Malaysia GLC varies across the types of society (listed and non-listed)?

**RQ3:** Is there any substantial correlation between Audit Committee Function and Financial literacy of board directors?

## 2.4 Conceptual Framework



The Sarbanes-Oxley Act of 2002 specifies the audit committee as “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the function of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer. “An effective audit committee has qualified members with the dominance and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts.(DeZoort *et al.*, 2002).Spira L.F. (1999) in her study reported that evidence of roles for the audit committee which may explain their popularity in large public companies in the UK that they are effective in improving financial reporting quality and standards of corporate governance.

## 2.5 Hypotheses Development

Therefore, the research questions RQ1 are to address the frequency of AC functions of Malaysia GLC.The aim of this hypothesis is to collect baseline data regarding the current state of AC functions in the Malaysian GLC.

The second supposition is to address whether the frequency of AC functions of Malaysia GLC varies across the types of company.The aim of this theory is to place different types of company (listed and not listed) perform differently in the AC offices.

### **Research Question 1: Performance of AC functions in Malaysian GLC**

The first research question is to address the frequency of AC functions of Malaysia GLC. The purpose of this hypothesis is to gather baseline information regarding the current state of AC functions in the Malaysian GLC.

H<sub>2</sub>alternative: The performance of AC functions in the Malaysian GLC’s is performed differently by public listed and not public listed company (RQ2).The second hypothesis is to address whether the frequency of

AC functions of Malaysia GLC varies across the types of company. The purpose of this hypothesis is to identify different types of company (listed and not listed) perform differently in the AC functions.

Hypothesis 3: Relationship between AC Function and Financial Literacy of AC Directors

The third hypothesis is to test whether the audit committee directors that has knowledge and skills in financial reporting is more likely to enhance the audit committee function. Therefore the prediction of this study is as follow:

H<sub>3</sub> null: The Audit Committee function is not associated with the financial literacy of AC directors

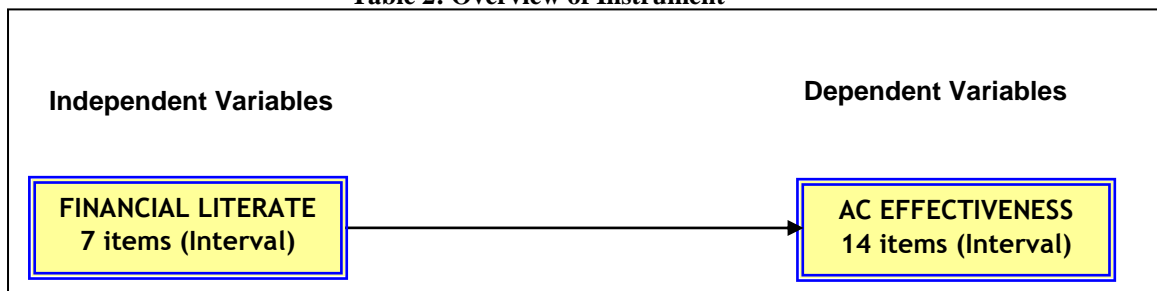
H<sub>3</sub> alternative: The Audit Committee function is associated with the financial literacy of AC directors

### III. Methodology

The data were collected through mail self-administered questionnaires. Answerer of the questionnaires is limited to either the Chief Executive Officer, Head Of Internal Auditor Company Secretary of the Government Linked Companies. A selection of these positions was based on their high and direct involvement with of Audit Committee activities. The random sampling technique was employed in the selection procedure. A list of Government Linked Companies was available from the Malaysian Treasury homepage and as at 31 December 2007, a total of 186 companies were listed along the network. On the ground of every second company on the list, one company to be picked, the selection process was continued and stopped after a total of 55 companies were on the samples' list. A response rate of 29.57% was achieved. The highest response rate was due to the medium utilized to mail the questionnaires to the respective respondent. All the questionnaires were sent through Jabatan Audit Negara, an organization who is responsible in auditing all the GLCs. Thus the respondent obliged to respond and render at the true scene of its Audit Committee because the GLCs are subject to audit at any time by Jabatan Audit Negara. The development of the questions and scales of the questionnaires pertaining to each individual variables in this study was done through replication of several related past research. Items under Audit Committee Function had been swept up from the work of Zulkarnain, et al., (2006). As provided in the questionnaires, for every item of variables or dimensions in this study, respondents were required to answer the questions based on a five-point Likert-scale (where 1 totally disagrees, to 5 which are totally agreed).

Table 2 and Table 3 illustrate the overview of instruments and instrumentation in this study which include the number of items and the respective type of data collected.

**Table 2: Overview of Instrument**



**Table 3  
Summary of Data Analysis Technique**

No	Investigations	Level of Measurement	Type of statistical test
RQ1	Frequency of AC function perform in Malaysian GLC's Audit Committee Sector Auditor	Interval	Descriptive Statistic: Mean
RQ2	AC function perform in Malaysian GLC's Audit Committee varies across the types of company (Differences between the listed and not listed company)	Interval (IT Control) and Norminal (Types of Organisation)	Test: t-Test – Two Group
RQ3	Correlation between AC Function and Financial Literacy of AC Directors	Interval	Test: Pearson's Correlation

Before the data analysis was done, the data screening process was done to explore the characteristics of the data (Coakes & Steed, 2003) in order to answer questions such as the accuracy of data, omitting data, the shape of the missing information, extreme responses, and manages the information fit the statistical assumptions. In data screening, the researcher evaluates the normality, linearity and homoscedasticity of the information as well as the recognition of multivariate outliers. As such this study takes on all the following test is satisfied and fit the statistical assumptions.

- i. Normality Test** - The data has a normal distribution of data. The shape of the distribution of values roughly approximates a bell-shape curve.
- ii. Linearity Test** – The variables in the analysis assume to be related to each other in a linear fashion
- iii. Homoscedasticity of data** - The quantitative dependent variables assume to have equal levels of variability across a chain of (either continuous or categorical) independent variables.
- iv. Mahalanobis Distance Value** – The data set assume not to have outliers

#### IV. Results

**Table 4: Frequency of Audit Committee Function by Malaysian (N=55)**

AC Funtion	Description	Mean	Standard Deviation
AC_Eff_1i	Monitoring on corrections by management of reported deficiencies in management letter	4.2727	0.5168
AC_Eff_1j	Review, analyze on adequacy on internal acct. and financial control	4.2364	0.4846
AC_Eff_1d	Review of financial statement and interim reports	4.1455	0.4417
AC_Eff_1h	Review, analyze results of annual audit by auditor	4.1455	0.7230
AC_Eff_1e	Selection of independent auditor	4.1091	0.7650
AC_Eff_1f	Evaluationof independent auditor's performance	4.0545	0.7500
AC_Eff_1g	Review, analyze scope and activities of annual audit by auditor	4.0545	0.6840
AC_Eff_1b	Review, analyze significant changes in acct. policies	4.0182	0.5556
AC_Eff_1c	Review, analyze acct estimates and judgement	3.9818	0.5556
AC_Eff_1a	Review, analyze GAAS	3.9636	0.6075

Table 4 shows that the three most significant parts of an audit committee, as graded by the bulk of respondents are to Monitoring on corrections by management of reported deficiencies in the management letter (Mean = 4.27), Review, analyze on the sufficiency of internal account and financial control (Mean = 4.23) and Review, analyze of financial statement and interim reports (Mean = 4.15). However, the majority of respondents also believed that the Review, analyze GAAS (Mean = 3.96) and Review, analyze acct estimates and judgment (Mean = 3.98); Review, analyze significant changes in accounting policies (4.02) were the three least important audit committee function in order to enhance the AC effectiveness. From the results, the most of the AC functions were done effectively (mean = 4 which indicate on the Likert scale 4 = Effective).

The results indicating that major of the AC of Malaysian GLC are performing, its AC functions effectively and necessary action needs to be assumed by the government this current performance of AC function is uniform and can be amended in future.

**TABLE 5: Mean & Standard Deviation**

AC Function	Company Status	n	Mean	Std. Deviation
	Public Listed	22	4.15	0.304
	Non Listed	33	4.06	0.466

Calculating  $t_{cal}$  using this formula:

$$t_{cal} = \frac{\bar{x}_1 - \bar{x}_2}{\sqrt{\left(\frac{s_1^2(n_1-1) + s_2^2(n_2-1)}{n_1+n_2-2}\right) \left(\frac{1}{n_1} + \frac{1}{n_2}\right)}}$$

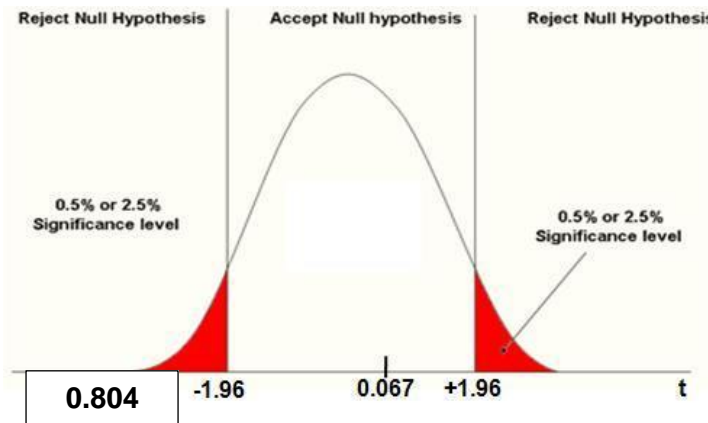
$$t_{cal} = \frac{4.55 - 4.06}{\sqrt{\left(\frac{0.304^2(22-1) + 0.466^2(33-1)}{22+33-2}\right) \left(\frac{1}{22} + \frac{1}{33}\right)}} = 0.804$$

Whereby:

$x$  = sample size      subscript<sub>1</sub> = sample 1 (listed)  
 $s^2$  = variance        subscript<sub>2</sub> = sample 2 (not listed)

Calculating  $t_{critical}$  formula:

$t_{critical, \alpha=0.05, df=22+33-2=53} = p\text{-value} = \pm 1.96$



At the confident level of 95%,  $t_{cal}(0.804) < t_{critical} (1.96)$ , therefore, fail to reject  $H_2$  null. The result explains the functions of Malaysian GLC's Audit Committee are not performed differently by listed and not listed company.

The outcome indicates that the operation of the AC function in listed and non-listed company gives same importance and performed equally among the cases of fellowships. It may due to the requirement of KLSE which require every public listed company need to constitute the audit commission and act as an effective purpose. On the other hand not listed companies are likewise commanded to comply the government circular to establish the Audit Committee. With this demand, the results show that both listed and non-listed companies are complying with rules and rules.

The formula for the Pearson product moment correlation coefficient,  $r$ , is:

$$r = \frac{\sum (x - \bar{x})(y - \bar{y})}{\sqrt{\sum (x - \bar{x})^2 \sum (y - \bar{y})^2}} = 0.53$$

where  $x$  and  $y$  are the sample means AVERAGE (array1) and AVERAGE(array2).

Based on from the excel output as per Appendix 3, the pearson correlation is  $r = 0.53$ . The result indicates that AC function is moderately and positively related to Financial Literacy of AC director.

Calculating t-test for significance of  $r$ :

$H_0: \rho = 0$ : There is no correlation between the AC function and the financial literacy of AC directors

$H_a: \rho \neq 0$ : There is correlation between the AC function and the financial literacy of AC directors

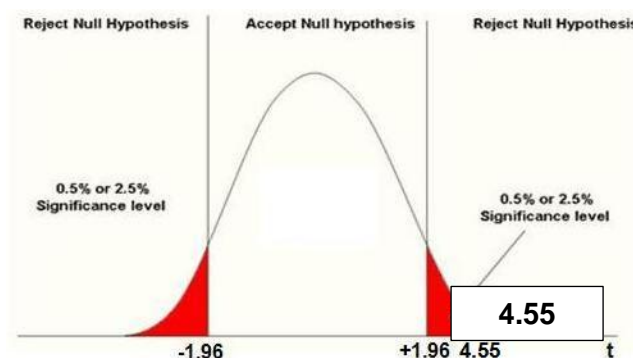
$$t_{cal} = r \sqrt{\frac{n-2}{1-r^2}}$$

$$t_{cal} = 0.53 \sqrt{\frac{55-2}{1-0.53^2}} = 4.55$$

Whereby,

$n$  = sample size;  $r$  = coefficient correlation = 0.53;  $df = n-2 = 55-2 = 53$

The third hypothesis is tested where the coefficient of correlation,  $r = 0.53$ . This denotes that the correlation between the financial literacy of the Audit Committee and the Audit Committee function is moderate. Next, the  $t$  value obtained ( $t_{cal}$ ) = 4.55.



**At the significant level of 95% where  $\alpha/2 = 0.025$ ,  $t_{crit} = \pm 1.96$  while the  $t_{cal} = 4.55$  ( $t_{cal} > t_{crit}$ ), therefore we reject  $H_3$  null. Thus, we can conclude that financial literacy of the Audit Committee directors is moderately and positively significantly associated with the of the AC function.**

The result shows that the AC function is associated with the financial literacy of audit committee directors. As such government must ensure that audit committee of Malaysian GLC's should include directors who are financial literate in order to assure the Audit Committee can perform it function effectively.

## V. Conclusion and Recommendation

Based on the analysis, it shows that monitoring on corrections by management of reported deficiencies in management letter is the most important roles of an audit committee. It also concludes that the functions of Malaysian GLC's Audit Committee are not performed differently by listed and not listed company. Lastly on the relationship shows that financial literacy of the Audit Committee is associated with the Audit Committee (AC) function.

It is recommend that government to monitor the audit committee functions are performed effectively by both listed and not listed Malaysian GLC and to assure that the directors of Audit Committee are financial literate to ensure the effectiveness of Audit Committee function.

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