AUDIT COMMITTEE CHARACTERISTICS AND EARNINGS MANAGEMENT: A MALAYSIAN CONTEXT

ONG FONG YEW

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UNIVERSITI TUNKU ABDUL RAHMAN

FACULTY OF ACCOUNTANCY AND MANAGEMENT

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By

ONG FONG YEW

This research project is supervised by:

Rahizah Binti Abd. Rahim
Lecturer
Department of Accountancy
Faculty of Accountancy and Management

DECLARATION

I hereby declare that:

(1) This GBMZ 2016 Research Project is the end result of my own work and that due acknowledgement has been given in the references to all sources of information be they printed, electronic, or personal.

(2) No portion of this research project has been submitted in support of any application for any other degree or qualification of this or any other university, or other institutes of learning.

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Name of Student: Ong Fong Yew

Student ID: 09UKM08905

Signature:

Date: 7th May 2013

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LIST OF ABBREVIATIONS

AC	Audit Committee
FPLC	Federation of Public Listed Companies
HLFC	High Level Finance Committee on Corporate Governance
MAICSA	Malaysian Association of The Institute of Chartered Secretaries and Administrators
MCCG	Malaysian Code on Corporate Governance
MIA	Malaysian Institute of Accountants
MICG	Malaysian Institute of Corporate Governance
MICPA	Malaysian Institute of Certified Public Accountants
MID	Malaysian Institute of Directors

ABSTRACT

AUDIT COMMITTEE CHARACTERISTICS AND EARNINGS MANAGEMENT: A MALAYSIAN CONTEXT

Ong Fong Yew

Earnings management among public listed companies is seen as a platform for companies to project favourable financial results. Such practice is indeed detrimental to the shareholders and it contradicts the principles of corporate governance. In this respect, the audit committee (AC) plays a vital role to deter occurrence of earnings management.

This study seeks to investigate whether there is any relationship between the characteristics of audit committees and earnings management under the Malaysian corporate environment. The characteristics of audit committee included in this study are size of AC, number of meetings, financial literacy of AC members, legal experience of AC members, tenure of AC members and independence of AC members. Earnings management is proxied as the restatement of financial results.

The time frame for this study is limited to year 2011. A total of 70 Malaysian public companies were selected for this study. The samples comprised of 35 firms which have restated their financial results in the year 2011 and another 35 control firms which did not restate their financial results. The total assets size of the company is used as a basis for the matching of a restated firm against a non-restatement firm.

The results of the study, using Binary Logistic Regression, indicate that the size of the audit committee has the most significant relationship with earnings management. No significant relationship was discovered for other characteristics of AC namely , number of meetings, financial literacy of AC member, legal experience of AC members, tenure of AC members and independence e of AC members.

However, it can be noted that there is a negative relationship between these characteristics and earnings management.

Therefore, it can be concluded that if the size of ACs is increased, the chances of earnings management to occur can be minimized.

This study is limited geographically as it only investigates the scenario in Malaysia. Furthermore, the year under study is confined to year 2011. Further studies can be conducted in neighbouring countries across several years to see if the results support that of this study.

CHAPTER 1

INTRODUCTION

1.1 EXECUTIVE SUMMARY

Audit committee is seen as an independent body to an organization which provides external parties with the assurance that the company is practicing good governance. The audit committee liaises much with the external and internal auditors (Abbott, Parker & Peters, 2010), as these two parties are the frontlines to ensure that good governance practices are in place. The primary objective of the establishment of an audit committee is to fulfill the governance structure of a public company as well as to act as a monitoring mechanism to ensure that the interests of the stakeholders, particularly minority shareholders, are protected.

The role of audit committees has become increasingly important these days. Over the years, the responsibilities of the audit committee members have increased greatly (Rezaee, 2009). Companies nowadays operate under greater risk environment and are subjected to higher level of public scrutiny. With the increase in public's awareness on corporate governance issues, audit committee members have to be diligent in discharging their duties.

It is mandatory to have an audit committee for public listed companies in many jurisdictions around the world. In Asia, for instance, the Jakarta Stock Exchange (JSX) mandates that all public companies to have a minimum of thirty percent independent directors and an audit committee of not less than three members which must be chaired by an independent director (Siagian & Tresnaningsih, 2011). In China, the China Securities Supervisory Commission (CSRC) issued the Standards of Corporate Governance for Listed Companies in 2002 which requires public listed companies to have an audit committee (Jun Lin, Xiao, & Tang, 2008). In Australia, mandatory audit committees for publicly listed firms were introduced in 2003 (Siagian & Tresnaningsih, 2011). In the United States, the securities exchange had imposed stricter mandatory requirements on audit committees in the post Sarbanes-Oxley Act era of 2002 (Zaman, Hudaib, & Haniffa, 2011).

The committee serves as a mechanism under the good corporate governance practice. In Malaysia, all public listed companies on the Main Market and ACE (Access, Certainty, Efficiency) Market of the Kuala Lumpur Stock Exchange are required to have an audit committee. The law in Malaysia requires at least three members in the committee, a majority of whom should be independent. All the members in the committee should be non-executive, which means they must not be involved in the day-to-day operations and decision making of the company. Their duties, as listed under the Malaysia Code on Corporate Governance (MCCG) 2012 include, but are not limited to:

- Appointment, resignation or dismissal of external auditor and audit fees
- Discuss the scope of audit with the external auditors prior to the commencement of audit
- Review quarterly and year end financial statements
- Discuss, with the external auditors, matters arising from interim and final audit
- Review external auditor's management letter and management's response
- Work closely with the internal audit function
- Consider major findings on investigations and management's response

Looking at the duties of the audit committee, if all the duties are discharged to the fullest, a certain degree of good governance can be asserted. Where there is good governance, the occurrence of earnings management should be minimized. Earnings management refers to the use of judgement by the managers of the firm to conceal or alter transactions in order to mislead the shareholders or stakeholders on the underlying performance of the company (Healy & Wahlen, 1999).

Over time, the audit committees and audit profession had received continuous attention due to the happenings of financial collapses of large multinationals and numerous cases of earnings management or creative accounting, which went undetected despite audits. The most notorious case was the collapse of Enron, the large Houston-based energy company founded by entrepreneur, Kenneth Lay. The company was created in 1985 by a merger of two American gas pipeline companies and by 1997 the company was making $4 billion in sales, which constituted close to a fifth of the North American wholesale market (Solomon, 2007). However, several years before 2001, the company faced signs of distress and in late autumn that year, the company was suffering serious financial problem with a possible takeover. The fall was largely due to the audit and accounting function in Enron which were fraudulent and opaque. The auditors were guilty of acting slowly and inadequately, as special-purpose vehicle created to offload liabilities from Enron's balance sheet went undetected. Furthermore, the audit partner in-charge of Enron, David Duncan, was found to have ordered disposal of certain documents even after investigation was launched by the Securities Exchange Commission (SEC) (Solomon, 2007).

Another case that can be observed is that of Maxwell. Its scandal was said to be the greatest fraud of the 20th century (Stiles & Taylor, 1993). Robert Maxwell, the founder, was discovered to be misappropriating funds out of his two public listed companies to finance his own activities but the auditors failed to notice the movement of funds. An estimated £ 1 billion was lost in terms of shareholders' value when the public companies owned by Maxwell crashed. In Europe, Parmalat, an Italian company specialized in long-life milk, gained attention in 2003 as it struggled to make bond payments totaling € 150 million when its accounting books show a cash rich position. It was subsequently discovered that a whopping € 3.9 billion of company's funds held in Bank of America's subsidiary account in Cayman Island did not exist. Fortunately, Parmalat was able to survive the crisis.

One of the mechanisms that give rise to accounting scandals is the occurrence of earnings management. Since the current and projected value of a company can be linked to the reported earning figure, managers of companies are increasingly pressured to engage in earnings management. According to Healy and Wahlen (1999), earnings management happens when managers use their judgements in financial reporting to mislead stakeholders regarding the underlying performance of the company. Earnings management poses severe threat to a company as upon discovery of such practice, investors' confidence in the financial reporting of the company can be eroded and it impedes the efficient flow of capital in the financial market (Jackson & Pitman, 2001). Such practice reduces the reliability of the reported earnings as the figures are bias and does not reflect the actual performance of the company.

However, the occurrence of earnings management should be reduced if there is an effective and functioning audit committee. As the audit committee serves as a governing mechanism to protect the interest of the shareholders, any irregularities in the company's reporting process should be identified and addressed.

1.2 PROBLEM STATEMENT

It is unclear in the Malaysian context which of the characteristics of audit committee will lead to occurrence of earnings management.

1.3 RESEARCH QUESTION

This study seeks to answer the following questions:

1. Is there a relationship between characteristics of audit committee and earnings management?
2. If there is a relationship, which is the most significant characteristic that will indicate a possible presence of earnings management?

1.4 RESEARCH OBJECTIVE

The primary objective of this study is to investigate whether there is any significant relationship between the characteristics of the audit committee towards the occurrence of earnings management in a company in the Malaysian context. In particular, the focus is also to investigate which characteristics of the audit committees has the most significant relationship with earnings management.

CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter sets out the past and present literature relating to the topic of this study, which is to investigate the relationship between audit committee characteristics and earnings quality.

Audit committee characteristics refer to the composition of the audit committee as well as its activities. For the purpose of this study, we investigate the following characteristics of audit committee: size of committee, independence of the committee, number of meetings, tenure of directors serving on the committee, as well as financial and legal literacy of the audit committee members. These characteristics will be used to determine if they can influence the occurrence of earnings management, which is the occurrence of managers using judgement in financial reporting to modify or alter financial reports to mislead shareholders or stakeholders about the underlying economic performance of the company (Healy & Wahlen, 1999).

2.2 CORPORATE GOVERNANCE

Corporate governance has become one of the most talked about issue in the corporate agenda. The ultimate reason for the existence of corporate governance is to protect and increase shareholders' value (Walker, 2009). The definition for the term corporate governance is rather wide. Parkinson (1994) defines corporate governance as the process of supervision and control intended to ensure that the company's management acts in accordance with the interests of shareholders. Tricker (1984) mentioned that the governance role is not concentrated on the running of business of the company per se but with giving overall direction to the company and overseeing and controlling the executive actions of the management and satisfying legitimate expectations of accountability and regulation by interests beyond the corporate boundaries. Cannon (1994) refers governance as the sum of those activities that make up the internal regulation of the business in compliance with the obligations placed on the firm by legislation, ownership and control. It includes trusteeship of assets, their management and their deployment. The Cadbury Report (1992) defines corporate governance as the systems and methods by which companies are controlled and managed. According to Ross and Crossan (2012), the Organization for Economic Co-operation and Development (2004) provides a better and widely accepted definition to corporate governance. It states that:

> *"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."*

In Malaysia, the Malaysian Code of Corporate Governance 2012 defines corporate governance as:

> *"The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interests of other stakeholders."*

In general, the definitions of corporate governance available in literature tend to share certain common characteristics, and one of which is the quality of accountability. In essence, it relates to accountability to shareholders.

2.3 CORPORATE GOVERNANCE IN MALAYSIA

In the case of Malaysia, it typifies the insider-based model of corporate governance, as most companies are owned and controlled by founding families (Solomon, 2007). Corporate governance issues have been cited as the cause in which Malaysia succumbed to the financial crisis of 1997 (Shamsul, 2001). This has inspired corporate governance reform among East Asia countries.

In 1998, in anticipation of the implementation of a code of corporate governance in Malaysia, the Malaysian Institute of Corporate Governance (MICG) was incorporated under the Companies Act 1965. The founding members of the MICG were the Federation of Public Listed Companies (FPLC), Malaysian Institute of Directors (MID), Malaysian Institute of Accountants (MIA), Malaysian Association of The Institute of Chartered Secretaries and Administrators (MAICSA) and Malaysian Institute of Certified Public Accountants (MICPA). The MICG serves to be a better governance tool to improve the corporate governance scene in Malaysia (Liew, 2007). The main objective of the MICG was to promote awareness of corporate governance among corporations and the investing public.

At the same time, the Malaysian government also set up the High Level Finance Committee on Corporate Governance (HLFC) to set out the framework and best practices for corporate governance in Malaysia. The main objective of the committee was to promote high standards of corporate governance to strengthen investor protection and enhance the standing of Malaysian companies (HLFC, 2000).

Such development in the corporate governance scene has attracted research interest from Kean and Cheah (2000), who came out with the potential impact of first code of practice for Malaysian corporate governance. The mandatory nature of the code is the most significant characteristic. Currently, in Malaysia the corporate governance practice is much governed by the Malaysian Code on Corporate Governance (2012). However, as this study focuses on samples collected under year 2011, the Malaysian Code on Corporate Governance (2007) is adopted as this is the code under which companies adhered to in year 2011. After all, the changes in MCCG 2012, as compared to MCCG 2007, do not affect the variables or areas investigated under this study.

It is interesting to note that despite the corporate governance reforms in recent years in Malaysia, corporate scandals continue to surface. One very recent notable case of governance failure is that of Transmile Group Berhad. In 2011, four former directors of the company (2 of them being the audit committee members of the company at the time when the offence was committed) were charged with furnishing misleading quarterly financial results for the year ending 31 December 2006 to Bursa Malaysia. In early 2011, a director of Megan Media Holdings Berhad was charged with submitting a false financial statement to Bursa Malaysia which consisted of inflated revenues in its quarterly financial statements in year 2006 and 2007. Apart from that, in 2011, two directors of Suremax Group Berhad were sentenced to jail for share manipulation. In 2010, two former directors of MEMS Technology Berhad were convicted of furnishing misleading financial statements for the 12 month period ended 31 July 2007 to Bursa Malaysia. The misleading financial statements include fictitious sales amounting to 41% of the company’s total revenue. In that same year (2010), a former director of LFE Corporation Berhad was charged with defrauding the company to finance his purchase of the company’s shares. All these corporate scandals surface year after year despite the presence of governance tools and mechanisms.

Several Malaysian researchers on corporate governance have placed the fault on poor governance practice. Mohamad (2002) stated that poor governance practice is one of the major reasons leading to the collapse of Malaysian companies. Graham, Litan, and Sukhtankar (2002) mentioned that the cost of poor corporate governance is borne heavily by minority shareholders, which is the case in emerging markets such as Malaysia. In fact, Chen, Chen, and Wei (2004) was of the opinion that in emerging markets, majority shareholders do not feel obliged to provide returns to shareholders.

2.4 SHAREHOLDER THEORY

The primary contributors to the shareholder theory are Berle and Means (1932). These two researchers have pointed out that the separation of ownership and control has led to the emergence of a new class of professionals (whose main role is to manage the firm) who took over the management of the firm from its owner.

Shareholder theory in the context of corporate governance dictates that firms will maximize their profits in order to maximize shareholders' value or wealth (Jensen & Meckling, 1976; Kay & Silberston, 1995). The theory states that the firm will attempt to increase its economic efficiency in order to increase shareholders' wealth. As shareholders are the ones who have contributed capital to the firms, they are also made the owners of the firms and therefore they must bear the risk in the event of a corporate failure (Ross & Crossnan, 2012). Due to this reason, shareholders, who are the owners of the firm, are entitled to control the firm (Nwanji & Howell, 2007).

However, in recent decades, the corporate structures do not provide a perfect mechanism for owners to exercise their control over the firm. The corporate firms are now controlled by managers, rather than the owners themselves. These managers who are appointed to control the firm have their own interest to pursue as well. As a result of such separation of ownership and control, the issue of principal-agent problems arises.

2.5 AGENCY THEORY

Maijoor (2000) argued that many issues of corporate governance arise in companies due to agency theory. This theory suggests that the separation between management and ownership has led to a principal-agent conflict and managers may act in manners that benefit themselves at the expense of the owners or the principals (Ugurlu, 2000). Such differences between the interest of the owner and that of the manager will lead to information asymmetry and therefore result in agency cost (Farrer & Ramsay, 1998).

One of the ways to minimize such cost, as suggested by Farrer and Ramsay (1998), is to offer managers a share of ownership of the company by way of offering the company's shares to the managers. Mat Nor and Sulong (2007) however found that the managers' incentive to pursue own benefits increases when they own a small portion of the company' shares, while such incentive decreases when they hold a greater number of shares (Fleming, Heaney, & McCosker, 2005). Crossnan (2007) stated that the main reason for the existence of the board of directors is to minimize such principal-agent problems.

Another means of reducing the problems arising from agency theory is to engage independent directors to sit on the board. Almost all public listed companies comprises of many small shareholders. These minority shareholders are in no position to control the company and do not have the power to influence decisions made by the board. As a result, all these minority shareholders collectively are unlikely to monitor the company. This class of shareholders is also being disadvantaged due to their lack of industry and professional knowledge as well as information asymmetry. As a result, each shareholder will hope that other shareholders will do the monitoring function but unfortunately every shareholder thinks the same way and this results in no-monitoring or almost zero monitoring (Hart, 1995). Therefore, in order to overcome this issue, one of the task entrusted to independent directors are to represent such shareholders in protection of their interest and value.

2.6 AUDIT COMMITTEE AND CORPORATE GOVERNANCE

To protect shareholders' interest and for good corporate governance practice, the Cadbury Report (1992) recommended that all companies should establish an audit committee. Despite the wide adoption of audit committee concept, corporate failures as a result of corporate governance issue continue to happen. Later initiatives such as the Smith Report (2003) have focused on improving the audit committee mechanism. The Smith Report (2003) emphasized the essential role of audit committee in ensuring independence and objectivity of external auditor, and the same time monitoring company's management. The report stipulated that the main role of audit committee is to monitor the integrity of the company's financial statements, review company's internal control system, monitor the effectiveness of the company's internal audit function, make recommendations to the board as to the appointment or removal of external auditors and their remuneration, monitor independence of external auditor, among others (Smith Report, 2003). The Smith Report also highlighted the need for audit committee to be proactive and raise relevant issues of concern with board of directors. It also states that all members of the audit committee should be independent, non-executive directors.

2.7 DEVELOPMENT OF AUDIT COMMITTEE IN MALAYSIA

In the case of Malaysian companies, the Malaysian Securities Commission gave notice to all companies listed on Bursa Malaysia (then Kuala Lumpur Stock Exchange) to form audit committees in 1993. A grace period of one year (1994) was given to companies to implement this requirement. A survey done by Kuppusamy, Nazim, and Shanmugam (2003) showed that by 1998, all companies have complied with the requirement.

In the aftermath of the 1998 financial crisis in Malaysia, the Malaysian Institute of Corporate Governance (MICG) was establish to pioneer corporate governance awareness in the country. The MICG developed the Malaysian Code of

Corporate Governance in year 2000 and by year 2001, the Code was made mandatory for all public companies. The mandatory nature was to create an environment that demands higher standards of conduct and disclosures. One provision under the code was the mandatory establishment of the audit committee. As such, the development of audit committee in Malaysia seems to replicate that in the United Kingdom and other developed countries.

2.8 EARNINGS MANAGEMENT

The agency theory suggests that the separation between ownership and control is likely to result in managers involving in activities that benefit themselves (Jensen & Meckling, 1976). The maximum value of the firm is not achievable arising from the conflict between the interest of the owners and of the management. The difference between the maximum value of the company which ought to be achieved as against the value created as a result of agency relationship gives rise to agency cost (Palliam & Shalhoub, 2003).

In order to fulfill the management's own interest, earnings management or manipulation may surface. Earnings management was defined by Healy and Wahlen (1999) as the occurrence of managers using judgement in financial reporting and in structuring transactions to alter financial reports to mislead stakeholders about the underlying economic performance of the company. Earnings management can be detrimental to firms' value (Jiraporn, Kim, & Davidson, 2008) as a result of its implications towards the quality of financial reporting. Prior studies have provided evidence of numerous motivations that drives managers towards earnings management, for instance the quality of accounting firm (Davidson, Jiraporn, Kim, & Nemac, 2004), distribution of company's ownership (Hsu & Koh, 2005), CEO duality in which two leadership positions are held (Davidson et al., 2004), adoption of International Financial Reporting Standards (IFRS) (Tendeloo & Vanstraelen, 2005), tax incentives (Dhaliwal, Gleason, & Mills, 2004) and the hiring of senior executives from the company's external accounting firm (Geiger, North, & O'Connell, 2005).

These studies have pointed out that earnings management practices are hiding the truth of the company's actual value and eventually shareholders' or stakeholders' interest will deteriorate.

The practice of earnings management poses severe threats to a company as upon discovery of such practices, investor's confidence in the financial reporting function of the company can erode and it impedes the efficient flow of capital in the financial market (Jackson & Pitman, 2001). The reliability of the reported earnings is tarnished as the figures do not reflect the actual performance of the company. In the past, several high profiled audit failures have prompted international investigations into the issue of earnings management (Arya, Glover, & Sunder, 2003; Imhoff, 2003). Focus has been placed especially relating to the impact of audit quality on constraining the magnitude of earnings managements (Becker et al., 1998).

According to past researches, there are several ways in which earnings can be potentially manipulated by companies. The main tools are categorized into four areas, namely, discretionary accruals and estimation of liabilities, income recognition, excessive reserves and provisions and breaches of requirements in financial reporting (Ayres, 1994; Bruns Jr & Merchant, 2005; Francis, 2001).

2.9 EARNINGS MANAGEMENT AND AUDIT COMMITTEE

Investors and creditors must have faith in a company before entrusting their assets the company. One way to ensure such faith is to consistently report earnings which are reliable and faithfully represented. Good governance should ideally lead to good earnings quality. When a firm practices good financial reporting quality, there will be better clarity and consistency in disclosures and therefore reducing the chances of manipulation and fraud (Thiravudi & Huang, 2011).

In this respect, an audit committee serves as a tool to achieve good governance. Audit committee, which is an external governance mechanism, can serve as a function to prevent or reduce aggressive earnings management (Thiravudi & Huang, 2011). The formation of an audit committee is a governance mechanism to effectively reduce the conflicts arising from the separation of ownership and control (Abbott & Parker, 2000). Klein (2002) stated that the audit committee is a vital institution that complements the board of directors in the function of overseeing transparency and integrity of firms' financial reporting process. Wild (1996) stated that the main objective for the establishment of the audit committee is to enhance earnings and financial reporting quality. Kanagaretnam, Lobo, & Whalen (2007) found that the quality of corporate governance is negatively related to information asymmetry around earnings management.

Lary and Taylor (2012) stated that an effective audit committee needs to have members who are well-informed, and which a majority of them must be independent directors. They must also have the required authority and access to resources to protect the interest of shareholders by ensuring reliable financial reporting practices, good internal accounting controls and proper risk management practices. Based on past literatures in the area of audit committees, the effectiveness of an audit committee is measured using three broad areas. First is the ability of the committee to continuously maintain the independence of external auditors (Abbott, Parker, Peters, & Raghunandan, 2003). The second proxy assesses the committee's effectiveness by determining its ability to promote shareholders' interest by purchasing audit services of higher quality (Carcello, Hermanson, Neal, & Riley, 2002). Thirdly, the effectiveness of the committee is measured by its ability to maintain the integrity of the financial statements which is proxied by the extent of restatements (Aier, Comprix, Gunlock & Lee, 2005), fraud disclosures (Farber, 2005) and abnormal accruals (Klien, 2002). In Malaysia, the Putrajaya Governance Committee (2006) places great emphasis on the function of audit committee in improving the financial reporting process. It particularly states that the effectiveness of an audit committee can be improved via certain mechanisms, including their independence, financial literacy and expertise, time for meetings and relevant discussions with the related parties.

When good governance is in place, agency cost will be reduced and managers will have lesser incentives to manage earnings (Klien, 2002; Xie, Davidson, & Dadalt, 2003). Rainsbury, Bradbury, & Cahan (2008) reported that independent audit committee members with financial expertise is one of the assurances of effective monitoring of financial reporting process.

Peter and Cotter (2009) investigated whether the presence of an audit committee have any association with better earnings quality in the context of Australian public companies and the result shows that audit committees' formation reduces the chances of earning's management's intention. Chtourou, Bedard, and Courteau (2001) found that for audit committees with higher percentage of independent non-executive directors, earnings management practice is less likely to occur. On top of that, the study also evident that audit committees with at least one member with financial expertise reduces the chances of earnings management and larger boards are associated with better earnings quality. Klein (2002) reported negative relationship between audit committee independence and discretionary accruals but found no significant relationship between discretionary accruals and all-independent audit committee. Xie et al. (2003) found that companies with audit committees with corporate members and investment bankers who meet often have lesser chances of earnings management. Carcello, Hollingsworth, and Klein (2008) discovered that independent members of the audit committees with financial expertise are most effective in deterring earnings management practices.

However, recent study by Iyengar, Land, and Zampelli (2010) found no strong evidence of significant association between earnings quality and independence of audit committee. In addition, Peasnell, Pope, and Young (2005) indicated little evidence between audit committee characteristics and discretionary accruals. Lin, Li, and Yang (2006) too found no strong evidence concerning the relationship between restatements and financial expertise of the audit committee members and the number of meetings.

2.10 RESTATEMENT AS PROXY OF EARNINGS MANAGEMENT

Financial restatements refer to the altered presentation in part or in full of an earlier financial statement. Restatements can occur under many circumstances, including omission of information, mathematical error, incorrect facts provided, or even errors in the application of accounting principles.

Financial restatements are meant to provide more accurate information for the users of the financial reports and more importantly for the protection of shareholders' interest. However, the management can use this for their interest, that is, they can use their insider knowledge of the coming restatement announcement to their own benefit (Li & Zhang, 2006). Anderson and Yohn (2002) state that financial restatements clearly show that the previous financial reports issued are not credible, which could possibly lead to serious economic implications. Lev (2003) stated that financial restatements indicate earnings management practices in public companies. Huang, Zhang, Shen, and Xie (2011) found that accounting misstatements can be restrained by strong governance, such that by having an audit committee to oversee the financial reporting process.

2.11 AUDIT COMMITTEE CHARACTERISTICS

Consistent with the arguments above, this study seeks to examine the effectiveness of certain characteristics of the audit committee to reduce the chances of earnings management in a company in the Malaysian perspective.

2.11.1 Independence of Audit Committee (IND)

Audit committee independence is important for the committee to discharge their duties effectively. The Malaysian Code of Corporate Governance (2007) states that the board of a company should establish an audit committee comprising of at least three members and a majority of whom should be independent. Furthermore, all the members should be non-executive directors. An independent non-executive director is one who has no family relations to other directors of the company and is not involved in the operations or management of the company. Abbott, Parker, and Peters (2004) think that the requirement to have a minimum number of independent non-executive directors on the audit committee is an effort to uphold the status of the committee and increase the organizational influence of this governance mechanism. Turley and Zaman (2007), in their study, showed that audit committees possess influence and power in an organization.

An independent audit committee is crucial to perform its financial reporting oversight. The more independent the audit committee is, the more it will be able to perform financial reporting oversight effectively as the audit committee is not influenced by the management. Thus, objectivity is ensured if there is independence in the committee (Kolins, Cangemi, & Tomasko, 1991). Furthermore, as independent directors also usually serve as directors in other public companies, and therefore care about their reputation, they will discharge their duties more diligently (Nguyen & Nielsen, 2010). This is supported by the Cornett, Marcus, & Tehranian (2008), who found that independent directors bring greater wealth of experience to the firm as they are eager to build a reputation in the market through monitoring performance.

It can be concluded that an audit committee is fully independent when all the members of the committee comprises of only independent non-executive directors. The common expectation that an independent board would ensure more reliable financial reporting is supported by Abbott, Park, & Parker (2000) and Beasley et al. (2000). Abbott and Parker (2000) documented that there is a negative relationship between occurrences of earnings restatement with audit committees that only consist of independent directors. Chen and Jaggi (2000) found that the independence of directors is positively associated with comprehensiveness of financial disclosures. On top of that, Bedard, Chtourou, and Courteau (2004) reported that a reduced earnings management is positively associated with a composition of fully independent non-executive directors. Cornett, McNutt, and Tehranian (2009) found that independence of directors has a negative association with earnings management activity by large banks in the United States. Dimitropoulos and Asteriou (2010) found that there is strong association between independence of directors with improved financial performance and a lesser use of earnings management. This is also supported by Luan and Tang (2007) who found that appointment of independent directors is positively related to firm performance. Siagian and Tresnaningsih (2011) researched on 80 public firms in Jakarta from 1999 to 2004 and found that independent audit committees improve earnings quality.

However, some past researches have indicated that there is no relationship between independence of audit committee and earnings management. In Malaysia, for example, the argument of audit committee independence being associated with monitoring effectiveness is not empirically supported (Abdullah & Mohd-Nasir, 2004). Peasnell et al. (2005) found no significant association between Audit Committee independence and management of earnings. Lin et al. (2006) found no strong relationship between independence and occurrence of earnings restatement in their study of United States' companies. In 2010, Iyengar et al. found no strong evidence of significant association between earnings quality and independence of audit committee in United States corporations too. In order to determine whether there is any association between independence of audit committees and restatement of earnings in Malaysian companies, this study tests the hypothesis H1.

H1: There is a negative relationship between independence of audit committee and restatement of earnings.

2.11.2 Financial Literacy of Audit Committee (FIN)

As a member of the audit committee, one is expected to be able to ask tough and probing questions to ensure that the management is faithfully representing the activities of the firm (Spira, 2003). This is crucial to safeguard the interests of the shareholders of the firm. The presence of a member with financial expertise in the committee adds value to the shareholders of the firm in respect of technical accounting issues.

The Malaysian Code on Corporate Governance (2007) specifies that all members of audit committee should be financially literate and at least one of the members should be a member of an accounting association or body. It is important for audit committee members to be able to read, analyze and interpret financial statements so that they can effectively discharge their duties. As many of the audit committee's duties are involved with financial aspects, such as dealing with external auditors and reviewing periodic financial reports, the audit committee needs to be staffed with members who are financially sound. A financially literate team of audit committee should garner more trust on the part of shareholders as the latter will perceive the financial reports and in particular the earnings figures reported as more reliable and less likely to produce erroneous financial reports, be it quarterly reports or year end financial statements, when the audit committee team is financially literate. For example, Raghunandan and Rama (2003) discovered that shareholders are likely to support ratification of appointment of auditors if there is a financial expert on the committee. Davidson et al. (2004) found that there are positive stock price reactions when appointments of members with financial expertise to the audit committee are announced. Furthermore, Lee, Mande, & Ortman (2004) suggest that auditors are more likely to enjoy working with audit committees with financial expertise on the board. All these suggest the importance of having such financial expertise on the committee.

Carcello and Neal (2003) found that financial literacy of audit committee members is indeed proxy to the integrity of annual financial statements. In relation to earnings, Abbott et al. (2004) reported a negative relationship between the audit committee's financial expertise and occurrence of earnings restatement. Furthermore, DeZoort and Salterio (2001) stated that the financial expertise of audit committee members increases the likelihood that any material misstatements detected will be corrected timely. Bedard et al. (2004) discovered that there is a negative relationship between having a member with financial expertise on the board and earnings management. However, Lin et al. (2006) found no strong relationship between financial literacy of audit committee members and occurrence of earnings restatement in their study of United States' companies. Johari, Saleh, Jaafar, and Hassan (2008) discovered that directors' knowledge in accounting and finance does not make any difference in earnings management practices. Hence, this study will test the hypothesis H2.

H2: There is a negative relationship between financial literacy of audit committee and restatement of earnings.

2.11.3 Legal Background of Audit Committee (LEG)

One of the measurements of directors' expertise is whether they have legal background. A person can be said to have a legal background if he or she has the academic or professional qualification pertaining to legal studies. Krishnan, Wen, and Zhao (2011) defines a director as a legal expert as one who posses a law school degree or working experience as a lawyer. In their study of United States sample corporations, they found that directors with legal background contribute positively to the quality of financial reporting and surprisingly, the magnitude of the positive effect of legal expertise on financial reporting quality is greater than that of accounting expertise.

Having a member with legal experience on the committee can be a great asset as practitioners of the profession understands the legal implications and its seriousness for any breach of duties. Langevoort (2007) suggests that directors with legal expertise understand the legal liabilities that may arise from poor-quality financial information. Therefore, these directors will provide more support to compliance and internal controls as their natural attention and interest is to attend to legal risk.

Hence, it can be inferred that audit committee meetings staffed with a member with legal knowledge will be in a better position to vet through documents and reports more thoroughly and meticulously, as compared to one which lacks the advice from legal perspectives. In fact, Schwarcz (2006) concluded that there is a strong public perception that lawyers, to certain extent, have responsibilities to prevent financial reporting failure. This public perception possibly explains the reason why audit committees with more experts such as legal knowledge will attract greater stock market returns (Coates, Marais, & Weil, 2007) Furthermore, Palmrose and Scholz (2004) found that financial restatements due to low quality financial reporting practice are associated with litigation.

Xie et al. (2003) have used legal qualification as a measurement in assessing earnings management. Van der Zahn and Tower (2004) also used similar measures. Hence, this study will test the hypothesis H3.

H3: There is a negative relationship between legal qualification of audit committee and restatement of earnings.

2.11.4 Tenure of Independent Non-Executive Directors (TENURE)

Independent directors who had served on the committee for a longer period of time may develop better governance competencies as well as provide additional knowledge and expertise to the firm, thus are more capable of monitoring management performance. A longer serving director will better understand the systems and operations within the company. More importantly, a longer serving director will be able to understand the risks portfolio of the company and the market risk of the particular industry. Peasnell et al (2005) found the average tenure of non-executive directors is negatively associated with the level of earnings management. This means that the longer the director serves, the less likely that earnings management will happen. Yang and Krishnan (2005) found that the tenure of independent directors is associated with reducing earnings management. On the opposite, Johari et al. (2008) discovered that there is no significant relationship between the tenure of the audit committee members and earnings management practices. To examine the relationship, this study will test the hypothesis H4.

H4: There is a negative relationship between tenure of independent non-executive director in audit committee and restatement of earnings.

2.11.5 Size of Audit Committee (SIZE)

The size of an audit committee can be related to the size the board of directors in a firm. A board size which is larger provides a greater variety in which the audit committee members can be appointed to discharge their respective monitoring roles (Adelopo, Jallow, & Scott, 2011). Klien (2002) stated that if a firm's board size is limited, the number of directors available to be appointed to serve on the audit committee will be restricted as well. When choices are limited, the skills set brought to the audit committee will be limited and hence the function of the audit committee can be adversely affected.

The Malaysian Code on Corporate Governance (2007) states that each audit committee should consist of at least 3 members. A larger size of audit committee generally carries more expertise and experience, and thus is able to raise more insights during meetings. Dalton, Daily, Johnson, & Ellstrand (1999) found a positive relationship between size of audit committee and monitoring function, which leads to higher performance.

Past studies have pointed out mix relationship between size of audit committee and earnings management. Abbott et al. (2004) found no effect of size of audit committee on earnings management and this is concurred by Xie et al. (2003). However, Yang and Krishnan (2005) discovered that audit committee size is negatively related to earnings management, which indicates that certain minimum level of audit committee members is needed to ensure quality reporting. Lin et al. (2006) pointed out that there is a negative association between the size of the audit committee and the occurrence of earnings restatement. Thus, to examine the relationship between audit committee size and earnings management, this study will test the H5:

H5: There is a negative relationship between size of audit committee and restatement of earnings.

2.11.6 Number of Audit Committee Meetings (MEET)

The Smith Report (2003) in United Kingdom recommends that audit committee members should meet at least 3 times a year. However, in Malaysia, there is no regulatory requirement to mandate the minimum number of audit committee meetings to be held each year. The Malaysian Code on Corporate Governance encourages that such meeting to be held as frequent as possible.

The number of meetings is one of the factors that may contribute to earnings management as inactive audit committee members are unlikely to monitor management effectively. Van der Zahn and Tower (2004) used the number of audit committee meetings as proxy to measure the activeness of audit committee members. Hutchinson, Percy, and Erkurtoglu (2008) also used the number of audit committee meetings as proxy to the activity of audit committee. A meeting provides an avenue for audit committee members to understand and to be informed of the activities of the companies, and more importantly to be informed of any material findings of the internal and external auditors. On the other hand, a more frequent audit committee meeting encourages the external auditors to raise issues of concerns at an earlier stage.

Past literature indicates that the frequency of meeting is an indirect signal of board diligence (Abbott et al, 2004). Diligence is one of the factors that determine the effectiveness of audit committees (DeZoort, Hermanson, Archambeault, & Reed, 2002). Kalbers and Fogarty (1998) conducted a survey on audit committee members and found that an effective audit committee requires diligence on top of strong institutional support.

Based on a research done on firms in the United States, McMullen and Raghundan (1996) found that as frequency of audit committee meeting increases, the likelihood of enforcement action by the US Securities and Exchange Commission reduces. In addition, a study by Anderson, Mansi, and Reeb (2004) shows that firms' cost of debt decreases when the number of meeting increases. In fact, Menon and Williams (1994) noted that audit committee with small number of meetings is less likely to be a good monitor.

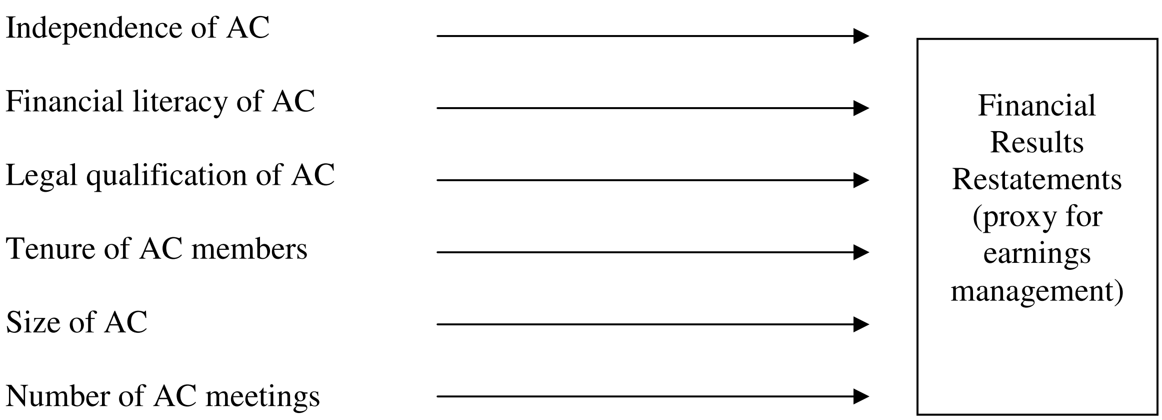
Beasley, Carcello, Hermanson, and Lapides (2000) found that audit committees of companies charged with fraudulent financial reporting meet lesser than those companies without financial reporting fraud. In addition, Abbott et al. (2004) found that audit committees of companies that restate their financial statements meet less than 4 times a year. Uzun, Szewczyk, and Varma (2004) on the other hand found no significant relationship between the frequency of audit committee meetings and the occurrence of corporate fraud. Lin et al. (2006) also found no strong relationship between the activeness of audit committee members and occurrence of earnings restatement in their study of United States' companies. There seems to be a conflicting relationship between number of audit committee meetings held and financial restatements. To further examine the relationship, we will test the H6:

H6: There is a negative relationship between number of audit committee meetings and restatement of earnings.

2.12 THEORETICAL FRAMEWORK

The following shows the theoretical framework of this study.

Independent Variables   Dependent Variable



AC = Audit Committee

The model above shows the independent variables affecting financial results restatements, which is the dependent variable.

2.13 CONCLUSION

Many past researches have been conducted in relation to audit committee and earnings management (Lin et al, 2006; Abbott et al, 2004; Becker, DeFond, Jiambalvo, & Subramanyam, 1998). From the literature there appears that most audit committee characteristics have an impact on earnings management with the exception of some studies. However, it may be noted that most of the research work done are centered on the western countries. This study, however, is conducted based on sample companies listed in Malaysia.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 INTRODUCTION

This chapter discusses the methodologies used in this study.

3.2 SAMPLE SELECTION AND DATA COLLECTION

Initially, the sample firms consists of 44 publicly listed companies in Malaysia that made amendments to their quarterly financial reports earnings for the fiscal year 2011. These companies are selected by screening the quarterly financial results of public companies listed on Bursa Malaysia. The details can be obtained from www.bursamalaysia.com. These firms are then screened for availability of the necessary financial information. The final samples include 35 companies after excluding 4 companies which financial information is not completely available, 3 companies which were delisted and 2 companies for which their control companies sample cannot be identified from Osiris database.

After identifying the 35 samples which has restated its financial results, the annual report of year 2011 are then downloaded for these companies and the information for the independent variables are identified, i.e. the size of the audit committee, financial background of the audit committee members, legal experience of the audit committee members, tenure of members, independence of members and number of meetings.

These earnings amendments samples are then matched with a non-amendment sample, also known as control samples, based on the industry involved and company’s size (total assets), using Osiris database. All the control samples are then screened for the absence of amendments in quarterly financial reports. This results in a final sample or pooled sample of 70 public companies. The size of 10 for every one independent variable is sufficient to arrive at a statistical conclusion, as provided by logistic regression authors Hosmer and Lemeshow (1989). Hence the 70 samples used in this study are sufficient.

The samples are selected based on year 2011 as this is the latest information available. Furthermore, this study seeks to determine whether there are any differences between the latest findings as compared to those conducted several years ago in Malaysia and other jurisdictions around the world.

3.3 MODEL

The following logistic regression model is being utilized. The dependent variable earnings restatement (RESTATE) equals “1” if the company restated its earnings for financial year 2011, and “0” otherwise. Independence of audit committee (IND), financial literacy of audit committee (FIN), legal qualification of audit committee (LEG), tenure of independent non-executive directors (TENURE), size of audit committee (SIZE) and number of audit committee meetings (MEET) are the six independent variables that measure the characteristics of audit committee.

$$RESTATE = \beta_1 IND + \beta_2 FIN + \beta_3 LEG + \beta_4 TENURE + \beta_5 SIZE + \beta_6 MEET$$

These independent variables are used because they have the ability to affect the effectiveness of an audit committee’s function. These independent variables adopted were only the internal characteristics of the audit committee. External or indirect characteristics such as whether the independent directors have directorship in other companies are not applied in the model because the study seeks to investigate the characteristics which are closest to the composition of the audit committee, thereby giving a conclusion which can better reflect the characteristics of the audit committee towards restatement.

Therefore, combining the effect of all the independent variables can provide an indication on the audit committees' characteristics towards restatements. As discussed in Chapter 2, many past literature across different countries have also adopted these variables to study the effectiveness of audit committees.

3.4 MEASUREMENT OF VARIABLES

The following table shows the measurements for the each of the variables.

Table 1: Operationalization of Variables

Variables	Measurement / Operationalization
Earnings restatement (RESTATE)	An indicator variable equal to "1" if sample company had restatements for the financial year under study, 2011, "0" otherwise.
Independence of audit committee (IND)	Measured by the percentage of independent directors over the total number of directors in the audit committee.
Financial literacy of audit committee (FIN)	Measured by the number of directors with accounting background.
Legal qualifications of audit committee (LEG)	An indicator variable equal to "1" if there is at least one director in the audit committee with legal background, "0" otherwise. The indicator is as such because the majority of the sampled companies have either 1 or no audit committee member with legal qualification.

Tenure of independent non-executive director (TENURE)	Measured by the average number of years that the audit committee members have served the company over the incorporated life of the company. Data is expressed in percentage. This measurement will best reflect the total years of experience that the audit committee members bring to the board.
Size of audit committee (SIZE)	Measured by the number of directors that serve the audit committee.
Number of audit committee meetings held (MEET)	Measured by the number of audit committee meetings held during the year under study.

This study has similarly adopted the operationalization method of variables under Saleh, Iskandar and Rahmat (2007) and Lin, Li and Yang (2006) which includes the measurement of the independence of audit committee (IND), financial literacy of audit committee (FIN), size of audit committee (SIZE) and frequency of meeting (MEET). In Saleh et al (2007), these variables were used to determine the relationship between audit committee characteristics and abnormal accruals. In Lin et al (2006), these variables were used to determine the relationship between audit committee characteristics and earnings quality.

The independent variable of legal qualification (LEG) of audit committee member is measured dichotomously, with "1" indicating there is at least one director in the audit committee with legal background, and "0" otherwise. This is measured as such because it is not mandatory to have audit committee members with legal background and hence most audit committees only have one member of legal background, if any.

The tenure of audit committee members (TENURE) is measured as the members' average years of serving the company against the incorporated years of the company. The measurement is such because the samples consist of varying appointment periods of the directors to the committee as well as varying incorporated years of the companies. Hence, using the average tenure best reflects the overall tenure of the independent directors.

3.5 STATISTICAL RESEARCH METHOD

For the purpose of this study, the binary logistic regression is adopted to analyze the relationship of the samples selected for this study. Binary logistic regression is adopted when the independent variables consists of metric and non-metric variables, while the dependent variable is non-metric with only two categories. In other words, the dependent variables are dichotomous.

CHAPTER 4

DATA ANALYSIS AND FINDINGS

4.1 INTRODUCTION

This chapter sets out the statistical analysis of the data obtain through the research and its findings. Data obtained were analyzed using Statistical Package for Social Sciences (SPSS), a statistical tool commonly used for business and management research.

4.2 DESCRIPTIVE STATISTICS

Table 2 shows the mean and t-statistics for the pooled sample firms, the restatement firms as well as the matched control firms.

The table shows that both the restatement and control samples scored rather identical means on legal expertise, which is 0.429. As for other variables, the means for them differ only slightly, as shown in the table.

An independent sample t-test was carried out on the sample that re-stated and the non-restatement sample and it was discovered that the size of the audit committees is significant (0.016) at confidence level of 95%. This means that we can conclude that there is a difference between the size of the audit committees that have restated as against the size of the audit committees for non-restated sampled companies. This finding is different from that of Lin, Li, and Yang (2006), who found that there was a significant difference in number of meetings between audit committees which have restated financial results and those which have not. However, their samples were based on United States firms and hence the difference in findings could be due to the variations in business and regulatory environment.

Table 2: Mean Tabulation for Independent Variables

Independent Variables	Mean			T- Test Sig.
	Pooled Sample	Restatement Sample	Control Sample	
Size of Committee	3.243	3.171	3.314	0.016*
Number of Meetings	4.914	4.971	4.857	0.496
Accounting Expertise	1.257	1.314	1.200	0.281
Legal Expertise	0.429	0.429	0.429	1.000
Independence of Members	0.700	0.714	0.686	0.798
Tenure of Members	0.427	0.440	0.420	0.385

* Significant at 0.05 level

Table 3 shows the maximum and minimum values for the independent variables which are non- dichotomous, i.e. size of audit committee, accounting expertise of audit committee, number of meetings and tenure of the directors.

The minimum number of directors is 3 which indicates that all selected samples meet the requirement of Malaysian Code on Corporate Governance (2007) in regards to the minimum number of members to serve on the audit committee. The maximum number of members is 5 from the samples selected. The mean for the pooled samples (restatement samples and control samples) is only 3.31, which may indicate that many companies are still reluctant to place more number of directors on the audit committee than the minimal requirement. This is probably due to the issue of remuneration cost for the directors as well as difficulty in identifying a suitably qualified candidate.

In terms of members with accounting expertise, the minimum number of audit committee members with accounting expertise is 1 while the maximum is 2. None of the sampled firms has all directors with accounting expertise. The mean of 1.26 obtained shows that a majority of the samples firms still do not have an audit committee which is made up of majorly directors with accounting expertise.

For number of meetings, there were two samples of audit committee who only met 3 times a year, which may be insufficient given that one of their main responsibilities is to review and approve quarterly financial results. The mean number of meeting is 4.89 times, which means on average the audit committees under study met an average of 5 times during the year under study, 2011.

In terms of tenure of directors, the mean of the pooled sample firms shows a value of 0.415, which means that on average, the tenure of the service of the audit committee members in their company made up of 41.5% of the total incorporated life of the company. It indicates that the audit committee members have served the company for a considerably long period of time since the company's incorporation. There are 2 samples of audit committees selected in which the directors have served as audit committee members since the incorporation of the said companies, thereby giving rise to a maximum value of 1.00 as indicated in the table below under the information for "TENURE".

Table 3: Descriptive Statistics for Non-dichotomous Variables

VARIABLES	No. of Samples	Minimum	Maximum	Mean	Std. Deviation
SIZE	70	3	5	3.31	.498
ACCOUNTING	70	1	2	1.26	.440
MEETING	70	3	9	4.89	1.043
TENURE	70	.04	1.00	.4153	.23067

The discussion below sets out the frequency of the samples for each of the independent variable. Table 4 shows the frequency distribution for size of audit committee. In terms of size, 70% of the samples selected have an audit committee size of 3 members while 28.6% have 4 members on the committee. Only 1 sample has a committee size of 5 members. Table 4.3 shows the frequency distribution for size of audit committees.

Table 4: Frequency Distribution for Size of Audit Committee

Number of Members	Frequency	Percent	Cumulative Percent
3	49	70.0	70.0
4	20	28.6	98.6
5	1	1.4	100.0
Total	70	100.0	

Table 5 shows the frequency distribution for audit committee members with accounting and finance background. 74.3% of the sampled audit committees have only 1 audit committee member with accounting qualification. This indicates that the majority of the audit committees are complying minimally to the regulatory requirement to have at least one member with accounting qualification. Only 25.7% of the sampled audit committees have 2 members with accounting qualification.

Table 5: Frequency Distribution for Members with Accounting Background

Number of Member	Frequency	Percent	Cumulative Percent
1	52	74.3	74.3
2	18	25.7	100.0
Total	70	100.0	

Table 6 shows the frequency distribution for audit committee members with legal background. The distribution of audit committee members with legal experience is rather balanced. 57.1 percent of the samples have no members with legal background, while 42.9% of the 70 samples selected have members with legal background.

Table 6: Frequency Distribution of Audit Committees with Legal Experience

With/Without Legal Experience	Frequency	Percent	Cumulative Percent
No Legal	40	57.1	57.1
With legal	30	42.9	100.0
Total	70	100.0	

Table 7 shows the frequency distribution for audit committee meetings for the samples selected. 45.7% of the samples selected met 5 times a year. This is followed by 34.3% of the samples who met 4 times a year. The distribution table indicates that 65.7% of the audit committees met 5 times and above during the year under study (2011) and this is a positive sign as the number of meetings held represents the activeness of an audit committee. Among the samples, only two audit committees met a minimum of 3 times during the year. (The minimum number of 3 times is a suggestion under the Smith Report 2003.) This minimum number of meeting may not be sufficient given the audit committee's responsibility to review quarterly financial results.

Table 7: Frequency Distribution for Number of Audit Committee Meetings Held

Number of Meetings Held	Frequency	Percent	Cumulative Percent
3	2	2.9	2.9
4	24	34.3	37.1
5	32	45.7	82.9
6	7	10.0	92.9
7	3	4.3	97.1
8	1	1.4	98.6
9	1	1.4	100.0
Total	70	100.0	

Table 8 shows the frequency distribution for the tenure of the directors who served on the audit committee. The tenure is measured in percentage using the average serving years of the directors over the firm's incorporated life. The percentages are then categorized to "below 50% - short tenure" and "50% and above – long tenure". The samples consist of 62.7% of audit committee members who served a short tenure and the remaining being audit committee members who had on average served the company for more than half of the incorporated life of the company.

Table 8: Frequency Distribution for Tenure of Audit Committee Members

Tenure	Frequency	Percent	Cumulative Percent
Short Tenure	44	62.7	62.7
Long Tenure	26	37.3	100.0
Total	70	100.0	

Table 9 displays the frequency distribution table for the independence of audit committees. All the samples selected have a minimum of two independent directors serving on the audit committee. For the purpose of analysis, the data are expressed as percentage of independent directors in the audit committee. The table shows that all the companies selected meet the requirement of Malaysian Code on Corporate Governance which requires the majority of audit committee members to be independent. In fact, 72.9% of the sampled audit committees have all independent directors on it. This shows that most of the sampled companies would want to project a strong governance image as a fully independent audit committee could be perceived to be better at discharging its oversight role.

Table 9: Frequency Distribution of Independence of Audit Committee Members

Percentage of Independent Directors	Frequency	Percent	Cumulative Percent
.67	13	18.6	18.6
.75	6	8.6	27.1
1.00	51	72.9	100.0
Total	70	100.0	

4.3 RESULTS OF BINARY LOGISTIC REGRESSION ANALYSIS

Table 10 shows the coefficient model for this study. The probability of the model chi-square 7.257 was 0.298. This indicates that the existence of a relationship between the independent variables and dependent variable is not supported.

Table 10: Coefficient Model

	Chi-square	Sig.
Model	7.257	0.298

Table 11 shows the test results for each of the independent variables. The standard error for each of the independent variables is less than 2, which indicates that there is no issue of multicolinearity in the logistic regression.

Table 11: Significance Table of Variables

Audit Committee Characteristics	Standard Error	Sig.
Accounting	.599	.403
Meeting	.264	.945
Independence	1.886	.899
Legal	.532	.810
Tenure	1.136	.593
Size	.574	.031

Table 12: Correlation Results

Audit Committee Characteristics	Accounting	Meeting	Independence	Legal	Tenure	Size
Constant	**-.235**	**-.412**	**-.438**	**-.108**	**-.100**	**-.707**
Accounting	1.000	-.136	.073	.150	-.080	-.010
Meeting		1.000	-.253	.202	-.102	.230
Independence			1.000	-.134	-.016	-.080
Legal				1.000	-.068	-.015
Tenure					1.000	.028
Size						1.000

Based on Table 11, the significance for each of the independent variable is greater than the level of significance of 0.05, except for size of audit committee with a significance level of 0.031. This indicates that size of audit committee has a significant relationship with financial statements restatements.

4.3.1 Analysis of Number of Meetings Held (MEET)

Based on Table 11, for the number of meetings held *MEET*, the significance level is at 0.945, which is not statistically significant. This finding supports that of Uzun et al. (2004) and Lin et al. (2006) who found no strong relationship between activeness of audit committee members and restatements. This is probably due to the fact that the ability to detect any irregularities within the financial reports does not necessarily increase with the increase in number of meetings. It could also be that the time between the supply of necessary information to audit committee members and the date of audit committee meeting is too close and hence there is insufficient time for the audit committee members to thoroughly vet through the information thus not being able to ask the right questions to detect any irregularities during the meetings.

However, the negative relationship between number of meetings and restatements (-.412), as indicated under Table 12, is supported by Abbott et al. (2004).

4.3.2 Analysis of Financial Literacy of Audit Committee Members (FIN)

For financial literacy of audit committee members *FIN*, the significance level is at 0.403 which is not statistically significant. This finding contradicts with that of Carcello and Neal (2003), Abbott et al. (2004) and Bedard et al. (2004) but supports the findings made by Lin et al. (2006) and Johari et al. (2008), who found no strong relationship between the financial literacy of audit committee members and restatements. This could be due to the fact that the audit committee members were not provided with sufficient information, especially on financial matters of the company, by the Chief Audit Executive. Therefore, the member(s) with accounting background is(are) unable to assess the financial condition comprehensively.

However, Table 12 shows that the relationship between financial literacy of audit committee members and restatements is negative (-.235), which supports that of Bedard et al. (2004) and Abbott et al. (2004).

4.3.3 Analysis of Independence of Audit Committee (IND)

The significance level for independence of audit committee *IND* is at 0.899, which is not statistically significant. This finding, although statistically insignificant, supports the negative relationship (-.438) (shown in Table 4.11) found by Abbott et al. (2000), Chen and Jaggi (2000), Bedard et al. (2004), Cornett et al. (2009), Dimitropoulos and Asteriou (2010) and Siagian and Tresnaningsih (2011).

The finding of this study on the relationship between audit committee independence and earnings management strongly supports that of Abdullah and Mohd-Nasir (2004), Peasnell et al. (2005), Lin et al. (2006) and Iyengar et al. (2010), who found no significant relationship between the independence of audit committee members and earnings restatement.

Hence, a fully independent audit committee does not necessarily prevent earnings restatements. Perhaps most independent directors, being outside directors, are unable to quickly detect any restatements as they are not involved in the day-to-day operations of the company and therefore may not be very familiar with the accounting environment of the company.

4.3.4 Analysis of Legal Experience of Audit Committee (LEG)

For audit committee members with legal experience *LEG*, the significance level is at 0.810, which is not statistically significant. This supports the findings made by Xie et al. (2003) and Van der Zahn and Tower (2004), indicating that the presence of a member with legal background on the audit committee does not necessarily deter earnings management. This is perhaps members with legal experience do not feel obliged to detect any irregularities in the financial records as there is(are) other member(s) with accounting background and the main purpose, to certain extent, of the latter's presence is to assess the accounting issues of the company.

However, Table 12 shows that the relationship between restatements and having an audit committee member with legal experience is negatively related (-.108) and this supports the findings of Langevoort (2007).

4.3.5 Analysis of Tenure of Audit Committee Members (TENURE)

The tenure of directors serving on audit committee *TENURE* is statistically insignificant at 0.593. This means that serving for a longer period on the audit committee does not necessarily help in detection of earnings management. Perhaps it is not the tenure but rather what matters are the skills of the directors in discovering irregularities of financial statements to prevent restatements.

The finding from this study supports that made by Johari et al. (2008) who found no significant relationship between the two variables. Peasnell et al. (2001) and Yang and Krishnan (2005) found that the relationship between tenure of audit committee member and restatements are negatively associated and this concurs with the correlation results of this study (-0.100) as shown in Table 12.

4.3.6 Analysis of Size of Audit Committee (SIZE)

The size of audit committee *SIZE* is the most significant of all the independent variables at the significance level of 0.031. The finding of this study supports that of Yang and Krishnan (2005) who found that the size of audit committee is significantly related to financial reporting quality. Lin et al. (2006) also pointed out a negative relationship between size of audit committee and the chances of restatement.

However, the finding in this study contradicts with that of Abbott et al. (2004) and Xie et al. (2003) who found no effect between size of audit committee and earnings management.

Therefore, based on the results of this study, size of audit committee is significantly related to earnings restatements. It can be inferred that having more members on the audit committee will increase the chances to detect any irregularities in the earnings quality. Each individual audit committee member possess different skills set and thus increasing the size of audit committee members enhances the overall performance of the audit committee, therefore resulting in a more competent and vigilant committee. This is necessary as the audit committee members do not meet on a frequent basis and any formal and meaningful communication or discussion is carried out during the audit committee meeting. Irregularities can be discovered easier if there are more inputs and queries from a larger audit committee.

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.1 CONCLUSION AND RECOMMENDATIONS OF STUDY

Audit committee is the cornerstone of corporate governance. It exists to ensure that proper systems and methods are in place for the proper running of the company. Together with the internal auditors and external auditors, the audit committees' aim is to protect the interest of stakeholders, in particular shareholders. Preventing earnings manipulation is just one of the responsibilities entrusted under the oversight role of the committee. Thus, it is crucial to have an audit committee which discharges its duties with commitment. To achieve this, only qualified, experienced and responsible directors should be appointed to the committee. If the audit committee fails, the structures, controls and systems of the organization will follow suit.

This study seeks to determine whether there is a significant relationship between financial restatements and audit committee characteristics of size, number of meetings, tenure, independence of directors, financial and legal literacy in Malaysia. The results show that the number of members in an audit committee has a significant relationship with financial statement restatements. The relationship is negative, meaning that when there are more members sitting on the audit committee, the chances of occurrence of financial restatement reduces. This is most likely due to the fact that bigger sized audit committees allows more space for discussion to take place as the additional directors contribute their thoughts and inputs.

For other characteristics of audit committees under this study, it is found that they do not significantly contribute to the occurrence of financial statement restatements. However, studies done in other countries using some similar variables indicate mix results. This could be attributed to the different business and regulatory environments. In this study, it is also interesting to note that audit committees staffed with more members with finance or accounting expertise does not necessarily prevent earnings management. This finding is surprising because theoretically it contradicts with the notion that the main objective of mandatorily requiring a member with accounting expertise to be appointed to the committee is to ensure that the committee can rely on this said director for expert advise relating to financial and accounting matters and that this director can support the audit committee in monitoring issues relating to finance and accounting. However, the results of this study do not strongly indicate so. The agency theory suggests engaging independent directors to be part of audit committees to reduce agency cost as the minority shareholders lack professional knowledge. It appears from the result of this study that independent directors with accounting and finance knowledge fail to reduce such agency cost in terms of accounting issues surrounding the organization.

In short, it can be concluded that restatement of financial results by companies are not fully attributable to the function and role of audit committee members except for the size of audit committee. This could mean that increasing the number of directors to sit on the audit committee will likely increase the chances to detect any issues in relation to the quality of financial reporting. This will not only reduce the chances of restatements, it will also increase deterrence of other undesirable activities such as manipulation of financial statements at the cost of minority shareholders. Therefore, based on the results of this study, the relevant Malaysian regulatory bodies, such as the Securities Commission, may consider exploring further to determine whether there is a need to impose mandatory requirement on public companies to increase the size of their audit committees. After all, the minimum size of three members for audit committees was set more than a decade ago and given the complexity of business transactions in recent years, it is logical that more directors be appointed to serve on the audit committee to facilitate a governance mechanism which is more comprehensive and inclusive. For a start, the Securities Commission may impose a comply-or-explain approach in relation to this exercise as certain companies may have difficulties identifying a suitable candidate as independent director due to reasons like remuneration cost and relevant industry experience of directors. In this respect, the Malaysian Institute of Corporate Governance can also play a role by actively engaging independent directors by providing the necessary support and trainings so that these directors are fully aware of their responsibilities.

Increasing the size of audit committees will also directly translate to an increase in the pool of experienced audit committee directors in Malaysia. In fact, this can help facilitate rotation of audit committee members among public companies. Such rotation can be seen as one of the means to improve or strengthen the corporate governance scene locally. Furthermore, allowing a larger audit committee will also create more opportunities for directors to build experience as well as reputation as independent directors, thus strengthening the skill set of the directors to discharge their monitoring and governance role. Not withstanding that, the individual company will benefit from the additional advisory provided by the additional audit committee member(s). Ultimately, the beneficiary will be the shareholders as the governance of companies will be further upheld through the inclusion of additional audit committee directors.

While increasing the size of the audit committee may possibly reduce financial restatement, care must be taken by boards of company to not overstaff the audit committee. An overstaffed team will likely to cause more issues than the benefits offered by such a big team. When the committee is overstaffed, chances are agreements are unlikely to be achieved as each director has his or her own view and may not be comfortable taking into others' point of view. Large committees also make it hard for arrangements to be made for meetings, whether it is face-to-face or virtually, such as teleconferencing. On top of that, it may also create situations where individual directors not contributing to the committee. Therefore, the number of directors appointed to sit on the committee must be carefully determined by the board, and that only qualified, experienced and ethical directors ought to be appointed to the committee as they are tasked with the duty to safeguard shareholders' interest.

5.2 LIMITATIONS OF STUDY

The timeframe of this study is limited to year 2011 only. Therefore, it is unclear as to the position of audit committee characteristics and financial restatements for the years leading to 2011. Future studies can stretch across years instead of just limiting the study to one particular year. A study that stretches over years may provide a more valuable insight as it takes into account the effect of regulatory and economic changes that occur under the years under study. For instance, the results could be different if the study is conducted in a period which includes year 2008, the year in which the economic climate was slow due to the slowdown and collapse of several large institutions in the United States. Also, studies can be carried out in the few years after the establishment of Minority Shareholders Watchdog Group in year 2000, an organization formed by the government of Malaysia in the interest of protecting minority shareholders and at the same time encouraging corporate governance best practices among public companies.

Furthermore, the characteristics of audit committees that are investigated under this study is confined to the size, tenure, independence, number of meetings and financial and legal literacy of the audit committees. The characteristics can be further expanded to areas such as gender of the audit committee member to determine if there are any differences between male and female directors. In addition, age and remuneration of audit committee members can also be investigated to determine whether there exist any relationship with restatements.

This study is also geographically limited as the sampled firms are selected from Malaysian companies. Further studies may focus on South East Asia countries, which will provide some insights as to whether audit committees operating in different business environments will affect financial restatements. Furthermore, researches can be conducted in Western countries such as the United States and United Kingdom to see if there are meaningful variations between the findings in this study and that of those countries. This is because the concept of corporate governance and audit committees originated from the Western countries and it can be said that these countries are far more matured where governance issues are concerned.

For certain, the responsibility to deter the occurrence of earnings management does not rest solely on audit committees. Auditors, both internal and external, play equally vital roles in ensuring the quality and reliability of financial statements prepared by the company. Hence, further studies can also be carried out in respect of auditors' role in deterring earnings management. For instance, whether the audit fees, non-audit fees, tenure of the external auditors or status of the accounting firm (Big Four or not) have a role to play in earnings management. Other than that, studies can also be carried out to investigate whether the characteristics of internal auditors or its activities contribute to the occurrence of earnings management. Since the chief audit executive reports to the audit committee, the functionality of the committee does rely upon the information provided or work carried out by the internal auditors.

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