

SENIOR MANAGERS' PERCEPTIONS OF AUDIT COMMITTEE COMPOSITION AND EFFECTIVENESS: SOME EVIDENCES FROM MALAYSIA

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ABSTRACT

The aim of this study is to investigate the perceptions of corporate management of audit committee composition and effectiveness. Issues examined include status of audit committee members, members' knowledge of financial matters, status of the chairman of audit committee, and characteristics of an effective audit committee. It has been found that the effectiveness of the audit committee would be enhanced if the committee comprised a majority of non-executive directors. The respondents also believed that the effectiveness of the audit committee would be enhanced if the majority of the audit committee members were knowledgeable in financial matters and the non-executive director assumed the chairmanship of the committee. It is also found that a characteristic of a good audit committee is its members have a good knowledge and understanding of the company's business activities.

INTRODUCTION

The corporate failures that have been reported in academic and professional journals and news media have led to major suggestions from the public of the corporate governance practices safeguarding shareholders' interests. Indeed, good corporate governance practice is the key factor for credible and reliable financial reporting

(Krishnan, 2005). In addition, good corporate governance practices would enhance investors' confidence and subsequently increase the marketability of corporate shares (Solomon and Solomon, 2004). Investors' trust and confidence in capital markets depend on the credibility of the financial information which is prepared by management, audited by external auditors and verified by an independent audit committee of the Board of Directors.

Malaysia experienced a prosperous economic climate for many years during the 1990s; however, the Asian Financial Crisis experienced by many countries in the region during 1997/1998 affected the country. The 1997/1998 Asian Financial Crisis in Malaysia was a product of weak legal institutions or legal mechanisms which failed to prevent the expropriation of the minority shareholders' interests, weak enforcement of shareholders' rights, ownership concentration, and weak corporate governance practices (Shleifer and Vishny, 1997; Claessens *et al.*, 1999). The crisis has severely affected many corporations listed on the Bursa Malaysia Berhad (BMB) (formerly known as the Kuala Lumpur Stock Exchange), and prompted the regulators to review and undertake appropriate measures to rectify the weaknesses (A-Kadir, 2000a, b; Abdullah, 2004).

As a result of the crisis, the Malaysian government established a high level Finance

Committee on Corporate Governance (FCCG) in March 1998 to identify corrective action taken to improve corporate governance practices. The FCCG (1999, p. 43) argued that weak corporate governance had resulted in investors losing confidence in the Malaysian capital market, and there was concern about the role of directors and regulators in safeguarding their interests. Furthermore, the FCCG (1999) highlighted the need for an effective audit committee, and noted, "We have very real experience in Malaysia in the form of audit committees, where companies merely comply in form by setting up such committees without giving heed to the spirit of the requirement by ensuring, for example, the quality of the people within the committee".

In addition, the chairman of the Malaysian Securities Commission, A-Kadir (2002a, b), noted that many boards and audit committees did not function as effective oversight mechanisms. Consistent with the above arguments, Mohamad *et al.* (2001) found that a large majority of companies listed on the BMB tended to comply with all regulations imposed on them but did not properly observe the spirit of such mechanisms.

Though corporate governance reforms in developed markets, such as in the US and UK, have led to an increase in investors' confidence in corporate reporting, there is a lack of research on this issue in the Malaysian context. Thus, it is timely to undertake this research to help identify current practices and to contribute toward improving the role of the audit committee in Malaysian corporations. It is anticipated that this research will contribute to the literature on audit committees from the perspective of developing countries. Thus, the objective of this study is to investigate the perceptions of corporate management i.e. senior managers of Malaysian public-listed companies concerning audit committee composition and its impact on the effectiveness of the audit committee.

LITERATURE REVIEW

An array of research efforts has been undertaken to study the relationships between audit committee effectiveness relating to composition, such as expertise, financial literacy, status of audit

committee members (i.e. executive and non-executive members) and chairman's status.

Criteria ensuring the independence of audit committees are important to the appearance of the committee (BRC, 1999; BMB, 2001). Indeed, the appearance of audit committee independence would enhance auditor independence and make the management and auditors more honest in financial reporting (Lam, 1976). This is because independent directors have a greater incentive to avoid activities that would damage their reputation than non-independent directors (Abbott and Parker, 2000; Abbott *et al.*, 2003). They would try to avoid any potential reputational damage, such as financial misstatement, because non-executive directors might view audit committee service as reputational capital enhancement (Abbot *et al.*, 2003).

The existence of a large number of non-executive directors on the audit committee board might indicate the level of protection against fraud, misstatement or negative behaviour of managers. Beasley (1996) found that firms with a significantly lower percentage of independent, outside directors commit a higher degree of financial statement fraud than matched firms with a higher percentage of independent directors. Klein (2002) showed that board independence is negatively associated with earnings management. Vicknair *et al.* (1993) argued that non-independent directors on the boards of audit committees could have a negative effect on the financial reporting process.

The existence of a large number of non-executive directors on the audit committee board was also found to have a positive impact on the financial reporting process. Abbott and Parker (2000) discovered that active and independent audit committees tend to hire industry specialist auditors. In addition, the literature has documented that audit committee members who are financially literate would contribute to their communication with the other monitoring agents. Raghunandan *et al.* (2001) revealed that audit committees that consist solely of independent directors and that have at least one member with accounting or finance credentials tend to have longer meetings and meet privately with the chief

internal auditor, assess the internal auditing programme and results, and review management's interaction with internal auditing. Cowan (2004) argued that financial knowledge should be a pre-requisite for members of audit committees in relation to the complex nature of business financial management. DeZoort and Salterio (2001) discovered that independent audit committee members who possess higher audit knowledge tend to defend auditors in accounting conflicts.

Bedard *et al.* (2004) discovered that audit committees that meet more than twice a year, have member(s) with financial knowledge (i.e. financial expertise) and consist solely of independent directors associated with less income-increasing earnings management (or are more independent). They also found a positive relationship between the financial expertise of audit committee members and reduced income-decreasing earnings management. The above empirical evidence provides support for the argument that active audit committees help maintain the integrity of the financial reporting process (DeFond and Jiambalvo, 1991; Dechow *et al.*, 1996).

In the US, the Blue Ribbon Committee (BRC) (1999) suggests that audit committees should have relevant experience and qualifications and that this would further enhance the committees' effectiveness. Consistently, the BMB listing requirement necessitates that one of the committee members has a good knowledge of accounting, business and finance. It was specifically required that one of the members "must be a member of the Malaysian Institute of Accountants" or "if he is not a member of the Malaysian Institute of Accountants, he must have at least 3 years working experience and he must have passed the examinations specified in Part I of the 1st Schedule of the Accountants Act 1967; or he must be a member of one of the associations of accountants specified in Part II of the 1st Schedule of the Accountants Act 1967" (BMB, 2001, para. 15-04). In the context of financial literacy, research findings in the US reveal that the majority of audit committee members did not have a related background in accounting or

auditing (Lee and Stone, 1997); thus, many US companies did not rely on their audit committees (Menon and Williams, 1994).

Another positive impact of the non-executive status of members of audit committees is the committee's effectiveness when the chairmanship of the committee is assumed by a non-executive director. The Bursa Malaysia Berhad listing requirement necessitates listed companies to appoint a non-executive director as the chairman of the committee (BMB, 2001). It can be that when a non-executive director holds the chairmanship of the committee, he/she would provide strong leadership and prevent any dominant figure who might not have financial oversight or ability from dominating the meeting and influencing the committee's role (DeZoort *et al.*, 2002). In Malaysia, Mohamad *et al.* (2001) found that the majority (80%) of Malaysian listed companies appointed non-executive directors as the chairperson and believed that this is a good indicator of the independence and strength of the committee.

METHODOLOGY

Objective of the Study

Based on the review of its literature, it is evident that this study attempted to answer the following research question: What are the perceptions and current practices of corporate management concerning issues of audit committee composition (e.g. expertise, independence) that contribute to the audit committee's effectiveness?

Questionnaire form

A postal questionnaire survey is the most appropriate research tool to answer the above question. It is an effective tool to seek opinions, attitudes and descriptions of issues relating to audit committee effectiveness. This technique also helps to enhance the generality of the data and ensures a greater level of veracity in the respondents' answers (Mason and Bramble, 1978). In the context of accounting research, Beattie and Fearnley (1998) pointed out that behavioural and qualitative technique is important in clarifying theories in accounting research that is able to give new insights into the 'relationships approach',

where statistical models and economic theory have failed to rationalise the causes of certain events.

The development of the questionnaire for this study has taken into account the unique nature of the Malaysian corporate environment and culture, which are different from those of developed and other developing markets. Indeed, the process could be more challenging because Malaysia is an emerging market that is under-researched in terms of accounting practices (Abdul Hamid *et al.*, 1995), with an associated lack of reliable references on audit committee issues as input to this study.

Thus, variables from international research on audit committees, particularly the UK, were used because the literature documents that Malaysia's accounting and corporate governance tend to mirror British practices (FCCG, 1999; M-Ali, 1999), and research findings on the UK audit market could therefore be a helpful source in developing a sound questionnaire.

Pilot Study

The questionnaire was pilot-tested in order to enhance the quality of the questionnaire and ensure its applicability to the practices in Malaysian corporations. This approach would ensure that the test respondents have had no problems understanding or answering the questions and could respond to the questions correctly. In this study, copies of the questionnaire were distributed among the accounting staff of the Glamorgan Business School and Malaysian researchers who reside in Cardiff. All the comments were found to be useful and were incorporated into the questionnaire.

Respondents

In this study, senior managers of public-listed companies were selected as the respondents. The subjects were selected because they are the key players in Malaysian corporations and corporate governance (FCCG, 1999). Their perceptions of audit committee effectiveness are valuable to this study because they are directly involved in audit committee monitoring activities.

A listing of Malaysian listed companies is available from the Bursa Malaysia Berhad web page. A total of 900 companies was listed on it (i.e. 622 companies listed on the main board and 278 companies on the second board). It was decided to distribute the questionnaire among 150 companies (i.e. 75 questionnaires each to the main and second boards). Therefore, companies were selected on the basis of every sixth company on the list, one company being selected to make up the sample list of 150 companies.

The response rate of the questionnaire survey was 23%, that is only 35 out of 150 questionnaires were returned after four weeks in circulation (i.e. from 1st July to 31st July 2005).

Investigating Non-Response Bias

A common phenomenon in questionnaire surveys is some of the distributed questionnaires are not returned (Wallace and Mellor, 1988; Oppenheim, 1992). The literature documents that responses to mail questionnaires are generally poor, and it is a common phenomenon to see return percentages as low as 15% to 20% (Saunders *et al.*, 1997). Therefore, it is important to undertake an examination of non-response bias in order to identify the reliability and validity of the data. Wallace and Mellor (1988) suggested a technique to investigate non-response bias by comparing the answers to the questionnaire provided by early respondents with those of the late respondents. Therefore, based on the received date recorded on each questionnaire, the first 10 questionnaires received from respondents were classified as 'early' and the last 10 questionnaires as 'late'. The early and late responses were matched with the aim of examining whether significant differences between the two groups existed. The Mann-Whitney test was used as a statistical tool to examine the differences. No significant differences were detected between the 10 early and 10 late responses, indicating the absence of non-response bias. Thus, the results provide an indication that the respondents who failed to return the questionnaires would have the same perceptions as those who responded.

RESULTS

Respondents' background

An analysis of the distribution of respondents across companies listed on the Bursa Malaysia Berhad (BMB) was carried out based on two criteria, namely board listing and industry. Following this, more specific criteria were used to analyse respondents' profiles, such as age, education and professional qualifications.

A large majority of the responses (i.e. 91%) came from senior managers of main board companies, and only 9% of the respondents were attached to companies on the second board of the BMB, as shown in Panel A of Table 1. As shown in Panel B of Table 1, the majority of respondents was concentrated on five industries, namely trading/services (25.7%), plantation (17.1%), consumer products (14.3%), technology (11.4%) and finance (11.4%).

Only a small number of responses was received from senior managers of companies in the sector of industrial products (2.9%), properties (5.7%), construction (5.7%), infrastructure projects (2.9%) and hotels (2.9%). Although this study recorded a relatively low response rate, i.e. 23% (as reported in the above section), the respondents

represented a wide range of industries of the Malaysian economy.

Since the questionnaire was directed at senior managers of public-listed companies, most of the respondents were more than 30 years old. As shown in Panel A of Table 2, 57% of the respondents fell in the age range of 30 to 40 years, 37% came from the age range of 41 to 50 years, and only 6% were more than 50 years old.

Respondents' qualifications

In terms of education, Panel B of Table 2 indicates that respondents with a minimum of professional qualifications (34%) degree (29%), degree without professional qualifications (37%). This might indicate that the respondents who participated in this study might have adequate or reasonable knowledge of Malaysian corporate governance in general and audit committees in particular. The large number of respondents who have a tertiary education (degree and professional qualifications) and mature age might provide deeper insights to this study.

The Bursa Malaysia Berhad (BMB) has specified certain criteria in its listing requirements for audit committees of listed companies to

Table 1. Classification of Respondents based on Board listing and Type of Industry

Panel A: Board Listing		
Board	Frequency	Per cent
Main	32	91
Second	3	9
Total	35	100
Panel B: Type of Industry		
Category of industry	Frequency	Per cent
Industrial products	1	2.9
Properties	2	5.7
Construction	2	5.7
Infrastructure projects	1	2.9
Technology	4	11.4
Consumer products	5	14.3
Trading/ services	9	25.7
Finance	4	11.4
Plantation	6	17.1
Hotels	1	2.9
Total	35	100

Table 2. Respondents' background Information

Panel A: Respondents' age		
Range	Frequency	Percentage
<30	0	0
30-40	20	57
41-50	13	37
>50	2	6
Total	35	100

Panel B: Respondents' level of education		
Education/Professional Qualification	Frequency	Percentage
Degree with Professional qualification	10	29
Degree without Professional qualification	13	37
Professional qualification (No degree)	12	34
Total	35	100

comply with. In the following section, issues relating to composition that are mentioned in the BMB listing requirements and those identified in literature review are examined, such as the status of audit committee members, members' financial literacy, the status of the chairman of the audit committee, and marks of a good audit committee.

Status of Audit Committee Members

The majority of the respondents (43%) indicated that audit committees composed of a majority of non-executive directors would enhance audit committee effectiveness. Moreover, a sizeable percentage of respondents indicated that audit committees consisting of two-thirds (31%) and all (23%) non-executive directors would contribute to an effective audit committee. Only 3% of the respondents indicated that audit committee effectiveness would be enhanced if the members consisted of a majority of executive directors.

This finding might indicate that the respondents have faith in the potential role played by non-executive directors in supporting the auditor's role of certifying financial statements. Indeed, non-executive directors who are not involved in the daily activities of companies would independently pursue good corporate governance and financial reporting. They would not have a personal interest in company transactions and would not influence or be influenced by any business transactions.

Audit Committee Members' Expertise

With regard to the financial literacy of audit committee members, the majority of the respondents (55%) indicated that an audit committee would be more effective if a majority of the members were literate in financial matters. 31% of the respondents agreed with the BMB requirement that at least one of the members of an audit committee be literate in financial matters. A small percentage (14%) of the respondents indicated that an audit committee would be more effective if all of the members were literate in financial matters.

It might be that members of an audit committee who are literate would contribute to the well-being of the audit committee. Indeed, sound knowledge of financial matters would enable members of an audit committee to read financial statements and thus identify weaknesses. In contrast, if members of an audit committee were unable to read financial reports, they could not effectively contribute to the committee's operation, especially in evaluating internal controls, risk management and financial reporting.

Chairman's Status and Audit Committee Effectiveness

The status of the chairman of the audit committee could enhance audit committee effectiveness; the

large majority (83%) of the respondents indicated that a non-executive director who acts as a chairman of the committee could contribute to the enhancement of audit committee effectiveness. Only a small percentage (6%) of the respondents indicated that an executive director holding the chairmanship would enhance audit committee effectiveness. On the other hand, 11% of the respondents decided that whether an executive or non-executive director holds audit committee chairmanship is irrelevant to the enhancement of audit committee effectiveness.

This finding indicates that non-executive directors who assume the committee's chairmanship could contribute to an effective audit committee. Non-executive directors might carry out their responsibilities independently to achieve good corporate governance and financial reporting. The strong leadership of a chairman who was also a non-executive director could perhaps contribute to an effective audit committee and prevent the committee's activities from being dominated by any executive director.

Chairman's Status and the Influence on Audit Committee Effectiveness

When respondents were further asked about the influence of the chairman of the audit committee on audit committee effectiveness, all of them agreed that it would influence audit committee effectiveness. It was found that 57% of the respondents indicated that the chairman's status would greatly influence audit committee effectiveness and 43% of them indicated that the chairman's status would influence the effectiveness only to a certain extent.

The results confirm the findings that the non-executive status of the chairman of an audit committee could greatly influence audit committee effectiveness. The findings indicate that respondents might have the perception that the non-executive status of the audit committee chairman plays a significant role in the success of the committee. It might be that this factor would motivate the committee in executing its duties effectively.

Characteristics of an effective Audit Committee

The majority (63%) of the respondents indicated that a characteristic of an effective audit committee is that the members have a good knowledge and an understanding of the company's business activities, and 31% of the respondents indicated that members should have thorough and extensive knowledge and understanding of the company's business activities. In addition, only 6% of the respondents agreed that a characteristic of a good audit committee is that the members have some knowledge and understanding of the company's business activities.

This finding shows that the respondents might hold the belief that audit committee members would be able to monitor a company's internal administration and undertake risk management activities only if they have a sound knowledge of the company's business activities. Indeed, a knowledge of the company's operations would enable the members to analyse financial reports and make necessary suggestions to improve internal administration and other areas of work. Consequently, an efficient committee is able to uphold good corporate governance.

DISCUSSION

The listing of Bursa Malaysia Berhad requirements necessitates that audit committees be composed of at least three members, the majority of them being non-executive directors. The perception of the majority of the respondents (43%) was consistent with this requirement, which might reflect their agreement that this requirement could result in the better functioning of audit committees.

Directors who lack the 'independence' criterion may not be able to play their role as internal enforcers of good financial reporting. This might be true, as a senior manager noted, "Executive directors who run the company will affect the decision of the committee if the majority of committee are executive directors". Indeed, the literature (Lam, 1976; Abbott *et al.*, 2003) pointed out that non-executive directors would defend their reputation.

However, in the Malaysian context, this issue might be undermined as a result of the ownership problem, where the major shareholders would influence audit committee operations. Another senior manager of a public-listed company pointed out that "a significant shareholder or his proxy who sits on the audit board would significantly influence decisions and activities, even if the committee consisted of a majority of non-executives".

The presence of a majority of non-executive directors in an audit committee could enhance audit quality, where Abbot and Parker (2000) found that non-executive directors tend to engage industry specialist external auditors. The result might also indicate the respondents' agreement that audit committees that are composed of a majority of non-executive directors might build better relationships with internal auditors (Scarborough *et al.*, 1998; Raghunandan *et al.*, 2001).

Furthermore, the presence of a majority of non-executive directors on the audit board could prevent an auditor being switched or terminated following the issuance of a non-favourable audit report (Archambeault and DeZoort, 2001). However, the presence of an executive director on the committee is crucial to clarify issues and events pertaining to business operations, and a senior manager pointed out "At least one director must be on the committee". This was further supported when another manager noted, "Executive directors are still required, as non-executive directors may not fully grasp the issue at hand".

The findings of the questionnaire survey also revealed that the majority of respondents believed that the audit committee would be more effective if a majority of the members were competent in financial matters. This finding is consistent with the BMB Listing Requirements, where audit committees of public-listed companies are required to appoint at least one member who is also a member of the Malaysian Institute of Accountants or another recognised accounting professional body. Indeed, a good mix of people from various backgrounds is important to the success of the committee. A senior manager who

responded noted, "While financial matters are important, operational issues are also equally important. It will be effective if the committee consists of people from operations and finance as well as administration".

This result might also indicate the respondent's agreement with the importance of having a majority of members that is able to understand financial information. Indeed, a lack of literacy in finance among the members of an audit committee is a common problem in worldwide corporations that have audit committees, where DeZoort *et al.* (2002) found that "many members lack adequate experience and expertise in relevant oversight areas".

The financial literacy among members should cover areas such as accounting, auditing and banking. The existence of a majority of members who are financially literate could result in firstly, longer and more thorough discussions of issues between the committee and the chief internal auditor, secondly, the ability to review internal audit proposals and findings, and finally, the gaining of private access to the internal audit function (see Raghunandan *et al.*, 2001). In this context, Menon and Williams (1994) presented evidence that the audit committee was not relied upon by the board of directors as a monitoring mechanism; as a result, the value of the audit committee to protect shareholders' interest would decrease.

With regard to the status of the chairman of the audit committee, it was found that the majority of the respondents were of the opinion that audit committee effectiveness would be enhanced if a non-executive director assumed the position. This result is consistent with the BMB listing requirement that specifically states that the chairman of an audit committee should come from the non-executive directors (BMB, 2001). The non-executive status of the chairman of an audit committee would provide strong leadership and if he/she had a dominant personality, he/she would influence the roles and duties of the committee.

As mentioned in Section 2, DeZoort *et al.* (2002) found evidence that the chairman (with non-executive status) could deter any dominant

figure who did not have financial knowledge from dominating the meeting. Consistent with this argument, all of the respondents were of the opinion that the chairman's status would greatly (57%) or to some extent (43%) influence audit committee effectiveness.

A chairman who does not have an executive role in a company could perhaps actively pursue shareholder activism and ensure good corporate governance and financial reporting. A strong chairman who does not have an interest in the day-to-day operations of a company (i.e. non-executive status) could provide checks and balances on significant transactions and other matters that need attention, like related party transactions. Regarding this, one of the respondents pointed out, "the chairman should have the credibility to influence not only the audit committee, but also the Board, if audit committee is to be effective".

The majority of respondents was of the opinion that a characteristic of an effective audit committee is the members have knowledge and understanding of the company's business activities. Indeed, well-informed members would help the committee to identify financial reporting problems or any irregularity. They would be fully aware of the company's operations and business transactions and would bring up problematic issues for discussion with other committee members, and internal and external auditors.

This finding might indicate the respondents' agreement with the notion that an audit committee with knowledge and understanding of the company's business activities would make good and consistent internal control judgements, and would have a higher degree of self-insight and consensus (DeZoort, 1998). Good business knowledge must be accompanied by good internal control to ensure the success of the company, as the committee would then easily identify any irregularity.

The reason why most companies fail and go bust although they are well equipped with business knowledge is a lack of internal control. Commenting on members' knowledge, a manager noted, "although knowing the business is important, understanding the control matter

would be more relevant". They would perhaps be better versed in all business arrangements and could consistently apply their judgement over time.

CONCLUSION

The insight gained from the questionnaire survey is that non-executive directors could play a significant role in enhancing audit committee effectiveness. The majority of the senior managers of public-listed companies who responded indicated that audit committee effectiveness would be enhanced if the committee comprised a majority of non-executive directors. The findings probably indicate that the respondents are confident that non-executive directors would be able to act as internal enforcers of good governance and financial reporting, and perhaps the non-executive directors would maintain their reputation by not associating with any wrongdoing or irregularity by reporting them to the board of directors or regulators.

In addition, non-executive directors could provide checks and balances on managerial behaviour in conducting daily business activities. In the light of the research question set out in Section 3, this finding seems to confirm that the majority of the respondents agreed with the listing requirement that a majority of audit committee members should come from non-executive directors.

It was found that the majority of respondents believed that the majority of audit committee members should be literate in financial matters. Knowledge in financial matters is important because the committee would oversee the financial reporting and internal control matters when discharging their duties. The finding seems to agree with the BMB listing requirement of at least one of the members being proficient in financial matters.

Consistent with the BMB listing requirement, this study found that the non-executive status of the chairman of the committee would influence audit committee effectiveness. Indeed, a strong non-executive director who assumes chairmanship of the committee would provide strong support to the external and internal auditors. Thus, the

committee would be able to provide strong support to the external auditors if there was any dispute with management.

In this study, the majority of the senior managers indicated that audit committee members should have good knowledge and understanding of the company's business activities. In carrying out its duties, the audit committee would be involved in issues relating to internal control and other financial reporting matters that are specific to a particular company. Thus, the knowledge and understanding of a company's operations would enable them to understand and solve current issues easily and efficiently.

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