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AUDIT COMMITTEE ATTRIBUTES AND FINANCIAL DISTRESS: A CASE OF MALAYSIAN PN17 COMPANIES

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Abstract

Companies that have a good financial health have opportunities to attract the investor to invest into the companies. Audit committee of the company have crucial responsibilities in monitoring the company's operations and internal control or act as an early detector of financial distress. Moreover, company that involved in financial distress tend to commit fraud and could lead to bankruptcy. The aim of this study is to investigate between the attributes of the audit committee (audit committee financial literacy and audit committee meeting) with the financial distress companies. The sample was selected from Bursa Malaysia, listed under Practice Note 17 (PN17), which consists of 18 companies in December 2017. The annual reports and financial statements were analysed and the company's financial health is measured by using Altman Z-Score. The results show that there is no significant relationship between audit committee financial literacy and audit committee meeting with financial distress. Hence, this study found that the attributes of the audit committee did not provide as an early detection of the financial distress.

Keywords: Financial distress firms, audit committee, audit committee literacy, audit committee meeting, PN17.

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1. Introduction

Over the past decade, numerous publicized company scandals such as Xerox and Banco Espírito Santo have caught the attention of regulators towards the need of corporate governance enhancement. Sarbanes-Oxley Act (SOX) of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 has been established to enhance the importance of audit committee's responsibility (Huang & Thiruvadi, 2010). SOX increased the requirements in terms of audit committee membership and composition. The Blue-Ribbon Commission's (BRC) recommendations were also included to the act in order to increase the operational efficiency, effectiveness and independence of the audit committee (Huang & Thiruvadi, 2010).

Audit committee plays an important role in monitoring the company's operation and internal control system in respect to protect the interest of shareholders (Rahmat et al., 2009). According to Huang & Thiruvadi (2010), the examination of audit committee characteristics and their influences on corporate governance is one of relevant importance to the current regulators, legislator and public investors. Meanwhile in Malaysia, the formation of an audit committee had been made mandatory for all companies listed in Bursa Malaysia in 1994 (Rahmat et al., 2009).

The rapid development of the capital market and the integration of the global economy have increased the number of companies that suffer from financial distress over the years (Geng et al., 2015). Financial distress firm is more likely to commit fraud, (Sawal, 2013). To reduce financial distress, a company must have a competent audit committee (McMullen & Raghunandan, 1996; Rahmat et al., 2009). In Malaysia, a listed company that is financially distressed or does not have core business, or has failed to meet minimum capital or equity and companies' shareholder' funds, will be classified as PN17 Company (Ali, 2012). Consequently, PN17 Company will be removed from the official list of Bursa Securities if they cannot comply with some requirement needed.

2. Problem Statement

Lack of monitoring over the management activity may resulted to the company financial distress and bankruptcy (Salloum et al., 2014). The shareholder needs to implement a sufficient control to the management of the company. Audit committee could help the shareholder to ensure the management conduct the business in a good manner, without affecting the shareholder's interest. Another issue is lack of competency among audit committee members which also contributes to the firm's financial distress (Norziaton & Hafizah 2019; Sharon, 2009). An effective audit committee would focus on improving the company performance and competitiveness, specifically in a changing business environment which is beyond the control of the company (Charan, 1998; Craven & Wallace, 2001; Rahmat et al., 2009). Audit committee attributes should be analysed thoroughly to enhance its effectiveness.

3. Research Questions

There are two research questions for this study; (a) does the audit committee financial literacy influence the detection of early financial distress in Malaysian company?, (b) does the audit committee meeting influence the detection of early financial distress in Malaysian company?

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4. Purpose of the Study

This study research objectives are; (a) to determine the relationship between audit committee financial literacy in detecting early financial distress in Malaysian company, (b) to determine the relationship between audit committee meeting in detecting early financial distress in Malaysian company.

4.1. Literature Review

4.1.1. Financial Distress

Financial distress is the situation when a company cannot meet or face difficulty to pay off its financial obligations to the creditors (Khaliq et al., 2014). The company's failure to overcome financial distress indicate the company's poor corporate governance (Siswanto & Fuad, 2017). Financial distress in companies could result to problems that can reduce the efficiency of management (Bhunia et al., 2011). Malaysian Stock Exchange issued Practice Note 17/2005 (PN17) in which it relates to companies that are in financial distress (Ali, 2012). Companies that fall within the definition of PN17 will need to submit their proposal to the Approving Authority to restructure and revive their company in order to maintain the listing status in Malaysian Stock Exchange (Ali, 2012).

4.1.2. Audit Committee

Audit committee is a part of board committee in the company that have special task which act as advisory group, audit committee members were elected by board of director in each general meeting. It established during 1994, it is because the board having problems with limited time in solving varies complexity of information. As mentioned by Rashidah (2011), the idea of establishing the committee as the ways out to reduce the workload among the board members. Thus, they can focus more in their related field by develop their own depth understanding on particular task (Rashidah, 2011). Undoubtedly, the audit committee hold a crucial responsible to ensure the effectiveness of the company. Thus, they also have authority over the auditor or management to disclose to the board if any intentionally or unintentionally misconduct is carried out in the companies. Khairul et al. (2014) also mentioned, the audit committee plays an important role in monitoring and overseeing the financial matters of a company. They also claimed that, any effort made or steps taken by management to engage in manipulation or misappropriation of assets should be detected and stop by the audit committee. According to Huang and Thiruvadi (2010), the role of audit committee has become more pronounced by Securities & Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB) and Blue-Ribbon commission (BRC) due to the various economic events that has shaken the stability of the financial markets & investor's confidence. Audit committee's responsibilities also to ensure the integrity of financial reporting is true and fair view. Hence, ensuring preparation of financial report is comply with all reporting requirement and accounting standard.

4.2. Hypothesis Development

4.2.1. Financial Literacy of Audit Committee

Previous study by Salloum et al. (2014) finds that there is no significant relationship between financial literacy of audit committee and financial distress. However, the combination of education and experience of an audit committee has positive relationship with market performance of a company (Aldamen et al., 2012). Meanwhile, previous study by Rahmat et al. (2009) finds that financial literacy has a negative and significant relationship with financial literacy. Audit committee members with enough knowledge of accounting and finance are able to monitor and review more effectively the operational and financial reporting of the company (Rahmat et al., 2009). Thus, based on the previous results, the hypothesis of this study will be as follows:

H_1: There is a significant relationship between financial literacy of audit committee and financial distress

4.2.2. Meeting of Audit Committee

Number of audit committee's meeting is how many meetings did the company's audit committee held in a year. Besides, there is most likely that when the meeting of audit committees being held frequently at minimum twice a year it helps to increase the efficiency and effectiveness in performance of the company (Khairul et al., 2014; Song & Windram, 2004). According to Siswanto and Fuad (2017) research, it shows that frequency of meeting is not impact in deterring company financial distress. However, according to Salloum et al. (2014), frequency of meeting being held are able to improve performance. Thus, the third hypothesis based on the previous studies:

H_2: There is a significant relationship between the numbers of audit committee meetings and financial distress.

5. Research Methods

Data collection is based on the sample comprises of 18 companies from Practice Note 17 companies (PN17) which are delisted by Bursa Malaysia. For this research, the data collection is collected by using the secondary data. The company data is collected from the annual report on Bursa Malaysia website.

5.1. Measurement of Variables

Financial Distress (FD) is evaluated by using Altman Z-score to indicate whether the company suffers from financial distress, in the grey area or non-financial distress (Demirkan & Platt, 2009). The linear equation is as follows: Z=0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5. Where X1 is working capital/ Total assets; X2 is retained earnings/ Total assets; X3 is earning before interest and taxes/ Total asset; X4 is market value of equity/ Total liabilities; X5 is sales/Total assets; Z is overall index (Demirkan & Platt, 2009). The lower of a company Z-score of the financial year, it indicates that they have financially problems. For example, the result for total Z-score of the Company A is 1.72 it indicates as financial distress, Company B is 2.19 concluded as in grey area and Company C become non-financial distress when its Z-score 3.16. On the other hand, the Financial Literacy of Audit Committee (ACLITERACY) is measured by calculate the number of AC with accounting and finance knowledge that have position in the audit committee and the Meeting of Audit Committee (ACMEET) measured by the frequency meeting that audit committee held for the financial years.

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6. Findings

6.1. Descriptive Analysis

Table 01. Descriptive Statistic Analysis (Year 2016)

Descriptive Analysis					
	N	**Min**	**Max**	**Mean**	**Std. Dev**
ACLITERACY16	18	1	4	2.11	.963
ACMEET16	18	4	15	6.17	2.662
FD16	18	.017711	1.125156	.54617084	.357560488
Valid N (listwise)	18				

Notes: ACLITERACY is financial literacy of Audit Committee; ACMEET is meeting of Audit Committee; FD is financial distress firms.

Table 02. Descriptive Statistic Analysis (Year 2017)

Descriptive Analysis					
	N	**Min**	**Max**	**Mean**	**Std. Dev**
ACLITERACY16	18	0	4	2.00	1.029
ACMEET16	18	4	12	6.00	1.879
FD16	18	-20.467226	1.212341	-.72378310	4.940344808
Valid N (listwise)	18				

Notes: ACLITERACY is financial literacy of Audit Committee; ACMEET is meeting of Audit Committee; FD is financial distress firms.

The descriptive statistics for the variables of this study is presented in Table 1 which analyse for year 2016, Table 2 for the year 2017. The tables show the minimum, maximum, mean, standard deviation and z-score for each year

Table 1 presented for the year 2016, there is a constant value of minimum, maximum and average of ACLITERACY from year 2016. As for ACMEET the minimum value is constant as in year 2016 while the maximum and average value had change. The value of maximum meeting held had increase to 15 and the mean value change to 6 meetings. Minimum of z-score 0.017711, maximum value is 1.125156 and the average value is 0.54617084. All the value is shown that all the companies in PN17 are financially distress.

Table 2 presented the audit characteristic for the year 2017, minimum value of ACLITERACY had decreased to 0 member and the maximum value is constant of 4 members and the mean value is 2 members. For ACMEET in 2017, the minimum value is constant and the maximum value is 12 meetings. Mean value of ACMEET is 6 times. Minimum value of z-score 2017 is -20.467226 while the maximum value is 1.212341 and the mean value is -0.72378310. All of the z-score value in 2017 is financially distressed.

6.2. Correlation Analysis

Table 03. Correlation Analysis

	2016		**2017**	
Ind. Variable	Correlation Coefficient	Sig. (2-tailed)	Correlation Coefficient	Sig. (2-tailed)
ACLITERACY	.236	.347	-.003	.990
ACMEET	.316	.201	.140	.579

**Correlation is significant at the level of 0.05 (2-tailed)*
Notes: ACLITERACY is financial literacy of Audit Committee; ACMEET is meeting of Audit Committee.

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Based on results of correlation from the data collected (table 03), the relationship between audit committee literacy and financial distress from year 2016 to 2017 are also positive and not significant as the p value is more than 0.05. The value generated are 0.347 and 0.99 for the year 2016 and 2017 in order. Lastly, the relationship between audit committee meeting and financial distress are also not significant as the p value are more than 0.05 as the value are 0.201 and 0.579 for each year of 2016 and 2017.

6.2.1. Hypothesis Testing

Hypothesis testing is an essential part in statistics. A hypothesis test evaluates two mutually exclusive statements about a population to determine which statement is best supported by the sample data (Ogee et al., 2015). This study found that there is no significant relationship between audit committee literacy and financial distress for the year 2016 and 2017. This result is supported with previous study by Salloum et al. (2014) whereby there is no significant relationship between audit committee literacy and financial distress. The education background or experience possess by the audit committee members could not guarantee the company's financial stability. Hence, the hypothesis H_1, is not supported.

This study finds that there is no relationship between audit committee meeting and financial distress for the year of 2016 and 2017. This result is consistent with the past study done by Rahmat et al. (2009). This also means that the frequency of audit committee meeting is not affecting the financial condition of a company. From the data collected, audit committee of the PN17 companies are following the regulations or practiced set by MCCG in which the audit committee meetings are handled at least 4 times or more per year, yet the 18 companies are still included in PN17 list throughout the years and failed to improve their financial condition. Thus, H_2 is not supported.

7. Conclusion

This study involves the financial literacy of audit committee and the meeting of audit committee as the independent variables. Meanwhile the financial distress company is used as the dependent variable whereby the PN17 companies are chosen as the sample. Hence, the objective of this study is to determine the relationship between audit committee attributes in detecting early financial distress in Malaysian company. Generally, audit committee plays important role in a corporate governance as they need to oversee the financial reporting process (MCCG, 2017).

The results generated from this study found that there is no relationship between audit committee financial literacy and audit committee meeting with financial distress. Hence, the hypothesis developed are not supported. It also could be concluded the audit committee financial literacy and audit committee meeting do not influence the financial condition of the companies. Also, the attributes of audit committee as mentioned could not assist in detecting the financial distress that occurred. The results are consistent with past researches such as Rahmat et al. (2009) in which there is no significant relationship between the meeting of audit committee and financial distress. Meanwhile, Salloum et al. (2014) also found that there is no significant relationship between the financial literacy of audit committee and financial distress. Therefore, the objectives of this study are accomplished.

This study also would contribute to the academic institution, by enhancing the existing study from past research. Hence, it is could help the company to improve the audit committee by focusing on other

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attributes. Thus, early detection of financial distressed that faced by the company could be done. Furthermore, this study will contribute to the regulatory such as Malaysian accountant Standard Board (MASB) or Bursa Malaysia, in order to decide whether to strengthen the rules and regulations or make some amendments on the existing regulations. It is to ensure that the practitioners or professional bodies will conduct their duties and responsibilities by referring to the guidelines and requirements developed by the regulator. In addition, this study also crucial to the organisation and company in Malaysia and the most concerned are PN17 companies. It might help them to improve or strengthen the corporate governance and prepared the financial reporting by following the accounting standard, at the same time they will be more motivated to ensure they are qualified to re-enter the Main Market by following the Main Market Requirement list.

7.1. Limitation and Recommendation

There are a few limitations occurred during the research to achieve the objectives of this study. One of the limitations is the research done does not include the public listed companies in Malaysia. Moreover, the small size of samples used might also affecting the result.

There are few recommendations that can be concluded based on this research. Future research could use both PN17 and non-PN17 companies for comparison by using audit committee attributes and financial distress as the variables. More variables should be considered. For example, the ethnicity and culture of the audit committee and also the audit committee independency. However, the limitation mentioned above will not invalidate the findings of the study.

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