AUDIT COMMITTEE CHARACTERISTICS AND QUALITY OF UNAUDITED FINANCIAL ACCOUNTS

by

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LIST OF ABBREVIATIONS

BMF : Bumiputra Malaysia Finance Limited
CEO : Chief Executive Officer
CPA : Certified Public Accountant
KLSE : Kuala Lumpur Stock Exchange
OLS : Ordinary Least Square
MIA : Malaysian Institute of Accountants
MICG : Malaysian Institute of Corporate Governance
MSEB : Malaysian Securities Exchange Berhad
PATMI : Profit After Tax and Minority Interest
RM : Ringgit Malaysia
ROA : Return On Asset
ROE : Return On Equity
SPSS : Statistical Package for Social Science
CIRI-CIRI JAWATANKUASA AUDIT DAN KUALITI AKAUN KEWANGAN TIDAK DIAUDIT

ABSTRAK

Pelaporan kewangan digunakan di dalam proses membuat keputusan ekonomi. Dengan itu, adalah perlu bagi pelaporan kewangan menyediakan maklumat kewangan yang benar. Pada masa yang sama, jawatankuasa audit ditugaskan untuk menyemak akaun kewangan dan diharap dapat memastikan ketepatan akaun kewangan. Oleh itu, selain daripada memeriksa kewujudan variasi antara keuntungan di dalam akaun kewangan tahunan yang tidak diaudit dan yang diaudit, kajian ini juga memeriksa kesan ciri-ciri jawatankuasa audit terhadap kewujudan variasi tersebut.

AUDIT COMMITTEE CHARACTERISTICS AND QUALITY OF UNAUDITED FINANCIAL ACCOUNTS

ABSTRACT

Since financial reporting is widely used in the process of making economic decision, it is vital for financial reporting to provide the truthfulness of information. Meanwhile, an audit committee which is discharged with the responsibility in reviewing the financial accounts is expected to ensure the accuracy of these financial accounts. Thus, besides of just examining the occurrences of variations between earnings in unaudited year-end financial account and audited annual account, this study also examines the effects of audit committee characteristics on these variations.

By using 261 sample companies listed on the Bursa Malaysia in 2004, it was found that 64-percent of companies do have variations in their financial accounts. The occurrences of these variations have raised questions regarding the quality of quarterly accounts produced. The results of the multivariate analysis provide support for the effect of audit committee characteristics on earnings variations, whereby audit committees with greater number of average directorship holdings in other companies and a higher number of members were found to be positively associated with non-variations financial accounts. These results add to the growing literature on the relationship between audit committee characteristics and financial reporting quality.
CHAPTER ONE
INTRODUCTION

1.0 Introduction

With the occurrence of the East Asian financial crisis in the mid-year of 1997, together with the corporate scandal involving Enron, the seventh largest company in the United States (during that time) and TRI Berhad in Malaysia, suggest the need for a better practice of corporate governance in the corporate world today. Corporate governance is a set of mechanisms adopted in order to ensure that directors and managers make decisions and act in the best interests of the stakeholders (Gillian and Starks, 1998; Lashgari, 2004; Thillainathan, 1999). Recently, the government has taken steps to review and strengthen the corporate governance in Malaysia where in 1998, the Malaysian Institute of Corporate Governance (MICG) was established to enhance the practice of corporate governance in the country. One of its main responsibilities was to develop guidelines on good practices for companies as other advanced countries around the world. In March 2000, the Finance Committee on Corporate Governance, formed by the MICG has released the Malaysian Code on Corporate Governance which was aimed at providing guidelines on structures and processes that companies can use to observe good corporate governance in their business practices. Initially, the Code was introduced as a voluntary requirement for companies to use as a guide to ensure and enhance corporate governance. However, by January 2001, it was made mandatory for companies to adapt the Code in order to create an environment that demands higher standards of conduct and higher quality of disclosures from public listed companies and their board of directors.

A few authorities have also introduced certain requirements in promoting good corporate governance. For example, the Companies Commission of Malaysia had
launched the Malaysian Directors’ Code of Ethics, which is applicable to all corporations including unlisted companies. Besides that, the government also initiated the establishment of the Minority Shareholders Watchdogs Group to encourage shareholders’ active participation and help raise corporate governance standards. In 2001, the Bursa Malaysia, [formerly known as the Kuala Lumpur Stock Exchange (KLSE)], has revamped the Main Board and Second Board listing requirement with the objectives to enhance corporate governance and transparency, enhance efficiency in capital market activities and strengthen and promote investors’ confidence. This new listing requirement is one rule book that is applicable to both Main Board and Second Board companies.

1.1 Background

1.1.1 Audit Committee

In the corporate structure, there are two different parties involved; the management and the providers of funds, and therefore potential conflicts of interest among these participants may arise (Gillian and Starks, 1998). These conflicts of interest, often referred to as agency problem, arises from two main sources; different participants have different goals and preferences; and the participants have imperfect information as to each others’ actions, knowledge and preferences (Gillian and Starks, 1998). Audit committee is one mechanism available to the board of directors to limit conflicts of interest between managers and stockholders (Menon and William, 1994). With the wide adoption for the formation of audit committees around the world suggests the importance of an audit committee as a governance mechanism. “The evolution of audit committees in the corporate environment can be divided into four phases: voluntary establishment of audit committee; mandatory establishment of audit committee;
functions and effectiveness of audit committee; and strengthening the effectiveness of audit committee” (Kuppusamy, Nazim and Shanmugam, 2003, p.514).

The debate on the need for better corporate governance in Malaysia had actually began to be highlighted much earlier following the Bumiputra Malaysia Finance Limited (BMF) scandal in mid-1982 causing a loss of RM 2.5 billion (see for example Ling, 1992). BMF, a subsidiary of Bank Bumiputra Malaysia Finance Berhad (BBMB) at that time, was a license-deposit-taking in Hong Kong. The nearly collapsed of BBMB, the largest domestic bank in the country at that time, could be said as the start of the audit committee development in Malaysia (Abdullah and Al-Murisi, 1997). In 1985, the Bank Negara required all financial institutions under its supervision to have an audit committee to be chaired by a non-executive director. The requirements were made clear through the “BNM/GP1 – Guideline on Duties and Responsibilities of Directors and Appointment of Chief Executives” which was issued on 1st November 1985. Responsibilities were placed on the board of directors of financial institutions to establish audit committees through Section 2(ii) of the guideline which states that the board must “establish an audit and examination Committee of Directors comprising of non-executive directors”.

However, the mandatory requirement for the formation of audit committee for listed companies in Malaysia came much later in 1993 when the Bursa Malaysia made amendments to their Listing Requirements by introducing a provision in Section 344A requiring the establishment of audit committees for companies listed on Bursa Malaysia effective from 1st September 1993. A period of one-year (1994) was given for the companies to comply with this requirement. Under this requirement, an audit committee must be composed of no fewer than three (3) members comprising a majority of non-executive directors and the audit committee members shall elect a chairman among them who shall be a non-executive director. The extent to which this mandatory
formation was complied can be seen in Table 1.1 of this study. The survey shows that in 1993 only 17 percent of the sampled Main Board companies and 5 percent of the sampled Second Board companies had formed audit committees. However, a year later an increase to 56 percent of Main Board companies and 24 percent of Second Board companies had formed their audit committees. All the sampled companies had formed their audit committees only by 1998.

Table 1.1
Formation Of Audit Committees In Listed Firms In Malaysia

| Year | Main Board | | | Second Board | | | |
|------|------------|------------|------------|----------------|----------------|------------|----------------|----------------|
|      | Frequency of Audit Committees formation | Total listed firms | % over listed firms | % over total sample | Frequency of Audit Committees formation | Total listed firms | % over listed firms | % over total sample |
| 1991 | 0 | 292 | 0.0 | 0.0 | 0 | 32 | 0.0 | 0.0 |
| 1992 | 1 | 317 | 0.3 | 0.3 | 0 | 52 | 0.0 | 0.0 |
| 1993 | 56 | 329 | 17.0 | 16.7 | 10 | 84 | 11.9 | 4.5 |
| 1994 | 187 | 347 | 53.9 | 55.8 | 54 | 131 | 41.2 | 24.4 |
| 1995 | 27 | 369 | 7.3 | 8.1 | 36 | 160 | 22.5 | 16.3 |
| 1996 | 28 | 413 | 6.8 | 8.4 | 43 | 208 | 20.7 | 19.5 |
| 1997 | 30 | 444 | 6.8 | 9.0 | 51 | 264 | 19.3 | 23.1 |
| 1998 | 6 | 454 | 1.3 | 1.8 | 27 | 282 | 9.6 | 12.2 |
| Total | 335 | | 100 | 100 | 221 | | 100.0 |


Changes were also made on audit committee composition under the revamping of the Listing Requirement, where alternate directors were not permitted to be appointed as a member of the audit committee and one of the members of the audit committee must be a member of the Malaysian Institute of Accountants (MIA) or if he/she is a non-member, he/she must have at least three (3) years working experience and further have passed the examinations specified in Part I of the 1st Schedule of the Accountants Act 1967 or a member of one of the associations of accountants specified in Part II of the 1st Schedule of the Accountants Act 1967.
1.1.1(a)  The Roles of Audit Committee

With the rapid growth in the Malaysian economy, especially with the privatization of the nation's postal, telecommunication, power and sewerage treatment operations, the business environment and laws are becoming more complex and these have created a greater demand for an acceptable level of corporate behavior, not lacking from professionalism and credibility, to uphold good corporate integrity (CheAhmad, 2001). Hence, with the wide adoption of the audit committee arguably suggests that the audit committee is an important element of the system of corporate governance.

The audit committee is a committee of the board of directors, which assumes some of the board's responsibilities (Menon and Williams, 1994). As widely recognized, the duties of the audit committees have been related to internal audit (see for example Raghunandan, Read and Rama, 2001), financial reporting (see for example McMullen and Raghunandan, 1996; Read and Raghunandan, 2001; Song and Windram, 2000), and external auditor (see for example Archambeault and DeZoort, 2001; Carcello and Neal, 2000; Carcello and Neal, 2003; DeZoort and Salterio, 2001). These three interrelated duties are discharged to audit committees to ensure that financial statements and external filings fairly represent the financial results of the company and to enable independent verification of the efficiency of systems and controls (Atkins, 2002). In Malaysia, the mandated functions of an audit committee which are based upon the Listing Requirements of Bursa Malaysia Securities Berhad (2001) also cover these three aspects. Under Chapter 15.13 of the Listing Requirements of Bursa Malaysia Securities Berhad (2001), the committee is discharged with the function of reviewing and reporting to the board of directors the following:

a) the external auditor audit plan, his evaluation of the internal control system, his audit report and assistance given by the employees of the company,
b) the adequacy of the scope, functions and resources of the internal audit functions and that it has the necessary authority to carry out its work,

c) the internal audit program, processes, the results of the internal audit program, processes or investigation undertaken and whether or not appropriate action is taken on the recommendations of the internal audit functions,

d) the quarterly results and year-end financial statements,

e) any related party transactions and situations regarding conflicts of interest,

f) any letter of resignation from the external auditors, and

g) whether there is a reason to believe that the external auditor is not suitable for re-appointment.

Besides that, the audit committee also plays a role in recommending the nomination of external auditors.

1.1.2 Financial Reporting

Financial reporting is an important element of the system of corporate governance and some failures of corporate governance may therefore be due to inadequate financial reports (Whittington, 1993). This is because, the financial reporting serves as the main means of communication between companies and stakeholders by relieving fundamental asymmetry information between the directors, who have access to management information, and providers of finance who are external to the company (Whittington, 1993). Published corporate annual reports are one of the many forms of accounting reports made available to third parties and probably the most common and well-known form (Stone, 1967).

Accounting data clearly furnishes one type of quantitative data that can be used as a basis for making some of the choices that have to be made from among the
alternatives available and for checking and evaluating progress and results (Stone, 1967). Audited financial statements also provide a common ground for investors to compare firms within or across time periods (Hodge, 2001). Therefore, financial reporting is a crucial link in enabling providers of finance to monitor directors (Whittington, 1993) and therefore help them to make economic decisions (Razman and Iskandar, 2003).

However, with the widespread manifestation of fraudulent or misleading financial reporting in the most recent spate of corporate disasters, have given impetus to inquiries concerned with the integrity of the financial reporting process, the responsibilities of those involved in it and the truthfulness of financial statements (Wolnizer, 1995). This is because the credibility and transparency of financial reporting of a company depends on the monitoring mechanism of that company (Fama, 1980).

In Malaysia, under the Malaysian Companies Act 1965, every company registered under the Act is required to produce financial accounts for every financial year. The Act also requires that this annually financial account be audited by an external independent auditor referred as the approved company auditor. An audited financial statement increases the reliability of financial information for users which is necessary if managers, investors, creditors and regulatory agencies are to make informed decisions about resource allocation (Messier and Boh, 2002). Therefore, by adding the audit function by an external independent auditor in the business environment, the users of the financial statements have reasonable assurance that the financial statements do not contain material misstatements or omissions and shall enhance the credibility of the audit report (Messier and Boh, 2002). The auditor’s report, which accompanies the financial statements, attests to the truth and fairness of such statements and in doing so provides a degree of assurance to users of the financial statements that the statements are free of material misstatements (Ismail and Iskandar, 2003). In addition
to this, under Chapter 9.23 of the Listing Requirements of Bursa Malaysia Securities Berhad (2001), listed companies are also required to produce their annual audited accounts no later than four (4) months by the end of their financial year and their annual reports no later than six (6) months by the end of their financial year.

In Malaysia, besides having required to comply with the Companies Act 1965, listed companies are also required to comply with the Listing Requirements of Bursa Malaysia Securities Berhad (2001), where under Chapter 9.22 of the Listing Requirement, all listed companies are required to produce quarterly financial accounts. The purpose of this requirement is so that shareholders can be informed more regularly (without having to wait for the companies’ annual audited accounts) and therefore, will enable the shareholders to monitor the performance of companies on a regular basis. In addition to this, the requirement also states that all listed companies are required to produce this report no later than two (2) months by the end of each quarter of their financial year.

1.2 Problem Statement

Since the Enron Corporation’s scandal in 2001 in the United States, there have been consistent moves for better quality and consistency of accounting and accurate reporting to protect the interest of the stakeholders (see for example, the Sarbanes-Oxley Act introduced in the United States in 2001). This is because financial reporting is an important element in the corporate structure, by relieving a fundamental asymmetry information between managers/directors and providers of finance (Whittington, 1993). The limited access to managerial information causes the providers of finance such as shareholders and debtholders, to be forced to rely on the financial reporting.
As financial reporting provides value-relevant information to the external parties of the organization, the heavy reliance placed on accounting numbers create powerful incentives for managers to manipulate earnings to their own advantage (Rahman and Ali, 2006). Hence, it is important for the financial accounts to provide the truthfulness/accuracy of financial information to enable the shareholders to make decisions wisely. The lack of accuracy in the financial results will lead to the shareholders' making wrong judgments concerning their decisions.

As noted earlier in the previous sub-section, besides having required to produce annual audited accounts, listed companies are also required to produce quarterly accounts. However, since the nature of quarterly accounts which are not generally audited and contain less disclosure as compared to annual audited accounts, the quality and reliability of these accounts have raised concerns (Yang and Krishnan, 2005). Thus, due to the nature of these accounts, managers may be more able to manage quarterly accounts as opposed to annual accounts (Yang and Krishnan, 2005) and may have relatively more latitude to manipulate the quarterly numbers than annual numbers (Jeter and Shivakumar, 1999). Besides that, the issues related to inaccuracy of quarterly accounts have also raised the concern of the Bursa Malaysia, where a requirement was mandated for companies with variations between profit after tax and minority interest (PATMI) in unaudited year-end quarterly account and audited annual account of 10 percent and more, to make immediate announcements concerning the variations and a complete explanation of the deviation to the Bursa Malaysia [Chapter 9.19(34) of Listing Requirements of Bursa Malaysia Securities Berhad (2001)].

The concerns regarding the quality of financial reporting have raised questions regarding the effectiveness of the monitoring mechanism of a company. Fama (1980) suggests that the credibility and transparency of financial reporting of a company depends upon the monitoring mechanism of the company itself. Effective corporate
governance mechanisms safeguard the rights of investors in getting true and fair information of the company (Rahman and Ali, 2006). One high-level governance device, which has been discharged in ensuring the quality of financial reporting, is the audit committee. This is because board of directors often delegates the responsibility for oversight of the financial statement reporting process to an audit committee (Beasley, 1996). In Malaysia, whether the audit committee should be formed or not is no longer a relevant issue since it has been strongly answered in affirmative: Chapter 15 of the Listing Requirements of Bursa Malaysia Securities Berhad (2001). What has been an issue of greater interest among academicians, investors and regulatory bodies are the effectiveness of audit committees in performing their functions. This is due to the fact that even though the formation of an audit committee is mandatory in Malaysia, their effectiveness as a governance mechanism may still be questionable. Moreover, from studies conducted in other countries, there have been sufficient evidence to conclude that the presence of an audit committee alone does not assure that the committee will perform their duties as expected (see for example Beasley, 1996; Collier and Gregory, 1996), where the formation of audit committees were said to be for cosmetic purposes (Menon and William, 1994) and as a training ground for new directors (Vafeas, 2001).

1.3 Research Questions

The situations as stated above, together with the arising issues on the quality of quarterly accounts and the effectiveness of audit committees in reviewing them lead to the following research questions:

1. Are quarterly financial accounts produced by companies reliable (in terms of their accuracy)?

2. Are audit committees effective in reviewing the quarterly accounts produced by companies?
3. Do the characteristics of audit committee have an effect on the accuracy of quarterly accounts?

1.4 Research Objectives

Based upon the problem statement and research questions stated in the earlier subsections, the objectives of this study can be categorized into two main objectives. Firstly, since the variations between profit after tax and minority interest (PATMI) in unaudited year-end quarterly account and audited annual account by listed companies in the Bursa Malaysia has never been examined in prior studies conducted (to the author’s knowledge), therefore this study attempts to examine the occurrence of this variations. Besides that, this study also tries to examine whether the characteristics of audit committees have an effect on the variations. Specifically, the study attempts to examine:

1. the occurrence of variations between profit after tax and minority interest (PATMI) in unaudited year-end quarterly account and audited annual account by listed companies in the Bursa Malaysia;
2. the differences in the characteristics of audit committee between companies producing an accurate unaudited year-end quarterly account and an inaccurate unaudited year-end quarterly account;
3. the relationship between the characteristics of an audit committee and accuracy of unaudited year-end quarterly account.

1.5 Significance of the Study

Consistent with recent studies done on the quality of financial reporting (see for example Guan, He and Yang, 2006; Yang and Krishnan, 2005) this study will also be
focusing on quarterly financial accounts. This is relevant because fraudulent financial reporting often begins with quarterly misstatements (Yang and Krishnan, 2005) and thus, by examining the factors associated with the quality of quarterly accounts, could therefore enhance the quality of annual accounts. In addition to this, since no previous studies (as yet) has been conducted to examine the variations between profit after tax and minority interest in unaudited year-end quarterly account and audited annual account, especially those done in Malaysia, this study could be beneficial in exploring this issue. Besides that, even though the mandatory requirement for the formation of audit committees in Malaysia has been mandated since 1993, there is still lack of empirical evidence in studies regarding the effectiveness of audit committees conducted in Malaysia (see for example Abdullah and Al-Murisi, 1997; Razman and Iskandar, 2003). Moreover, even though some of the earlier studies have indicated that the characteristics of audit committees can contribute to their effectiveness in ensuring the compliance of a company’s financial reporting with the regulatory requirements and accounting or auditing standards (Abbott, Park and Parker, 2000; Beasley, 1996; McMullen and Raghunandan, 1996; Song and Windram, 2004), ensuring the accuracy of annual audited accounts (Abbott, Parker and Peters, 2004; McMullen and Raghunandan, 1996), limiting the manipulation of accrual accounting treatment (Davidson, Stewart and Kent, 2005; Klein, 2002b; Rahman and Ali, 2006; Xie, Davidson and DaDalt, 2002; Yang and Krishnan, 2005) and increasing disclosure practices (Alsaeed, 2006; Craig and Diga, 1998; Haniffa and Cooke, 2002), the effectiveness of audit committees in ensuring the accuracy of unaudited year-end quarterly accounts may still be questionable. Therefore, findings from this study could be beneficial in exploring and understanding the characteristics of an effective audit committee which could then benefit several parties such as regulatory bodies, board of directors and shareholders in enhancing the effectiveness of their audit committees.
1.6 Organization of Remaining Chapters

This chapter discusses the background of audit committees and financial reporting. It is then followed by a discussion on problem statement, research questions and objectives and the significance of the study. Chapter 2 reviews the relevant literature on financial reporting and audit committees, followed by the development of theoretical rationale and hypotheses to be tested. This is followed by a discussion of the research design, variables measurements and sample selection in Chapter 3. Chapter 4 discusses the results of analyses conducted in this study and Chapter 5 discusses the findings, limitation, implication and the conclusion of this study.
CHAPTER 2
LITERATURE REVIEW

2.0 Introduction

This chapter begins with the review of studies on financial reporting and audit committees. The chapter then develops the theoretical rationale to relate audit committees with variations between profit after tax and minority interest (PATMI) in unaudited year-end quarterly account and audited annual account and the hypotheses that will be tested in the study.

2.1 Financial Reporting

The quality of financial reporting has always been an issue of interest among regulatory bodies, shareholders, researchers and the accounting profession itself. This is due to the fact that financial reporting has been a principle means of communicating financial information to outside users (Johnson, Khurana and Reynolds, 2002) and the use of financial reporting itself in assessing the economic performance and condition of a business, in the quest to monitor management’s actions and assists in making economic decisions (Warren and Reeve, 2004). Lev and Ohlson (1982) have contended that financial information has a dual role in the capital market which aids in establishing a set of equilibrium share prices that affects the allocation of resources and the production decisions implemented by companies and enables individuals to exchange claims to present and future consumption and the sharing of social risks. The use and usefulness of financial accounts to the market participants in estimating a company’s value has been proven by previous studies. Markets have shown to react to the annual audited accounts (see for example Cheung and Sami, 2000; Eddy and Seifert, 1992; Isa and Subramaniam, 2000) and quarterly accounts (see for example
produced by companies. They have also shown that markets react positively to favorable earnings and react negatively to unfavorable earnings in the financial accounts. As it provides value-relevant information to external parties of the organization, the heavy reliance placed on accounting numbers create powerful incentives for managers to manipulate earnings to their own advantage (Rahman and Ali, 2006). Therefore, since the nature of quarterly accounts which are not generally audited and contain less disclosure as compared to annual audited accounts, many have concerns on their quality (Yang and Krishnan, 2005). This is because, due to this nature, managers may be more able to manage quarterly accounts as opposed to annual accounts (Yang and Krishnan, 2005) and may have relatively more latitude to manipulate the quarterly numbers than annual numbers (Jeter and Shivakumar, 1999). Furthermore, a recent study by Guan, He and Yang (2006) had shown that companies tend to engage in cosmetic earnings management in each of the four fiscal quarters. They also found that the degree of cosmetic earnings management is significantly less severe in the fourth fiscal quarter, which is the only quarter audited, than any of the other quarters.

Besides the markets (shareholder), the users of financial reporting information include customers, suppliers, government, lenders, employees, competitors, managers, community representatives and investment analysts (Atrill and McLaney, 2001). Since the financial reports are prepared to meet the varying and potentially conflicting needs of all user groups, the financial reporting should be adaptive to the needs of all interested parties. Atrill and McLaney (2001) outlined certain key criterias that should be owned by the financial reporting in order to meet the needs of users which are identified as relevance, reliability, comparability, understandability, timeliness and cost/benefit. They also claimed that the relevance and reliability of the financial reporting can help to produce useful information but the lack of comparability,
understandability, timelines and cost/benefit on getting the information in turn will limit its usefulness.

### 2.1.1 Proxies for Quality Financial Reporting

Several determinants have been used by previous researchers as proxies for quality financial reporting in their studies. Among the proxies that have been used are the compliance with accounting or auditing standards (Abbott, Park and Parker, 2000; Beasley, 1996; McMullen and Raghunandan, 1996; Song and Windram, 2004), accuracy of accounts (Abbott, Parker and Peters, 2004; McMullen and Raghunandan, 1996), manipulation of accounting treatments (Davidson, Stewart and Kent, 2005; Klein, 2002b; Rahman and Ali, 2006; Xie, Davidson and DaDalt, 2002; Yang and Krishnan, 2005) and disclosure (Alsaeed, 2006; Craig and Diga, 1998; Haniffa and Cooke, 2002).

Most of the earlier studies have used the compliance of financial reporting with accounting and auditing standards as a proxy for quality financial reporting. Motivated by earlier studies by Beasley (1996) who had used a sample of companies that were subject to regulatory enforcements as a proxy for low quality financial reporting, later studies by Abbott, Park and Parker (2000) and Song and Windram (2004) have replicated this approach. Besides that, since the need to restate financial accounts is only required if material information is misstated or omitted (Abbott, Parker and Peters, 2004), McMullen and Raghunandan (1996) also included companies that have restated their financial accounts into their sample. A recent study by Abbott, Parker and Peters (2004) had also used restatement of financial reporting as a proxy for low financial reporting quality in their study. In addition to this, based on the argument that even though the manipulation of accruals accounting is being done not in violation of the accounting standards but it may lead to inaccurate information (Rahman and Ali, 2006),
past researchers have also used accruals accounting manipulation as a proxy for financial reporting quality in their studies. Xie, Davidson and DaDalt (2002), Klein (2002b), Yang and Krishnan (2005), Davidson, Stewart and Kent (2005), Rahman and Ali (2006) had implemented the level of accruals as a proxy for their financial reporting quality, whereby companies with higher level of accruals are identified as having low quality financial accounts and vice versa. On the other hand, studies by Craig and Diga (1998), Haniffa and Cooke (2002) and Alsaeed (2006) had used the level of voluntary disclosures as their proxy for quality financial reporting. This is based on the argument that since there is inadequacy of compulsory information, the voluntary disclosures provide investors with necessary information to make more informed decisions (Alsaeed, 2006). While earlier studies have concentrated on the annual financial reporting, various concerns on quality financial reporting have recently been focused on quarterly reports (see for example Yang and Krishnan, 2005).

### 2.1.2 Factors Affecting Financial Reporting Quality

Besides of just determining the appropriate proxy to be used to represent the quality of financial reporting, previous studies have also examined the factors that effect financial reporting quality. One of the most arguable factor is the monitoring mechanism of the company. Fama and Jensen (1983) have argued that the credibility and transparency of financial reporting of a company depends on the effectiveness of the monitoring mechanism of the company itself, hence have led researchers to examine the effects of several monitoring mechanisms such as board of directors, audit committees, internal audit and external audit to the financial reporting quality.

Since the board of directors receives its authority for internal control and other decisions from stockholders of corporations (Beasley, 1996), Fama and Jensen (1983) claimed that the highest internal control and monitoring mechanism is the board of
directors. Based on this contention, researchers have argued that board of directors has an effect on the quality of financial reporting. They hypothesized that, to perform effectively as a monitoring mechanism, the board of directors should be structured properly by considering its independency and optimum number of members.

The independence of board of directors has been widely argued by researchers to have an effect on the financial reporting quality. This is to ensure that, the board is not to collude with top management and therefore increase their ability to monitor top management (Fama and Jensen, 1983). Thus, by using several variables, prior research have examined whether board independence has an effect on the financial reporting quality. One of the most arguable factor is the inclusion of independent directors on the board. This is based on the argument that outside directors have incentives to carryout their monitoring tasks and not to collude with top management (Fama and Jensen, 1983). Studies by Davidson, Stewart and Kent (2005) and (Klein, 2002b) had found support for this argument whereby their analyses have shown a significant negative relationship between the board that is comprised of a majority of non-executive directors and accruals. Furthermore, studies by Song and Windram (2004) and Beasley (1996) have also found a significant negative relationship between board independence and financial statement fraud. However, Rahman and Ali (2006) did not find any significant relationship between the percentage of independent directors on the board and discretionary accruals. Abbott, Parker and Peters (2004) also did not find any significant relationship between the percentage of outside directors and restatement of financial statements.

Besides the inclusion of independent directors on the board, researchers have also highlighted the importance of having the separation between board chair and Chief Executive Officer (CEO). They argued that the appointment of a CEO to the position of chair can lead to a concentration of power (Beasley, 1996) and possible conflicts of
interest, resulting in a reduction in the level of monitoring (Davidson, Stewart and Kent, 2005). Centralization of control in the hands of CEO will result in the CEO with too much power (Rahman and Ali, 2006) and gives the CEO the ability to override the firm’s internal control structure (Abbott, Park and Parker, 2000). Prior studies have found mixed evidence for this contention. A study by Abbott, Park and Parker (2000) indicated that the combination of board chair and CEO position is positively related with financial statement fraud, however, Beasley (1996) had found it to be insignificant. Meanwhile, findings from Rahman and Ali (2006) indicated a significant negative relationship between companies separating the board chair and CEO and accruals which Davidson, Stewart and Kent (2005) failed to show their significance. A study by Abbott, Parker and Peters (2004) also did not find any support for the relationship with financial restatements.

Related to the size of board of directors, Song and Windram (2004) have argued that a larger board may create a diminished sense of individual responsibility and could undermine its effectiveness. On the other hand, Rahman and Ali (2006) postulated that large board members with varied expertise could increase the synergetic monitoring of the board. However, findings from previous studies have shown that the number of members on the board of directors has a negative impact on the financial reporting quality, whereby board size has been found to be positively significant with the level of discretionary accruals (Rahman and Ali, 2006), financial restatements (Abbott, Parker and Peter, 2004) and positively related to financial fraud companies (Song and Windram, 2004).

However, with the formation of an audit committee, which has been discharged with the responsibility of monitoring the financial reporting on behalf of the board of directors, have led researchers to examine the effect of the audit committee to the financial reporting quality (see for example Beasley, 1996; McMullen, 1996). However, there has
been inconsistency in the findings related to the existence of audit committee and the quality of financial reporting (see for example, Beasley, 1996; McMullen, 1996). This inconsistency may be due to the differences in the level of effectiveness of audit committees between different companies. Therefore, recent studies have argued that the characteristics of an audit committee have a greater deal of influence towards the effectiveness of the audit committee itself in monitoring the financial reporting process (see for example Abbott, Parker and Peters, 2004; Song and Windram, 2004).

Besides that, researchers have also argued that the quality of an external auditor as an important factor effecting financial reporting quality, whereby a high quality external auditor is expected to have an influence on the quality of financial reporting. Given the existence of information asymmetries and the potential conflicts of interest between company management and outside users of financial information, an audit of financial reports by third party can enhance the quality of the financial information reported by management because a high quality auditor is more likely to detect questionable accounting practices and to a certain extent may compel management to follow accounting practices as prescribed by the accounting standards (Rahman and Ali, 2006). However, prior studies have failed to prove this contention. By using a proxy of brand name auditor as provider of higher quality audit, Davidson, Stewart and Kent (2005) did not find any significant relationship with the level of discretionary accruals and Alsaeed (2006) did not find any significant relationship with the level of voluntary disclosures.

Another argument postulated was that the presence of an internal audit function could enhance the quality of financial reporting. The voluntarily establishment of an internal audit function provides supplement to a company’s existing internal governance framework (Davidson, Stewart and Kent, 2005) by functioning both as monitor and advisor to the company (Brody and Lowe, 2000). The establishment of an internal audit
is beneficial in assisting the audit committee (Scarbrough, Rama and Ragunandhan, 1998) and the external auditor in discharging their duties and as an internal safeguard, the internal auditor is one vehicle mechanism in identifying, controlling and detecting the existence or attempting of misappropriating financial reporting information. However, a study by Davidson, Stewart and Kent (2005) failed to prove its significance relationship with the level of discretionary accruals.

Besides monitoring mechanisms, researchers have also argued the effects of other firm characteristics on the quality of financial reporting. Among the firm characteristics variables that have been widely discussed by previous researchers are firm assets, firm age, firm profitability and firm debt.

One of the most arguable firm characteristics which has an effect on financial reporting quality is firm asset (size). Since large companies are more exposed to public scrutiny (Alsaeed, 2006) and are more complex (Craig and Diga, 1998), than smaller companies, they need to provide better quality of financial reporting. Besides that, large companies also have greater resources and may be able to appoint prestigious external auditors and attract reputable non-executive directors (Song and Windram, 2004), which in turn could help them in enhancing the quality of financial reporting and at the same time posses sufficient resources for collecting, analyzing and presenting extensive amount of data at minimal costs (Alsaeed, 2006). Evidence from previous studies have shown that the size of company assets was significantly positively associated with the level of disclosures (Alsaeed, 2006; Craig and Diga, 1998) and negatively associated with discretionary accruals (Abbott, Parker and Peters, 2004; Davidson, Stewart and Kent, 2005; Rahman and Ali, 2006; Yang and Krishnan, 2005).

On the other hand, changes in the level of asset have also been argued to have an adverse effect on the quality of financial reporting. Abbott, Park and Parker (2000) had
argued that the increase in firm assets cause inadequacy of financial controls and create the management incentives to mask downturns and thus will increase the likelihood of financial misstatements. In their study, Abbott, Park and Parker (2000) had found evidence that asset growth as having a positively significant relationship with firms sanctioned for fraudulent reporting. However, Beasley (1996) failed to find any significant relationship with financial account fraud and another study by Abbott, Parker and Peters (2004) also failed to show any significant relationship with financial account restatement.

Besides that, a company’s profitability has also been argued to have an influence on the quality of financial reporting. Alsaeed (2006) argued that a profitable firm may feel proud of its achievements and therefore would wish to disclose more information to the public in order to promote positive impressions of its performance. However, even though a study by Haniffa and Cooke (2002) did find a significant positive relationship between return on equity (ROE) with voluntary disclosure, a study by Alsaeed (2006) on the other hand, had found insignificant relationships. Besides that, the level of profit has also been argued to have an influence on the manipulation of accounting accruals because managers may manage earnings to increase their bonus rewards (Yang and Krishnan, 2005). However, Yang and Krishnan (2005) and Rahman and Ali (2006) did not find any significant relationships between the level of net income and discretionary accruals. This inconsistency and insignificant in the results is probably due to the use of current profitability, instead of changes in profits. Therefore, studies by Klein (2002b) and Davidson, Stewart and Kent (2005) have argued that the changes in profit influence the manipulation of accounting accruals. Both of the studies have found support for this argument whereby their studies indicated a significant positive relationship between changes in net income and accruals in financial accounts.
Meanwhile, firms which have experienced losses for several years have also been argued to have the tendency to engage in lower financial reporting quality. A study by Loebbecke, Eining and Willingham (1989) claimed that poor financial performance often causes management to undue emphasis on earnings and profitability, thereby increasing the likelihood of financial statement frauds and misstatements. However, previous studies have failed to show any significant relationship between firms experiencing losses and financial reporting quality. While Beasley (1996) had failed to find any significant relationship with financial reporting fraud, Klein (2002b) also failed to find any significant relationship between firms experiencing losses for two or more consecutive years and abnormal accruals. Abbott, Parker and Peters (2004) had also failed to find any significant relationship between firms experiencing losses and restatement of their financial accounts.

The level of debt has also been argued by past researchers to have an influence on the financial reporting quality. In terms of the level of disclosure, Alsaeed (2006) argued that higher debt companies have higher agency costs and therefore need to have more information disclosed in order to satisfy the needs of creditors for information. A study by Craig and Diga (1998) had found a significant positive relationship between debt ratio and the level of disclosure, while Alsaeed (2006) had failed to find it significant, whereby it was argued that this was probably due to the fact that the creditors may have shared private information with their debtors. In contrast, higher leverage company is argued to have higher bankruptcy risk, which in turn will lead to litigation risk (Rahman and Ali, 2006) and thus, increase management’s tendency to manipulate firm financial reporting to overcome this risk. This has been supported by findings by Klein (2002b) which showed that a company’s leverage is significantly positively related to the level of abnormal accruals. Moreover, a study by Davidson, Stewart and Kent (2005) had also found a significant positive relationship between leverage and discretionary accruals. However, a subsequent study by Rahman and Ali (2006) and
Yang and Krishnan (2005) did not find any significant relationship between company leverage and accruals.

Another argument which has been postulated was that the age of a company has a positive effect on financial reporting quality. This is based upon arguments that new companies may encounter difficulty in making changes to comply with the requirements (Abbott, Park and Parker, 2000; Beasley, 1996), meanwhile old firms might have improved their financial reporting practices (Alsaeed, 2006). At the same time, younger companies have a pressure to boost earnings (Abbott, Park and Parker, 2000). A study by Abbott, Parker and Peters (2004) had found support for this contention, whereby findings from their study indicated that the number of years a firm has been publicly traded is negatively significantly related with the incidence of restatement. However, a recent study by Alsaeed (2006) did not find any significant relationship between firm age and disclosure level, while another study by Abbott, Park and Parker (2000) and Beasley (1996) also failed to find any significant relationship between firm age and fraudulent financial reporting.

2.2 Audit Committee in Corporate Governance

Corporate governance is a set of mechanisms adapted in order to ensure that directors and managers make decisions and act in the best interest of the stakeholders (Gillian and Starks, 1998; Lashgari, 2004; Thillainathan, 1999). It is concerned with managing the relationship among various corporate stakeholders (Lashgari, 2004) and should be designed primarily to protect shareholders and creditors (Thillainathan, 1999). The wide adoption of audit committee suggests the importance of an audit committee as an element in the framework of corporate accountability, where audit committees are expected to serve as the guardian of investors' interests and corporate accountability (Zanni and Terrell, 2002). As it comprises of directors from the full board, the formation