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Audit Committee and the Amendments of Quarterly Financial Reports among Malaysian Companies

(Jawatankuasa Audit dan Pindaan Laporan Kewangan Suku-tahun di Kalangan Syarikat Malaysia)

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ABSTRACT

This paper examines the association between audit committee characteristics (independence, expertise and activities) and the amendments of quarterly financial reports of Malaysian companies. Control variables, namely size of board of directors, size of company, profitability and auditor are also included in this study. In this study, each of the 63 sampled companies that amended their quarterly reports in 2005 is matched with a company that did not make any amendments. Results of the regression test indicate that companies having audit committees with two or more financial experts are less likely to amend their quarterly reports. Although other variables (except for auditor) appear to have a negative association with amendments, statistically the association is insignificant. This study also observed that most of the amendments are due to oversight, mathematical mistakes and typographical errors. The findings suggest that to be effective, audit committees should have more than one financial expert.

ABSTRAK

Kertas ini mengkaji hubungan antara ciri-ciri jawatankuasa audit (kebebasan, kepakaran dan aktiviti) dan pindaan terhadap laporan suku tahunan syarikat. Pemboleh ubah kawalan seperti saiz lembaga pengarah, saiz dan keberuntungan syarikat, dan juru audit juga diambilkira dalam kajian ini. Dalam kajian ini, kesemua 63 syarikat yang dikaji yang meminda laporan suku tahunan bagi tahun 2005 dipadankan dengan syarikat yang tidak membuat sebarang pindaan. Hasil ujian regresi menunjukkan lembaga pengarah yang mempunyai dua atau lebih orang pakar dalam bidang kewangan tidak mempunyai kecenderungan untuk meminda laporan suku tahunan. Walaupun faktor lain (kecuali juru audit) mempunyai hubungan yang negatif dengan pindaan, secara statistik hubungan adalah tidak signifikan. Kajian juga menunjukkan yang pindaan biasanya dibuat atas alasan terlepas pandang, kesilapan matematik, dan kesilapan menaip. Penemuan kajian menunjukkan bahawa bagi mewujudkan jawatankuasa audit yang berkesan, seharusnya ia mempunyai lebih daripada seorang pakar dalam bidang kewangan.

INTRODUCTION

The Malaysian government has taken initiatives as early as 1994 by mandating audit committee to all public listed companies in the country. Furthermore, because of major corporate governance collapses worldwide, the government, through Ministry of Finance has established a High Level Finance Committee with the task of reviewing and reforming corporate governance practices in Malaysia. This committee was assigned to come out with the Malaysian Code on Corporate Governance (MCCG). The Code was first issued in March 2000. While the Code remains as a voluntary guide and is meant to be non-statutory and self-regulatory, in January 2001, Bursa Malaysia (formerly known as the Kuala Lumpur Stock Exchange) strengthened its efforts towards enhancing corporate governance practices in Malaysia by revamping its Listing Requirements. For instance, Chapter 15 of the revamped Listing Requirements specifically addresses corporate governance issues, and in particular the recommendations of the MCCG have become an integral part of the revamped Bursa Malaysia Listing Requirements (BMLR). In relation to audit committee, the MCCG suggests that the board should establish an audit committee with at least three directors, a majority of whom are independent and the chairman of the audit committee should be an independent non-executive director. Part 2 of the Code also specifies the duties of audit committees and the need for the board to establish an internal audit function. Compliance to Part 2 of the Code is voluntary but firms are required to state in their annual reports the extent of their compliance with an explanation for any departure.

An audit committee is an important board committee that monitors the management and assists the board of directors in overseeing and ensuring adequate functioning of internal control mechanisms (Hasnah, Jantan & Eow 2005). An audit committee helps determine indicators of problems, mitigate possible damages, and enhance shareholders' value. One of the duties of the audit committee is to oversee companies' financial performance and ensure the reliability of their reporting. As outlined in the MCCG (Finance Committee on Corporate Governance 2000), an audit committee is to review the quarterly and year-end financial statements of a company. The review

should focus on any changes in accounting policies and practices, significant adjustment arising from the audit, the going concern assumption and compliance with accounting standards and other legal requirements. The audit committee should also discuss problems and reservations arising from the interim and final audits and any matter the auditor may wish to discuss (in the absence of management, where necessary).

Recently, the issue of whether the audit committees are effective in carrying out their duties has been the subject of numerous investigations. This is because of the pervasive cases of financial statement errors and irregularities, which in some cases amount to fraudulent reporting. Recent cases of accounting irregularities in Malaysia include companies such as Megan Media Holdings Berhad, NasionCom Holdings Berhad, United U-LI Corporation Berhad and Transmile Group Berhad.

Bursa Malaysia requires financial statement errors and regularities to be restated immediately in an amended quarterly report. Therefore, one way of assessing the effectiveness of an audit committee is by observing the amendments made to the quarterly reports. This paper attempts to investigate the association between amendments of quarterly financial reporting and audit committee characteristics. This is because it is the duty of the audit committees to review the quarterly financial statements and ensure that they are reliable. We particularly focus on the amendments made to quarterly reporting because to our knowledge, no such specific studies have been conducted in Malaysia. Similar to prior studies (see The U.S General Accounting Office (GAO) 2003; Abbott *et al.* 2004), this study presumes that weak audit committee is at least partially responsible for financial reporting errors that manifest ultimately as amendments. In particular, the objective of this study is to determine whether audit committee characteristics (namely committee independence, members' expertise and activity) are associated with amendments of the quarterly reports. These characteristics are tested based on the belief that to be effective, an audit committee should among others, be independent, financially literate and meet regularly. In addition, this study explores the reasons as to why quarterly reports are amended.

Amended quarterly reports are the quarterly reports published and issued after the first report has been released and before the next quarter's report is issued. When a quarterly report is amended, a new set of financial statements would be submitted to Bursa Malaysia and released to the public on its website. There are a number of studies regarding audit committee characteristics and restatements of financial reporting (Agrawal & Chadha 2005; Abbott, Parker & Peters 2004). Abbott *et al.* (2004), for example, examine the association between the characteristics of audit committee and the likelihood of financial statement restatements. As far as we are concerned, most of the studies were concentrated outside Malaysia. Perhaps, the closest studies to ours are those conducted by Norman, Mohd Iskandar and Rahmat (2007) and Hasnah *et al.* (2005). The former examines the effectiveness of audit committee characteristics in monitoring management behaviour with respect to their incentives to manage earnings. It is found that the presence of a fully independent audit committee reduces earnings management practices, and the interaction between proportion of audit committee members with accounting knowledge and the frequency of meeting is significantly related to earnings management practices. The latter investigates whether financial distress in companies is associated with audit committee effectiveness. However, there was no evidence of association between the financial health of companies and audit committee effectiveness.

This study is a significant contribution because it examines the effectiveness of audit committees in monitoring the reliability of quarterly reporting in an emerging market and in a Southeast Asia region, Malaysia. Malaysia. Like most other Southeast Asian markets, Malaysia faces challenges in developing reliable and transparent corporate financial reporting. As discussed by Zarinah and Kar (2003), the following factors may contribute to the challenges: companies having high degree of family ownership, minority shareholders and institutional investors are generally passive, many boards and audit committees are not effective oversight mechanisms, and enforcement systems are generally inadequate. More importantly, this study will determine if the initiatives taken by the authorities to require companies to have audit committees that are independent, financially literate and "active" are supported. As the Malaysian market is similar to some other Southeast Asian markets such as Thailand and Indonesia, the findings of this study would be useful to the business societies in the region.

The remainder of this paper is organised as follows. In the next section, a review of the requirements for quarterly reporting and audit committee in Malaysia will be presented. Next, there will be a review of literature regarding audit committee effectiveness. It is followed by sections on hypothesis development and research methods. Next, the findings will be discussed, and finally, the paper will end with a conclusion section.

INSTITUTIONAL SETTING

All companies listed on the Bursa Malaysia are required to issue quarterly financial reports since 1999 to replace half-yearly reports, following the 1997/98 Asian financial crisis. The reports are to be issued to the Exchange within 60 days after the end of the quarter and they need not be audited. Bursa Malaysia will subsequently release the quarterly financial reports to the public on its website. The Bursa Malaysia Listing Requirement (BMLR) requires companies to correct inaccurate, incomplete or misleading financial disclosure in a timely manner. Where quarterly financial reporting is concerned, the corrected report is usually released as an amended quarterly financial report,

before the next quarterly report is due for release. The amendment provides an explicit acknowledgement of material omissions, or misstatements in the previously issued financial statement. Similar to the original report, the amended report will include the whole set of financial statements.

The Listing Requirements require every company to form an audit committee comprising of at least three members, a majority of whom should be independent directors. A director is classified as independent if he or she is a non-management director, free of any family relationship or any material or business relationship (other than stock ownership and the directorship) with the company or its management. This requirement is imposed to improve investors' confidence and enhance the capability of audit committees to achieve their objectives and to promote better corporate governance and transparency in the capital market.

In order to fulfill audit committee responsibilities for monitoring internal control and financial reporting, *audit committee* members should possess the necessary financial expertise. The Listing Requirements requires that at least one of the audit committee members is a member of The Malaysian Institute of Accountant (MIA) or if he or she is not a member of MIA, he or she must have at least 3 years' working experience and (1) must have passed the examinations specified in Part l of the 1st Schedule of the Accountants Act 1967; or (2) must be a member of one of the associations of accountants specified in the Act; or fulfils such other requirement as prescribed by Bursa Malaysia. In short, to be considered a financial expert, an audit committee member should possess an accounting background.

AUDIT COMMITTEE EFFECTIVENESS

In an agency framework of a company, the board of directors (BOD) and the audit committee evolve as monitoring mechanisms because of a separation of ownership from control and a possible discrepancy of the incentives of outside shareholders and managers. According to Fama and Jensen (1983), agency theory suggests that owing to the separation of corporate management and ownership, shareholders require protection because management may have agendas different from their owners and thus may not always act in the owners' best interest. Hence, based on agency theory, the formation of an audit committee is expected to protect the interest of the principal and to ensure that the management carries out its roles in accordance with the contract. However, audit committees are not necessarily effective in carrying out their duties. For instance, an audit committee may not be effective if its members are not independent of management. Audit committees may also be ineffective in monitoring the financial reports if none of the members is accounting literate.

Several approaches have been adopted in measuring the effectiveness of audit committees. According to Song and Windram (2004), one of the ways is to seek perceptions of economic players such as the internal and external auditors and audit committees as to various measures of effectiveness. Another approach is by examining the activities carried out by the audit committees (Menon & Williams 1994). Other studies associate the effectiveness of audit committees with the quality of financial reports of which the latter is measured, among others, by compliance with accounting standards (Song & Windram 2004), earnings management (Klein 2002), accounting fraud (Beasley 1996) and financial restatements (Abbott *et al.* 2004). DeZoort, Hermanson, Archambeault and Reed (2002) provide a comprehensive review of literature on audit committee effectiveness. Our approach mirrors the method used by Abbott *et al.* (2004), except that we examine the restatements of quarterly reports, instead of annual reports.

HYPOTHESIS DEVELOPMENT

Another aspect of audit committee that has been the subject of investigation is the influence of audit committee characteristics on its effectiveness. The recent requirements by stock exchanges and other authoritative bodies worldwide have implicitly assumed that independence, financial literacy and activity of an audit committee will improve its effectiveness. Thus, we develop the hypotheses as discussed below.

AUDIT COMMITTEE INDEPENDENCE

Based on agency theory, the more independent the audit committee is, the more effective it would be in monitoring managerial opportunism. DeZoort and Salterio (2001), for example, found that when there were disputes between management and external auditors, independent audit committee members were more likely to support the auditors rather than the management. Independent audit committee members add value to a firm as they bring in experience and reputation that help improve the committee's decision making and effectiveness in performing their monitoring duties. It is also argued that independent audit committees have a greater incentive to avoid activities that would damage their reputation than non-independent audit committees (Abbott & Parker 2000).

Various studies provide evidence of the positive influence of audit committee independence on its effectiveness. Among others, Song and Windram (2004) provided strong evidence that in the UK, audit committee independence was negatively associated with the violation of accounting standards. In another study, Klein (2002) showed that audit committee independence was negatively associated with abnormal accruals. Abbott and Parker (2000) suggested that independent audit committees

were less likely to be involved in fraudulent or misleading financial reporting. Along the same vein, Beasley, Carcello, Hermanson, and Lapides (2000) found that fraud companies in the technology, healthcare and financial service industries appeared to have a lower level of audit committee independence compared to non-fraud companies. The foregoing discussion leads us to the following hypothesis:

H_1: There is a negative association between the independence of audit committee and the amendment of quarterly reporting.

AUDIT COMMITTEE FINANCIAL EXPERTISE

The expertise requirement is generally fulfilled by having a background in accounting that permits the board to conclude in good faith that the director is capable of understanding the most complex issues of accounting and finance encountered in the course of the company's business. Moores (2004) as cited in Razaee, Olibe, and Mimmier (2003) argues that an audit committee with financial literacy would have the ability to understand the important accounting judgments management makes, why management makes them and how management can use those judgments to manipulate financial statements.

The reported empirical evidence supports the argument that financially literate and expert audit committee is beneficial to a company. Bedard, Chtourou, and Courteau (2004) suggest that an audit committee whose members have more financial experts is more effective in constraining earnings management. They find that the presence of at least one member with financial expertise is associated with a lower likelihood of aggressive earnings management.

Agrawal and Chadha (2005) show that the probability of earnings restatement is lower in companies whose audit committees have an independent director with a background in accounting or finance. Abbott *et al.* (2004) find that the absence of a financial expert on the audit committee is significantly associated with an increased probability of financial misstatement and financial fraud. Along the same vein, Xie, Davidson and Dadalt (2003) show that the presence of investment bankers on an audit committee is associated with lower discretionary accruals in companies. DeFond, Hann and Hu (2004) report a positive market response to the addition of a financial expert to the audit committee.

Using an experimental approach, McDaniel, Martin and Maines (2002) examine the effect of financial expertise on audit committee's judgments of financial reporting quality. They find that a financial expert is able to distinguish certain quality shortcomings in financial reporting issues that a financial illiterate member is not able to distinguish. Pearce and Zahra (1991) found that boards lacking expertise and independence were less powerful and had less than superior corporate financial performance.

There is an increasing recognition that service on an audit committee might require an occupational background that provides a strong working knowledge, business practices and concepts (Kesner 1988). Kalbers and Forgarty (1993) note that an audit committee member with skills in accounting and finance as well as knowledge of the company and industry could contribute to the effectiveness of the committee and thus provide "expert power". DeZoort (1998) documents that audit committee members with auditing or previous internal control evaluation experience make better judgments of the internal control oversight. According to DeZoort and Salterio (2001), audit committee expertise increases the possibility that detected material misstatements will be communicated to the audit committee and corrected in a timely fashion. Collectively, the above evidence suggests that audit committee expertise can reduce restatement of financial reporting, leading to the following hypothesis:

H_2: There is a negative association between financial expertise of an audit committee and the amendment of quarterly reporting.

The level of financial expertise is measured as follows: a score of "1" is given if there are two or more financial experts, otherwise "0" is given. Consistent with BMLR and as mentioned earlier, an audit committee member is considered an expert if he or she is a member of the MIA, or if he or she is not a member of the MIA, he or she must have at least 3 years' working experience and (1) must have passed the examinations specified in Part l of the 1st Schedule of the Accountants Act 1967; or (2) must be a member of one of the associations of accountants specified in the Act; or fulfils such other requirement as prescribed by Bursa Malaysia.

AUDIT COMMITTEE ACTIVITIES (MEETINGS)

An active audit committee would indicate the level of effort that has been made to ensure quality financial reporting. Activity can be measured in different ways, such as meeting frequency, meeting duration and information exchange during the meeting (Song & Windram 2004). It has been suggested in the literature that meetings are significant events for monitoring financial reporting (Menon & Williams 1994).

The number of meetings held by an audit committee in a year would give an indication of how active the committee is. In Malaysia, the regulation does not stipulate a minimum number of meetings that shall be held by an audit committee. Kang (2001) suggest that at least five meetings annually are required to gain sufficient insight into the firm's financial situation.

Meanwhile, the Blue Ribbon Committee (1999) and the Treadway Commission (1987) suggested that audit committees should meet at least four times a year. Abbott *et al.* (2004) find that companies with audit committee meetings of at least four times annually have lower occurrence of financial reporting restatement compared

to those with less than four meetings. Xie *et al.* (2002) found that audit committee meeting frequency is directly associated with reduced level of discretionary current accruals. Abbott, Park and Parker (2000) provided evidence that audit committees that met at least twice a year were less likely to be sanctioned by the US Securities Commission (SEC) for fraudulent financial reporting. Similarly, Beasley *et al.* (2000) revealed that audit committees of fraud companies in the technology and healthcare industries held fewer meetings than industry benchmarks. Although not statistically significant, Song and Windram (2004) provided an indication that an audit committee that meets regularly has a positive influence on its effectiveness as far as conformance with the accounting standards is concerned.

Based on the above discussion, it is believed that a committee that meets more often should be able to devote more time to issues regarding the quality of financial reporting. Therefore, this study expects the incidence of amendments to be inversely related to the number of audit committee's meeting. The hypothesis to be tested is as follows:

H_3: There is a negative association between the number of audit committee meetings and the amendment of quarterly reports.

CONTROL VARIABLES

This paper acknowledges that various other variables may also influence the quality of financial reporting. For the purpose of this study, board of director size, company size, company performance and auditor are used as control variables. Size of the board of directors is expected to have a negative influence on the amendments. Larger boards provide a bigger pool of candidates from which audit committees are appointed. Size of a company is also expected to be negatively associated with the amendments of financial reporting. This is because large companies have greater resources which would enable them to appoint reputable auditors and non-executive directors, thus improving audit committee effectiveness (Song & Windram 2004). Beasley *et al.* (2000), for example, found that companies committing fraud are relatively small. We also expect that size of an auditor would have a positive impact on the quality of financial reporting. Large auditors are more concerned with maintaining their reputation, and thus are less likely to produce erroneous reports. Although quarterly reports are not necessarily audited, auditors play a role in reviewing the quarterly reports. In her survey, Ku Nor Izah (2003) for example found that about one-third of sampled companies in Malaysia had their first three quarterly reports reviewed by the auditors (although none were audited). As for the final quarter's report, 60 percent and 20 percent of the companies had the reports audited and reviewed, respectively.

Previous studies often associate financial misstatements with less profitable or troubled companies. As cited by Beasley (1996), companies with poor financial performance would place too much emphasis on earnings and profitability, thus would be more likely to commit financial fraud. Similarly, we believe poor performing firms are more likely to produce financial statement errors that ultimately result in amendments.

RESEARCH METHODS

DATA COLLECTION

Data are collected from the Bursa Malaysia website by searching all quarterly financial reports published in year 2005 that were later amended. Quarterly reports of the year 2005 (being the latest reports available at the time the study was conducted) are investigated. Because quarterly financial reports were introduced in 1999, we believe that by 2005 companies are already used to preparing the reports. Thus, non-accounting and unintentional errors would be much reduced. Only companies listed on the main board of Bursa Malaysia are investigated. This is because they are large and more likely to be followed by analysts. Out of 647 main board companies listed in 2005, 126 (19.5 percent) amended their quarterly reports during the year. The amended quarterly reports of these 126 companies are observed in identifying the reasons for amendments. In determining the influence of audit committee on amendments, one-half of these companies (63) are selected as the subjects of investigation. A proportionate stratified random sampling technique based on sectors is used. The distribution of companies according to sectors is depicted in Table 1. A majority of the companies are from the trading/services, industrial product and consumer product sectors.

TABLE 1. Distribution of sampled companies by sector

Bursa Malaysia sector	No. of amend companies	Sampled companies
Trading/Services	32	16
Industrial Product	31	15
Consumer Product	20	10
Properties	13	6
Finance	10	5
Construction	8	4
Plantation	6	3
Technology	4	2
IPC	1	1
Hotel	1	1
Total	126	63

Accordingly, each of the 63 sampled companies that amend their quarterly reports is matched with a non-amend company. This results in a total of 126 companies in the sample, representing 19.5 percent of the main board companies. According to Roscoe's rule of thumb (Sekaran 2003), a sample that is larger than 30 and less than 500 is appropriate for most research, and in order to run a multiple

regression analysis, an average of 10 observations per variable is sufficient. Having a sample size of 126 and seven variables in the model, our sample size more than meets the requirement. Subsequently, annual reports of selected companies are collected in order to scrutinize the Audit Committee Report therein and to collect other relevant information about the companies.

There are two ways of selecting the control or matching companies, either by randomly selecting the non-amend companies, or by matching each of the amend company with a non-amend company having similar characteristics, such as business activities and size. For the purpose of this study we use the latter approach, an approach commonly used by researchers (see, for example, Wan Nordin 2009). Initially, each of the amend company is matched with a company listed on the main board of Bursa Malaysia and having the same core business. If there are more than one company having the same core business, a company with total assets closest to the amend company is chosen.

DATA ANALYSIS

A multiple logistic regression represented as follows is used to test the hypotheses.

$$AMEND = \alpha + \beta_1 INDAC + \beta_2 EXPERT + \beta_3 MEET + \beta_4 BDSIZE + \beta_5 COSIZE + \beta_6 ROA + \beta_7 AUDIT + \varepsilon$$

where,

AMEND = "1" if a company amends and "0" if a company does not amend.

INDAC = Independence of audit committee measured by the percentage of independent directors in the audit committee. A director is considered independent if he or she is a non-management director, free of any family relationship or any material or business relationship (other than stock ownership and the directorship) with the company or its management.

EXPERT = Financial expertise of the audit committee, "1" if there are two or more financial experts, and "0" if less than two. One is considered an expert if he or she is a member of the MIA, or if he or she is not a member of the MIA, he or she must have at least 3 years' working experience and (i) must have passed the examinations specified in Part l of the 1st Schedule of the Accountants Act 1967; or (ii) must be a member of one of the associations of accountants specified in the Act; or fulfils such other requirement as prescribed by Bursa Malaysia.

MEET = Level of activity, measured by the number of meetings in the financial year.

BDSIZE = Size of the board of directors, measured by the number of directors on the board.

COSIZE = Size of a company, measured by the natural log of total assets.

ROA = Performance of a company, measured by return on assets.

AUDIT = Auditor of a company, "1" if audited by Big 4, "0" otherwise.

ε = error term of residual.

The measurements used in measuring the above variables are consistent with those adopted in other similar studies (Abbott *et al.* 2004; Beasley *et al.* 2000; Bedard *et al.* 2004; Klein 2002; McDaniel *et al.* 2002).

FINDINGS

An analysis of the amendments reveals that a majority of the companies (102 out of 126 or 81 percent) amend only once during the year. Nineteen (15 percent) of the companies amended twice and 5 others issued three amendments, which gives a total of 155 amendments (see Table 2).

Table 2 shows the distribution of amendments according to quarters. It appears that a majority of the amendments (40.6 percent) are related to the fourth quarter's report. The first and third quarterly reports accounted for 22.6 and 21.9 percent of the amendments, respectively, while only 14.8 percent of the amendments are related to the second quarter's reports. It is not surprising that more amendments are made to the fourth quarter's report than any other reports. This is because the fourth quarter's report, covering not only the quarter but also the whole year, is just like another annual report. Companies would try to produce the same figures in both reports because any difference that arises between the fourth quarter's report and the annual report is to be explained to Bursa Malaysia. Therefore, it is likely that companies amend the errors before they issue the audited annual reports.

Upon reviewing the amended quarterly reports, six reasons for amendments were identified. Some companies had more than one reason. Table 3 shows the distribution of the reasons. It appears that a majority of the amendments are due to oversight (26.9 percent), mathematical mistakes (26.4 percent), and typographical errors (23.9 percent). They are followed by incorrect used of existing facts (18%). Two other reasons, change in presentation and errors in the application of accounting principles, are infrequent.

TABLE 2. Distribution of amendments by quarter

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total
No. of amendments	35 (22.6%)	23 (14.8%)	34 (21.9%)	63 (40.6%)	155

TABLE 3. Reasons for amendments

Reasons of amendments	Frequency	Percent (%)
1. Oversight	45	26.9
2. Mistakes in mathematics	44	26.4
3. Typographical error	40	23.9
4. Incorrect use of existing facts	30	18.0
5. Change in presentation	5	3.0
6. Errors in application of the accounting principle	3	1.8
Total	167	100%

The question of whether the amendments are due to errors or irregularities is however, not addressed in this study. According to Gleason, Jenkins and Johnson (2004), errors are unintentional misstatements in the financial statement, while irregularities are intentional misstatements. Intent is often difficult to determine in practice, particularly in matters involving accounting estimates and the application of accounting principles. Mere observation of the reasons shows that most of the amendments in this study are likely due to errors since 78 percent of the reasons are either mathematical, or typographical errors, or due to oversight. Although these amendments are less likely to be caused by irregularities, the misstatements or omissions would still jeopardize the reliability of the reports.

Table 4 shows the composition of the audit committees of amend and control companies with regard to independence, financial expertise and number of meetings. Generally, amend companies are less independent, have lesser number of financial experts and meet less regularly compared to control companies. This is consistent with prior evidence such as that of Song and Windram (2004). A majority of audit committees (94.4%) meet the requirements of the BMLR in which a majority of the audit committee members are independent. However, seven (5.6%) of the sampled companies did not observe the requirement. The overall mean for the percentage of independent directors in each audit committee is 70 percent.

As for the number of financial experts, Table 4 shows that a majority of the audit committees (98.4%) have at least one financial expert. Only two audit committees (1.6%) did not have any experts and thus did not comply with the Listing Requirements. The overall mean number of experts is 1.10. Comparing this result with that of Hasnah *et al.* (2005), there appear to be an improvement as far as expertise is concerned. Hasnah *et al.* found that 91% of the companies in their studies have at least one member of audit committee who is financially literate. A Pearson correlation analysis shows that the number of experts is positively correlated with the size of a company.

Although Bursa Malaysia does not specify the number of meetings to be held by an audit committee, there have been suggestions that audit committees should at least meet four or five times a year (Blue Ribbon Committee 1999; Kang 2001). Table 4 shows that a majority of the audit committees meet between four to six times a year with a mean of 5. Only 4 audit committees (3.2%) meet less than four times. This is consistent with Hasnah *et al.* (2005) who found that 99 percent of the sampled firms meet at least four times a year. The Pearson correlation coefficients reveal that companies that are bigger in size and board size tend to meet more regularly. This is expected as bigger companies and boards would have more policies and decisions to be made. However, it is observed that the number of meetings is not associated with industry type.

Table 5 shows the descriptive statistics of the variables and the results of the univariate analysis comparing the difference in means between companies that amend and companies that do not. INDAC (audit

TABLE 4. Composition of audit committees

	Amend company		Control company		Total	
Variables	Freq. (%)	Mean	Freq. (%)	Mean	Freq. (%)	Mean
AC independence:						
50% and less	5 (7.9%)		2 (3.2%)		7 (5. 6%)	
More than 50%	58 (92.1%)		61 (96.8%)		119 (94.4%)	
Total	63	0.68	63	0.71	126	0.70
No. of experts:						
0	0 (0.0%)		2 (3.2%)		2 (1.6%)	
1	61 (96.8%)		49 (77.8%)		110 (87.3%)	
2	2 (3.2%)		11 (17.4%)		13 (10.3%	
3	0 (0.0%)		1 (1.6%)		1 (0.8%)	
Total	63	1.03	63	1.17	126	1.10
No. of meetings:						
1-3	3 (4.8%)		1 (1.6%)		4 (3.2%)	
4-6	57 (90.4%)		55 (87.2%)		112 (88.8%)	
7-9	2 (3.2%)		6 (9.6%)		8 (6.4%)	
10 and more	1 (1.6%)		1 (1.6%)		2 (1.6%)	
Total	63	4.86	63	5.14	126	5.0

committee independence), NMEXPERT (number of experts), EXPERT (whether companies have two or more experts), and BDSIZE (size of board of directors) seem to differ between the two groups of companies, significantly. Results suggest that amend companies are more likely to have audit committees that are less independent and less financially expert. Amend companies also tend to have smaller board of directors. The mean size of boards is 7 for amend companies, and 8 for non-amend companies. The above results are consistent with most of the previous findings. Other variables (MEET, COSIZE, ROA and AUDIT) do not appear to differ.

TABLE 5. Descriptive statistics and t-test

	Amend companies		Control companies		t-test
	Mean	Std. Dev	Mean	Std. Dev	Sig.
INDAC	0.677	0.105	0.714	0.191	0.066*
NMEXPERT	1.03	0.177	1.17	0.493	0.032**
EXPERT	0.03	0.177	0.19	0.396	0.004***
MEET	4.86	1.635	5.14	1.83	0.357
BDSIZE	7.16	1.752	7.89	1.902	0.027**
COSIZE (LnAssets)	19.947	1.919	20.296	2.112	0.334
ROA	0.523	4.087	2.212	12.159	0.298
AUDIT	0.83	0.383	0.83	0.383	1.000

*Significant at 10 percent level.
**Significant at 5 percent level.
***Significant at 1 percent level.

Where:

INDAC = Percentage of independent directors in the audit committee.
NMEXPERT = Number of financial experts in the audit committee.
EXPERT = "1" if there are two or more financial experts in the audit committee, and "0" if less than two.
MEET = Number of audit committee meetings in the financial year.
BDSIZE = Number of directors on the board.
COSIZE = Natural log of total assets.
ROA = Return on assets.
AUDIT = "1" if audited by Big 4, "0" otherwise.

Where board independence is concerned, the result is in line with agency theory that holds that greater independence would result is greater monitoring of managerial opportunism. Independent audit committees tend to avoid activities that would damage their reputation (Abbott & Parker 2000). This study also supports the argument that a financially expert audit committee is more effective in reducing financial statement errors, irregularities and earnings management. This is because the experts understand the accounting and financial issues faced by companies. As far as board size is concerned, this study supports the contention that larger boards would provide a larger pool of experts from which audit committee members are appointed. Thus, companies with larger boards are more likely to produce quality financial reports.

For the purpose of regression, we drop NMEXPERT and use EXPERT because a majority of companies have only one expert. To detect any significant multicollinearity problem, we conducted a pair-wise correlation analysis, the results of which are depicted in Table 6. The highest correlation coefficient of 0.509, that is between company size and ROA shows that there does not appear to be a multicollinearity problem in the model.

Table 7 presents the results of the logistic regression. Cox & Snell R^2 and Nagelkerke R^2 account for 12.6 percent

TABLE 6. Pearson correlation coefficients (n = 126)

	IND	EXPERT	MEET	BDSIZE	COSIZE	ROA	AUDIT
AMEND	-.164	-.253**	-.083	-.197	-.087	-.093	.000
INDAC		.110	.088	.137	.111	-.075	-.013
EXPERT			.117	.091	.219*	-.051	.096
MEET				.216*	.313**	.047	.133
BDSIZE					.226*	.070	.062
COSIZE						-.509**	.127
ROA							.069

* Significant at 5 percent level (2-tailed).
** Significant at 1 percent level (2-tailed).

TABLE 7. Logistic regression results

Variable	B	S.E.	Wald	Sig.
INDAC	-2.635	1.880	1.963	0.161
EXPERT	-1.823	0.806	5.111	0.024**
MEET	-0.013	0.138	0.010	0.922
BDSIZE	-0.158	0.112	1.965	0.161
COSIZE	-0.084	0.131	0.414	0.520
ROA	-0.038	0.031	1.481	0.224
AUDIT	0.281	0.500	0.316	0.574
Constant	4.759	2.714	3.075	0.080

Notes:
1. Cox & Snell R^2 = 0.126, Nagelkerke R^2 = 0.169.
2. Hosmer and Lemeshow goodness of fit statistic = 10.933 (p-value = 0.206).
3. ** Significant at 5 percent level.

and 16.9 percent of the variation, respectively. Hosmer-Lemeshow statistics (p = 0.206) show that the model fit is acceptable. The classification table (Table 8) indicates how many observations have been predicted correctly. It shows a prediction of 61.1% correctness. Generally, the higher the overall percentage of correct predictions, the better the model is. This indicates that the results statistically support the model used in the analysis.

TABLE 8. Classification table[a]

		Model's Predicted Amendment		
		Control Company	Amend Company	Percentage Correct
AMEND	Control Company	31	32	49.2
	Amend Company	17	46	73.0
Overall Percentage				61.1

[a] The cut value is .500

Results of the logistic regression shows that audit committees that have two or more experts are less likely to produce errors and amend the quarterly reports. This shows that increasing the number of financial experts to two or more would improve the effectiveness of audit committees in ensuring the quality of the quarterly reports. The result supports the findings of previous studies such as those of Agrawal and Chadha (2005) and Abbott *et al.* (2004) that found that financial expertise on the audit committee is negatively associated with financial misstatements. The coefficient of INDAC (independence) in the regression model is high and there is an indication that it is negatively associated with amendments. However, statistically, the regression results provide weak evidence to support the hypothesis. Similar to what we predict, other variables, except for AUDIT, also tend to have a negative association with amendments. However, statistically they are not significantly associated. This is shown by the negative values of the coefficients for independence, number of meetings, board size, company size and return on assets, and a positive value for auditor.

CONCLUSIONS

The requirement for companies to form an audit committee is aimed to improve investors' confidence in the capital market. One of the tasks of an audit committee is to oversee companies' financial performance and ensure the reliability of their reporting including the annual and quarterly reports. Despite the existence of audit committees in all listed companies, financial statement errors which give rise to amendments of the financial statements (annual and quarterly) are common among companies in Malaysia. This study examines if characteristics of an audit committee (namely independence, expertise and activity) would influence the quality of financial quarterly reports issued, particularly by examining the amended reports. Board of director size, company size, company performance and auditor are the control variables. Univariate analysis provides evidence that companies that amend are more likely to have audit committees that are less independent, comprised of less than two financial experts and have smaller board of directors. Results of the regression test support the univariate analysis that to be more effective in monitoring financial statements, audit committees should comprise of at least two financial experts. The regression results provide an indication that other variables (except for auditor) also affect the amendments in the hypothesized direction (negatively) but statistically they are not significant.

Results also show that most of the companies amend their quarterly reports due to oversight and to correct mathematical mistakes and typographical errors. Although it is not the intention of this study to observe if the amendments are due to errors or irregularities, the reasons imply that they are more likely to be errors.

Overall, this study supports the initiatives taken by the relevant authorities at tightening up the rules and regulations pertaining to audit committees in ensuring that they perform their responsibilities effectively. The requirement by Bursa Malaysia that companies have at least one member in its audit committee who is a financial expert is a positive move. However, this study suggests that the effectiveness of an audit committee would be improved if it is comprised of more than one financial expert. The authorities may consider requiring audit committees to have more than one financial expert in the future. The findings of this study may not only benefit the business communities, but also the academicians and business students. As trainers of future business managers, academicians may use the findings in discussing issues of corporate governance in classes.

The fact that this study only focuses the test of the effectiveness of audit committees on only three of its features may limit the findings. Other features of an audit committee that may influence its effectiveness such as the real activity of an audit committee and meeting duration may be employed in future studies. This study is also limited by the fact that company variables such as complexity and internal control are not included in the

model. The fact that this study does not consider interactive factors is another limitation. Future research may also test the effectiveness of an audit committee in monitoring the quality of financial reports by observing the incidence of irregularities and fraud.

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