



OVERLAPPING MEMBERSHIPS ON AUDIT AND  
OTHER BOARD COMMITTEES: IMPACTS ON  
FINANCIAL REPORTING QUALITY

BY

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A dissertation submitted in partial fulfilment of the  
requirement for the degree of Master of Science  
(Accounting)

Kulliyyah of Economics and Management Sciences  
International Islamic University Malaysia

DECEMBER 2016

## **ABSTRACT**

Corporate boards are categorised into compulsory and/or voluntary sub-committees, with each sub-committee having specific roles to play on the board. However, members of these different committees overlap other committees on the same corporate board. This study investigates how overlapped members on the audit committee impact the primary role of the committee specially in regards to improving the quality of financial reporting of the firm. Agency theory assumes that overlapping memberships negatively impact the financial reporting quality since members are busy with the activities of other board committees. However, resources dependency theory views that overlapping memberships increase the firm's internal dependency through collaboration and information sharing between different board committees. This improves the effectiveness of each board committee and the financial reporting quality of the firm. The population of the study consists of non-financial institutions listed on Bursa Malaysia. Using purposive sampling, cross-sectional data were collected from the annual reports of the 100 top companies listed on Bursa Malaysia. The descriptive statistics of the study shows that almost every company observed in this study has overlapping membership on audit and other board committees. The study also shows that more than three-fourths of the audit committee members also work on other board committees. From regression analysis, the study found that overlapping memberships on audit committee and other mandatory committees, such as remuneration and nominating committees, significantly and positively impact the financial reporting quality (negatively impact earnings management). The study also indicates that the chair of the audit committee contributes better in improving the financial reporting quality when he/she overlaps other board committees. This result supports resources dependency theory over agency theory. Thus, regulatory bodies and investors should encourage the chair of the audit committee to work on other board committees to bring in relevant information to improve the performance of the audit committee.

## ملخص البحث

تصنف مجالس إدارة الشركات إلى لجان فرعية إجبارية أو اختيارية. كل لجنة فرعية ذات دور معين في مجلس الإدارة. ومع ذلك، تتداخل أعمال أعضاء هذه اللجان المختلفة في لجان أخرى في مجلس إدارة الشركة نفسه. تبحث هذه الدراسة في أثر تداخل عمل أعضاء لجنة المراجعة على الدور الأساسي للجنة فيما يخص جودة التقارير المالية. وتفترض نظرية الوكالة أن تداخل عمل الأعضاء له تأثير سلبي على جودة التقارير المالية لأنهم مشغولون بأنشطة أخرى في لجان فرعية أخرى. ومع ذلك، ترى نظرية تبعية الموارد أن تداخل عمل الأعضاء يزيد من الاعتماد الداخلي للشركة على نفسها، من خلال التعاون ومشاركة المعلومات بين اللجان المختلفة لمجلس الإدارة. وهذا يرفع من فعالية اللجنة وجودة التقارير المالية. يتكون مجتمع الدراسة من المؤسسات غير المالية المدرجة في بورصة ماليزيا. وقد تم جمع البيانات عن طريق استخدام عينات هادفة لأفضل مائة شركة مدرجة في بورصة ماليزيا. وقد أظهر التحليل الوصفي للعينة أن هناك تداخلاً بين أعضاء لجنة المراجعة ولجان مجلس الإدارة الأخرى. وأظهرت أيضاً أن ثلاثة أرباع أعضاء لجنة المراجعة يعملون في لجان مجلس الإدارة الأخرى. وقد أظهر تحليل الانحدار أن تداخل الأعضاء في لجنة المراجعة واللجان الإلزامية الأخرى، مثل لجنة المكافآت ولجنة الترشيحات، له تأثير إيجابي على جودة التقارير المالية ويؤثر سلباً على إدارة الأرباح. وأشارت النتائج إلى أن رئيس لجنة المراجعة له أثر كبير على جودة التقارير المالية عندما يعمل أيضاً في لجان أخرى. هذه النتائج تعزز نظرية تبعية الموارد على نظرية الوكالة. وبالتالي، ينبغي للهيئات التنظيمية والمستثمرين تشجيع رئيس لجنة التدقيق للعمل في لجان المجلس الأخرى لتقديم المعلومات ذات الصلة لتحسين أداء لجنة المراجعة.

## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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## ACKNOWLEDGEMENT

In the name of Allah, the Most Gracious, the Most Merciful. All praises and thanks be to Allah SWT, and peace and blessings be upon Prophet Muhammad (*saw*) his family, his companions, and his followers until the day of judgement.

First and foremost, I am indeed very grateful to Allah SWT for allowing me to complete this dissertation. With His Mercy and His Grace, I was able to withstand all the challenges that I encountered all throughout my master's degree journey.

Completing this dissertation would have been much more difficult were it not for the support of others. It is an honour to have Assoc. Prof. Dr. Hafiz-Majdi Ab. Rashid as a supervisor, who diligently advised and guided me despite his busy schedule and other commitments. Similarly, it is an honour to have Assoc. Prof. Dr. Hairul Azlan Annuar as a supervisor, who friendly advised and guided me.

I would also like to extend my gratitude to the examiners Assist. Prof. Dr. Ahmad Zamri Osman @ Hussin and Asst. Prof. Dr. Intan Suryani Abu Bakar who provided comprehensive and constructive comments on the improvement of my thesis. Thanks are also due to the faculty members of the Department of Accounting who shared their invaluable knowledge and experience in academic research.

I appreciate the International Islamic University Malaysia (IIUM) for providing us an avenue for academic excellence. Likewise, I am truly grateful to SIMAD University (SU) for allowing me to pursue my Master's degree on official time.

I extend my gratitude to all my friends and classmates who have contributed to the completion of this thesis. Last but not the least, I extend my special thanks to my family especially to Abi and Omi for the financial and moral support. You have given me much more than I needed. Allah SWT alone knows the depths of gratitude and love for you.

I am very thankful for all of your support, guidance and love. May Allah SWT bless you all for everything and may He guide us all to the straight path.

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## LIST OF ABBREVIATIONS

AC	Audit Committee
AC_SIZE	Audit Committee Size
AC_FE	Audit Committee Financial Expert
BOD	Board of directors
BSIZE	Board Size
BIND	Board Independence
DAC	Discretionary Accruals
EM	Earnings Management
FRQ	Financial Reporting Quality
FSIZE	Firm SIZE
GTH	GROWTH
LEV	Leverage
NC	Nomination Committee
OVC	Other Voluntary Committees
OV_FE	Overlap of Audit Committee Financial Experts
OV_CH	Overlap of Audit Committee Chairperson
OV_MC	Overlap between Audit and Other Mandatory Committees
OV_RMC	Overlap between Audit and Risk management committee
OV_OVT	Overlap between Audit and Other Voluntary Committees
OV_P	Overlap Proportion
RC	Remuneration Committee
RDT	Resource Dependency Theory
RMC	Risk Management Committee
SPSS	Statistical Package for Social Sciences
VCs	Voluntary Committees

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 BACKGROUND OF THE STUDY**

Many countries have improved their corporate governance mechanisms and systems to safeguard the rights of the shareholders. One of the corporate mechanisms which have received the attention and the interest of the finance and accounting researchers in recent decades is the board of directors. Indeed, the effectiveness of the board of directors reflects its capability to accomplish its role in the company accurately, particularly its oversight role (Annuar & Abdul Rashid, 2015). Within this role, the board performs monitoring of management and oversight of the quality of financial reporting (Baccouche & Omri, 2014). Given its responsibilities, the board normally delegates its diverse activities into different committees (Carson, 2002; Main et al., 2008; Spira & Bender, 2004).

Audit committee is one of the most important sub-committees in the corporate board whose main responsibility is to ensure the financial reporting quality (FRQ) of the firm (Bruynseels & Cardinael, 2014; Greco, 2011). The main role of the audit committee is to check the quality of financial statement of the firm (Annuar & Abdul Rashid, 2015) by hiring internal and external auditors who check and report the accuracy and reasonableness of the financial reporting of the firm to this committee (Carson, 2002). However, audit committee directors may also work on other committees on the corporate board (Chandar et al., 2012; Kusnadi et al., 2015; Spira & Bender, 2004). In other words, there are shared common directorships among different committees within the board.

In this study, when an independent director; e.g. an audit committee member; works on more than one of the committees on the same corporate board it is referred to as overlapping board memberships (Chandar et al., 2012). Such overlapping on the board will affect the main responsibility of the audit committee (Cotter & Silvester, 2003; Laux & Laux, 2009; Liao & Hsu, 2013; Spira & Bender, 2004). This study focuses on the relationship between overlapping memberships on audit committee and financial reporting quality.

Financial reporting quality means the correctness within which financial statement conveys information about a firm's operations, specifically a firm's expected cash flow (Verdi, 2006). In its perfect sense, financial statements should assist capital providers, investors and creditors assess the amounts, timing and uncertainty of future cash flow to the related enterprises (Alzoubi, 2014). The three factors that affect the financial reporting quality of the firm are standard setters' decision, management choices on the accounting method and management judgement and estimates implementing the chosen alternates (Alzoubi, 2014). The management's manipulation of earnings negatively affects the financial reporting quality (Alzoubi, 2014; Baccouche & Omri, 2014). Financial reporting quality will be lower if the earnings management of the firm is higher.

In Malaysia, according to the Malaysian corporate governance framework, each public listed company must have at least three committees namely the audit committee, remuneration committee, and nomination committee (MCCG, 2012). In addition, firms can have more than the statutory required committees. For example, other committees include risk management committee, and other voluntary committees such as environmental and sustainability committees and others depending on the necessity of the committee (Yatim, 2010). The audit committee members could play different roles

in different committees on the same board. Hence, even though the audit committee is the most powerful among sub-committee on the board (Annuar & Abdul Rashid, 2015), the effectiveness of its members could be affected by distributing their attention over other committees (Kusnadi et al., 2015).

Since the members of the audit committee can sit on several other committees on the same board, an interesting question is to what extent that overlapping membership on audit committee can deter earnings management and improve the quality of the financial reporting of the firm.

Some literature found a relationship between overlapping memberships on audit committee and financial reporting quality of the firms (Chandar et al., 2012; Chang, J. C., Luo, M., & Sun, 2011; Laux & Laux, 2009; Liao & Hsu, 2013; So & Smith, 2009), while others did not find any such relationship (Kusnadi et al., 2015). In addition, previous studies were limited only to the overlapping membership between audit committee and remuneration committee (Chandar et al., 2012; Kusnadi et al., 2015; Laux & Laux, 2009). This study examines the impact of overlapping memberships between audit committee, remuneration committee, nomination committee and voluntary committees, if any, on the financial reporting quality of the firm.

It is interesting to understand if the intra-company overlapping memberships on different board committees affect the effectiveness of the committees (Kusnadi et al., 2015). Specifically, this study examines the relationship from the perspective of the audit committee using financial reporting quality as a proxy for audit committee effectiveness. In addition, this study analyses companies in developing countries especially the Malaysian public listed companies. This assists Malaysian regulatory bodies and companies to improve board effectiveness as well as enhance the quality of the financial reporting of the firm. Finally, as this study is the first of its kind in

developing countries, the result of this study could be generalised to the other developing countries or those countries which share a similar market and governance structure to that practised in Malaysia.

## **1.2 PROBLEM STATEMENT**

The audit committee has been the focus of corporate governance since the wake of spectacular accounting scandals, e.g Enron and Worldcom., which lead to the creation and establishment of Sarbanes–Oxley Act, SOX (Chandar et al., 2012). The audit committee has a role in the financial reporting process of firms and its members represent half of the board of directors. For instance, members of the audit committee would be assumed to contain three individuals if the overall size of the board contains six members. Since the board has other committees namely remuneration committee, nomination committee, risk management committee, and perhaps other board committees depending on its necessity, there must be overlapping members across these committees (Annuar & Abdul Rashid, 2015; Carson, 2002; Spira & Bender, 2004). Overlapping board members may affect the activities and effectiveness of these committees including audit committee either positively or negatively (Chandar et al., 2012; Kusnadi et al., 2015).

There are concerns related to how these overlapping board memberships effect the role of the audit committee in monitoring the FRQ (Kusnadi et al., 2015). It is necessary to know whether membership on different board committees is beneficial to the audit committee members in performing their oversight function of the financial reporting.

In the context of Malaysia, only the audit committee and remuneration committee were mandatory in the public listed firms before 2011. However, the recent

Malaysian code on corporate governance, 2012 amendment, made it mandatory to establish another board committee called nominating committee to improve the control mechanisms of the firms. Extra committees other than these three committees may exist in the corporate board such as risk management committee, investment committee, environmental and sustainability committees (Yatim, 2010). Moreover, the majority of the members of each three mandatory committees should be independent non-executive directors (MCCG, 2012).

Referring to independent board members needed in the audit committee, nominating committee, and remuneration committee, the ideal number of the independent directors that every public listed company should have will be nine. However, the average number independent directors in Malaysian public listed firms is 3.52 directors (almost four members) only (Nelson & Devi, 2013). Since these independent directors are needed in the different committees on the board, there must be shared directors among committees. Overlapping memberships on audit and other board committees may make it challenging to the members of the audit committee to undertake their activities effectively (Annuar & Abdul Rashid, 2015; Chandar et al., 2012; Kusnad et al., 2015; Liao & Hsu, 2013). The audit committee may neglect to detect the irregular earnings management exercised by the top management (Liao & Hsu, 2013).

Thus, discovering the impact of intra-company overlapping memberships from the audit committee perspectives on financial reporting quality helps the investors, regulators and other players in the market to know the effectiveness of audit committee and to assess their contribution to the firms in Malaysia.

### **1.3 RESEARCH MOTIVATION**

This research seeks to provide empirical evidence as suggested by Kusnadi et al. (2015) that examines the impact of the overlapped board members on the primary responsibility of the audit committee to detect earnings management and improve the quality of the financial reporting of the firm (Klein, 2002a, 2002b; Nelson & Devi, 2013).

The latest amendment (in the year 2012) to the Malaysian code on corporate governance (MCCG) related to the board composition mandates the establishment of nominating committee in all public listed companies in Malaysia. Added to the existing committees namely audit committee and remuneration committee, the minimum number of board committees required in every Malaysian public listed company is three though a company could have more than three committees on its board. MCCG also recommends the independence of the directors sitting on these committees. Given the few numbers of available independent directors, there must be shared directors across different committees. Although these different committees perform monitoring functions, they have different roles to play in that function (Spira & Bender, 2004). Overlapping memberships could have advantages for the audit committee which is bringing information from other committees. Additionally, overlapping memberships could have negative impact which is the loss of agenthood of the audit committee members and being busy on the non-related accounting activities going on other committees. Taking into account the conflicting roles of the overlapped audit committee directors, this study examines the impact of intra-company common memberships on audit committee in improving financial reporting quality.

Thirdly, most of the prior studies on overlapping board memberships were conducted in developed countries mainly in the United States (Chandar et al., 2012;

Liao & Hsu, 2013). To the best knowledge of the researcher, there is no study related to overlapping memberships in Malaysia or any other developing country even though there are many studies related on financial reporting quality in Malaysia. Therefore, this study is the first of its kind conducted in Malaysia.

#### **1.4 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS**

The research is centred on determining the impact of overlapping memberships between audit and other board committees on the financial reporting quality in Malaysian listed firms. Specifically, the aim of the research is to:

1. To investigate the extent of overlapping memberships on audit and other board committees in Malaysian listed firms.
2. To determine the impact of overlapping memberships between audit and other board committee of Malaysian listed firms on financial reporting quality

In lieu of the above, the research questions arising from the study objectives are:

1. What is the extent of overlapping memberships on audit and other board committees in Malaysian listed firms?
2. What is the impact of overlapping memberships between audit and other board committee of Malaysian listed firms on financial reporting quality?

#### **1.5 SIGNIFICANCE OF THE STUDY**

This study is useful for Malaysian companies and regulatory bodies as it highlights the contribution of the audit committee to the quality of firm's financial information. The also help investors ascertain the impact of shared board members on the effectiveness of the audit committee particularly the effect of intra-company overlapping memberships on the financial reporting quality. In addition, it offers Malaysian firms

guidelines for decision-making to enhance the effectiveness of the board of directors as well as the quality of the financial information of the firm.

Furthermore, the study is important to investors as they expect high-quality financial reporting because of their reliance on the audit committee. The findings familiarise the shareholders with the impact of intra-company overlapping memberships and how it relates to the financial reporting quality. Investors can use the result of this study as a basis to rethink and relook the roles of the audit committee members on the corporate board.

Lastly, the study provides additional literature on corporate governance especially in the context of audit committee effectiveness. It studies overlapping memberships between different board committees in the same company and the way it influences the performance of each committee especially the audit committee. In addition, this study expands the literature of the audit committee effectiveness by providing a new empirical research in the context of Malaysia. Apart from accounting scholars and researchers interested in corporate governance research, this study is beneficial to the public listed firms, investors, and regulatory bodies in Malaysia.

## **1.6 ORGANISATION OF THE STUDY**

The thesis contains six chapters. The first or the present chapter introduces the main theme of the study. The chapter focuses on the background of the study, the research problem, motivation for the study, the research objectives, and research questions, the significance of the study and the likely contributions of the study.

The second chapter of the study is the literature review. It reviews prior literature and empirical works related to both dependent and independent variables of the

study. At the end of this chapter, the gaps in the literature are identified, which this current study tries to fill.

Chapter three discusses the theoretical framework of the study. Firstly, it explains theories used in this study and how it relates to the relationship between variables of the study. Secondly, the chapter provides the research framework of the current study. Finally, the chapter formulates and develops the research hypotheses.

Chapter four explains the research methodology of the study. It covers the research design of the study that includes a sample of the population, research instrument, data collection, measurement of the dependent and independent variables as well as data analysis employed for the study.

In the fifth chapter, the findings, analysis, and discussion of the data are explained. The study is concluded in chapter six where the summary, conclusion, limitations, and recommendation of the study are presented.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

This chapter reviews prior literature and empirical works on the audit committee, specifically overlapping memberships. The chapter discusses the prior empirical works in relation to the overlapping memberships on audit committee and financial reporting quality of the firm and concludes by identifying the gaps in the literature.

#### **2.2 OVERLAPPING BOARD MEMBERSHIPS ON AUDIT COMMITTEE**

According to the agency theory, the BOD is needed to mitigate the conflict of interest between managers and shareholders (Fama & Jensen, 1983a, 1983b; Jensen & Meckling, 1976). One of the main duties of the board of directors is to monitor and supervise managers to make sure that the managers' actions are in line with the interest of the shareholders (Annuar & Abdul Rashid, 2015; Baccouche, 2015). Any costs incurred by the company, specifically shareholders, to hire the board of directors are considered agency costs (Fama & Jensen, 1983a). These costs are paid to the board of directors to protect the interest and the rights of the shareholders in the firm (Baccouche & Omri, 2014).

The oversight role of corporate boards is perceived to mitigate the agency problems between investors and managers of the firm (Fama & Jensen, 1983b). These oversight roles encompass approving and reviewing strategies, nominating new board director, appointing CEO, deciding CEO and top managements' compensations, lowering potential risks, monitoring controls and dealing with external auditors

(Chandar et al., 2012). Given such diverse responsibilities, corporate boards can be clustered into different sub-committees with each sub-committee delegated to certain activities.

Furthermore, regulatory bodies urged that the members of these committees should be independent. It is compulsory in every public listed company to have vast majority independent audit committee members, while it is required that the majority of the nominating committee and remuneration committee be independent non-executive directors (MCCG, 2012).

Nevertheless, due to a limited number of independent directors available in the market, the majority of the independent board members sit on two, or three of these committees (Chandar et al., 2012; Epps & Ismail, 2009; Kusnadi et al., 2015). This leads to overlapping board memberships, which occurs when at least an independent director, for instance, an audit committee member sits on more than one committee in the same corporate board.

### **2.2.1 Audit committee**

One of the most important sub-committee of the corporate board is the audit committee whose main responsibility is to oversee financial reporting process (Hoitash et al., 2009). The audit committee assists the board of directors in fulfilling its legal duties related to the issues of accounting, auditing, internal control, and financial reporting (Annuar & Abdul Rashid, 2015).

The audit committee ensures the quality of the financial reporting of the firm. This committee verifies whether the financial statement of the firm presents the main activities and resources of the firm. They also verify whether the financial statement is prepared fairly by using their personal experiences and skills as well as recruiting

internal and external auditors to help them enhance the financial reporting quality of the firm (Badolato, Donelson, & Ege, 2014).

The audit committee monitors all audit and non-audit services provided by internal auditors to ensure their independence (Carson, 2002; Cotter & Silvester, 2003; Klein, 2002a). Internal auditors also report regularly to the audit committee. Moreover, according to the Sarbanes-Oxley Act of 2002, the audit committee is also responsible for appointments, compensation, retention, and oversight of the activities of the firm's external auditors.

The audit committee contracts with the external auditors regarding the issues of auditing the financial statement. The committee decides the nature of items to be audited, the type of audit to be done, the duration of the auditing process, and audit fees (Klein, 2002b). In addition, external auditors report the result of the audit engagement to the AC of the board (Carson, 2002).

To fulfil such activities, the members of the audit committee meets quarterly in which they convey the result of their meeting to the board (Annuar & Abdul Rashid, 2015). Finally, according to the Malaysian Code on corporate governance, the audit committee must contain at least three members, and each member of the audit committee must be a non-executive director (MCCG, 2012).

### **2.2.2 Remuneration committee**

Another important board committee is the remuneration committee, which has responsibility for determining and choosing suitable remuneration packages for top management (Annuar & Abdul Rashid, 2015; Main et al., 2008). The remuneration committee also assesses the performance of executives periodically (Carson, 2002; Main et al., 2008). The committee is also responsible for monitoring company's equity