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Financial restatements and corporate governance among Malaysian listed companies

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Abstract

Purpose – This paper seeks to examine the effects of Malaysian Code on Corporate Governance on the nature of financial restatements in Malaysia and whether corporate governance characteristics are associated with financial restatements.

Design/methodology/approach – Data for this paper are obtained from annual reports that had been restated for the period of 2002-2005 with firm-years being the unit of observation. A control group comprising non-restating firms is formed using match-pair procedures where restated and non-restated firms are matched by size, industry, exchange board classification, and financial year end. The data are subsequently analyzed using a *t*-test, the Pearson correlation and logistic regression.

Findings – The results show that the primary reason for misstating the accounts is to inflate earnings. The nomination committee of the firms that restated is found to be less independent with higher managerial ownership. The logistic regression analysis indicates that the extent of ownership by outside blockholders deters firms from misstating accounts. Surprisingly, audit committee independence is associated with the likelihood of financial misstatement. Financial restatements, nevertheless, are not found to be associated with board independence, managerial ownership, and CEO duality. Finally, the results show that firms with high level of debts are more likely to commit in financial misstatement.

Practical implications – The research is significant as it provides evidence on the role of corporate governance, especially the independence of the nomination committee and extent of ownership by outside blockholders in Malaysia. It shows that outside blockholders is effective in disciplining managers so that the accounts so prepared are not misleading. The move in 2007 by the Malaysian Government to require companies audit committee to be composed of only independent and non-executive directors, as well as requiring audit committee members to be financially literate, should be seen as important in ensuring the effectiveness of the audit committee.

Originality/value – This research is considered as the first study which examines the effects of corporate governance variables on the incidents of financial restatements in a developing country. The findings of this paper would be useful for policy makers in evaluating the importance of corporate governance in emerging countries, specifically on the issue of quality financial reporting.

Keywords Financial reporting, Boards of Directors, Audit committees, Malaysia, Corporate governance, Corporate ownership

Paper type Research paper

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Introduction

The issue of financial restatements[1] continues to gain prominence as the number of restatements continued to grow following high profile cases in the recent past that left investors with substantial losses. The US General Accounting Office or GAO (2002), renamed Government Accountability Office in 2004, estimated that between January 1997 and June 2002, accounting restatements in the USA have caused market capitalization to lose around US$100 billion. Between July 2002 and September 2005, a further US$36 billion was lost in market capitalization in the days around the initial restatement announcement (GAO, 2006). Enron, for example, announced US$618 million loss in its 2001 third quarterly report. A few weeks following this announcement, Enron disclosed that it had to restate earnings for the previous several years (Sridharan *et al.*, 2002). As a result, the value of Enron's shares dropped from its highest US$90 per share (or about US$60 billion in total) to only cents, resulting in a paper loss of US$90 billion to its shareholders.

Reasons for financial restatements vary, and restatements, especially when frauds are involved, have raised significant concerns about the adequacy of corporate governance and financial disclosure oversight (GAO, 2002). Research shows that there is a link between corporate governance practices and the incidence of financial restatements (for example, see Efendi *et al.*, 2004). Coffee (2005) argues that differences in the structure of ownership led to differences in the nature of corporate scandals and the incidents of restatements. Comparing corporate scandals in the USA and Europe, he suggests that "dispersed ownership systems of governance are prone to the forms of earnings management that occurred in the USA but concentrated ownership systems are much less vulnerable" to those forms. In Europe, the controlling shareholders tend to exploit the private benefits of controls through misappropriation of assets (Coffee, 2005). This also explains why in the USA the incidents of financial restatements are quite common (Huron Consulting Group, 2003, 2005; GAO, 2002, 2006), while in Europe, financial restatements are rare (Coffee, 2005). Studies by the GAO in the USA show that between January 1997 and June 2002, there were 919 cases of restatements reported; 1,390 cases between July 2002 and September 2005, and another 396 cases for the period between October 2005 and June 2006 (GAO, 2002, 2006).

For public companies, corporate governance is regarded as one of the mechanisms that could effectively safeguard the interests of a firm's shareholders. Agency theory views that managers do not always act in the best interests of the shareholders; they have incentives to expropriate the firm's assets, for instance, by undertaking projects that benefit themselves, at the expense of shareholders' wealth (Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1997), known as a moral hazard problem. Corporate governance is thus seen as an enabler to ensure an effective check and balance system, so that management acts in accordance with shareholders' interests. Thus, corporate governance acts as a tool to discipline, scrutinize, and monitor management.

The high profile cases of restatements that are caused by pervasive accounting and financial irregularities, such as the case of Enron and WorldCom in the USA, have led to the enactment of the Sarbanes-Oxley Act in 2002 and the adoption of new corporate governance rules for exchange listed firms by the National Association of Securities Dealers Automated Quotations (NASDAQ) in November 2003. The fact that regulators have placed greater emphasis on strengthening corporate governance standards in the aftermath of major financial statement frauds suggests that regulators view corporate governance rules as an important mechanism in deterring financial statement frauds (Persons, 2005) and hence restatements.

Given its significant impact, financial restatement is a very important issue and has received considerable attention from academicians, regulators, and practitioners. However, most studies on financial restatements are carried out in developed economies. Eilifsen and Messier (2000), for example, note that most studies investigating the nature of misstatements are done in the USA and that only two studies (i.e. Chan and Mo, 1998; Eilifsen *et al.*, 2000) examine non-Anglo-American settings. Another recent study is that by Young *et al.* (2008a) in Taiwan. Its pervasiveness, therefore, warrants studies in various countries (Flanagan *et al.*, 2008). Each country is unique with regard to the regulatory and cultural frameworks, as well as the ownership patterns. Compared to developed countries, the ownership structure in Malaysia is interesting because each listed company must have at least 25 percent of their shares being held by the public (Bursa Malaysia Listing Requirement, 2006). With such rules in place, certain parties, such as a family founder of the firm or other connected parties, would still dominate and control the decision-making process for the reason that the three quarters of shares could be in their hands (Pascoe and Rachagan, 2005).

The objectives of this study, hence, are twofold. First, this study seeks to explore the nature of financial restatements among Malaysian public listed companies, i.e. the extent of financial restatements in Malaysia, the types of restatements or items in financial statements that are commonly misstated, and the reasons of restatements. Second, this study aims to investigate whether corporate governance characteristics such as board structure and ownership structure are associated with the incident of financial restatements.

Data for this study are obtained from the restated annual reports for the period of 2002-2005, with firm-years being the unit of observation. For regression analysis purposes, a control group is formed using match-pair procedures where restated and non-restated firms are matched by size, industry, exchange board classification and financial year end. Given the different regulatory and cultural environments, our evidence will provide insights as to the extent and causes of financial restatement in this country. The findings of this study could be useful for regulatory bodies such as the Bursa Malaysia and the Securities Commission (SC) as well as the Malaysian Institute of Corporate Governance, for policy deliberations purposes. The findings contribute to the corporate governance literature by suggesting that outside blockholders are effective in disciplining managers and hence improve the financial reporting of the firm. This is consistent with Yeo *et al.* (2002) and Dechow *et al.* (1996).

The remainder of this paper is structured as follows. Next, a section on the Malaysian context is presented, followed by literature review and hypothesis development. A section outlining the research methodology is provided in the subsequent section. This is then followed by the findings and discussion, and finally a section on the conclusions will follow.

The Malaysian context

In Malaysia, the issue of financial restatements has received considerable attention from the regulators, especially in recent years where many cases have been discovered and made public. The cases of financial restatements are usually reported in the business section of the local newspapers. Table I shows companies which had been directed to restate their accounts by the SC[2].

Company	Restatements
CSM Corporation Bhd	Directed by the SC in 2002 to restate its 1999 financial statements (Securities Commission, 2002)
OilCorp Bhd	Directed by the SC to restate its 2004 financial statements (Securities Commission, 2005)
Aktif Lifestyle Bhd	Directed by the SC to restate its 2002 and 2003 financial statements (Securities Commission, 2005)
Goh Ban Huat Bhd	Ordered by the SC to reissue its 2004 fourth quarter report after being found overstating the profits by RM121 million (Securities Commission, 2005)
Celcom Bhd (a subsidiary of Telekom Malaysia Bhd)	The auditor discovered fictitious invoices issued to the Group amounting to RM259.32 million (about USD70 million)
Transmile Group	Misstatement was discovered in a special audit that the Company has inflated its revenue by RM522 million for financial years 2004-2006. Additional RM341 million and RM189 million of invalid transactions were also discovered during the period. As a result, the price of Transmile's share declined from RM15 to RM2 per share, resulting in a total paper loss, thus far, of RM3.4 billion
BBS Consortium Bhd, Karensoft Technology Bhd, Paxelent Corp Bhd, and Lityan Holdings Bhd	Substantial discrepancies between unaudited and audited results (Oh, 2005)

Table I.
Recent cases of restatements in Malaysia

Though the evidence in Table I does not suggest financial restatement incidents are rampant, it has to be addressed as it affects investor's confidence in Malaysian companies. One of the major initiatives instituted by the government was the issuance of the Malaysian Code on Corporate Governance (MCCG) by the SC in 2000. The code was subsequently revised in 2007. The code is adapted from the UK's Hampel Report. Since corporate governance reforms in Malaysia are adopted and adapted from the Anglo-American setting (Liew, 2007), it is therefore interesting to examine whether the incidence of financial restatement in Malaysia is also similar or dissimilar to those in the USA.

The MCCG, *inter alia,* stresses the need for board independence to ensure transparency and accountability of management. Hence, the MCCG recommends that independent non-executive directors make up at least one-third of the board memberships. The MCCG defines independence as being free from the influence of management and of the significant shareholders of the firm. In a similar vein, Section 166A (3) of the Malaysian Companies Act (1965) stipulates that directors of a company need to ensure that the accounts of the company have been made out in accordance with the Malaysian Accounting Standard Board approved accounting standard (known as Financial Reporting Standards effective from January 1, 2006).

MCCG identifies six specific responsibilities of directors; one of which is to review the adequacy and the integrity of the company's internal control systems and management information systems, including systems for compliance with applicable laws, regulations, rules, directives, and guidelines. This responsibility expects directors, both independent and executive directors, to be conversant in the firm's systems, including the accounting systems that generate the accounts and financial statements.

Thus, if the directors fulfill these duties effectively, the likelihood of errors in the financial statement is reduced. Fama and Jensen (1983) argue that a high number of non-executive directors means a more a board would be more effective in monitoring managerial opportunism.

Literature review and hypothesis development

Definition of financial restatements is generally viewed as corrections made to the financial statements due to non-compliance with generally accepted accounting principles (Palmrose and Scholz, 2000; Efendi *et al.*, 2004; Myers *et al.*, 2004). The GAO (2002, p. 1) states that "A financial statement restatement occurs when a company, either voluntarily or prompted by auditors or regulators, revises public financial information that was previously reported." Huron Consulting Group (2003)[3] reports three primary causes of accounting errors: problems in applying the accounting rules, human and system errors, and fraudulent behaviors. In their 2004 study, they find the leading causes of restatements to be revenue recognition, equity accounting, reserves, accruals, and contingencies (Huron Consulting Group, 2005). Empirical studies are consistent with these findings: income-increasing motivation (DeFond and Jiambalvo, 1991); debt covenant constraints (Efendi *et al.*, 2007; Dechow *et al.*, 1996; Richardson *et al.*, 2002); and diffuse ownership (DeFond and Jiambalvo, 1991). It is also noted that corrections involving prior year earnings are less frequent for understatements compared to overstatements of earnings (DeFond and Jiambalvo, 1991). Firms that corrected previously reported quarterly earnings are found to be smaller, less profitable, with high debt levels, slower growth, and facing more serious uncertainties (Kinney and McDaniel, 1989). The result is consistent with the findings by Ku-Ismail and Abdullah (2010) who find that companies that defer the recognition of the exceptional items, a tool used to manipulate quarterly earnings to the fourth quarter tend to be smaller and less profitable. Misstatements are also more likely for firms that have a CEO who also serves as board chairman (Efendi *et al.*, 2007; Persons, 2005). Similarly, Lin *et al.* (2006) find only size of audit committee is associated with restatements, while its independence, expertise, activity, and stock ownership of the committee, on the other hand, are not. As such, the role of corporate governance in monitoring financial restatement needs to be strengthened.

Studies reveal that there is a large negative market reaction following the announcement of earnings restatements (for example, Richardson *et al.*, 2002; Akhigbe *et al.*, 2005). Restatements have caused concern regarding the quality of financial reporting (Levitt, 1998; Palmrose and Scholz, 2000). However, despite the negative publicity from misstatement, it is noted that restating firms do not appear to adopt a more conservative financial reporting strategy following restatement (Moore and Pfeiffer, 2004). Also, a decline in investor confidence regarding financial reporting following restatements is only short-term; and that suspicion regarding the information loss of post-restatement earnings in the long-term is unfounded (Wilson, 2008). Nevertheless, Arthaud-Day *et al.* (2006) find that directors and audit committee members were more likely to exit in restatement firms. Srinivasan (2005) also finds that directors experience significant labour market penalties when their companies experience financial restatements.

Several subsequent studies have examined the role of corporate governance and restatements (such as Klein, 2002; Aier *et al.*, 2005; Srinivasan, 2005;

Marciukaityte *et al.*, 2009). However, the results are mixed. It is argued that the restatement arises because of weak governance structure (Flanagan *et al.*, 2008). On the other hand, some studies find no evidence on the relationship between corporate governance elements and restatements (for example, Agrawal and Chadha, 2005).

Financial restatement and board independence

Studies investigating the role of the board of directors generally reveal that its independence is an important characteristic for its effectiveness (see, for example, Kosnik, 1987; Hermalin and Weisbach, 1988; Weisbach, 1988). It has been shown that board independence is associated with less likelihood of financial frauds (Beasley, 1996), less earnings management (Chtourou *et al.*, 2001; Klein, 2002; Peasnell *et al.*, 2005). However, having more independent directors does not necessarily lead to an effective board (Mace, 1986; Conyon and Peck, 1998; Ho and Wong, 2001; Gul and Leung, 2002) and in fact it can still lead to on financial restatements (Baber *et al.*, 2005). In Malaysia, extant evidence linking board independence, a measure of board monitoring intensity with firm's performance, is not conclusive. For instance, the study by Abdullah (2004) demonstrates that non-executive directors do not influence a firm's financial performance. In another study, Abdullah and Mohd-Nasir (2004) document evidence of insignificant association between board independence and discretionary accruals, a proxy for earnings management. Mohd-Saleh *et al.* (2005) also document similar findings. Thus, it appears to suggest that non-executive directors in Malaysia are not seen to be effective in constraining managerial manipulative acts.

Misstatements or financial restatements, however, unlike earnings management, could lead to a bad reputation to the independent directors, who are argued to be expert in decision controls (Fama and Jensen, 1983). Kosnik (1987, 1990) also argues that independent directors are more ready to use their power during crisis. Weisbach (1988) also documents the likelihood of the board to remove CEOs is higher when the board is independent of management and when the firm profitability is declining. Beasley (1996) shows that the incident of financial frauds is associated negatively with board independence. Dechow *et al.* (1996) document a link between violations in accounting that were subjected to Securities and Exchange Commission accounting enforcement actions and management-dominated boards. In Malaysia, evidence by Mohd-Nasir and Abdullah (2004) shows that board independence is associated with greater voluntary disclosure levels among distressed firms. Thus, the evidence seems to confirm the argument by Kosnik (1987, 1990).

The main objective of appointing independent directors is to bring their expertise and knowledge to the companies. It is expected that independent director's skills would make the company more transparent. Nevertheless, the independent directors face a very high risk if they fail to carry out their duties properly. With such a liability, they need to avoid acting merely as rubber stamp for management. It is found that the more vigilant the independent directors are, the better the accounting conservatism is (Wei *et al.*, 2008). In fact, the independence of the board of directors is associated with more effective monitoring activities by the board, following the issuance of Sarbanes-Oxley Act in 2002 (Marciukaityte *et al.*, 2009). Since, financial restatements affect adversely the board integrity and the reputation of independent directors, it is expected that the extent to which the board is independent is associated negatively with the incident of financial restatement. Thus, the maintained hypothesis is as follows:

H1. There is a negative association between financial restatement and board independence.

Financial restatement and independence of the nominating committee

MCCG (Finance Committee, 2007) recommends listed firms to establish nominating committees composed wholly of non-executive directors, the majority of whom are also truly independent. The nominating committee recommends to the board candidates for all directorships, as well as candidates proposed by the CEO or by any other senior executive or any director or shareholder. The committee also recommends to the board of directors who will fill the seats on the board committees. The nominating committee also needs to determine annually the required mix of skills and experience and other core competencies that non-executive directors should have. In addition, the nominating committee is expected to evaluate annually the effectiveness of the board as a whole, the board committees and the contribution of each director. Thus, though the role of nominating committee has not been examined extensively, Brown and Caylor (2004) find that the link between nominating committee independence and firm performance is superior to the link between board independence and firm performance, as indicated by the correlation coefficients. Therefore, from their evidence, it seems that the independence of the nominating committee is more important than board independence. The importance of the nominating committee independence is due to the fact it is the committee which has the specific roles of nominating nominees for new directors and to evaluate the board as well as individual directors' performance.

The nominating committee should be composed wholly of independent directors to ensure its objectivity (US Congress, 2002; revised MCCG, Finance Committee, 2007). The objective of the appointment outside director to the committee is to safeguard shareholder rights (Vafeas, 1999). The quality of the candidates for directorships depends on nominating committee independence and the board committees. Hence, the more independent the board is, the more likely it is for the board to have independent directors who are independent and well conversant in accounting. Thus, the hypothesis is as follows:

H2. There is a negative association between financial restatement and nominating committee independence.

Financial restatement and independence of the audit committee

The fact that the audit committee is a committee of the board, it is argued, could lead to the audit committee becoming ineffective as it does not have the power to improve the firm's financial reporting process without the board's consent. Thus, it is argued that audit committee independence is important for its effectiveness. The more independent the audit committee is, the more likely it is to be able to perform its financial reporting oversight more effectively because the audit committee is not influenced by management. The independence of the audit committee is important because it ensures its objectivity (Kolins *et al.*, 1991). In respect of board reliance on the audit committee, Menon and Williams (1994) show that the proportion of independent directors on a board is associated positively with the frequency of audit committee meetings. Thus, an audit committee that is composed solely of independent directors should enhance its incentive to oversee the financial reporting process and this is reflected by the new requirement by the New York Stock Exchange and NASDAQ, which was introduced in December 1999.

The new requirement mandates all listed companies to maintain audit committees consisting of at least three directors, all of whom have no relationship to the company that could impair the exercise of their independence from management and the company. The Sarbanes-Oxley Act (2002) requires firms in the USA to maintain an audit committee composed solely of independent directors. The MCCG recommends that an audit committee should consist of at least three directors, the majority of whom are independent[4].

Empirical evidence shows that the audit committee is associated with better earnings quality (Wild, 1994; Klein, 2002). Audit committee independence is also found to be associated with fewer incidents of accounting errors, irregularities and illegal acts (McMullen, 1993). It has also been shown that audit committee independence is associated with a low likelihood of fraudulent financial reporting. The presence of an audit committee is also found to reduce the likelihood of profit overstatements (DeFond and Jiambalvo, 1991; Abbott *et al.*, 2004). Abbott *et al.* (2004) find that the independence and activity level of the audit committee are associated with a significant and negative association with the occurrence of restatement. This is consistent with their prediction where firms that conducted more audit meeting and discussion (at least four times during the first misstatement year) have lower incidence of restatement.

In Malaysia, the argument of audit committee independence being associated with monitoring effectiveness, as measured by its ability to constraint accrual management, is not empirically supported (Abdullah and Mohd-Nasir, 2004; Mohd-Saleh *et al.*, 2005). In a subsequent study among distressed firms, Mohd-Nasir and Abdullah (2004) also fail to find a relation between audit committee independence and voluntary disclosure. One reason for the insignificant findings in Malaysian studies is due to the fact that audit committees in Malaysia are still very much influenced by management because prior to the revision of the MCCG in 2007, there was no prohibition for the CEO or finance director of the firm to serve on the audit committee. Further, establishing the audit committee is seen as a matter of complying with Bursa Malaysia listing requirements. Thus, an audit committee in Malaysia lacks rigor. Consistent with the development in the USA, the revised MCCG (Finance Committee, 2007) stipulates that all committee members be non-executive directors, be financially literate and the MCCG also stipulates the frequency meetings. Nevertheless, the issue of the independence of the committee members has been an issue of concern because it relates to audit committee effectiveness and thus the role of committee independence to deter financial misstatement warrants investigation. In the present study, the primary focus is on financial restatement. Because financial restatement could adversely affect the reputation of the independent audit committee members, especially when it involves irregularities and illegal acts, it is predicted that independent audit committee members would play their role to avoid these incidences. The hypothesis is as follows:

H3. There is a negative association between financial restatement and audit committee independence.

Financial restatement and CEO duality

Board leadership refers to the division of powers between the board chairman and the CEO. Combining these two roles weakens the firm's internal corporate governance systems where there is a conflict of interest between the monitor (i.e. the board chairman) and the implementer of the board's decisions (i.e. the CEO). Separating these two roles avoids resting excessive powers in the hand of the chairman-cum-CEO rendering the board as a whole ineffective. This is because combining these two roles provides an opportunity to the CEO to pursue his interest rather than the shareholders' interests (Jensen, 1993; Boyd, 1994). Rechner (1989) suggests that the ideal corporate governance structure is one in which the board is composed of a majority of outside directors, a chairman who is an outside director and argues that the weakest corporate governance is where the board is dominated by insider directors and the CEO holds the chairmanship of the board. In fact, Jensen (1993, p. 866) argues that "for the board to be effective, it is important to separate the CEO and chairman positions". Dechow *et al.* (1996) find that earning manipulators are more likely to have a company founder as CEO and are more likely to have a CEO who also serves as the Chairman of the Board.

The separation should provide greater incentives to the non-executive chairman to act in the interest of the shareholders rather than to protect the interest of the CEO. Brown and Caylor (2004) provide evidence that shows the separation of chairman and CEO is associated with a higher firm value, as measured by Tobin's *Q*, indicating a favorable market view of the separation of the board chairman and CEO. Efendi *et al.* (2004) further reveal that firms that restated financial statements had a weaker corporate governance structure, whereby CEOs of restatement firms more frequently hold the position of board chairmen. Having a non-executive chairman ensures that important issues that relate to shareholders' interests are covered adequately in board meetings. If the CEO is also the board chairman, he/she would control and determine the agenda of board meetings and might not disclose important information adequately to enable the board to assess the performance of the CEO appropriately (Abdullah, 2004). However, separating the board chairman and CEO roles can be good for shareholders (Conyon and Peck, 1998; Dahya, 2004; Cheng and Courtney, 2006; Faleye, 2007). Despite the mixed results, the consensus among the shareholder activists, institutional investors and regulators is that it is a good practice to separate the top two roles, as reflected in various codes on corporate governance. Additionally, Marciukaityte *et al.* (2009) suggested that CEO dominance could compromise board objectivity. In fact, MCCG (Finance Committee, 2001, 2007) recommends firms to separate the top two roles. The hypothesis is thus as follows:

H4. There is a positive association between financial restatement and CEO duality.

Financial restatement and managerial ownership

The pattern of a firm's ownership signals the firm's agency costs and the extent of monitoring of management. Two issues that are associated with firm's ownership structure is the extent of managerial ownership and large shareholders. Managerial ownership mitigates the agency conflicts (Jensen and Meckling, 1976) and thus leads to higher earnings informativeness (Warfield *et al.*, 1995). Fama and Jensen (1983) argue that a diffused ownership structure creates conflicts between owners and managers because managers do not always act in the best interest of shareholders. In a diffused ownership firm, agency problems are predictably acute. In Malaysia, firm's shares are heavily concentrated among a few individuals or institutions (La Porta *et al.*, 1999; Abu-Bakar, 2001). Thus, in Malaysia and in other East Asia countries, the conflict is not solely between owner-manager as agency theory argues to exist, but rather between controlling shareholders and minority shareholders or "principal-principal" conflict

(Young *et al.*, 2008b). The public therefore perceives that the controlling owners report accounting information for their own purposes rather than for other shareholders and thus outside shareholders lose confidence in the reported earnings (Fan and Wong, 2002). Managerial ownership mitigates agency costs, as argued by Jensen and Meckling (1976). Conversely, substantial managerial ownership could lead to management entrenchment (Weston, 1979; Stulz, 1988) and is associated with controlling owners holding up minority shareholders (Fan and Wong, 2002). Thus, this could be counter-productive. Hence, mitigating the agency costs is only achieved when managers own up to a certain level of shares, beyond which minority shareholders are disadvantageous. This is in fact the findings by Morck *et al.* (1988) and McConnell and Servaes (1990).

The extent of managerial ownership is expected to be associated with financial restatement because managerial ownership indicates the extent to which managers are being truthful to other shareholders. As argued by Fan and Wong (2002), managers who own substantial shares have the incentives to hold up other shareholders by not disclosing important information. However, the relationship may not be linear; rather it is curvilinear (Morck *et al.*, 1988; McConnell and Servaes, 1990; Warfield *et al.*, 1995). At the lower levels of managerial ownership, managers are expected to be truthful to the other shareholders because they are being monitored by other shareholders. Thus, the financial statements are expected to be free of errors or irregularities. However, when managers own substantial shares, they are expected to dominate the firm. They would have greater incentives to show to other shareholders that the firm has performed very well financially. These incentives are achieved by inflating revenues and thereby profits. Thus, accounting errors and irregularities leading to financial restatements are expected to be high when managerial ownership is high. Evidence in Singapore, whose firm's ownership patterns resemble to that of Malaysia, supports a curvilinear relationship between managerial ownership and earnings management; negative relation when managerial ownership is between 0 and 25 percent and positive relation when ownership is beyond 25 percent (Yeo *et al.*, 2002). Thus, the hypothesis is as follows:

H5. There is a non-monotonic relationship between managerial ownership and financial restatement, negative at lower levels and positive at higher managerial ownership levels.

Financial restatement and outside blockholders

Outside blockholders, who hold substantial shares, play important monitoring roles (Shleifer and Vishny, 1986, 1997; Admati *et al.*, 1994; Huddart, 1993; Maug, 1998; Noe, 2002). The greater incentives for outsiders to monitor management arise due to the fact that their wealth is tied directly to the firms and they have the necessary resources to monitor closely their investments. In fact, in the year prior to the 1997 financial crisis, about 37 percent of Malaysian firm shares were held by the firm's largest shareholder (Abdullah, 2002). La Porta *et al.* (1999) also report that blockholdings and institutional shareholdings account, average, 54 percent of shares in the ten largest firms in Malaysia and 49 percent in ten largest firms in Singapore compared to 20 percent in ten largest firms in the USA.

Dechow *et al.* (1996) find earning manipulators are less likely to have outside blockholders. The importance of outside blockholders to monitor arises because of the influence of these outside blockholders on the share price of the firms and the ability of these investors, by virtue of the shares they hold, to determine the decisions made by the board. If these outside blockholders decide to sell the firm's shares in large quantity, the firm's share price will be adversely affected. Further, they are commonly represented on the firm's board and thus are influential in determining the direction of board meetings. Therefore, the presence of outside blockholders provides an important monitoring mechanism to ensure management acts in the interest of the shareholders. Acting in the shareholder's interest requires management to provide shareholders with financial statements, which are true and fair and free from errors or irregularities. The fact that these blockholders including institutional investors, compared to retail investors, are expected to be sophisticated and thus are able to determine whether the financial statements have been prepared in a manner that would give the firm "true" and "fair" view. Furthermore, these outside blockholders have the resources required to monitor the firm's management.

However, empirical evidence in Singapore supports the earlier contention where outside unrelated blockholders are associated with lower incidence of earnings management (Yeo *et al.*, 2002). Thus, the likelihood of financial restatement is expected to be low with presence of outside blockholders due to better monitoring of management. The maintained hypothesis is thus:

H6. There is a negative association between financial restatement and extent of ownership by outside shareholders.

Three control variables are included in the analyses. First, auditor independence is one of the control variables. Audit by a Big 4 auditor indicates that the work done by this auditor produce a high quality audit compared to a non Big 4 firm. It is argued that their audit procedures are more structured and systematically organized and there is a greater chance to discover accounting errors. DeFond and Jiambalvo (1991) propose that larger audit firms have a greater economic interest in ensuring the financial statement is free from material errors. Their evidence shows that the relationship between Big 8 (now Big 4) and overstatement errors is negatively related. Another control variable is a firm's probability of bankruptcy. Companies that have a financial problem are more likely to manipulate earnings, make errors and create losses to the users (Palmrose and Scholz, 2000). Altman (1968) *Z*-score is be used to measure a firm's bankruptcy probability. Abbott *et al.* (2004) also use Altman *Z* as an indicator of troubled companies. They predict that weak financial position could lead management to restate the financial statement in the subsequent financial year. Finally, the third control variable is the firm's debt level, which has been found to be associated with restatement (Dechow *et al.*, 1996; Kinney and McDaniel, 1989; Richardson *et al.*, 2002). The debt level indicates the risk and the extent of debt covenants imposed on the firm. Thus, there is a higher likelihood of misstating the accounts in the presence of high debt level.

Research method

Sample selection and variable measurement

The population of this study covers all companies listed on the main board and the second board of Bursa Malaysia for the following years: 2002 (total listed firms: 856), 2003 (total listed firms: 874), 2004 (total listed firms: 900) and 2005 (total listed firms: 914). We started with the 2002 financial year because during this period, the 1997/1998 financial crisis was already over and the economy had started to recover. Thus, the confounding effect of the crisis is not present in the sample because the crisis was declared over in 1999. Further, MCCG had already been effective for two years. Companies involved in finance, trust, close-end funds, real estate investment trusts and exchange traded funds were excluded from the final sample, as they are subject to their own industry's rules and regulations.

Corporate governance variables and financial data were collected from the sample company's annual report and Datastream. Firms that restated their financial statements in corporate annual reports during the period of 2002-2005 were first identified. In so doing, keywords of "restatement", "restate", "restated", or "prior year adjustments" were searched in each annual report for evidence of restatement. As a result, we included only 31 firm-years companies which were deemed to have restated their annual reports according to the GAO's definition (refer to the Appendix, Table AI for GAO's definition of restatements). A sample of a control group was subsequently formed using the match-pair procedures. The control group consists of firms which did not restate their accounts, had a similar financial year end, classified in the same Bursa Malaysia sectorial classification, about the same size as the matched restated firm, and listed on the same Bursa Malaysia board. The matching process yielded 62 sample firm-years, which consists of 31 restating companies and 31 matched control companies. A similar procedure was followed by Arthaud-Day *et al.* (2006) where they used industry and company size for matching process between restatement firms and non restatement firms.

Dichotomous variables were used for: nomination committee independence ("1" if all members are independent directors, and "0" otherwise), audit committee independence ("1" if all audit committee members are independent, "0" otherwise), CEO duality ("1" if the posts of board chairman and CEO are combined, "0" otherwise) and audit quality ("1" if the auditor is a Big 4 auditor, "0" otherwise). Nomination committee and audit committee independence is treated as a dichotomous variable because it is argued that only when these committees are wholly composed of independent directors are they effective. This is consistent with the Sarbanes-Oxley Act (2002) and the UK Combined Code (Finance Reporting Council, 2008). Meanwhile, board independence is measured by the percentage of independent directors on the board; whereas managerial ownership is based from percentage the shares held by executive directors (both direct and indirect interests) relative to the firm's total shares. The outside blockholder share ownership is measured as the cumulative shareholdings (in percentage of shares) of outside investors, including institutional investors whose ownership is in excess of 2 percent (both direct and indirect interests) relative to the firm's total shares. Finally, the probability of bankruptcy is computed using the Altman Z; while the gearing ratio is derived at by dividing total debts over total assets. The hypotheses are tested using logistic regression analysis.

Results and discussion

The sample selection procedures are presented in Table II. The sample consists of all non-finance companies listed on the Bursa Malaysia on both main and second boards for the 2002-2005 years, inclusive.

The number of firms that restated the annual reports, on a year to year basis, was fairly constant during 2002-2005 periods, representing less than 1 percent of the listed firms. Thus, it could be concluded that the incidence is not high. Nevertheless,

Item	Year 2002	2003	2004	2005
Main board companies	562	598	622	646
Second board companies	294	276	278	268
Total number of companies	856	874	900	914
Less finance companies	59	50	52	46
Less trust companies	3	3	3	0
Less close-end fund companies	1	1	1	2
Less real estate investment trust companies	0	0	0	6
Less exchange-traded funds	0	0	0	1
Total number of listed companies observed	793	820	844	860
Number of companies found as a result of a keyword search	440	560	391	269
Less restatement not within GAO's definition of restatement	433	554	384	258
Total restatement companies	7	6	7	11[a]
Percentages from the population	0.8	0.7	0.8	1.2

Note: [a]One of the companies had restatement in 2004 as well

Table II.
Sample selection procedures

the incidence of restatement is not predicted to be random. Companies from a certain industry may be more prone to restate their accounts. To understand this, the companies were classified according to the Bursa Malaysia industrial sectors, the results of which are shown in Table III.

It is noted that almost half of the restatement companies were classified under trading and services. Construction firms, on the other hand, made up the least number of restatement firms. Thus, companies from trading and services sector appear to be more prone to restatements than companies from other sectors. Table IV presents the number of incidents of restatements according to the GAO's definition.

Almost 40 percent of the firms restated the costs or expenses. Restatements involving revenue recognition accounted for 14 percent of the total restatements. These two categories of restatements are presumably intended to manipulate the reported income. Thus, this finding is consistent with the primary motive of misstatements which is to increase the reported income as argued by DeFond and Jiambalvo (1991). The descriptive statistics is presented in Table V.

Results in Panel A of Table V indicate that, on average, more than one-third of the board of directors of firms in the sample is composed of independent directors, thus complying with MCCG requirements. It is also found that the audit committees of the firms that restated the accounts are composed wholly of independent directors. The difference in the independence of the audit committees of these sub-samples

Industrial classification	2002	2003	2004	2005	Total	%
Trading and services	4	2	1	7	14	45
Consumer products	2		1		3	9.7
Properties		2	2	1	5	16
Industrial products	1	2	3	1	7	23
Constructions			1	1	2	6
Total	7	6	8	10	31	100

Table III.
Restatements based on Bursa Malaysia sectorial classification

is statistically significant ($t = 2.24$, $p < 0.05$). Nevertheless, the fact that the audit committees of the firms that restated the accounts are more independent than the firms that did not restate the accounts contradicts the prediction that an audit committee that is independent is more effective in discharging its duties. Thus, based on this evidence, audit committee independence does not play a role in deterring misstatement, consistent with prior findings (Abdullah and Mohd-Nasir, 2004; Mohd-Saleh *et al.*, 2005; Mohd-Nasir and Abdullah, 2004). As predicted, in Panel B, the nomination committees of the firms that restated is less independent that that of the non-restating firms and the difference is statistically significant ($t = -3.78$, $p < 0.05$). Similarly, fewer restating than non-restating firms employ Big 4 auditors.

Managerial ownership is found be higher for the firms that restated their accounts that have no-restatement (Panel A). One explanation for this finding is that firms that restated the accounts are mostly family-owned. Family-owned firms tend to be less transparent compared to non-family firms, consistent with the earlier evidence in Singapore (Hossain *et al.*, 1994; Fan and Wong, 2002; Eng and Mak, 2003). The percentage of share ownership by outside blockholders is significantly higher ($t = -2.51$, $p < 0.05$) among firms that do not restate the accounts. Results in Panel A of Table V also show that the performance of restating firms is significantly lower ($t = -1.70$, $p < 0.10$) than the performance of the non-restating firms, as indicated by the *Z*-score[5]. This evidence suggests that a possible reason for misstating the accounts was to inflate earnings. This is consistent with the results in Table IV, where 87 percent of the restatement involved misstatement relating to costs or expenses (39 percent), revenue recognition (14 percent) and other types[6] (34 percent). It is also noted that firms that restated their accounts have higher level of gearing ratio compared to the firms that did not restate accounts. To test the correlation between independent variables, the Pearson correlation analysis was carried out, the results of which are presented in Table VI.

Results in Table VI indicate a strong correlation between board independence and audit committee independence. This strong and positive correlation is not unexpected and this is consistent with Klein (2002). A strong and strong correlation is also observed between managerial ownership and outside blockholder ownership. However, the correlation is less than 0.8, the threshold for the presence a severe collinearity as suggested by Cooper and Schindler (1998).

Results on logistic regression analysis are shown in Table VII. In Panel A, the regression model included only the hypothesized variables. In Panel B, three control variables were included in the model, namely audit quality, gearing ratio and *Z*-score[7].

Year	2002	2003	2004	2005	Total incidents of restatement	%
Cost or expense	2	8	2	5	17	39
Other	3	2	5	5	15	34
Revenue recognition	–	5	–	1	6	14
Restructuring, assets or inventory	1	1	0	2	4	9
Acquisitions and mergers	1	–	–	–	1	2
Reclassification	–	1	–	–	1	2
Total number of restatements	7	17	7	13	44	100

Note: The number of incidents (i.e. 44) is different from 31 (in Table II) because certain companies gave more than one reason for restatement

Table IV. Reasons of restatements

Table V.
Descriptive statistics and t-test results

Panel A – continuous variables

					t-*test*		
Variable	*Mean*	*SD*	*Skewness*	*Kurtosis*	*Mean (restatement)*	*Mean (non-restatement)*	t-*value*
BDIND	0.43	0.15	0.91	0.89	0.45	0.42	0.73
MGOWN	25.03	23.08	0.45	−0.88	29.63%	20.43%	1.59
OUTBLK	34.70	24.98	0.64	−0.71	27.07%	42.33%	−2.51*
Z-score	4.75	18.72	7.09	53.58	0.77	8.73	−1.70**
GRG	0.61	0.55	2.68	9.919	0.82	0.38	−3.38*

Panel B – dichotomous variables ($n = 62$)

			t-test		
Variable	*Frequency with "0"*	*Frequency with "1"*	*Mean (restated)*	*Mean (non-restated)*	t-*value*
NOMIND	52 (84%)	10 (16%)	0.00	0.32	−3.78*
ACIND	49 (79%)	13 (21%)	0.32	0.10	2.24*
DUAL	58 (93%)	4 (7%)	0.10	0.03	1.03
AUDQ	19 (31%)	43 (69%)	0.58	0.81	−1.96**

Notes: $^{*}p < 0.05$; $^{**}p < 0.10$, two-tailed test; $n = 62$

In Panel A, except for managerial ownership and the square of managerial ownership, there is no evidence of severe multicollinearity between independent variables as the variance inflation factors (VIFs) are less than ten. The VIFs for managerial ownership and the square of managerial ownership variables are more than ten because they are basically the same variable. Results in Panel A of Table VII show that only H6 is supported. Thus, the extent of shares owned by outside blockholders is associated negatively with restatement. The evidence thus indicates that the extent of ownership by outside blockholders constraint managers from misstating accounts which subsequently require restatement. Hence, outside blockholders are effective in controlling management's opportunistic behaviors, supporting previous evidence (Shleifer and Vishny, 1986, 1997; Admati *et al.*, 1994; Huddart, 1993; Maug, 1998; Noe, 2002; Yeo *et al.*, 2002). Audit committee independence is significantly ($p < 0.05$) associated with financial restatement, but not in the hypothesized direction. However, this finding is consistent with the previous findings in Malaysia where audit committee independence has been found to be not associated with its effectiveness (Mohd-Saleh *et al.*, 2007; Abdullah and Mohd-Nasir, 2004; Mohd-Nasir and Abdullah, 2004) and in the USA (Baber *et al.*, 2005), Thus, as the evidence suggests, audit committee independence leads to financial misstatements, suggesting that audit committee independence is ineffective and counter-productive. Two explanations could be given for such a finding. First, the formation of the audit committee in Malaysia is mandatory and there is no provision requiring it is composed wholly of independent directors. Further, the audit committee chairman is not required to be independent, which may impede the effectiveness of the audit committee. Further, prior to 2007, it is customary for the managing director (or the finance director) of the firm to sit on the audit committee. This could have adversely affected the audit committee effectives. Second, it is the issue audit committee expertise in accounting. Prior to 2007, the requirement was that only one member should be expert in accounting. The audit committee will not be effective unless the audit committee members are qualified who understand the accounting standards.

The other four hypotheses are not supported. The directions of the association are as predicted, but they are not statistically significant. The ineffectiveness of the independence of the board of directors seems to be consistent with previous mixed findings on this issue (Wan-Hussin *et al.*, 2003; Abdullah and Mohd-Nasir, 2004; Mohd-Saleh *et al.*, 2005, Mohd-Ghazali and Weetman, 2006) and on the incidents of restatement in the USA (Baber *et al.*, 2005). Thus, the independence of the board of directors does not mean the board being expert, diligent, vigilant, or strict as a monitor of management as argued in agency theory (Jensen and Meckling, 1976;

Variable	BDIND	NOMIND	ACIND	DUAL	MGOWN	OUTBLK
BDIND	1.000	0.037	0.530*	0.012	−0.002	−0.168**
NOMIND		1.000	−0.010	0.063	0.162	−0.107
ACIND			1.000	−0.135	0.050	−0.163
DUAL				1.000	0.357*	−0.177
MGOWN					1.00	−0.727*
OUTBLK						1.00

Notes: $^{*}p < 0.05$; $^{**}p < 0.10$, two-tailed test; $n = 62$

Table VI. Pearson correlation matrix

Variable	Predicted sign	Coefficient	SE	p-value	VIF
Panel A – Without control variables					
Constant	Indeterminate	2.530	2.121	0.233	
BDIND	Negative	−1.944	2.810	0.245	1.479
NOMIND	Negative	−0.004	1.267	0.497	1.031
ACIND	Negative	2.503	1.227	0.020*	1.481
DUAL	Positive	0.002	0.0.871	0.499	1.412
MGOWN	Negative	−0.038	0.074	0.319	14.346
MGOWN^2	Positive	0.001	0.001	0.304	11.570
OUTBLK	Negative	−0.043	0.023	0.033*	2.620
Overall percentage of correct prediction	80.6%				
Nagelkerke R^2	0.579				
Panel B: With control variables					
Constant	Indeterminate	1.802	2.507	0.472	
BDIND	Negative	−2.119	3.090	0.246	
NOMIND	Negative	−0.004	1.34	0.499	
ACIND	Negative	4.933	2.288	0.016*	
DUAL	Positive	0.002	9.698	0.499	
MGOWN	Negative	−0.022	0.033	0.255	
OUTBLK	Negative	−0.029	0.026	0.127	
AUDQ	Negative	−0.092	1.045	0.455	
Z-score	Negative	−0.587	0.498	0.123	
GRG	Positive	1.680	0.799	0.017*	
Overall percentage of correct prediction	87.1%				
Nagelkerke R^2	0.720				

Notes: $^{*}p < 0.05$, $^{**}p < 0.10$, two-tailed tests; $n = 62$
Model: $\ln(\mathrm{R}/1-\mathrm{R}) = \alpha_0 - \beta_1{\cdot}\mathrm{BDIND} - \beta_2{\cdot}\mathrm{NOMIND} - \beta_3{\cdot}\mathrm{ACIND} + \beta_4{\cdot}\mathrm{DUAL} + \beta_5{\cdot}\mathrm{MGMOWN} - \beta_6{\cdot}\mathrm{OUTBLK} - \beta_7{\cdot}\mathrm{AUDQ} - \beta_8{\cdot}\mathrm{Z} + \beta_9{\cdot}\mathrm{GRG} + \varepsilon$,
where *R*, "1" if restatement and "0" no restatement; BDIND, board independence, ratio of independent directors to the board size; NOMIND, nomination committee independence, dummy variable, "1" if all members are independent directors and "0" otherwise; ACIND, audit committee independence, "1" if all audit committee members are independent, "0" otherwise; DUAL, CEO duality, "1" if the posts of board chairman and CEO are combined, "0" otherwise; MGOWN, percentage of shares held by executive directors (both direct and indirect interests); OUTBLK, percentage of shares held by outside investors in excess of 2 percent (both direct and indirect interests); AUDQ, auditor quality, "1" if the auditor is a Big 4 auditor, "0" otherwise; *Z*, probability of bankruptcy, based on Altman *Z*-score; GRG, ratio of total debt to total assets

Table VII.
Logistic regression results

Kosnik, 1987, 1990; Weisbach, 1988; Beasley, 1996). Rather, independent directors on the board may serve as provider of service and "window to the world" for the firm (Pfeffer, 1972). Thus, the role of independent directors in Malaysia is mainly to provide independent views to the board rather than to monitor management.

Managerial ownership is also not found to have any association with the incident of financial restatement, consistent with earlier evidence in the USA (Baber *et al.*, 2005). Nevertheless, Mohd-Ghazali and Weetman (2006) reveal that executive directors' ownership and disclosure are negatively associated. Hence, both findings suggest that managerial ownership does not mitigate agency costs. The average managerial ownership among the sample firms in the present study is high, i.e. at 25 percent. Hence, managerial ownership is a tool for managerial entrenchment hypothesis (Bebchuk *et al.*, 2009).

Another variable that does not have a significant association with financial restatement is leadership structure, which is consistent with the evidence in the USA (Baber *et al.*, 2005). One explanation for this finding could be due to the fact that separating the roles of the board chairman and CEO is required by the MCCG. Thus, almost all firms, except four firms, separated the roles.

Finally, the independence of nominating committee is not related to financial restatement. One explanation for the insignificance is due to the fact that nominating committee is not very well established in the Malaysian corporate governance framework compared to board independence and audit committee independence. Unlike in other developed countries such as UK or USA, the issue of nominating committee is rarely discussed or debated. Only in the revised MCCG (Finance Committee, 2007) are the roles of the nominating committee are clarified. Hence, prior to 2007, there was no clear guidance on the role of the nominating committee.

Panel B of Table VII reports the logistic regression results with the inclusion of three control variables. Results generally remain the same as in Panel A of Table VII, with the exception of the gearing ratio. There is a positive and significant association between gearing ratio and the probability of financial restatement ($p < 0.05$). Thus, with the presence of debt covenants, firms with high level of debts are more likely to commit in financial misstatement. This is consistent with the earlier findings (Dechow *et al.*, 1996; Kinney and McDaniel, 1989; Richardson *et al.*, 2002).

Table VIII presents results from the logistic regression analyses by adding additional three control variables, namely firm's size, type of auditor's opinion and board listing on Bursa Malaysia.

Generally, results in all models in Table VIII are similar to those in Table VII. In Model 1, it is found that firm's size does not have any significant association with the probability of financial restatement. In Model 2, the type of auditor's opinion is

Variable	Predicted sign	Model 1 (coefficient)	Model 2 (coefficient)	Model 3 (coefficient)
Constant	Indeterminate	−2.580	6.339	2.577
BDIND	Negative	−2.605	0.268	−3.761
NOMIND	Negative	−0.004	0.003	−0.004
ACIND	Negative	5.251*	4.766	5.485*
DUAL	Positive	0.002	0.002	0.002
MGOWN	Negative	−0.105	−0.000	0.001
OUTBLK	Negative	−0.04**	−0.059**	−0.047**
AUDQ	Negative	−0.295	−1.258	−0.741
Z-score	Negative	−0.492	−1.623**	−1.013*
GRG	Positive	1.592*		
LNASSET[a]	Negative	0.265	–	
AUDOPIN[b]	Negative		−5.136*	–
BRDLIST[c]	Negative			2.135**
Percentage with correct prediction		87.1	91.9	91.9
Nagelkerke R^2		0.727	0.875	0.757

Notes: *$p < 0.05$, **$p < 0.10$, two-tailed tests; [a]LNASSET, log natural of total assets; [b]AUDOPIN, 1 if "unqualified auditor's report"; 0 if "otherwise"; [c]BRDLIST, 1 if "main board"; 0 if "otherwise"; $n = 62$

Table VIII. Further logistic regression results associated negatively and significantly with the likelihood of financial restatement ($p < 0.05$). Thus, if the auditor's report is other than "unqualified", there is a higher likelihood that financial misstatement has occurred in the accounts, and vice-versa. Finally, in Model 3, board listing is associated positively and significantly ($p < 0.10$) with the incident of financial restatement. However, the evidence suggests that firms that are listed on the main board of Bursa Malaysia are more likely to misstate accounts than firms in the Second Board.

Summary and conclusion

The purpose of this study is to examine the nature of financial restatements among Malaysian listed companies for the years 2002-2005 and to investigate whether the corporate governance characteristics are associated with financial restatement. Using a sample of 31 firms that restate their accounts and a matched control group of 31 non-restated firm years, the findings indicate that ownership by outside blockholders is associated with less likelihood of financial misstatement. This shows that outside blockholders is effective in disciplining managers so that the accounts so prepared are not misleading. This finding thus supports the effective monitoring by outside blockholders (Shleifer and Vishny, 1986, 1997; Admati *et al.*, 1994; Huddart, 1993; Maug, 1998; Noe, 2002). The evidence is important because the ownership pattern in Malaysia, like other East Asian countries, is such that about 50 percent of shares are owned by institutional shareholders or blockholders (Claessens *et al.*, 2000).

However, other corporate governance variables, namely board independence, nomination committee independence, CEO duality and managerial ownership, do not have any significant impact on the likelihood of financial restatement. This evidence is consistent wit the findings on restatements in the USA (Baber *et al.*, 2005). It could be argued therefore that the presence of independent directors on the board is simply to fulfill the MCCG's one-third requirement on the board composition. In fact, it is also found that audit committee independence is associated with higher likelihood of financial restatement incidence, which is unexpected. Based on this evidence, the recent changes in MCCG (Finance Committee, 2007) which require the audit committees be composed of wholly independent audit committees who are financially literate could improve audit committee vigilance and diligence.

The findings may serve as an input for the regulatory bodies in Malaysia on policy deliberation or policy review in order to strengthen their roles in overseeing the company and to curb the possibility of directors functioning as rubber stamp. This is consistent with the new requirement in Companies (Amended) Act 2007 that requires directors to exercise reasonable care, skills, and diligence at all times. It is further hoped that the revised version of the MCCG would overcome the shortcomings identified in the original version of the code to ensure an effective financial reporting oversight by the various corporate governance players.

There are three main limitations in this study. First, the fact that the data are cross-sectional could lead to the problem of endogeneity. Second, there may be other factors that affect restatements but are not included in this study, such as audit committee qualifications and tenure. Third, the results of this study may be not applicable to other developing countries with a different structure of ownership and regulations. Further, research on this issue could be undertaken in the future, such as to investigate the incidence of restatements in quarterly financial reports. Furthermore, other corporate governance variables, like the frequency of audit committee meetings and the effectiveness of the internal control system, can also be tested. Studies also can be conducted to see the impacts of restatement announcement on the company's shares price in the Malaysian setting. Finally, a study could be carried out on the effect of share options given to employees. Employee Share Option Schemes have been found to be an influential factor of financial misstatement in USA. The question is whether this finding also holds in Malaysia.

Notes

1. Financial restatement refers to correction of earlier misstated information found in the previous year's annual reports.
2. The SC is a body established by the Government with the responsibility to ensure fair, transparent, and secure trading on the Malaysian capital market. The commission has the power to order public listed companies to restate their financial statements if their financial statements are deemed to be misleading. The SC also has the power to exercise other enforcement actions including instituting civil proceedings, criminal prosecutions, and levying compounds for the breaching of securities rules (Securities Commission, 2010).
3. Huron Consulting Group is an independent provider of financial and operational consulting services based in Chicago, USA. Among the area of services provided by the Group are litigation, disputes, investigations, regulatory compliance and financial distresses (*Source:* www.huronconsultinggroup.com).
4. Effective from 2008, the revised MCCG recommends that audit committee be composed solely of non-executive directors, majority of whom are independent. Further, all members should be financially literate with at least one member being a member of an accounting association or body.
5. $Z = 1.2$ (working capital/total assets) + 1.4 (retained earnings/total assets) + 3.3 (earnings before interest and taxes/total assets) + 0.6 (market value of equity/book value of total liabilities) + 0.999 (sales/total assets).
6. According to GAO, other types of restatement include restatement due to insufficient loan-loss provision, delinquent loans, loan write-offs, improper accounting for bad debts, frauds or accounting irregularities.
7. The GRG and *Z*-score variables were transformed to reduce the skewness using rank transformation by employing the Van der Waerden procedure in SPPS.

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(The Appendix follows overleaf.)

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Appendix

Table AI. GAO's restatement category description

Category	Description
Acquisitions and mergers	Restatements of acquisitions or mergers that were improperly accounted for or not accounted for at all. These include instances in which the wrong accounting method was used or losses or gains related to the acquisition were understated or overstated. This does not include in-process research and development or restatements for mergers, acquisitions, and discontinued operations when appropriate accounting methods were employed
Cost or expense	Restatements due to improper cost accounting. This category includes instances of improperly recognizing costs or expenses, improperly capitalizing expenditures, or any other number of mistakes or improprieties that led to misreported costs. It also includes restatements due to improper treatment of tax liabilities, income tax reserves, and other tax-related items
In-process research and development	Restatements resulting from instances in which improper accounting methodologies were used to value in-process research and development at the time of an acquisition
Other	Any restatement not covered by the listed categories. Cases included in this category include restatements due to inadequate loan-loss reserves, delinquent loans, loan write-offs, or improper accounting for bad loans and restatements due to fraud, or accounting irregularities that were left unspecified
Reclassification	Restatements due to improperly classified accounting items. These include restatements due to improprieties such as debt payments being classified as investments
Related-party transactions	Restatements due to inadequate disclosure or improper accounting of revenues, expenses, debts, or assets involving transactions or relationships with related parties. This category includes those involving special purpose entities
Restructuring, assets, or inventory	Restatements due to asset impairment, errors relating to accounting treatment of investments, timing of asset write-downs, goodwill, restructuring activity, and inventory valuation, and inventory quantity issues
Revenue recognition	Restatements due to improper revenue accounting. This category includes instances in which revenue was improperly recognized, questionable revenues were recognized, or any other number of mistakes or improprieties that led to misreported revenue
Securities related	Restatements due to improper accounting for derivatives, warrants, stock options and other convertible securities

Note: We excluded announcements involving stock splits, changes in accounting principles, and other financial statement restatements that were not made to correct mistakes in the application of accounting standards
Source: GAO (2006)