Factors Affecting Independent Audit Committee Members’ Effectiveness – The Case of Listed Firms on Bursa Malaysia

Nur Ashikin Mohd Saat*, Yusuf Karbhari, Jason Zezhong Xiao and Saed Heravi

Studies on audit committee effectiveness have so far examined the relationship between significant presence of independent directors and the establishment of influential independent standpoint on the committee’s decision-making. However, independent composition does not necessarily guarantee audit committee members performance of financial oversight duties competently. This paper aims to investigate the characteristics of audit committee members in 221 listed firms in Bursa Malaysia. The results show that audit committee governing enhanced firm performance when there is high proportion of independent audit committee members with practicing accountant experience on the committee and firm explicitly disclosed the right of audit committee to report to the Stock Exchange of its breaching of Exchange and other regulatory rules. On the contrary, the relationship between composition of audit committee exclusively by independent director and the convening of independent committee members meeting with the external auditor without executive officers presence and firm performance is negative. The audit committee effectiveness is crucially dependent on audit committee members collective commitment to fulfill their oversight duties responsibly and management giving full co-operation and support to the access of required information for decision-making.

Field of Research: Audit committee, corporate governance and firm performance.

1. Introduction

The governance imposed on capital market activities and the extent of legal, regulatory and institutional reliability and enforcement affects the proper functioning of a country’s equity market (La Porta, Lopez-de-Silanes, Shleifer & Vishny 1997, 1998). The East Asian 1997 financial crisis demonstrated the importance of establishing formal rules and regulations to monitor and discipline corporations’ behaviors and to secure investors’ investments (Prowse 1998). In East Asian economies, founder-owned firm and public listed firms are seen as contributors to economic growth, employment and stability (Scott 1999). In the case of Malaysia, the pervasive insider corporate governance system, the higher level of concentrated ownership, the cross-holdings and the significant participation of owners in management further signify the important role of independent directors in overseeing and controlling management misappropriation (Khatri, Leruth & Piesse 2002).

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Audit committee becomes a prominent subset of the corporate board with the delegation of specific responsibilities to oversee and govern the credibility of a firm's financial position and reporting and auditing process [Public Oversight Board (POB) 1993; Turpin & DeZoort 1998; Blue Ribbon Committee (BRC) 1999; Malaysia Code on Corporate Governance (MCCG) 2001; McDaniel, Martin, Maines & Peecher 2002]. Particularly, the empowerment of the board's financial oversight duties to the audit committee establishes its authority and the formal procedure for effective evaluation of the firm's financial position, reporting practice and internal control procedures (BRC 1999; MCCG 2001; OECD 2004). Moreover, an audit committee is needed to act as an independent and objective governing body in the firm, which is vital to improve the firm's corporate governance (DeZoort & Salterio 2001) and to facilitate effective enforcement of the audit committee’s oversight function, which again is critical to mitigate the risk of corporate failures and the lessening of public confidence (Hackenbrack & Nelson 1996; Lee & Stone 1997; DeZoort 1998). To achieve this, the strength of audit committee members' impartial views and judgment and attention to details are imperative to effective oversight and sustainability of firm’s financial position, reporting and auditing practice (Abbott, Park & Parker 2000). The strength of this set up is much dependent on the majority composition of committee by independent outside directors. It has been found that the presence of non-independent directors on the committee, such as top executives and their affiliates, will not encourage the independent members from freely expressing their real concerns about current circumstances affecting the company (Bédard, Chtourou & Courteau 2004).

Although through regulatory requirement (for instance Bursa Malaysia listing requirement 2001) audit committee in public listed firms in Malaysia has to comprise of majority non-executive director and recently in 2007 (with the revision of MCCG in 2007) wholly by independent directors, there is a need for examining how the environment of its setting affect their performance and ultimately firm performance. Hence, the aim of this paper is to investigate factors that influence the effectiveness of independent members of audit committee in safeguarding shareholders' interests through its financial oversight responsibilities. In Section 2, the paper reviews literatures on audit committee’s characteristics and development in reporting disclosures that have critical impact on its performance of duties. In Section 3, the paper presents the methodology and research model to examine the relationship between audit committee’s attributes and firm performance. Section 4 elaborates the results of the study OLS regression analyses. The discussion in Section 5 concludes the findings of the study, limitations as well as suggestions of future research.

2. Literature Review

2.1 Audit Committee Responsibilities

The audit committee's internal control oversight duties have been frequently cited by many researchers, for example, Abdolmohammadi & Levy 1992; Wolnizer 1995; DeZoort 1998; Tan & Kao 1999; Millichamp 2002; all of whom have emphasised the importance and implications of the performance of such a role for the credibility and reliability of the firm’s systems of control and investors’ investment decisions. The audit
committee’s experience and comprehension of the internal control evaluation process is necessary to support and encourage auditors’ assessment of the state of the firm’s control system such that their audit plan and procedures are structured to identify and uncover errors and fraudulent practice (DeZoort 1998; Caplan 1999).

Due to its primary duties in overseeing the firm’s financial processes, the formation of the audit committee has been linked with the strengthening of a firm’s financial control (see, for example, Collier 1993; English 1994; Vinton & Lee 1993). In particular, studies by Defond & Jiambalvo (1991) and Dechow, Sloan & Sweeny (1996) have examined the role of the audit committee in curbing the misrepresentation of financial statement items. Further, according to Diamond & Verrecchia (1991), when value-maximising managers use corporate disclosure as a mean of reducing information asymmetry this improves the future liquidity of the company in the form of lower capital-cost.

A study by Gendron, Bedárd & Gosselin (2004) on audit committee meetings, found key aspects of the committee’s work included asking challenging questions and evaluating the reports and feedback of managers and the audit findings of auditors. Such findings signify the importance of audit committee members’ self-awareness and initiative, that is, the need for them to be proactively involved and committed to the tasks and matters pertaining to their duties. On a large scale, these actions will generate a subsequent improvement in corporate governance, better protection of shareholders’ interests, and mitigation of the misappropriation of assets and misrepresentation of information (Kirk, 2000; Turley & Zaman 2004). The credibility of a firm’s corporate governance is important to ensure and increase investors’ confidence and has further implications for reducing the cost of doing business (Kala, 2001).

According to Financial Reporting Council 2003, audit committee members’ roles are specifically to act independently from executives and ensure the financial reporting practice and internal control of the listed issuer are reliable and credible to protect the interests of shareholders. Importantly, the size, complexity of the business and risk profile of the company will further determine the extent of the audit committee’s oversight responsibilities and working schedules.

It is important for audit committee members to recognise and understand what their job description requires them to accomplish, because this will affect their commitment to performing their responsibilities. In addition, the rights and authorities attached to their job designation, particularly their access to the firm’s resources, documents and personnel, employees’ cooperation and the company’s provision for them to seek external experts’ advice, will affect their efficiency and the quality of their job performance, when taking into account the time and costs they spend completing their specific tasks.

In particular, the Malaysia Bourse Securities Berhad Listing Requirements 2001(Para 15.18) establishes the authority of the audit committee as being to:

i) investigate any matter within its terms of reference,
ii) access the resources required to perform its duties,
iii) obtain full and unrestricted access to any information pertaining to the listed issuer,
iv) have direct communication channels with external auditors and person(s) carrying out the internal audit function or activity,
v) obtain independent professional or other advice when needed, and
vi) convene meetings with external auditors without the presence of executive members of the committee whenever this is deemed necessary.

Another vital role of the audit committee is to preserve and protect auditors’ independence (Klein, 2002). This is crucial to ensure the credibility of a firm’s financial reporting practice, to provide fair representation and appropriate protection of shareholders’ interests, and to protect auditors from unnecessary pressures that may affect their work performance and expose them to unethical conduct inherent in their profession (Kirk & Siegel, 1996). To achieve this, the Sarbanes Oxley Act (2002) extended audit committees’ responsibilities to evaluating the performance of external auditors in order to reduce management influence on auditors and thus strengthen auditors’ positions.

Moreover, the practice of establishing separate sessions for the meeting between independent audit committee members and external and internal auditors without the presence of executive directors or officers will provide an open, useful and dynamic forum (Williams 2007:14; Norman, Rose & Seon Suh, 2011), especially on issues that may be sensitive to the executives.

2.2 Independent audit Committee

As outside parties that are free from association with management, outside directors’ involvement in the board proceedings is essential to minimise agency costs, especially when credible and vigilant monitoring duties are practised (Beasley 1996). In other words, they should be able to perform monitoring tasks effectively and have fewer incentives to collaborate with management in expropriating a firm’s assets. Significantly, independent directors are viewed as people who can provide a better quality and assurance of reasoned corporate judgement (Ferris, Jagannathan & Pritchard 2003). Also, their external experience will supplement inadequate skills in both strategic processes and the setting of plans (Robinson Jr 1982; Gupta, Otley & Young, 2008).

Whilst Lee, Rosenstein, Rangan & Davidson III (1992) showed that outside directors have the tendency to ensure shareholders’ wealth interests are accounted for appropriately in the case of a management buyout attempt. They reveal that, in this situation, such directors acted by forming independent committees with the necessary capabilities and competencies to examine properly the implications and feasibility of the company’s performance to ascertain shareholders’ value creation.

The strength of audit committee members’ impartial views and judgment and attention to details, critical in overseeing a firm’s financial position, reporting and auditing practice, and hence will rely on the committee’s majority composition of independent
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outside directors (Abbott, Park & Parker 2000). It has been argued that the presence of non-independent directors, such as top executives and their affiliates may prevent committee members from easily and freely expressing their real concerns about current circumstances affecting the company (Bèdard, Chtourou & Courteau 2004).

Additionally, the effectiveness of the audit committee depends on its collective ability to meet its oversight objectives (DeZoort 1998). The rules and regulations pertaining to its authority and functions are strengthened by regulatory bodies’ support and this, in turn, signifies its importance as an oversight body in the firm and hence facilitates the ease with which it can fulfill its prescribed duties with the co-operation of employees and management in the firm (Carcello, Hermanson, Neal & Riley 2002; Haron, Jantan & Eow 2005; Seifert, Sweeney, Joireman & Thornton, 2010). The moves by the Stock Exchange to incorporate audit committee rules in its corporate governance listing requirements are perceived to be effective in enforcing the good functioning of the board and board committees (see, for example, Shleifer & Vishny 1997; Abdulrahman, Brierley & Gwilliam, 2002; La Porta, Lopez-de-Silanes, Shleifer & Vishny 2002; Orbay & Yurtoglu, 2006).

In the case of Malaysia, Malaysia Bourse Securities Berhad’s (presently known as Bursa Malaysia) Listing Rulings 2001, MCCG 2001 and the Smith Report 2003 (Para 3.10) emphasise the importance of an audit committee’s independent members convening at least one meeting in a year with the external auditor, without the presence of management representatives. This practice is encouraged to establish an objective and impartial assessment of the firm’s financial reporting practice, auditing process and financial position as well as increase auditor independence and hence effectiveness [See, for instance, BRC 1999; Williams 2007; Gibbins, McCracken & Salterio 2010].

Furthermore, in Para 15.17 of Chapter 15 of the MBSB Listing Rulings, the Stock Exchange requires audit committee members to report to the Exchange any company’s failure to resolve appropriately those issues that have been raised by the committee to the firm’s board, which has resulted in the company breaching the MBSB listing requirements. Further, the effectiveness and independence of the judgments of audit committee independent member(s) and the auditor will be enhanced if the two parties are able to conduct a meeting without the presence of executive members of the company (See, Kirk and Siegel 1996). In particular, Para 15.18(f) of Chapter 15 of the MBSB listing requirements and MCCG 2001’s Best Practices Guide stipulates such meetings as part of the rights of audit committee members. Hence, a company’s disclosure of its implementation of Para 15.17 and Para 15.18(f) in the audit committee report signifies its commitment to ensure orderly and independent reviews and judgments of its financial position, reporting and auditing practice.

2.3 Knowledge and Experience of Audit Committee

To ensure the quality, reliability and credibility of audit committee oversight performance, and vigilance regarding circumstances affecting shareholders’ interests, it has been highly recommended that the audit committee should comprise at least one member with an accounting and financial background, preferably an accounting
The latter’s presence will ensure cognizant assessment of a firm’s financial reporting, accounting and auditing procedures (McMullen & Raghunandan 1996; Moroney & Carey 2011).

Moreover, Dionne & Triki (2005) report that the presence of independent directors with financial knowledge and skills enhances evaluation of management resolutions’ impact on shareholders’ wealth. Their absence limits board of directors’ active participation in the evaluation of management derivatives plans (Buckley & Van Der Natt 2003). Consistently, Booth & Deli (1999) and Guner, Malmendier & Tate (2004) found that, directors with a commercial banking background are able to assist the firm in managing the financing options of its debts. Despite their relevant knowledge, financial experts’ effective performance requires them to be objective, vigilant and accountable when performing the oversight responsibilities (DeFond & Francis, 2005; DeFond, Hann, & Hu 2005).

### 2.4 Audit Committee’s Chairman

At the same time, the chairman of the audit committee should be elected from amongst the independent directors. Notably, the chairman plays a vital role in ensuring the committee’s meetings are conducted in a fair and cooperative environment, such that each member and all other parties, namely, the external auditor, internal auditor and key corporate officers who are invited to the meeting, do not feel inhibited from expressing their real concerns (see Raghunandan, Rama & Scarborough 1998; BRC, 1999). Additionally, Kirk & Siegel (1996) suggest for best practice it is beneficial for auditors to meet the audit committee’s chairman in advance to discuss and explain any issues in a less-pressured environment. This will allow the auditors to clarify their motivation and objectives and give the chairman the opportunity to discuss with them issues of concern, which will help the auditors prepare appropriate materials for the forthcoming meeting.

In consideration of all the above discussion, the paper aims to answer the following research questions:

(i) Does the composition of audit committee, solely by independent directors have an impact on firm performance?
(ii) Does the presence of audit committee members with specific accounting experience have an impact on firm performance?
(iii) Does the audit committee’s chairman accounting experience have an impact on firm performance?
(iv) Does the establishment of separate meeting between independent directors and external auditor has an impact on firm performance?
(v) Does the disclosure on the audit committee report of the committee’s authority to report violation of MBSB’s listing ruling have an impact on firm performance?
3. The Methodology and Model

The current study employed a cross-sectional research approach where the audit committee variables and financial performance of Main and Second Board Malaysian listed firms were examined over a two-year period (2002 and 2003; 2003 and 2004). Specifically examination of the performance of audit committee in these periods will provide further insights onto the weaknesses in Malaysian firms’ corporate governance practices which were the central issue to the Malaysian economic crisis between mid 1997 until the last quarter of 1999. Many studies have identified these elements as one of the main causes of the country’s economic suspension (for instance, the Eight Malaysian Plan 2001-2005: Chapter 6; Claessens, Djankov, Fan & Lang 1999; Iskander, Meyerman, Gray & Hagan 1999; Thillainathan, 1999; Johnson, Boone & Friedman, 2000; Kawai 2000). Moreover, in year 2000, Malaysian policy-makers’ (i.e. members of the High Level Finance Committee and Working Groups on Best Practices of Corporate Governance) has established the Malaysian Code on Corporate Governance as an immediate response and recognition of the need to enforce good corporate governance practices in Malaysian corporations.

Furthermore, in January 2001, in light of the Asian financial crisis between 1997 to 1999 and cases of corruption and fraud by big international corporations, greater awareness of the importance of good corporate governance was indicated with the adoption of the principles and best practices of the Malaysia Bourse Securities Berhad Revamped Listing Rulings 2001. Also observations conducted during these periods allowed realistic assessment of companies audit committee activities reporting based on MCCG 2001 as all of them will be doing it without prior-reporting experience on the matter.

To date, the empirical studies conducted by Abdullah (2004) and Chang Aik Leng & Abu Mansor (2005) on the link between Malaysian listed firms’ corporate governance practice and their firm performance have examined the set-up in year 2001 and earlier. Much more, the corporate governance surveys undertaken by KLSE & PwC 2002 and PwC (2004) gathered wide-ranging corporate governance information notably encompassing the responses of members of Board of Directors, public listed companies, independent directors and institutional groups) on Malaysian listed firms corporate governance practice in general and in particular their implementation of MCCG 2001. Given the significance of continuous study on this subject, it was felt appropriate to utilise the respective information gathered by KLSE and PwC’s surveys (amongst others) by undertaking empirical study that extends the period of observation of previous studies and hence providing ongoing evidence on the impact of Malaysian firms internal corporate governance practices on firm performance. Furthermore, the designation of the current study will considerably assist in fulfilling the aim of the Malaysia Securities Commission and Malaysia Bourse of Securities Limited to ensure commitment amongst listed companies in Malaysia to enhance their corporate governance conduct responsibly. In addition, the examination of firm’s audit committee characteristics will provide empirical evidence of whether policy makers’ corporate governance initiatives have been sufficient or need to be extended further.
The sample size of firms was determined using random sampling. The audit committee and firm’s financial data were gathered from Malaysian public listed companies’ annual reports, Datastream and OSIRIS database, respectively. Data were subsequently explored and analysed using multiple regression analysis to examine and identify their statistical significance for the purposes of the study.

The following research hypotheses are postulated to assess the influence of audit committee attributes on firm performance.

**H1:** The audit committee’s composition entirely of independent directors will have a positive impact on firm performance.

**H2:** The proportion of audit committee members with practicing accountant experience will have a positive impact on firm performance.

**H3:** The presence of an audit committee’s chairman with practicing accountant experience will have a positive impact on firm performance.

**H4:** The convening of audit committee meetings between its independent directors and the external auditor will have a positive impact on firm performance.

**H5:** The disclosure in the audit committee report of the committee’s authority to report firm violation of MBSB’s listing requirements will have an impact on firm performance.

The research hypotheses are tested using subsequent model:

\[ \text{Firm Performance}_{it} = \alpha + \beta_0 \text{AUDF} + \beta_1 \text{ACHSIN} + \beta_2 \text{NACPRI} + \beta_3 \text{MTEXT} + \beta_4 \text{RBRE} + \text{Control Variables} + \varepsilon_{ij} \]

(i) AUDF: binary coding of 1 or 0 otherwise when the audit committee is solely comprised of independent directors,

(ii) ACHSIN: binary coding of 1 or 0 otherwise when a senior independent director is appointed as the committee’s chairman,

(iii) NACPRI: proportion of independent audit committee members with practicing accountant experience,

(iv) MTEXT: binary coding of 1 or 0 otherwise when independent committee members convene at least one meeting with the external auditor without the presence of executive officers and,

(v) RBRE: binary coding of 1 or 0 otherwise when the firm has disclosed the right of the audit committee to report to the Stock Exchange any firm breaching Exchange and other regulatory rules.
In addition, Tobin’s Q and return on equity are used as the measures of firm performance.

4. Analyses and Results

Table 1 and 2 present the descriptive statistics and correlation analysis of the dependent and explanatory variables, respectively. Variables that begin with capital N represent the transformed data to normal scores using Van der Waerden approach (See, Cooke 1998).

Table 1: Descriptive statistics (year 2002, 2003 and 2004)

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Table 2: Pearson correlation analysis of audit committee governance (year 2002, 2003 and 2004) and firm performance (year 2002 and 2003)

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*p < 0.05*, *p < 0.01**.

Table 3(i) and 3(ii) show the regression results of audit committee governance and firm performance models.

Table 3(i): Audit committee governance 2002 and Firm performance 2002 and 2003

<table>
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<tr>
<th></th>
<th>NTOBQ02</th>
<th>NROE02</th>
<th>NTOBQ03</th>
<th>NROE03</th>
</tr>
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<tbody>
<tr>
<td>Constant</td>
<td>-.321</td>
<td>-.142</td>
<td>-.505**</td>
<td>-0.107</td>
</tr>
<tr>
<td>AUDF02</td>
<td>-.119</td>
<td>-.593***</td>
<td>-.222</td>
<td>-0.263</td>
</tr>
<tr>
<td>ACHSIN02</td>
<td>-.361***</td>
<td>.098</td>
<td>-.246</td>
<td>0.143</td>
</tr>
<tr>
<td>NACPRI02</td>
<td>-.101</td>
<td>.116</td>
<td>-.030</td>
<td>0.01</td>
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<tr>
<td>MTEXT02</td>
<td>.175</td>
<td>-.040</td>
<td>.237</td>
<td>-0.129</td>
</tr>
<tr>
<td>RBRE02</td>
<td>.010</td>
<td>.093</td>
<td>.076</td>
<td>0.247*</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.284</td>
<td>0.228</td>
<td>0.274</td>
<td>0.209</td>
</tr>
</tbody>
</table>

Table 3(ii): Audit committee governance 2003 and Firm performance 2003 and 2004

<table>
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<tr>
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<th>NTOBQ03</th>
<th>NROE03</th>
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<th>NROE04</th>
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<td>Constant</td>
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<td>.179</td>
<td>-.304</td>
<td>.006</td>
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<td>-.070</td>
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<tr>
<td>ACHSIN03</td>
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<td>.185</td>
<td>-.099</td>
<td>.014</td>
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<tr>
<td>NACPRI03</td>
<td>.055</td>
<td>.109</td>
<td>.161**</td>
<td>.192**</td>
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<tr>
<td>MTEXT03</td>
<td>.110</td>
<td>-.357**</td>
<td>.080</td>
<td>-.157</td>
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<tr>
<td>RBRE03</td>
<td>.033</td>
<td>.293**</td>
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<td>-.045</td>
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<tr>
<td>$R^2$</td>
<td>0.263</td>
<td>0.261</td>
<td>0.157</td>
<td>0.187</td>
</tr>
</tbody>
</table>

*p < 0.1*, *p < 0.05**, *p < 0.01***.
5. Conclusions

The results show that audit committee governing enhanced firm performance when there is higher proportion of independent audit committee members with practicing accountant experience and firm disclosed the right of the audit committee to report to the Stock Exchange of any firm breaching Exchange and other regulatory rules. The significance of audit committee members’ financial knowledge and skills, in particular accounting practitioners’ experience has been linked with their greater capability to comprehend and perform financial oversight duties effectively. Further assistance from members with accounting, auditing and/or finance experience provides the committee’s members with greater knowledge and awareness of the state of management’s administration of the firm’s internal control, reporting practice and financial activities in comparison to other directors’ knowledge on the same subject.

On the contrary, the relationship between composition of audit committee entirely by independent director and the independent committee members’ exclusive meeting with the external auditor, and firm performance is negative. Nonetheless, the presence of a higher proportion of independent director on the audit committee will facilitate the deliberation of objective and impartial evaluation of the firm’s business and financial risks and vigilance. Since in the committee, they represent more than majority number they are in better position to challenge management’s unwarranted proposition on firms' investment strategies. However, the productivity of the audit committee team is affected by the collective commitment of its members to fulfill their oversight duties responsibly and the sufficient co-operation of management in supplying required information to ensure effective audit committee decision-making. In addition, the committee members need to be able to gather relevant and sufficient information and conscious of the impact of the firm’s business relationships on the firm’s financial performance. There must also be a close working relationship between independent directors and the external auditor to establish strong corporate governance practice in the firm and to enhance auditor’s accountability and professionalism. This would require effective communication and judgments between audit committee and auditor in order to produce reliable and credible financial report. This practice will eventually safeguard shareholders’ interests.

The current study has examined the impact of audit committee’s attributes (i.e. composition, structure and authority) as at financial year 2002 and 2003 with firm performance in 2002, 2003 and 2004, respectively. Nevertheless, the potential benefits of these corporate governance practices may be better captured by its firm performance when the observation period is extended to five years for instance. Yermack (2004) pointed to the importance of conducting a study on board of directors’ practices over a certain period, namely 5 years. He argued that, such period would allow better understanding of how outside directors’ skills evolve with time, given their lack of knowledge of the company’s operations when they first commenced their job in the firm and their reputation’s dependence on their past and current working experience. Importantly, after certain period they may have accumulated the required and relevant knowledge and skills to influence the firm’s strategic decision. Future research on this subject could be conducted using questionnaires surveys and/or interviews approach to
gather details understanding of how audit committee working environment affected their decision-making.

Another research avenue would be to examine the implications of firms disclosing related party transactions for the effectiveness of their internal control system and administration. This type of transaction also requires further identification, examination and disclosure of a company’s engagement with a wide range of related parties, for example, subsidiaries, directors, employees and suppliers, given the non-recognition of certain transactions by accounting measures, i.e. the provision of free business services by related parties, and potential creative accounting maneuvers in the recognition and treatment of certain business transactions.

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Saat, Karbhari, Xiao & Heravi


