AUDIT COMMITTEE AND THE SELECTION OF EXTERNAL AUDITORS: THE MALAYSIAN EVIDENCE

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Abstract

The role of audit committee in corporate governance includes monitoring the system of corporate financial reporting, the process of internal control and internal audit, and the appointment of external auditors. Past studies examine the relationship between the selection of external auditors with audit committee variables, which include the activeness, independence, financial literacy of members and their director position in other companies. However, This study examines the relationships between these variables and interactions of some of the variables with the effectiveness in terms of selecting good auditors. Based on logistic regression, the study finds that independence and activeness respectively are significantly related to the selection for industry specialist external auditors. Financial literacy of members of audit committee is found to be unrelated to the selection of external auditor. However, the study finds that the interaction between independence of audit committee and frequency of meeting has negative significant relationship with the selection of industry specialist auditors.
INTRODUCTION

The incidence of corporate scandal in large companies, particularly in the US and UK involving losses of millions of dollar (Brariott 1994), have made audit committee an imperative part of the mechanism of corporate governance of listed companies. In the US for example, the Securities Exchange Commission (SEC) has proposed that audit committee be responsible for the selection of external auditors (Brariott 1994). An audit committee has become an important link between external auditors and internal auditors particularly with respect to the review of the effectiveness of internal controls.

In Malaysia, the formation of audit committee has been enforced by the Central Bank of Malaysia on all financial institution in 1985 following the collapse of Bumiputra Kewangan Malaysia (BMF) in Hong Kong in 1984 causing a loss of RM115 million (Abdullah & Al-Murisi 1997). In August 1993, the setting up of audit committee becomes mandatory for all companies listed on the Bursa Malaysia (BM). Similarly, the earlier scandal involving Pan Electric Group in Singapore in 1985, has also made the formation of audit committee mandatory in that country (Samsudin & Al-Murisi 1996).

It may be argued that the failure of external auditors in carrying out their entrusted roles has, to some extent, contributed to the above-mentioned business problems. This may be due to the lack of competency and expertise or the absence of independence. The enforcement by regulatory bodies, such as SEC in the US and Security Commission (SC) in Malaysia, for audit committees to monitor the selection of appropriate external auditors has received supports from various parties. The monitoring role of audit committee on the selection of external auditors is, therefore, expected to improve the quality of external audit and minimise the probability of misappropriation or misconduct by the management. The question remains as to what extent has the audit committee been effective in meeting the responsibility of selecting competent external auditors with an appropriate specialisation. This in turn will improve the economic decision-making and the allocation of economic resources as a whole.

This study, therefore, examines whether audit committee has any influence on the selection of external auditors in an attempt to provide evidence of the role of audit committee in strengthening the corporate governance of companies. Specifically, this study examines the relationships between the characteristics of audit committee and the selections of external auditors. The characteristics include independence, activeness, and financial literacy of audit committee members. This study extends the Abbot and Parker (2000) study including financial literacy of audit committee as an additional characteristics which is expected to have a relationship with the selection of external auditors. Abbot and Parker (2000) investigate the relationship between the selection of external auditor and only two of audit committee characteristics, i.e. independence and activeness. Since the financial literacy is an important element of audit committee effectiveness (Kalbers et al. 1993; DeZoort 1998; Abdulrah & Al-Murisi 1997; Razman & Iskandar 2002), it is expected that this study will provide a better reflection of the work of audit committee. In addition, this study is using the data from KLSE listed companies to see whether the results of the Abbott and Parker (2000) study in the US can be generalized to the Malaysian economic and regulatory environments.
AUDIT COMMITTEE AND THE SELECTION OF EXTERNAL AUDITORS

The existence of audit committee strengthens the role of directors (CICA 1981) and improves the quality of corporate reporting (Razman & Iskandar 2002). Audit committee is an important element in corporate governance as it plays a critical role in the framework of corporate accountability. The responsibility of audit committee covers the supervisory and monitoring of the system of corporate financial reporting, process of internal and external auditing (Braiotta 1994). With regard to the external audit, one of the main functions of audit committee is to propose the appointment of external auditors, determination of audit fee, and overseeing the conduct of external audit (Ali 1990; SC 1998). The involvement of audit committee in the selection of external auditors is expected to enhance the quality of audit services (Apostolou & Jeffords 1990). The selection of competent auditors helps produce good financial reporting and hence, enhance the image of the company. As indicated by NYSE (1999) high quality audit will provide an assurance for a detection of fraud, an identification of financial risks, and enhancement of accurate, reliable and timely financial information.

Researchers in the past have used auditors' specialisation in industry to measure the quality of audit (e.g. Schroeder et al 1986). Auditors who specialise in the industry are able to provide audit services more effectively (William 1988). William (1988) finds that companies tend to change auditors from those with no industry specialisation to those with industry specialisation. Hence, the selection of auditor who can provide high quality audit is aimed at meeting the demand for agency and information needs (Jensen & Meckling 1976). It is evident that audit committees give emphasis on expertise, experience, skill, proper planning and communication as important factors in determining the quality of audit. Big audit firms with these characteristics or better known as industry specialists are in the position to provide high quality audit (Hogan & Jeter 1999; DeFond et al 2000). Audit committees are of the view that audit expertise is an important factor in determining the quality of audit (Schroeder et al 1986; Carcello et al. 1992), thus, it is expected to have an influence on its selection of external auditors.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Earlier studies in this area examine the relationship between the existence of audit committee and the selection of external auditors (e.g. Kunitake 1981; Eichenseher & Shields 1986; Cottell & Rankin 1988). For all companies, the existence of audit committee has resulted in an increase of the selection of Big 8 audit firms (Kunitake 1981). However, no significant difference is found between companies in the selection of Big 8 firms. Nevertheless, Eichenseher & Shields (1986) find that companies that have audit committees and audited by non-Big 8 firms tend to select Big 8 firms as their auditors. On the other hand, companies that do not have audit committees tend to select non-Big 8 audit firms. These findings suggest that the existence of audit committee has an influence on the company’s choice for Big 8 audit firms. Other factors such as company size, leverage, and industry regulation are also found to have an influence on the selection of auditors. The tendency for a company that has an audit committee to change their external auditors to Big 8 audit firms is also found in the Cottell & Rankin (1988) study.

The other different measures include auditors' expertise and audit group experience with clients (Schroeder et al 1986; Carcello et al. 1992), meeting the requirement of clients and compliance with auditing standards (Schroeder et al 1986), size of audit firms and period of establishment (Knapp 1991), and brand name of audit firm (Firth & Smith 1992).
Past studies have demonstrated consistent results on the relationship between the existence of audit committee and the choice for Big 8 audit firms. However, the studies do not distinguish between Big 8 audit firms in terms of their expertise, i.e. industry specialisation. Hence, it is not clear whether the selection of external auditors by the audit committee is towards audit specialists or not. The classification of audit firms according to their industry specialisation is important because as audit firms with industry specialisation provide better quality service (Craswell et al. 1995). Hence, this study provides further research in this area by classifying Big 5 audit firms into the industry specialist Big 5 and the non-industry specialist Big 5.

Characteristics of Audit Committee

Past studies show a number of audit committee characteristics that contribute towards its effectiveness in carrying out the monitoring role. These characteristics include independence (e.g. Vicknair, Hickman & Carnes 1993; McMullen & Raghunandan 1996; Carcello & Neal 2000), activeness (e.g. Menon & Williams 1994; McMullen & Raghunandan 1996; Song & Windram 2000), and financial literacy (e.g. Kalbers 1998; Collier 1993; McMullen & Raghunandan 1996; DeZoort 1998; Razman & Iskandar 2002). The studies suggest that these characteristics are important to audit committee in monitoring the company effectively.

Independence of Audit Committee

In past studies, independence of audit committee is determined based on the proportion of the membership of independent non-executive directors in the committee. McMullen & Raghunandan (1996) find that companies that do not have independent non-executive director members in the audit committee are faced with financial reporting problems. While companies that have external director members in the audit committee, manage to avoid manipulation of earnings. Companies with a high composition of non-independent director members in the audit committee have the tendency to receive going concern audit opinion as a result of financial pressure (Carcello & Neal 2000). Vicknair et al. (1993) suggest that non-independent director members in the audit committee are the source of less independence of audit committee. It can be concluded that independence of audit committee is an important element that helps produce a good quality financial reporting.

Independence of audit committee has been given emphasis since the earlier stage of its development in the early 1940s. The SEC for example, requires that members of audit committee be appointed from non-executive directors. An audit committee is expected more effective in protecting the credibility of the company financial reporting if its members are independent from any managerial responsibility (Blue Ribbon Committee 1999). They are required to review the work of external auditor and discuss audit duties with external auditors. In addition, audit committee is responsible for the selection of external auditor. Independence of audit committee is a critical point in monitoring effectively to ensure management duly performs its responsibility to the shareholders (Menon & Williams 1994). There is evidence that the incidence of financial statement fraud is lower when the audit committee becomes active as a result of independence of its members (NYSE 1999).

It is argued, therefore, that directors are able to perform more effectively and objectively if they are free from any personal biases resulting from financial or personnel relationships with the management. Hence, they will be obliged to choose good quality auditor to ensure
proper monitoring of the internal control system, management performance, and financial reporting process of the company. Hence, an effective audit committee should be to exercise its responsibility properly in the appointment of external auditor and in monitoring the accounting function of the company. This is because an independent audit committee member would want to maintain their reputation as the financial monitor through the selection of efficient and supportive external auditor. Therefore, it is argued that an independent audit committee would obtain services from auditors with industry specialisation. The following hypothesis is developed:

H1: The higher the composition of non-executive directors in the audit committee the higher the tendency the company selects industry specialist auditors.

**Activeness of Audit Committee**

The activeness of audit committee is determined by the frequency of meeting (Menon & Williams 1994; Collier & Gregory 1999). The frequency of meeting reflects the seriousness of audit committee in monitoring the work of external auditors and the process of financial reporting (Menon & Williams 1994). Past studies show that the frequency of audit committee meeting is positively related to the company size (Menon & Williams 1994) and level of the company leverage (Collier & Gregory 1994). The audit committee meets more often as there are many issues to discuss. Both Menon and Williams (1994) and Collier and Gregory (1999) studies indicate that active audit committee is positively related to the quality external auditors (i.e. Big 6 audit firms). External director members of audit committee would attempt to protect their personal interest from being exposed to public liabilities, which may be incurred during the term of appointment.

It is evident that the activeness of audit committee is an important factor influencing the selection of quality audit (Collier & Gregory 1999). The choice of high quality audit helps the company reduce financial risk and produce good financial reporting. The collaboration between an active audit committee and industry specialist auditors may be able to detect accounting problems at the early stage. An early remedial action can, therefore, be taken before financial reporting is issued (Pastuszenski & O’Connor 1999). Hence, an active audit committee is argued to be the driving factor to the demand for high quality audit services particularly from the industry specialist auditors to assist the company monitor the process of financial reporting. A close collaboration between both external auditors and audit committees is necessary in the implementation of the monitoring process of financial system and in ensuring high quality financial reports. As a result, legal action against the company for misstatements in the financial statements may be minimised. It is argued, therefore, an active audit committee has higher tendency to select industry specialists as external auditors. Based on the above discussion the following hypothesis is developed.

H2: The more the audit committee is active the higher the tendency the company selects industry specialist auditors.

**Financial Literacy of Audit Committee**

The effectiveness of audit committee is significantly related to their knowledge in financial reporting (Kalbers et al 1993; McMullen & Raghunandan 1996). Good financial reporting
requires monitoring by audit committee members who have high technical skills. Song and Windram (2000) find that knowledge and experience in the area of accounting, auditing, or finance reduce fraud in corporate financial reporting. The knowledge and experience obtained by audit committee members help them gain an in-depth understanding of reporting and, hence, improve their ability to monitor the company management and encourage the compliance of regulatory requirements. As a result, companies are pressured into producing highly reliable and credible financial information.

It is suggested, therefore, that there should be at least one member in the audit committee with the knowledge in accounting (Kalbers et al. 1993). DeZoort (1998) finds that members of audit committee with experience in auditing make similar judgments to external auditors compared to audit committee members with no audit experience. It is argued that audit committee members with accounting and auditing knowledge make consistent judgments, have deeper self-insight and higher consensus in the judgment, and are capable of producing high quality financial reporting. This is in line with Razman and Iskandar (2002) who find that companies with high ratio of accountant in the audit committee produce better quality financial reporting compared to companies with lower ratio of accountant in the committee.

The expertise of audit committee member is needed to enable the company produce good quality financial reporting and would indirectly become the reference point to the other members of the committee and board of directors (Kalbers et al. 1993). Audit committee members who have experience in the evaluation of internal control are found to make similar judgments on monitoring the financial reporting process as that made by the external auditors' (DeZoort 1998). Their technical skills and competencies, as well understanding of the work enable them to make more accurate and consistent judgments compared to the other committee members. These are basic technical skills of the qualified accountants.

Hence, the need to have a qualified accountant as a member audit committee is necessary in order to carry out the responsibility effectively (Abdullah & Al-Murisi 1997). This is particularly true for the purpose of making decisions on the selection of external auditors who can provide high quality of audit services. A member of audit committee with an accounting qualification is expected to select auditors to meet the needs of the company. This is because audit committee members who have financial literacy can understand the work of external auditors better as they themselves have been exposed to similar experience. Hence, they are able to evaluate the quality of auditor that would be suitable for the company. This discussion leads to the following hypothesis.

H3: Companies with at least one accountant member of audit committee has the tendency to select industry specialist auditors.

Interaction between Independence and Activeness of Audit Committee

An active audit committee may be able to improve the effectiveness of audit if the committee comprises non-executive directors (Abbott & Parker 2000). The existence of both audit committee variables provides a strong drive for the company to choose high quality auditors to help the company produce high quality financial reporting. This situation happens because external directors always try to protect their interest from any liability through high commitment when carrying out responsibilities given to them without any personal gains. As a
consequence, the audit committee will able to maintain their performance at a high level. This helps audit committee perform their selection process more cautiously to meet the need of the company. An effective monitoring function of audit committee helps the company achieve its objective of high quality reporting. The following hypothesis is developed.

H4: The interaction of independence of audit committee and its activeness is positively related to the selection of external auditors.

Discussions on the characteristics of audit committee above are summarised in the following logistic regression model for analysis of data (Abbot & Parker 2000).

\[ \text{Aud}_\text{Spec} = \alpha + \beta_1 \text{Independence} + \beta_2 \text{Activeness} + \beta_3 \text{Ind_Active} + \beta_4 \text{FinLiteracy} + \beta_5 \text{Size} + \beta_6 \text{Leverage} + \varepsilon \]

Where:
- \( \text{Aud}_\text{Spec} \) = Industry specialist auditor
- \( \text{Independence} \) = Independence of audit committee
- \( \text{Activeness} \) = Activeness of audit committee
- \( \text{Ind_Active} \) = Interaction of independence and activeness of audit committee
- \( \text{FinLiteracy} \) = Financial literacy of audit committee
- \( \text{Size} \) = Size of company
- \( \text{Leverage} \) = Leverage of company

**METHODOLOGY**

**Sample**

The sample is selected from companies listed in the Kuala Lumpur Stock Exchange (KLSE) in the year 2000, which are audited by Big 5 audit firms. The information relating to the composition of external director members of audit committee, frequency of audit committee meeting, size, level of leverage and total sale of the company, is collected from company annual reports. The information on financial literacy of audit committee is obtained by reference to the list of accountant in Malaysia that is issued by Malaysian Institute of Accountants.

**Independent Variables**

Three independent variables of the study are independence, activeness and financial literacy of audit committee. The dependent variable is the selection of industry specialists as external auditors.

**Operationalisation of Variables**

Industry specialisation of auditors is determined based on Craswell, Francis and Taylor (CFT) (1995) method. On the basis of CFT (1996) method, Big 8 audit firms with a minimum of 10% audit market share of a particular industry is considered as industry specialist of the industry. The audit market share of an audit firm is calculated based on the number of audit clients of the company an industry divide by over the total number of companies the industry.
Abbott and Parker (2000) use the same basis in a similar study to determine the audit market share.

Independent variables are operationalized in the following manner. Independence of audit committee is measured based on the ratio of non-executive director members of audit committee to the total number of committee members. The frequency of meeting per annum is used to determine the activeness of audit committee. Financial literacy of the committee members is determined by the existence of at least one accountant member in the committee. An audit committee with at least one accountant as a member is considered financially literate and is coded 1. Whereas audit committees that do not have an accountant as a member is coded 2, which means the committee is not financially literate.

In this study, independence of board of directors, size of company and level of leverage of the company are treated as control variables. These variables are found to have significant relationships with the selection of external auditors (Menon & William 1994; Collier & Gregory 1999; Abbott & Parker 2000). However, it is not the objective of this study to examine these variables.

RESULTS OF ANALYSIS

This is a cross-sectional study on KLSE listed companies audited by Big 5 audit firms. A total of 436 companies are selected as sample representing 54.91% of total number of companies across industries. Table 1 summarizes the distribution of sample by industry and auditor specialization.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Industry Specialist Big 5</th>
<th>Non-Industry Specialist Big 5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No</td>
<td>%</td>
<td>No</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>49</td>
<td>80.33</td>
<td>12</td>
</tr>
<tr>
<td>Trading/Services</td>
<td>84</td>
<td>86.60</td>
<td>13</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>124</td>
<td>81.05</td>
<td>29</td>
</tr>
<tr>
<td>Construction</td>
<td>16</td>
<td>45.71</td>
<td>19</td>
</tr>
<tr>
<td>Property</td>
<td>41</td>
<td>89.13</td>
<td>5</td>
</tr>
<tr>
<td>Plantation</td>
<td>27</td>
<td>79.41</td>
<td>7</td>
</tr>
<tr>
<td>Technology</td>
<td>8</td>
<td>80.00</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>349</td>
<td>80.05</td>
<td>87</td>
</tr>
</tbody>
</table>

Except for the construction industry, about 80% of companies in all industries receive audit services from the Big 5 that is industry specialist.
The distribution of audit market share for each Big 5 audit firm in each industry is presented in Table 2.

### Table 2
The distribution of Audit market Share

<table>
<thead>
<tr>
<th>Industry</th>
<th>Big 5 Audit Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>AA</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>9.09</td>
</tr>
<tr>
<td>Trading/Services</td>
<td>19.81*</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>5.80</td>
</tr>
<tr>
<td>Construction</td>
<td>7.42</td>
</tr>
<tr>
<td>Property</td>
<td>15.08*</td>
</tr>
<tr>
<td>Plantation</td>
<td>1.86</td>
</tr>
<tr>
<td>Technology</td>
<td>21.26*</td>
</tr>
</tbody>
</table>

* Industry specialist based on audit market share of more than 10% (CFT, 1995).

Note: AA - Arthur Andersen; KPMG - KPMG Peat Marwick; DTT - Deloitte Touche Tohmatsu; PWC - Price WaterhouseCoopers; EY - Ernst & Young

Table 3 presents the mean of each variable of this study. The table shows about 70% of the companies have independent non-executive directors. The audit committee of these companies meets about 3 times a year. Only about 30% of these companies have at least one accountant as a member of audit committee.

### Table 3
Descriptive Statistics of Variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry specialist</td>
<td>0.8065</td>
<td>1.00</td>
<td>0.4001</td>
<td>0.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Independence</td>
<td>0.7474</td>
<td>0.6667</td>
<td>0.1398</td>
<td>0.33</td>
<td>1.00</td>
</tr>
<tr>
<td>Frequency of meeting</td>
<td>2.7317</td>
<td>2.00</td>
<td>1.2314</td>
<td>1.00</td>
<td>17.00</td>
</tr>
<tr>
<td>Accountant members</td>
<td>0.3073</td>
<td>0.00</td>
<td>0.4619</td>
<td>0.00</td>
<td>1.00</td>
</tr>
</tbody>
</table>

### Analysis of Logistic Regression

The multicollinearity is examined using test of correlation between variables. Results show low coefficient correlations indicating no multicollinearity problems among independent variables.
Results of the analysis are summarized in Table 4. The table that shows the value of $R^2$ is 0.20. Results show that two independent variables, that is independence and activeness and the interaction of these variables have significant relationships with selection of external auditors.

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Expected direction of relationship</th>
<th>Estimated parameters</th>
<th>Wald $\chi^2$</th>
<th>Value of $p$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>+</td>
<td>-6.355</td>
<td>7.444</td>
<td>0.006</td>
</tr>
<tr>
<td>Independence</td>
<td>+</td>
<td>7.277</td>
<td>6.114</td>
<td>0.013</td>
</tr>
<tr>
<td>Activeness</td>
<td>+</td>
<td>3.074</td>
<td>11.542</td>
<td>0.001</td>
</tr>
<tr>
<td>Independence x Activeness</td>
<td>+</td>
<td>-3.301</td>
<td>9.077</td>
<td>0.003</td>
</tr>
<tr>
<td>Financial literacy</td>
<td>+</td>
<td>0.087</td>
<td>0.084</td>
<td>0.772</td>
</tr>
<tr>
<td>BEBAS_LP</td>
<td>+</td>
<td>0.578</td>
<td>0.540</td>
<td>0.463</td>
</tr>
<tr>
<td>SAIZ_FIRMA</td>
<td>+</td>
<td>0.000</td>
<td>15.378</td>
<td>0.000</td>
</tr>
<tr>
<td>UMPIL_FIRMA</td>
<td></td>
<td>-0.439</td>
<td>7.509</td>
<td>0.003</td>
</tr>
</tbody>
</table>

| $R^2$                       |                                   | 0.289                |               |             |
| No. of companies using Big 5 industry specialists | 349                          |
| No. of companies not using Big 5 industry specialists | 87                           |
| Total sample                |                                   | 436                  |               |             |

Results show independence of audit committee has a significant positive relationship with the selection of auditors at $p=0.013$. This finding supports H1. It means that the more independent the audit committee is the higher the tendency that will select external auditors with industry specialisation. The results is in consistent with Carcello and Neal (2000) and McMullen and Raghunandan (1996) studies, which indicate that independent audit committee helps external auditors to issue 'going concern' opinion particularly for companies facing financial distress and have reporting problems. However, this finding contradicts with results of sensitivity analysis by Abbott and Parker (2000) who find that independence of audit committee does not relate to selection of auditors especially industry specialist auditors. This inconsistency may be due to differences in the regulatory environment between stock exchange in the US and that in Malaysia.

The study also finds that activeness of audit committee is significantly related to the selection of industry specialist Big 5 auditors at $p=.001$. This means that the more often audit committee meets the more opportunity for them to discuss their choices of good external auditors.
Hence, H2 is supported. This finding is in consistent with that of the Collier and Gregory (1999) finding although it contradicts with that of Abbot and Parker (2000).

Results of the analysis show that the interaction between audit committee independence and its activeness has a significant negative relationship with the selection of external auditors at \(p=.003\). The relationship is in the opposite direction than that expected in H4. The result contradicts with that of Abbot and Parker (2000), which suggest positive relationship between the interaction with the selection of external auditors. This may be because Abbott and Parker (2000) study defines independence as audit committee having all members who are independent non-executive directors.

However, this study finds no significant relationship between financial literacy of audit committee and selection of auditors \((p<.05)\). The results suggest that the membership of at least one accountant in the audit committee does not necessarily provide a drive for the committee to choose industry specialists as external auditors. Hence, H3 is not supported. This result is not in line with past studies (Kalber et al. 1993; DeZoort 1998) which suggest financial literacy is an important characteristic of audit committee which contributes to the effectiveness of the committee. However, this result is consistent with the Razman and Iskandar (2002) study, which indicate that financial literacy of audit committee has no significant relationship with the quality of corporate reporting of KLSE listed companies. This inconsistency may be due to the inaccuracy of the measurement of financial literacy, which in this study mainly based on the membership of at least one accountant in the audit committee. There may be a better measure which is able to capture financial knowledge gained through general and specific experience.

DISCUSSIONS AND CONCLUSIONS

The main objective of the paper is to evaluate the effectiveness of audit committee in terms of monitoring the selection of the external auditors. Three audit committee variables have been identified to see if they have any relationship of audit committee in this exercise. The variables include independence, activeness, and financial literacy of audit committee members and the interaction between independence and activeness of the committee.

The study finds the independence of audit committee has a positive significant relationship with the selection of external auditors. Companies with independent audit committee tend to select external auditors with industry specialization. Independent non-executive directors who are members of audit committee would always want to protect their interest by properly discharge the responsibility given to them in achieving the objective of the company. They would expect that high quality audit services to provide them protection against any liability that may arise due to negligence. A good quality reporting would result from high quality audit and hence, lower agency costs to the company.

The study also finds that the activeness of audit committee is significantly related to the selection of industry specialist auditors. Active audit committees tend to select auditors with industry specialization. Active audit committees would carry out their responsibility with integrity. As the selection of external is believed to be an important function of the committee, the ultimate objective of an active committee is to produce quality financial reporting. H2 is supported. The study finds the interaction between independence and activeness of audit
committee does not have any significant relationship with the selection of auditors. With regard to financial literacy, the study finds no significant relationship between this variable with the selection of auditors.

The findings show that both independence and activeness of audit committee are very important characteristics for the committee to perform effectively. This provides good input to management of company in forming the audit committee for the company. The result on the financial literacy is not significant. This could be due to a crude measure of the variable. Further research is necessary to examine those variables by refining its measurement to include not only accountant but also any other profession or experience that provide means of developing knowledge and expertise in the area of business and finance. The frequency of meeting used as a proxy of activeness of audit committee may not be very accurate. It may be necessary to investigate further of the contents of the meeting that are relevant to the development of the company.

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