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The Influence of Risk Committee Board Attributes on Modified Audit Opinion in Malaysia

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Abstract

The presence of a separate risk management committee (SRMC) in non-financial organizations is viewed as crucial. It is an important part of the risk management process as well as a vehicle for corporate governance. The relationship between RMC attributes and amended audit opinion is described in this research using a conceptual framework. It emphasizes the importance of separating roles and obligations between an audit committee (AC) and an RMC. Furthermore, there must be no relationships between RMC and auditors for all risk management (RM) functions to be evaluated fairly. Following the Malaysian Corporate Governance Code of 2017, the board should establish an RMC with a majority of independent members to supervise the company's RM structure and policies, as well as their execution.

Keywords: Risk Management Committee; Risk; Modified Audit Opinion; Malaysia

1. Introduction

As a result of the global economic downturn, many firms and organizations' RM systems have been exposed. Many factors may have contributed to recent business failures such as Enron, WorldCom, Parmalat, Bear Stearns, Citigroup, Lehman Brothers, and Dexia in the West, and Transmile, Megan Media, and Oil Corp. in the East, but excessive risk-taking is most certainly one. Furthermore, a competitive environment that continues to shape and drive market development enhances competition among enterprises, prompting them to take on even greater risks over time. Because of these factors, it is necessary to have continuous risk monitoring and assessment to preserve corporate accountability (Brown, Steen, & Foreman, 2009). Malaysia has proposed several governance reforms to improve corporate governance, with a heavy focus on RM. An effective RM system aids the organization in attaining its business objectives, enhancing financial reporting, and protecting its reputation (Subramaniam, McManus, & Zhang, 2009; Ng, Chong, & Ismail, 2013). The Malaysia Stock Exchange's Corporate Governance (2017) has defined RM standards for Malaysia's publicly traded firms, with the board of directors being primarily responsible for establishing and implementing a proper RM system. The board appoints an RMC with a majority of independent members to supervise the company's RM structure and policies.

The RMC will strengthen corporate board supervision and dissuade management from continuing to participate in unethical activity, according to the agency theory (Alles, Datar, & Friedland, 2005). Aside from the agency theory, the resources dependence theory claims that the RMC, as a subsidiary of the firm, is needed to offer more talents and resources to increase reporting earnings and reduce the risk of agency challenges (Hillman & Dalziel, 2003; Hillman, Cannella, & Paetzold, 2000).

The once-insignificant RMC has now become a focal point. Traditionally, RM operations have been considered as part of an audit committee's main responsibilities. In response to regulatory changes, the scope of an AC has been broadened to encompass RM and internal control, in addition to ensuring accuracy and transparency in the financial reporting process (Ng et al., 2013).

Despite past studies exploring various components of corporate governance, such as board meetings and board size, no study has yet investigated the relationship between a stand-alone RMC, RMC characteristics, and MAO. However, there is little evidence to indicate a relationship between the RMC and the MAO. One explanation for the scarcity of empirical data is the relative newness of RMC in non-financial sectors in general and the state of the Malaysian non-financial business. As a result of establishing a link between RMC and MAO in Malaysia, this research uncovers the RMC's value to non-financial businesses. In this study, which covers a research gap, the impact of stand-alone RMC existence and RMC characteristics on MAO in Malaysia is studied.

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2. Literature Review and Hypotheses Development

2.1. Separate Risk Committee

Large-scale business failures have prompted requests for a special oversight committee to assist the board of directors in monitoring and analyzing RM activities (Patigan & McAvoy, 2010). The Malaysian Securities Commission highly advises an RMC, as stated in the Malaysian Corporate Governance Code (MCGC). In the same line, as part of their listing criteria, Bursa Malaysia demands companies to make a statement on their RM and internal control affairs. The need for a stand-alone RMC is clearly stated in the 2017 amended code of corporate governance, which requires significant corporations to establish an RMC to monitor their risk management policies and practices. It is important to note, however, that the company should keep this group apart from the AC because they have different responsibilities and tasks inside the company. In actuality, the MCGC considers that as the highest authority in the corporate structure, the board of directors should be fully responsible for risk management decisions. As a result, it is the board of directors' responsibility to start and/or organize a separate committee that is solely responsible for risk management in their company. To protect its shareholders, the organization established this committee to determine its risk tolerance as well as identify and evaluate significant risk variables.

Besides, the stand-alone committee is expected to improve the risk assessment process and reduce financial risk (Abdullah and Said, 2019; Aldhamari, Mohamad Nor, Boudiab, and Abdulsalam Mas'ud, 2020). According to Subramaniam, McManus, and Zhang, businesses with RMC separate from the AC are more likely to have effective governance processes, decreased risk exposure, and higher financial reporting quality (2009). Previous research, such as that by Beasley, Carcello, Hermanson, and Neal (2009) and Klein (2002), has repeatedly claimed that RMCs, such as AC, help to improve the board's monitoring ability and reduce the possibility of managerial entrenchment.

Additionally, the RMC is expected to strengthen corporate board monitoring and prevent management from continuing to participate in unethical activity, according to agency theory (Alles, Datar, & Friedland, 2005). Aside from the agency theory, the resources dependency theory claims that the RMC, as a subsidiary of the business, is obliged to offer additional talents and resources to boost reporting revenues and reduce the risk of agency challenges (Hillman & Dalziel, 2003; Hillman, Cannella, & Paetzold, 2000).

2.2. Risk Management Committee Financial Expertise

The board committee's (BC) financial understanding is also a distinctive feature that has been connected to the committee's success and has gotten a lot of attention in the past. Financial knowledge is important to the committee's effectiveness because the BC's principal responsibility is to oversee the financial reporting and controls process (PricewaterhouseCoopers, 2005). A lack of competence or understanding of difficult technology and financial considerations may result in ineffective BC judgments and performance (DeZoort, 1998). By addressing the issue of accounting and financial management competency, Mangena and Pike (2005) explain how to increase the BC's efficacy. According to them, members of the board's finance committees should have experience in both management accounting and financial management. They will allow committee members to do their tasks more efficiently, according to the author, and will urge management to give more information.

Furthermore, members of board financial committees must be familiar with the business environment and include an expert in accounting or a related field of financial management to read basic financial statements and efficiently carry out their obligations. At least one member of the committee has previously or currently worked in finance or accounting and is a member of a professional organization in these fields (Smith, 2003).

According to Felo, Krishnamurthy, and Solieri (2003), the board's financial committees are in charge of overseeing the quality of financial reporting. As a result, having accounting or financial management specialists on the RMC can help ensure that the firm's financial disclosure is correct. Members of the committee must be able to read and comprehend financial information accurately, as well as ensure that shareholders receive a higher-quality financial report, according to Vafeas (2005). If members of the AC have a better grasp of the AC, they will be better able to appreciate the auditors' conclusions and recognize the significance of rifts between the external auditors and management.

In addition, the BC's ability to detect and challenge the management and auditor will be enhanced (Levitt, 2000). As a result, to be more successful in supervising the board and increasing voluntary corporate disclosure, members of the BC must create room for resources such as accounting and financial management. According to Felo et al. (2003), the board's financial committees are in charge of overseeing the quality of financial reporting. As a result, incorporating accounting or financial management knowledge into the RMC aids in ensuring that the firm's financial disclosure is correct.

If RMC members have a greater understanding of the subject, they will be better equipped to understand the judgments and recognize the significance of rifts between the external auditors and RMC issues. In addition, the RMC's ability to detect and challenge management and auditors will be enhanced (Levitt, 2000). As a result, members of the RMC must create room for the resources (such as accounting and financial management experience) that the firms require for the RMC to be more effective in supervising the board and increasing voluntary corporate openness (Bédard et al., 2004).

RMC members should also have excellent accounting or equivalent financial management skills to understand and comprehend basic financial statements to properly deal with complaints about financial reporting quality (Felo et al., 2003). Members of the RMC should be knowledgeable about the company environment and have experience in accounting and financial management to better understand, correctly interpret, and improve voluntary corporate disclosure. Members of the RMC must have accounting and financial management skills to adequately perform their tasks. Because they have a greater knowledge of the annual report's quality, members of the RMC having a background in accounting and financial management may be a crucial component in determining the success of their oversight (Mangena & Pike, 2005).

As a result, having RMC members with technological know-how or abilities is crucial for them to carry out their responsibilities more effectively and efficiently, especially when it comes to voluntary corporate disclosure. Financial professionals on the AC, according to McDaniel, Martin, and Maines (2002), increase the quality and consistency of the overall reporting process. Besides, according to Maraghni and Nekhili (2014), RMC members are more aware of the need for accounting professionals to improve the committee's functioning and, as a result, promote voluntary corporate disclosure.

2.3. Risk Management Committee Meetings

According to the International Finance Corporation (2010), board and committee meetings should be well-organized and held regularly, and directors should participate fully in board meetings. The RMC can freely debate, deliberate, and work toward a single goal in risk monitoring and control at the meeting (Ng et al., 2012). Corporate boards, according to agency theory, have great capacities for reviewing, disciplining, and controlling managerial actions, which improves the performance of organizations that have more regular board meetings (Jensen, 1993; Lipton & Lorsch, 1992; Vafeas, 1999). The frequency of meetings reflects how much effort a committee puts in to carry out the roles and responsibilities allocated to it (Muhamad Sori, & Mohamad, 2009), as well as how much time committee members devote to sanitized issues (Muhamad Sori, & Mohamad, 2009). (Abdul Rahman, & Mohamed, 2006).

However, there are two explanations for the link between RMC meeting frequency and revised audit opinions. According to the first point of view, the high frequency demonstrates the committee members' dedication and focus on the task at hand (Abdul Rahman and Mohamed, 2006). Furthermore, the regularity with which meetings are held will allow for the presentation of a variety of ideas to improve the company's internal control. As a result, the RMC is more than likely to place a high priority on lowering the company's risk, and risk management issues will be thoroughly examined. This will lead to enhanced company performance in the long run.

On the other hand, the large number of meetings could suggest that some difficulties need to be addressed. These concerns are intrinsically linked to the firm's current threat of threats, and they require the RMC's full attention. According to studies, the company that meets the most is a high-risk organization with bad financial returns (Ng et al., 2013; Elamer and Benyazid, 2018).

2.4. Risk Management Committee Size

The size of the board may have an impact on RMC production. The larger the board, the more likely it is to include people with the required expertise to serve on an RM subcommittee (Abubakar, Ado, Mohamed, & Mustapha, 2018). The total number of members on an RMC at the end of a fiscal year is the size of the committee. The RMC size is sometimes used as a proxy for an organization's willingness to devote board-level resources to enhancing its ERM operations (Malik, Shan, & Tong, 2020). The size of the RMC is critical (Kakanda, Salim, & Chandren, 2018; Ng et al., 2012).

The size of the committee has a considerable impact on its effectiveness and capacities. According to Erkens, Hung, and Matos (2012), the RMC must have at least three members to function efficiently. The committee should be granted sufficient authority and resources to function efficiently, according to DeFond and Francis (2006). Increasing the size of RCs with diverse knowledge, according to agency theory, may increase monitor managers' RM behavior and ensure that investment is in line with strategic goals to avoid financial crisis by reducing adverse selection and moral hazard, both of which can have an impact on performance (Aebi, Sabato, & Schmid, 2012; Jensen & Meckling, 1976; Yatim, 2010).

Proponents argue that smaller RCs make decision-making easier, faster, and more effective (Ng et al., 2013; Battaglia, Gallo, & Graziano, 2014). In practice, the committee's work will be more focused, with less time spent on topics not directly related to RM. Proponents of the RMC's high size, on the other hand, claim that with more members, different viewpoints can be heard (Be'dard, Chtourou, & Courteau, 2004). As a result, the ultimate verdict will be more thorough and accurate. The discussion's findings will become more conclusive when various opinions, suggestions, and recommendations for how the organization might manage risk are discussed.

2.5. Risk Management Committee Overlapping

A member of the RMC or other BCs of a corporation may serve on multiple committees at the same time, such as the remuneration and audit committees. However, not all members belong to multiple organizations. RMC overlaps designate

RMC members who serve on multiple committees and have dual or supplemental responsibilities. The Federation of European Accountants, the Institute of Chartered Accountants of Australia, and the Centre for Audit Quality (2013) feel that overlapping membership between the AC and RMCs is crucial for effective communication on major risk supervision concerns. A single director can be a member of several board committees. An RMC member can also be a member of the AC. This overlapping board of directors is seen as a window into the company's corporate governance framework (Zajac & Westphal, 1996).

The discrepancy in the evidence presented in the literature could be due to the absence of certain cases when the impact of overlapping membership could be more significant (Habib, Bhuiyan, & Uddin, 2016). At least one director should serve on both the audit and pay committees, according to experts (Chandar, Chang, & Zheng, 2012). RMCs with more overlapping members or more responsibilities in other board committees may be able to find better work. Outsourcing board tasks to committees, according to Laux and Laux (2009), can help to limit free-riding, which is typical in larger groups. This is because if there is committee overlap, the subgroup structure and its benefits will become obvious.

Additionally, a high percentage of committee membership overlap suggests that responsibilities are being spread, which would ensure multi-accountability (Chandar, Chang, & Zheng, 2012). A director who serves on two committees can also examine the relationship between the firm's risk exposure and the share of risk-taking incentives in compensation packages, according to Tao and Hutchinson (2013). Because all BCs are sub-committees of the board, it's best if board committee members overlap (Carcello & Neal, 2000). Companies that have fewer overlapping directorships do worse (Gilson, 1990). This thesis is reinforced by the fact that having fewer overlapping directorships leads to financially challenged corporations (Kaplan & Reishus, 1990).

2.6. Risk Management Committee Gender

In terms of gender diversity, despite steady growth in recent years, women continue to be underrepresented on corporate boards (Green & Homroy, 2017). The board of directors, according to agency theory, is crucial in resolving agency problems and establishing a balance of interests between management and investors (Solimene, Coluccia, & Fontana, 2017). Furthermore, Ahmadi, Nakaa, and Bouri (2017) suggest that there should be a positive association between female board members and corporate disclosure because the inclusion of females on the board increases the board's independence.

The agency theory and the stakeholder theory both predict a favorable correlation between women on boards of directors and corporate disclosure. Female directors are regarded to be one of the internal techniques for decreasing agency conflict between business shareholders and managers, or between majority and minority shareholders, as part of corporate governance qualities (Lakhal, Aguir, Lakhal, & Malek, 2015). The inclusion of at least one female director on the board is likely to affect the efficiency and effectiveness of the board (Amran, Manaf, Bahrain, & Ishak, 2015).

In addition, Adams and Ferreira (2009) observed that female directors are less likely to have attendance worries than their male colleagues. Their findings also imply that female directors are more likely to be placed in monitoring-related committees like RMC.

According to prior lectures and studies, women and men differ in their conduct, amount of labor and planning, confidence level, and risk tolerance. Women, on the other hand, are thought to devote more time and effort to establishing effective audit processes to avoid losses and reduce control and detection risks. In the first place, such traits are more likely to influence and increase the quality of any desired outputs (Niskanen, Karjalainen, Niskanen, & Karjalainen, 2011). Following the logic of the preceding reasons, this study predicts that appointing women to the RC will improve the quality of the risk management process and reduce the likelihood of the company receiving a modified audit opinion.

3. Theoretical Background

The difficulty in implementing "better" corporate governance has been identified as stemming from the potentially heated relationship between shareholders and the board of directors. This has been addressed by both resource dependency theory and agency theory.

3.1. Agency Theory

The separation of ownership and control in significant organizations was studied by Berle and Means (1932), which led to the development of the Agency theory. Agency theory is widely used in both economic and financial research, as various experts have pointed out (Fama, 1980; Jensen & Meckling, 1976). The theory focuses on the relationship between the shareholder (principal) and the manager (agent). Both the principal and the agent are recognized as working hard to attain their aims, which could lead to a conflict of interest between them, according to the idea (Fama & Jensen, 1983b; Jensen & Meckling, 1976).

According to Fama and Jensen (1983b), the best way to effectively reduce agency challenges generated by ownership and control separation is for businesses to establish a structure that distinguishes between decision management and decision control. The costs of the agency will be kept under control, and management will ensure that the interests of the

shareholders are effectively represented. Academics like Fama (1980), Fama and Jensen (1983a), and Shleifer and Vishny (1986) discovered that corporate governance measures diminish management opportunism. The agency theory also recognizes the firm's governance, which is manifested in its numerous internal and external procedures. This is because regulatory bodies are designed to reduce agency difficulties, protect shareholders' interests, and ensure that principal-agent interests are aligned (Davis, Schoorman & Donaldson, 1997).

Moreover, when it comes to managing management, governance solutions are less expensive to apply than other options such as takeovers, according to Fama (1980). According to agency theory, a better board structure reduces agency expenses, which improves corporate performance (Al-Shammari & Al-Saidi, 2014; Herdjiono & Sari, 2017). Nevertheless, agency theorists argue that board sub-committees like RMC are crucial in reducing agency expenses and difficulties because they aid the board in carrying out its supervisory duty over management, particularly concerning risk-related concerns (Abdullah & Shukor, 2017). Organizations perform better when all stakeholders' interests are aligned, according to the Agency Theory. Furthermore, better RM procedures and increased communication flow as a result of improved corporate governance, according to agency theory, contribute to lessening knowledge asymmetry among stakeholders.

3.2. Resource Dependency Theory

The resource dependency theory is a useful alternative hypothesis that has been employed in corporate governance research (RDT). In the corporate governance structure, this idea emphasizes the relevance of directors and board sub-committees like RMC. RDT is one of the most well-known theories in organizational and strategic management (Hillman, Withers, & Collins, 2009).

The RDT suggests that an organization functions in a certain environment and is limited in its long-term survival by the resources available in that environment. The theory lays the groundwork for understanding how corporate directors are responsible for providing the resources and abilities necessary to run their companies. RDT maintains that the major job of the sub-committees is resource provision, in contrast to agency theory's premise that directors' roles include monitoring (Pfeffer & Salancik, 1978). Furthermore, the efficiency of sub-committees is contingent on the external resources that external directors can supply and that will be employed to achieve the organization's objectives.

Furthermore, according to Pfeffer (1972), the RDT arose from his research, which highlighted the relevance of exchange and power correlation in organizations. Furthermore, it was further upon by Aldrich and Pfeffer (1976). According to Pfeffer (1972), RDT believes that a company's performance is determined by its ability to maintain control over certain resources that affect the smooth execution of its operations. The RDT highlights the board's role in safeguarding and gaining critical resources for the organization's survival in general (Garba & Mohamed, 2018). This can be performed through developing connections with a variety of resources, such as important units, raw materials, information, skills, clients, public officials, and social organizations, to name a few (Hillman & Dalziel, 2003).

As a result, the RDT's subcommittee is a wellspring of diverse resources that help the organization's operations and general success, as well as its survival (Daily, Dalton, & Cannella, 2003). The RMC can be considered as an organizational resource because it is a board committee. RMC members are expected to give their knowledge and talents to the organization (Baysinger & Hoskisson, 1990).

Subcommittees like the RMC assist the organization in obtaining critical resources in a cost-effective manner while also serving as a conduit between the business and its external stakeholders (Chen, 2014; Davis & Cobb, 2010). Creating stand-alone RMCs as supervisory mechanisms, according to the RDT, could improve mitigation (Jia, Li, & Munro, 2019).

3.3. Proposed Conceptual Framework

Risk management committees have been the subject of very little research. As a result, it's critical to figure out which RMC in Malaysia has an impact on modified audit opinions. Two hypotheses were employed as a conceptual connection in the proposed conceptual framework to explain the relationship between RMC and revised audit opinions of Malaysian publicly traded companies. Businesses should identify their risk appetite by creating proper risk management and internal control regulations, according to MCCG 2017. The board should form an RMC, consisting of a majority of independent members, to supervise the company's risk management structure and policies, as well as their implementation, as a Step-Up practice. RMC characteristics are also incorporated to cover the gap created by earlier investigations. As a result of the above discussion, this study develops a conceptual model that explains the link between RMC characteristics and revised audit opinions. This is illustrated in figure 1 below:

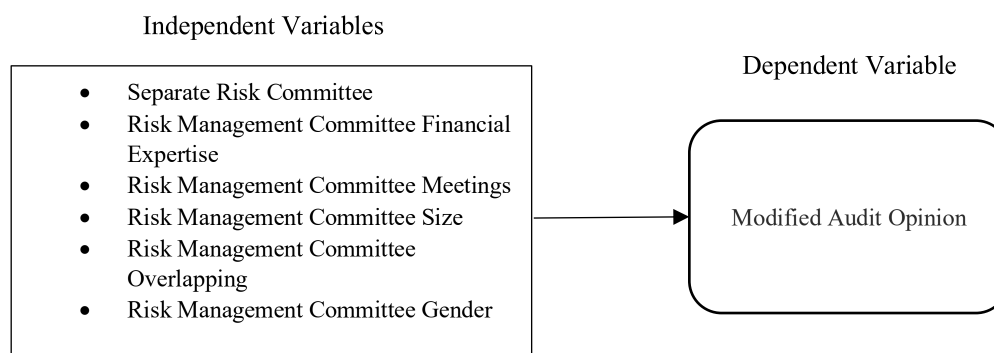

Fig. 1. Proposed Conceptual Model

4. Conclusion

Financial crises, corporate failures, the competitive environment, and globalization all put a strain on organizations' ability to endure. As a result, to preserve corporate accountability and improve operating performance, continuous risk monitoring and assessment have become a key priority in corporate management and public policy execution. The RMC has proven to be a very important statistic for most firms because of this.

The proposed conceptual framework for this study contributes to theory, context, and policy. It is proposed that RMC characteristics play a role in improving modified audit opinion. While there have been many studies on corporate governance and disclosure, the impact of RMC and revised audit opinions has been underestimated.

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