



AN INVESTIGATION ON THE AUDIT
COMMITTEE'S EFFECTIVENESS: THE CASE FOR
GLCs IN MALAYSIA

BY

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A research paper submitted in fulfillment of the
requirement for the degree of Master of Science in
Accounting

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MARCH 2012

ABSTRACT

Financial reporting quality has been under scrutiny especially after the collapse of major companies. The main objective of this study is to investigate the audit committee's effectiveness on the financial reporting quality among the Malaysian GLCs. In particular, the study examined the impact of audit committee characteristics (independence, size, frequency meeting and financial expertise) on earnings management in periods prior to and following the transformation program (2003-2009). As at 31 December 2010, there were 33 public-listed companies categorized as Government-Linked Companies (GLC Transformation Policy, 2010) and there were 20 firms that have complete data which resulted in the total number of firm-year observations to 120 for six years (year 2003-2009). Results show that the magnitude of earnings management as proxy of financial reporting quality is influenced by the audit committee independence. However, no evidence was found to support the effect of audit committee size, meetings and expertise on the magnitude of earnings management. Agency theory and resource dependence theory were applied to explain audit committee, as a monitoring mechanism as well as reducing agency costs via gaining competitive advantage in knowledge, skills, and expertise towards financial reporting quality. However, contrary to expectation, the theories were not fully supported hence there is a need for alternative theory that can explained the relationship further. This study is different from prior studies, in that it makes a significant contribution towards enhancing one's knowledge in the interacting role of audit committee's effectiveness and financial reporting quality subsequent to the transformation program in GLCs. The study is important as it provides additional knowledge about the impact of audit committee's effectiveness on reducing the earnings management, and assist practitioners, policymakers and regulators such as Malaysian Institute of Accountants, Securities Commission and government to determine ways to enhance audit committee's effectiveness and improve the financial reporting of GLCs, as well as improving the quality of the accounting profession.

خلاصة البحث

وكانت التقارير المالية جودة تحت المجهر خصوصا بعد انهيار شركات كبرى. والهدف الرئيسي من هذه الدراسة هو تحقيق فاعلية لجنة التدقيق على جودة التقارير المالية بين GLCs الماليزي. على وجه الخصوص، درست دراسة تأثير الخصائص جنة التدقيق (الاستقلال، وحجم الاجتماع تردد، والخبرة المالية) في إدارة الأرباح في الفترات السابقة واللاحقة لبرنامج التحول (2003-2009). كما في 31 ديسمبر 2010، كان هناك 33 القطاعين العام والشركات المدرجة تصنف باعتبارها مرتبطة بالحكومة الشركات (GLC سياسة التحول، 2010)، وكان هناك 20 شركات التي لديها بيانات كاملة والتي أسفرت عن العدد الإجمالي للشركة عاما الملاحظات لتصبح 120 ست سنوات (عام 2003-2009). أظهرت النتائج أن يتأثر حجم إدارة الأرباح والوكيل من جودة التقارير المالية من قبل لجنة المراجعة الاستقلال. ومع ذلك، لم يتم العثور على أدلة لدعم تأثير حجم جنة لمراجعة الحسابات، والاجتماعات والخبرات على حجم إدارة الأرباح. تم تطبيق نظرية الوكالة والموارد نظرية التبعية لشرح جنة لمراجعة الحسابات، بوصفها آلية الرصد، فضلا عن خفض التكاليف عن طريق وكالة اكتساب ميزة تنافسية في مجال المعرفة والمهارات والخبرات من أجل جودة التقارير المالية. ومع ذلك، خلافا للتوقعات، لم تكن النظريات يؤيد تأييدا كاملا وبالتالي هناك حاجة لنظرية بديلة أخرى يمكن أن يفسر العلاقة في شكل ايجابي. هذه الدراسة تختلف عن الدراسات السابقة، في أنه يجعل من مساهمة كبيرة نحو تعزيز المعرفة 1 في دور التفاعل من فعالية لجنة المراجعة وجودة التقارير المالية لاحقة لبرنامج التحول في GLCs. الدراسة مهمة، إذ أنها تقدم معرفة إضافية حول تأثير فعالية لجنة المراجعة بشأن الحد من إدارة الأرباح، ومساعدة الممارسين وصناع القرار والجهات التنظيمية مثل المعهد الماليزي للجنة المحاسبين للأوراق المالية، والحكومة لتحديد سبل تعزيز فعالية لجنة المراجعة وتحسين التقارير المالية من GLCs، فضلا عن تحسين نوعية لمهنة المحاسبة.

APPROVAL PAGE

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

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DECLARATION

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

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**AN INVESTIGATION ON THE AUDIT COMMITTEE'S
EFFECTIVENESS: THE CASE FOR GLCs IN MALAYSIA**

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ACKNOWLEDGEMENTS

First of all, thanks to Almighty Allah s.w.t. for graciously bestowing me the perseverance to undertake this research. I sincerely thank all those who have supported and helped me in writing this thesis report. A special thank and deepest appreciation to my supervisor, Dr Sherliza Puat Nelson who with strong perseverance guided me patiently through the process of writing of the proposal until the completion of this dissertation. Without Allah's (SWT) and her guidance, it would be impossible for me to produce research of a high standard.

Secondly, I would also like to record my sincere appreciation to my lecturers for their guidance and encouragement which have enabled me to acquire precious knowledge. I am grateful to all my fellow Master's classmates who had supported me since I began the journey of the Master's program. My gratitude also goes to my fellow colleagues and friends, who have endlessly given me their moral support, concern and kindness.

I would like to convey my highest appreciation to my beloved mother, who guided me and my siblings since my father's passing with her prayers and perseverance. My prayers to my father's spirit without whom I would never have had the courage or ability to achieve this stage of learning. My sincere appreciation also goes to my brothers and sister for giving me their sincere love and prayers. Finally, if this modest effort is successful, it is by Allah's grace and guidance and if it falls short of the readers' expectations, we can only pray for Allah's forgiveness.

TABLE OF CONTENTS

| | |
|-----------------------------|------|
| Abstract | ii |
| Abstract in Arabic | iii |
| Approval Page..... | iv |
| Declaration | v |
| Copyright Page..... | vi |
| Acknowledgement | vii |
| Table of contents..... | viii |
| List of Tables | x |
| List of Figures | x |
| List of Abbreviations | xi |

| | |
|-------------------------------------|----------|
| CHAPTER 1: INTRODUCTION..... | 1 |
| 1.0 Introduction | 1 |
| 1.1 Background of the study | 1 |
| 1.2 Problem Statement | 4 |
| 1.3 Objectives of the study..... | 6 |
| 1.4 Motivation of the study | 7 |
| 1.5 Significance of the study..... | 9 |
| 1.6 Organization of the study | 9 |
| 1.7 Conclusion..... | 10 |

| | |
|--|-----------|
| CHAPTER 2: GOVERNMENT-LINKED COMPANIES AND AUDIT COMMITTEE: LITERATURE REVIEW | 11 |
| 2.0 Introduction | 11 |
| 2.1 Government-linked Companies overview..... | 12 |
| 2.2 Green Book Manual Implementation..... | 14 |
| 2.3 Audit Committee Effectiveness and Financial Reporting Quality | 15 |
| 2.3.1 Audit Committee Independence..... | 16 |
| 2.3.2 Audit Committee Size | 16 |
| 2.3.3 Audit Committee Meeting | 18 |
| 2.3.4 Audit Committee Expertise..... | 19 |
| 2.4 The Gap: Audit Committee Effectiveness and Financial Reporting Quality in GLCs | 24 |
| 2.5 Conclusion..... | 25 |

| | |
|---|-----------|
| CHAPTER 3: THEORY AND HYPOTHESIS DEVELOPMENT | 26 |
| 3.0 Introduction | 26 |
| 3.1 Theories in Corporate Governance | 26 |
| 3.1.1 Agency Theory..... | 26 |
| 3.1.2 Resource Dependence Theory | 27 |
| 3.1.3 Agency Theory, Resource Dependence Theory and Financial | |

| | |
|---|-----------|
| Reporting Quality | 29 |
| 3.2 The Research Framework and Hypotheses Development | 30 |
| 3.3 Hypothesis Development | 32 |
| 3.3.1 Audit Committee’s Effectiveness | 32 |
| 3.3.1.1 Audit Committee Independence | 34 |
| 3.3.1.2 Audit Committee Size | 35 |
| 3.3.1.3 Audit Committee Meeting..... | 35 |
| 3.3.1.4 Audit Committee Expertise | 36 |
| 3.4 Conclusion..... | 37 |
| | |
| CHAPTER 4: RESEARCH METHODOLOGY | 38 |
| 4.0 Introduction | 38 |
| 4.1 Sample selection..... | 38 |
| 4.2 Variable Measurement | 41 |
| 4.2.1 Dependent Variables | 41 |
| 4.2.2 Independent Variables..... | 43 |
| 4.2.3 Control Variables | 45 |
| 4.3 Regression model | 46 |
| 4.4 Conclusion..... | 48 |
| | |
| CHAPTER 5: ANALYSIS OF RESULTS AND DISCUSSIONS | 49 |
| 5.0 Introduction | 49 |
| 5.1 Analysis and Discussions | 49 |
| 5.1.1 Descriptive Analysis | 49 |
| 5.1.2 Correlation Analysis | 51 |
| 5.2 Regression Analysis | 54 |
| 5.3 Research Findings and Discussion | 56 |
| 5.4 Conclusion..... | 60 |
| | |
| CHAPTER 6: CONCLUSION..... | 61 |
| 6.0 Introduction | 61 |
| 6.1 Summary of the study | 61 |
| 6.2 Implications of the study | 64 |
| 6.2.1 Implications for theory | 64 |
| 6.2.2 Implications for stakeholders, practitioners and regulators | 65 |
| 6.2.3 Implications for research..... | 66 |
| 6.3 Limitation of the study | 66 |
| 6.4 Suggestions for future research..... | 68 |
| 6.5 Conclusion..... | 69 |
| | |
| BIBLIOGRAPHY | 71 |

LIST OF TABLES

| <u>Table No.</u> | | <u>Page No.</u> |
|------------------|--|-----------------|
| 2.1 | Studies on audit committee and financial Reporting quality | 21-23 |
| 4.1 | Sectors on study sample | 40 |
| 4.2 | Definitions of variables | 47 |
| 5.1 | Descriptive Statistics | 50 |
| 5.2 | Pearson Correlations | 53 |
| 5.3 | Pooled Regression Analysis | 55 |

LIST OF FIGURE

| <u>Figure No.</u> | | <u>Page No.</u> |
|-------------------|--|-----------------|
| 3.1 | Agency Theory and Resource Dependence Theory | 31 |

LIST OF ABBREVIATIONS

| | |
|------|--|
| AC | Audit Committee |
| EPF | Employee Pension Fund |
| GCG | Good Corporate Governance |
| GLC | Government Linked Companies |
| KLSE | Kuala Lumpur Stock Exchange |
| KNB | Khazanah Nasional Berhad |
| MCCG | Malaysian Code of Corporate Governance |
| MIA | Malaysian Institute of Accountants |
| MoF | Ministry of Finance |
| PCG | Putrajaya Committee of High Performance GLCs |
| SOE | State-owned Enterprises |
| SOX | Sarbanes Oxley Act |

CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

This chapter introduces the study in four sections. Firstly, the chapter discusses the background of the study, followed by problem statements, objectives of the study and motivations of the study. The following section discusses the significance of the study and finally, the chapter concludes with a presentation of the organization of the study.

1.1 BACKGROUND OF THE STUDY

Financial reporting quality has been under scrutiny especially after the collapse of major companies. This has been proven with many cases happening in and outside Malaysia. Several high profile cases involving big companies such as Malaysian Airlines Systems, Technology Resources Industries, Perwaja Steel, Megan Media, Transmile, Enron and WorldCom have been witnessed. Most of them manipulate their financial reporting to show that they have achieved a commendable performance (Norwani et al., 2011). Various ideas and theories have surfaced, trying to link the financial reporting quality to certain factors including corporate governance mechanisms (Karamaou and Vafeas, 2005; Firth et al., 2007 and Petra, 2007). In the wake of series of accounting collapse, the board effectiveness in monitoring the financial reporting quality is one of the significant themes in corporate governance debates (Gendron and Bedard, 2006). These debates have led to the introduction of significant corporate governance reforms which focused on board effectiveness, so as to improve the quality of governance over financial reporting.

For emerging economies like Malaysia particularly, regulators are taking initiatives in enhancing the governance of public listed companies and Government-Linked Companies (GLCs). The Malaysian Code of Corporate Governance (2000, 2007) and Bursa Listing Requirement (2001), both are particularly mandatory to public listed companies including GLCs, have introduced the best practices of corporate governance aimed at becoming more transparent in their business activities. The enforcement of corporate governance in Malaysia was strengthened when the government introduced the Green Book through GLC's transformation program in year 2004. The comprehensive guidelines on the 'Green Book on Enhancing Board Effectiveness' were distributed to all GLCs by 31st December 2005 and they were required to follow these guidelines by 1st January 2007 (GLC Transformation Manual, 2005).

The Green Book's objective is to provide a manual guideline to raise the overall effectiveness of board, consistent with the Malaysia Code of Corporate Governance (MCCG), Bursa's Listing Requirements and all other rules and regulations. It is not intended to be a comprehensive guideline of best practices, but designed to be a helpful document that deals with some key conformance aspects of Boards and their Directors. The Putrajaya Committee on GLC High Performance (PCG) expects all listed GLC Boards to assess their current level of Board effectiveness, and subsequently develop and begin to implement an actionable improvement program following the requirements in the Green Book by 1st January 2007.

Chapter one of the Green Book sets out the guidelines structured along the three main components of an effective board; this included the audit committee charter which has become the best practices standards that all GLCs board should

adhere. The present study focuses on one of the important aspects of corporate governance stated in the Malaysia Code of Corporate Governance (MCCG), revised in 2007, i.e., the audit committee. This is because under the Code, the audit committee is responsible for reviewing the quarterly and year-end financial statements, and discussing with the auditor regarding any matters that might arise from the audit. The committee also has the explicit authority to have full access to information, and therefore, it is expected that the audit committee play a significant role in the monitoring process.

Subsequently, the integrity of corporate governance in Malaysia is strengthened when the government introduced the Green Book through GLC's transformation program in 2004. The comprehensive guidelines on 'Green Book on Enhancing Board Effectiveness' were distributed to all GLCs by 31st December 2005 and the latter were required to follow the guidelines by 1st January 2007 (GLC Transformation Manual, 2005). This program aims to assist GLCs to be at par and competitive with their regional competitors.

Even though GLCs are represented by five percent of the total companies listed in Bursa Malaysia, they contribute as much as RM232 billion (34 per cent) from total market capitalization which is more than half of the Malaysian Gross Domestic Products for that year (Cheng, 2004). To date, four percent or 20 GLCs in Bursa Malaysia's GLCs are able to generate RM 235.5 billion (49 per cent) of total market capitalization to the Malaysian economy, and directly contribute about ten per cent to the Malaysia Gross Domestic Product. These figures proved that the GLCs as a group are one of the contributors towards the growth of country.

The present study basically attempts to augment the existing evidence on the association between audit committee as part of corporate governance mechanism, to

examine the impact of audit committee's effectiveness on improving financial reporting quality of Malaysian GLCs. Therefore, this study intends to shed some light on the issue of whether audit committee characteristics (independence, size, frequency meeting, and financial expert) can be monitoring mechanisms in controlling the magnitude of earnings management in GLCs, and this will reflect the effectiveness of the guideline provided in the Green Book on the GLCs' financial reporting quality. Apart from contributing to the existing literature, the study not only explores the effects of transformation programs, but also provides insights in audit committee roles in monitoring the magnitude of earnings management in GLCs. Hence, the thesis provides empirical evidence on the effectiveness of the audit committee on enhancing financial reporting quality, which subsequently provides recent evidence on Malaysian GLCs and contributes to the current literature.

1.2 PROBLEM STATEMENT

In the age of globalization and high demand for transparency, Malaysia is now exposed to more intense competition from other nations around the world. In its move towards the creation of an effective and high quality of financial reporting which will supplement the financial system required to support Malaysia's economic development, one of the actions taken by the Malaysian government is to transform the government-linked companies (GLCs) into high performing organizations. In Malaysia, the GLCs Transformation Manual (pg. 2) reported that most of the GLCs were inefficient in their operations and finances since 1990. The media has repeatedly reported that most of the GLCs incurred a huge sum of losses and were involved in activities or projects that were not related to their core business and thus resulted in

the poor performing portfolios of business among several GLCs (Najid and Rahman, 2011).

In particular, by recognising the significance and prominent role of GLCs in the economic growth of the nation, this study is able to shed some light to the public on the effectiveness of an audit committee as a monitoring mechanism to ensure better financial reporting quality in GLCs. There have been several studies concerning the attributes of audit committees and the magnitude of earnings (Klein, 2002; Xie et al., 2003; Abbott et al., 2004; Carcello et al., 2006; Dhaliwal et al., 2007; Yatim, 2009; Abdullah, 2009 and Garcia et al., 2010). This study complements prior studies by specifying on GLC's transformation program, and in light of the increased criticisms on GLCs in Malaysia, the transformation program is meant to improve the GLCs performance. A Putrajaya Committee on GLC High Performance (PCG) was introduced and emphasized the importance of board effectiveness in their guideline book, the Green Book. Subsequently, it provided a potential research area, looking at audit committee as an influential tool for board effectiveness and their oversight duties.

The transformation program is expected to have improved the audit committee's effectiveness as stated in the Green Book, where the audit committee is one of the components to improve GLCs' performance. Based on the above research objective and the expectation that transformation program has improved audit committee's effectiveness as mentioned in the Green Book, the research was undertaken to provide answers to the research question:

RQ: What is the impact of the Green Book on enhancing audit committee's effectiveness on the financial reporting quality in Malaysian GLCs?

1.3 OBJECTIVES OF THE STUDY

The main objective of this study is to investigate the effectiveness of the audit committee on enhancing financial reporting quality, subsequently providing recent evidence on Malaysian GLCs. In particular, the study examined the impact of audit committee characteristics (independence, size, frequency meeting and financial expertise) on earnings management in a period prior to and following the transformation program (2003-2009). In general, the result of this study is expected to improve audit committee's effectiveness in GLCs as mentioned in the Green Book manual (audit committee) to be at par and parallel with the introduction of the transformation program through its effective monitoring role.

Additionally this study is expected to provide fresh insight in enhancing confidence for the public at large on the government's effort that will contribute towards high performance of GLCs. Therefore, improving the performance of GLCs is one of the importance measures government can undertake to become a competitive nation. Previous studies reported that, in general, audit committee characteristics are related to earnings manipulation. So, good implementation of corporate governance is needed to detect possible manipulations by management (Abbott et al., 2004 and Agrawal and Chadha, 2005). According to Garcia et al. (2010), the more frequently the audit committee meets, the better the opportunity to detect possible errors in financial statements, while for the audit size the greater number of directors in audit committee means it is more likely to detect any manipulation in financial statements.

Apart from Mak and Chng (2000) who examined how Temasek's governance practices fit the News Corporate Governance framework, Agung (2009) examined the effectiveness of Good Corporate Governance (GCG) in Indonesian's State-owned Enterprises (SOE). Thus, there is a need to expand the literature, complementing prior

studies by providing recent empirical research in Malaysia in the same area. The research objective is twofold, where firstly, it is to examine the existing recommendations for adopting the best practice of corporate governance specifically through audit committee effectiveness as to improve board's oversight role to be better than others. Secondly, it is to examine specifically GLCs' financial reporting quality with respect to the impact of transformation programs on Malaysian GLCs.

The study investigates whether the independence of audit committee, size of audit committee, audit committee meeting frequency and financial expertise of audit committee in GLC companies affect the quality of financial reporting. The findings will be significant because they will enable government authorities to assess the effectiveness of the transformation program and thus take appropriate actions. The study extends the literature by using a longitudinal study, pre and post transformation programs so as to study the impact of the effectiveness of the audit committee on the GLC's financial reporting quality following the GLCs transformation program.

1.4 MOTIVATION OF THE STUDY

The motivation of enhancing and upgrading GLC's audit committee's effectiveness is made possible through the introduction of the Malaysian Code Corporate Governance (2000), the enforcement of Bursa Listing Requirement (2005) and progress requirement through Transformation Policy (2006). Firstly, the study is motivated from the empirical result by Hamid (2011) who concluded that GLCs are relatively more transparent in corporate governance practices and this adds to their higher valuations. Thus, the effectiveness of the audit committee is the main subject in the current study to examine whether the best practice adopted will bring in value to GLCs through its financial reporting quality.

Secondly, the emphasis on the importance of reducing the earning management activities for companies in Malaysia has also motivated this study. The focus is on the level of earning management in Government-linked Companies (GLCs) in Malaysia. This is due to the fact that GLCs contribute significantly to the Malaysian economy. In addition, as GLCs' financial performance becomes a major concern to the Malaysian government, it will motivate GLCs to engage in earning management activities.

The study is also motivated by prior research in developed countries such as the United States (US) and United Kingdom (UK). Although there are studies on earnings management in Malaysia, few have focused on Government-linked companies (GLCs) such as Yen et al. (2007) and Shawtari (2009). Several studies focused on public-listed companies which include only some GLCs, such as Hashim and Susela (2006), Salleh et al. (2005), Rahman and Ali (2006), Takiah and Rina (2009) and Samsuri (2010).

1.5 SIGNIFICANCE OF THE STUDY

The study contributes in a number of ways. Firstly, the study provides recent evidence on the effectiveness of the audit committee's effectiveness after the transformation program. The findings of the effectiveness of the changes in corporate governance practices as recommended by the PCG will further contribute to the debate on the effective firm's control mechanism. Secondly, the study will provide latest empirical evidence on the impact of audit committee characteristics on earnings management. This research will also help the government to evaluate whether the existing approach in monitoring GLCs is effective and provides guidance for future improvement in formulating government policy. This is important to safeguard investors and public's

interest as principal against the misbehavior of managers, and thus increases investor and public confidence in the Malaysian GLCs. In addition, the audit committee characteristics in relation to earnings management also have been investigated in other studies such as Rahman and Ali (2006), Saleh et al. (2007), Baxter et al. (2009) and Nelson (2011). Thus, there seems a growing need for the literature, to expand and complement prior studies by providing recent empirical research in Malaysian GLCs.

1.6 ORGANISATION OF THE STUDY

The remainder of the thesis is organized as follows. The next chapter, Chapter 2 discusses on the prior literature review. This chapter includes a review of prior studies concerning government-linked companies, government transformation program, the Green Book, board effectiveness, audit committee and financial reporting quality. The chapter will identify the gaps that need further research, such as this one. Chapter 3 explains the theoretical framework and hypothesis development. This chapter explains the general agency theory and resource dependence theory and their relations to this study. This chapter also includes the theoretical framework on how the hypotheses are developed; the assumptions from prior studies are also included in this chapter in order to support the hypotheses development. This chapter will also discuss the expected relationships of all independent variables (independence, size, frequency meeting and financial expertise) and control variables (firm size, leverage, and return on asset) on the magnitude of earnings management in Malaysian GLCs. In addition, Chapter 4 presents the research methodology utilized in the study. This chapter covers the research design, research questions, measurement of earnings management, data collection method and data analysis. This chapter details how the research question of this study will be answered and the hypotheses tested.

The sample selection process will also be thoroughly discussed in this chapter. Chapter 5 discusses on research findings and analysis. In this chapter, the findings will be analyzed and interpreted and compared with findings found in prior studies. Finally, Chapter 6 concludes the overall results, acknowledges limitations inherent in the scope of study and research design and identifies potential issues for future research.

1.7 CONCLUSION

The study extends the literature on audit committee's effectiveness in relation to financial reporting quality, and complements prior studies on audit committee's effectiveness. The objective is to investigate the association between this audit committee's effectiveness with financial reporting quality, using one indicator of financial reporting quality, namely, earnings management.

CHAPTER 2

GOVERNMENT-LINKED COMPANIES AND AUDIT COMMITTEE: REVIEW OF LITERATURE

2.0 INTRODUCTION

Much research has been conducted to measure the relationship between corporate governance and financial reporting quality. However, the results are mixed and inconclusive. It may be due to different countries experiencing different impacts from their corporate governance implementation (Claessens and Fan, 2002; Leuz et al., 2003 and Nam and Nam, 2004).

This chapter focuses on the literature reviews that are related to this study, especially on government-linked companies (GLC) and the implementation of GLCs transformation program specifically through the Green Book as the manual guidance for GLCs to adhere. This chapter comprised three main sections. The first section provides an overview of GLCs in Malaysia. Next, a review on government transformation program and the Green Book manual in general will be provided and why it is significant to GLCs, reasons and impacts of the guideline to GLCs. This is followed by a literature on board effectiveness, audit committee and financial reporting quality. Finally, this chapter concludes by presenting the contributions of the study.

2.1 GOVERNMENT-LINKED COMPANIES: AN OVERVIEW

GLCs are peculiar economic entities as they may have public policy objectives although they operate as corporate bodies (Mazzolini, 1979; Powell, 1987). They engage in a vast range of activities in diverse fields and can be fully owned or partially

owned by Government. According to Putrajaya Committee GLC (PCG) high performance, (2007) GLCs are defined as companies that have a primary commercial objective and in which the Malaysian Government has a direct controlling stake through Khazanah, Ministry of Finance (MOF), Kumpulan Wang Amanah Pencen (KWAP), and Bank Negara Malaysia (BNM). The GLCs are also controlled by other federal government linked agencies such as Permodalan Nasional Berhad (PNB), Employees Provident Fund (EPF) and Tabung Haji. Apart from percentage ownership, controlling stake also refers to the government's ability to appoint board members, senior management and make major decisions (e.g. contract awards, strategy, restructuring and financing, acquisitions and divestments etc.) for GLCs either directly or through Government Link Investment Companies (Hamid, 2011).

GLCs were established as a solution to accelerate economic and social developments. Governments created GLCs in order to control certain key sectors considered vital for the development of the national economy (Razak et al., 2011). GLCs are controlled by the Malaysian government via the Federal Government-Linked Investment Companies (GLICs). GLICs are investment arms of the government that allocate government funds to the GLCs and they are vital in the Malaysian economy. Though GLCs account for only five percent of the total companies in Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange), their market capitalization reaches RM 232 billion (US\$ 61 billion), more than half of Malaysia's Gross Domestic Products (Dahlan, 2009). The GLC Transformation Manual was released last July 2005, comprises a 10-year revamp program and the manual covers a broad spectrum of prescriptions from revamping boards to cutting procurement costs (Putrajaya Committee for GLC High Performance, 2005). Therefore, the significant of investigating GLCs with respect of their financial

reporting quality and how the transformation program has impacted the reporting quality is undeniable.

The GLC transformation program includes various strategies aimed at enhancing corporate governance, developing social leaders and clarifying social obligations to steer the GLCs, particularly in upgrading the effectiveness of GLCs' Board through the guideline provided in the Green Book manual. According to Mak and Chng (2000), in Singapore, its GLCs were one of the instruments in the rapid transformation of the Singapore economy from an entrepot-based economy to an industrialized economy through the improvement program in enhancing the efficiency of their GLCs management such as changes in boards' committee structure. Similar to Indonesia, for their GLCs efficiency, they implement good corporate governance (GCG), as an alternative to boost financial reporting quality through internal reform programs that aim to improve organizational self-discipline like directors' independence, credibility and expertise (Agung, 2009). For GLCs in Malaysia, the measure of adequacy of these mechanisms is how effective the guideline provided in the Green Book is in enhancing board effectiveness represented by GLCs's audit committee with the financial reporting quality. In response to the need to improve the financial reporting quality of GLCs, the transformation program is equipped with the Green Book manual to provide guideline in enhancing board effectiveness. A specific part of the Green Book contains an audit committee charter for GLCs to adhere and its function, as recommendations for improving audit committee effectiveness. It is expected that with high reporting quality, would contribute governance mechanisms in monitoring the GLCs management and in the end, contribute to the long term sustainability in GLCs reporting.