FINANCIAL RESTATEMENTS AMONG MALAYSIAN LISTED COMPANIES: DO CORPORATE GOVERNANCE AND OWNERSHIP MATTER?

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2008

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ACKNOWLEDGEMENT

We wish to thank Philip Sinnadurai of Macquarie University, Mohd Khalid Mohd Noor, Siti Rohaizad Jalal and colleagues at College of Business, Universiti Utara Malaysia for their helpful comments. The research grant from Universiti Utara Malaysia is acknowledged and appreciated.

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ABSTRACT

With the issuance of Corporate Governance Code in 2000 in Malaysia, it is expected that corporate governance has played an important role ensuring the reliability of financial statements. This study seeks to examine the nature financial restatements in Malaysia. It also seeks to investigate whether the corporate governance characteristics are associated with financial restatement.

Using the restated financial statements during the period of 2002 to 2005 matched with a control group of non-restating firms, the results show that the primary reason for misstating the accounts is to inflate earnings. The nomination committee of the firms that restated is less independent and managerial ownership and the logistic regression analysis indicates that the extent of ownership by outside blockholders is able to constrain managers from misstating accounts. The results also show that firms with high level of debts (an indicator of the presence of debt covenants) are more likely to commit in financial misstatement.

The research is significant as it provides evidence on the role of corporate governance, especially the ownership by outside blockholders in Malaysia. This shows that outside blockholders is effective in disciplining managers so that the accounts so prepared are not misleading.

This study does not support the move by Malaysian Government to require companies audit committee to be wholly independent. It is suggested that the more important thing is to have audit committee members who understand accounting and the related standards.

Keywords: Financial restatement, nomination committee, ownership, audit committee.

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INTRODUCTION

The issue of financial restatements has gained prominence in recent years as investors' losses from high-profile financial restatements [1] continue to rise. Restatements, especially when frauds are involved, have raised significant concern about the adequacy of current corporate governance and financial disclosure oversight (GAO, 2002). The pervasive accounting and financial irregularities such as the case of Enron and WorldCom in the US 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 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 views corporate governance rules as an important mechanism in deterring financial statement frauds (Persons, 2005).

Research shows that there is a link between corporate governance practices and the incidence of financial restatement (for example, see Effendi, Srivastava and Swanson, 2004). Coffee (2005), for instance, argues that differences in the structure of ownership led to differences in the nature of corporate scandals. Dispersed ownership systems as in the US are prone to the forms of earnings management, and the incidents of financial restatements are quite rampant (see Huron Consulting Group, 2003 & 2005). However, in the European concentrated ownership systems, the incidents of financial statement restatements are rare; and while Europe also had financial scandals, most were characteristically different from the US style of earnings manipulation. In Europe, the controlling shareholders tend to exploit the private benefits of controls through misappropriation of assets.

It has been shown by DeFond and Jiambalvo (1991) that twenty-four percent of financial statement restatement cases involve frauds. The US General Accounting Office (GAO; renamed Government Accountability Office in 2004) estimated that between January 1997 and June 2002, accounting restatements in the US have caused market capitalization to lose around US$100 billion. Enron, for example, announced $618 million loss in its third 2001 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; Low, 2004). The number of restatements in the US also has climbed in the year 2004 to 414 as compared to 323 the previous year (Huron Consulting Group, 2005). This is the highest number of restatements of any of the last seven years (2002: 330 restatements; 2001: 270; 2000: 233; 1999: 216; 1998: 158) (Huron Consulting Group, 2003 & 2005).

In Malaysia, CSM Corporation Bhd, a listed company, was directed to restate its 1999 financial statements (Securities Commission, 2002). Recently, the Securities Commission (SC) ordered OilCorp Bhd (to restate its 2004 accounts) and Aktif Lifestyle (to restate its 2003 and 2002 accounts). Goh Ban Huat was also ordered to reissue its 2004 fourth quarter report after being found overstating the profits by RM121 million (www.sc.com.my). Other listed companies that showed substantial discrepancies between unaudited and audited results were SBBS Consortium Bhd, Karensoft Technology Bhd, Paxelent Corp Bhd and Lityan Holdings Bhd (Oh, 2005). In Celcom's case (a subsidiary of Telekom Malaysia), the auditor of Celcom Bhd discovered fictitious invoices issued to the Group amounting to RM259.32 million (about USD70 million). More recently, in 2007, misstatement by Transmile Group was discovered in a special audit to have inflated its revenue by RM 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 price declined from RM15 to RM2 per share, resulting in a total paper loss, thus far, of RM3.4 billion. These high profile financial frauds expose board's inactivity, lack of expertise or being dominated by executive directors (Skousen, Glover and Prawitt, 2005). For instance, in 2000 letter to shareholders, the CEO of Enron reported that the company hit a record of USD1.3 billion in net income. However, after restatement, the audited net income was only USD978.5 million. Yet, the board did not detect the discrepancy. Board ineptness might have contributed to the misstatement.

The objectives of this research are, therefore, as follows. First, we aim to examine the extent of financial restatement in Malaysia. Second, we seek to identify the items in the financial statements that are commonly restated. Third, we intend to reveal the reasons that had led to financial statement restatements. Finally, we are interested to investigate whether the board of directors, the audit committee and ownership structure are associated with financial restatement. The findings are useful for regulatory bodies such as the Bursa Malaysia and SC as well as the Malaysian Institute of Corporate Governance for policy deliberations. Given the different regulatory and cultural environments, our evidence will provide insight as to the extent and causes of financial restatement in Malaysia, a developing country. In fact, Eilifsen and Messier (2000) note that most studies investigating the nature of misstatements are done in the US and that only two studies (Chan and Mo, 1998; Eilifsen, Austen, and Messier 2000) examine non-Anglo American settings.

Data for this study are obtained from the restated annual reports for the period of 2002 to 2005 with firm-years being the unit of observation. For regression analysis purposes, a control group is formed using the match-pair procedures where restated and non-restated firms are matched by size, industry, exchange board classification, and financial year end. The findings show that even though the incidence of financial restatement, which met the GAO's definition, is not rampant in Malaysia, but almost 40% of restatement relates to costs and expenses. Contrary to many arguments, audit committee of the restated firms is found to be more independent than non-restated firms; whereas managerial ownership is found to be higher for restated firms. The results also suggest that outside blockholders are effective monitoring as they are negatively associated with the incident of restatements. The findings contribute to the corporate governance literature by suggesting that outside blockholders is effective in disciplining managers and hence improve the financial reporting of the firm. This is consistent with Yeo *et al.* (2002) and Dechow, Sloan and Sweeney (1996).

The remaining of this paper is structured as follows. Next, literature review on financial restatement and corporate governance is presented followed by 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.

HYPOTHESIS

Financial restatement is generally viewed as corrections made to the financial statements due to non-compliance with the GAAP (Palmrose and Scholz, 2000; Palmrose, Richardson and Scholz, 2001; Efendi et al. 2004; Myers, Myers and Palmrose, 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." It includes only those financial restatements arising from accounting irregularities but excludes restatements due to normal corporate activities or simple presentational issues (refer to Appendix 1 for detailed definition). Huron Consulting Group [2] (2003) reported three primary causes of accounting errors: problems in applying the accounting rules, human and system errors, and fraudulent behaviors. In the 2004 study, they found the leading causes of restatements, namely revenue recognition, equity accounting, reserves, accruals, and contingencies (Huron Consulting Group, 2005). The repercussion of restatements is the adverse public confidence in the business community and capital market (GAO, 2002). Restatements also have caused concern regarding the quality of financial reporting (Levitt, 1998 and Palmrose and Scholz, 2000).

Efendi et al. (2004) show the likelihood of a restatement is significantly higher for firms that are constrained by debt covenants. Coffee (2005), on the other hand, argues that restatements are rare in Europe as contrast to the US, which experienced an accelerating incidence of financial statement restatements that began in the late 1990s. Coffee argues that a sudden change in executive compensation during the 1990s, from a predominantly cash-based system to an equity-based system which has not been accompanied by any compensating change in corporate governance has contributed to the sudden rise in financial misstatements. Unlike US, Europe experienced lesser accounting irregularities than in the US for two reasons. First, they use less equity compensation; and secondly, they have lesser interest in the short-term stock price (Coffee, 2005).

Restatements have been found to be driven by income-increasing motivation (DeFond and Jiambalvo, 1991), debt covenant constraints (Dechow *et al.*, 1996; Richardson, Tuna and Wu, 2002) and the desire to attract external financing at a low cost (Dechow *et al.*, 1996; Richardson *et al.*, 2002). 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), consistent with the findings by Ku-Ismail and Abdullah (2005) 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.

Large negative market reactions following the announcement of earnings restatements have been observed (Anderson and Yohn, 2002; Richardson *et al.*, 2002). Similar observation was noted in Malaysia where the share price of Transmile Group shed by as much as eighty-seven percent following the revelation of financial misstatement. It is also noted that firms that have manipulated their earnings experience significant increase in cost of capital when the manipulation is made public (Dechow *et al.*, 1996). Palmrose *et al.*, (2001) argue that the negative market reaction signals the market's negative perception on management integrity and competence. However, despite the negative publicity from misstatement, it is further noted, restating firms do not appear to adopt a more conservative financial reporting strategy following restatement (Moore and Pfeiffer, 2004).

In 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). This is consistent with moral hazard problem. Corporate governance is thus seen 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. In Malaysia, the Malaysian Code on Corporate Governance (MCCG, subsequently revised in 2007) was implemented in 2000 with the aim of strengthening a firm's internal corporate governance. The MCCG, *inter alia*, stresses on the need for board independence. This is 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 Malaysia 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 MASB approved accounting standard (known as Financial Reporting Standards effective from 1 January, 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 are better because the more effective the board would be in monitoring managerial opportunism.

Studies investigating the role of the board of directors generally reveal that its independence is an important characteristic of its effectiveness (see for example Kosnik, 1987; Hermalin and Weisbach, 1988; Weisbach, 1988). Nevertheless, 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 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-Salleh, Rahmat and Mohd-Iskandar (2004) 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. In fact, findings by Wan-Hussin *et al.*, (2003) suggest that it is executive directors instead of independent non-executive directors' who influence a firm's early adoption of the standard on segmental reporting.

Misstatements or financial restatements, however, unlike earnings management, could lead to bad reputation to the independent directors, who are argued to be expert in decision controls (Fama and Jensen, 1983). Kosnik (1987 and 1990) also argues and finds 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 SEC accounting enforcement actions and board structure. 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 and 1990). 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:

H_1: The extent of the board independence of management is associated negatively with the incident of financial restatement.

MCCG recommends listed firms to establish nominating committees composed wholly of non-executive directors, majority of whom are independent. The nominating committee recommends to the board candidates for all directorships taking into account nominees for directorships proposed by the CEO or by any other senior executive or any director or shareholder. The committee subsequently recommends to the board directors who will fill the seats on the board committees. The nominating committee needs also to determine annually the required mix of skills and experience and other core competencies which non-executive directors should bring to the board. In addition, the nominating committee is expected to assess 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. Thus, the hypothesis is as follows:

H_2: The extent of the independence of the nominating committee is associated negatively with financial restatement.

The fact that the audit committee is a committee of the board, it is argued, could lead to the audit committee to become ineffective as it doesn't have the power to improve the firm's financial reporting process without the board's consent. Thus, it is argued audit committee independence is important for its effectiveness. This is because the more independent the audit committee is, the more likely it is for the audit committee to be able to perform its financial reporting oversight more effectively. This is because the audit committee is not influenced by management. The independence of the audit committee is important because it ensures its objectivity (Kolins, Cangemi and Tomasko, 1991). Studies have also found greater outside directors' proportion on a board leads to audit committee formation (Pincus, Rusbarsky and Wong, 1989; Collier, 1993). Menon and Williams (1994) show that the proportion of outside directors on a board is associated positively with the frequency of audit committee meetings, indicating that the intensity of the audit committee to oversee the financial reporting process is influenced by the proportion of outside directors on the committee. Thus, an audit committee that is composed solely of outside directors should increase its incentive to oversee the financial reporting process and this is reflected by the new requirement by the NYSE 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. In The Sarbanes-Oxley Act (2002), firms in US are required to maintain an audit committee composed solely of independent directors. The MCCG recommends that an audit committee should consist of at least three directors and the majority of whom are independent [3].

Empirical evidence shows that 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 audit committee is also found to reduce the likelihood of profit overstatements (DeFond and Jiambalvo, 1991; Abott, Parker, and Peters, 2004). Abott *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. Dechow *et al.* (1996) find earning manipulators are less likely to have an audit committee and the majority of earnings manipulations found are originally due to overstatement of revenues.

In Malaysia, argument of audit committee independence being associated with monitoring effectiveness, as measured by its ability to constraint accrual management, is not supported (Abdullah and Mohd-Nasir, 2004; Mohd-Salleh *et al.*, 2004). 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 role of audit committee in Malaysian studies is due to the fact that audit committee formation is mandatory in Malaysia. Maintaining the audit committee is thus a matter of complying with the requirements. In the present study, the focus of the study 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:

H_3: There is a negative association between audit committee independence and financial restatement.

Board leadership refers to the division of powers between the board chairman and the CEO. Combining the 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 avoid 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 (see 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 and a chairman who is an outside director and argues that the weakest corporate governance is one where the board is dominated by insider directors and the CEO holds the chairmanship of the board. In fact, Jensen (1993: 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 that than to protect the interest of the CEO. MCCG (2001) recommend firms to separate the top two roles. 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 weaker corporate governance 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 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. The hypothesis is thus as follows:

H_4: Separating the roles of the board chairman and CEO is associated with lower likelihood of financial restatement.

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, Wild and Wild, 1995). Fama and Jensen (1983) argue that 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 between owner-manager as agency theory argues to exist, but rather between more severely manager (who are also owner) and the other owners. 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, Shleifer and Vishny (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 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. Thus, these incentives are achieved by inflating revenues and thus 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 resemblance to that of Malaysia, supports a curvilinear relationship between managerial ownership and earnings management; negative relation when managerial ownership is between 0-25 percent and positive relation when ownership is beyond 25 percent (Yeo *et al.*, 2002). Thus, the hypothesis is as follows:

H_5: There is a non-monotonic relationship between managerial ownership and financial restatement, negative at lower levels and positive at higher managerial ownership levels.

Outside blockholders, who hold substantial shares, play important monitoring roles (Shleifer and Vishny, 1986 and 1997; Admati, Pfleiderer and Zechner, 1994; Huddart, 1993; Maug, 1998; Noe, 2002). The greater incentives for outside to monitor management arise due to the fact that their wealth are tied directly to firms and they have the necessary resources to monitor closely their investments. In fact, in the year prior to the 1997 financial crisis, about thirty-seven 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, fifty-four percent of shares in the ten largest firms in Malaysia and forty-nine percent in ten largest firms in Singapore compared to twenty percent in ten largest firms in US.

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:

H_6: The extent of ownership by outside blockholders is negatively associated with financial restatement.

METHODOLOGY AND RESULTS

Firms that restated their financial statements in corporate annual reports during the period of 2002 to 2005 were first identified. We started with 2002 financial year because during this period, the 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. 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 found that only thirty-one companies restated their annual reports which met the GAO’s definition (refer to Appendix 1 for GAO’s definition of restatements).A sample of control group was subsequently formed using the match-pair procedures. The control group consists of firms which did not restate their accounts, had 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.

Table 1 presents the sample selection process. Sample consists of all non-finance companies listed on the Bursa Malaysia on both Main Board and Second Board for the year 2002-2005. Finance companies are excluded as they are subject to their own industry’s rules and regulations.

“Insert Table 1 about here”

The number of firms that restated the annual reports was fairly constant during 2002-2005 periods, representing less than one percent of the listed firms. Thus, it could be concluded that the incidence is not high. Table 2 reveals the Bursa Malaysia sectorial of the restatement companies.

"Insert Table 2 about here"

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. Table 3 presents the number of incidents of restatements according to the GAO's definition.

"Insert Table 3 about here"

Almost forty percent of the firms restated the costs or expenses. The other thirty-four percent fell under "other" category. Restatements involving revenue recognition accounted for fourteen percent of the total restatements. Table 4 presents the descriptive statistics of the variables in this study.

"Insert Table 4 about here"

Results in Table 4 indicate that, on average, more than one-third of the board of directors of firms in the sample is composed by 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 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. As predicted, 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. 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. 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 Table 6 also show that the performance of restating firms is significantly lower ($t = -1.70$, $p < 0.05$) than the performance of the non-restating firms, as indicated by the Z-score [4]. This evidence suggests that a possible reason for misstating the accounts was to inflate earnings. This is consistent with the results in Table 4, where eighty-seven percent of the restatement involved misstatement relating to costs or expenses (39%), revenue recognition (14%) and other types [5] (34%). 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 hypotheses that were developed, logistic regression analysis was employed. Auditor independence is one of the control variables. Audit by Big 4 firms indicates that the works done by this auditor will produce a high quality job compared to non Big 4 firms. It is argued that their audit procedures are more structured and systematically organized. 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-Z score is be used to measure a firm's bankruptcy probability. Abbot *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. Results are shown in Table 5. 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 [6].

"Insert Table 5 about here"

Results in Panel A of Table 5 show that only H_6 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 and 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 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-Salleh *et al*., 2004; Abdullah and Mohd-Nasir, 2004; Mohd-Nasir and Abdullah, 2004). Two explanations could be given for such a finding. First, the formation of the audit committee in Malaysia is mandatory and it is required to be composed in majority of independent directors by Bursa Malaysia since 1993. However, until 2007, the audit committee chairman is not required to be independent, which may impede the effectiveness of the audit committee. Further, it is customary for the managing director (or the finance director) of the firm to sit on the audit committee. Second, even if the audit committee is composed solely of independent directors, 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-Salleh *et al*., 2004). Thus, the independence of the board of directors does not mean it being expert, diligent, vigilant, or strict as a monitor of management as argued in agency theory (Jensen and Meckling, 1976; Kosnik, 1987 and 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 (e.g. Pfeffer, 1972).

Managerial ownership is also not found to have any association with the incident of financial restatement. Thus, if this is true, high managerial ownership leads to less likelihood of financial restatement, as evidenced in Singapore with regard to voluntary disclosure (Yeo *et al*., 2002). Another variable that does not have a significant association with financial restatement is leadership structure. 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 US, the issue of nominating committee is rarely discussed or debated.

Panel B of Table 5 reports the logistic regression results with the inclusion of three control variables. Results generally remain the same as in Panel A of Table 5, 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 6 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.

"Insert Table 6 about here"

Generally, results in all models in Table 6 are similar to those in Table 5. 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 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 ($p < 0.05$) 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.

CONCLUSION

Using a sample of thirty-one firms that restate their accounts and a matched control group of thirty one non-restated firm years, the findings indicate that ownership by outside blockholders is associated with less likelihood of financial misstatement. This thus 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 and 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 fifty percent of shares are owned by institutional shareholders and blockholders. 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.

The insignificant influence of board independence supports the previous findings on the ineffectiveness of independent directors in constraining management's actions (Wan-Hussin *et al*., 2003; Abdullah and Mohd-Nasir, 2004; Mohd-Salleh *et al*., 2004). 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. Based on this evidence, the recent reforms announced by the Malaysian Government in the 2008 Budget Speech [7] on the requirement for wholly independent audit committees may not improve audit committee vigilance and diligence. What is more important is to have audit committee members who understand accounting and the related standards. The findings may serve as the input for the board of directors to improve their roles especially with regard to supervising the company and to remove the functions of directors as a rubber stamp. This is consistent with the new requirement in Companies (Amendment) Act 2007 that requires directors to exercise reasonable care, skills and diligence at all times. As the incidence of restatement and its magnitude could result in negative investors' perception on the credibility of Malaysian financial reporting, it is suggested that the corporate governance conducts need be enhanced. It is hoped that the revised version of the MCCG issued by the SC 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.

Future research on this issue could be undertaken. For instance, future research could investigate the incidence of restatements in quarterly financial reports. Furthermore, other corporate governance variables, such as the frequency of audit committee meetings, and the effectiveness of 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. ESOSs have been found to be an influential factor of financial misstatement in US. The question is whether this finding also holds in Malaysia.

ENDNOTES

1 Financial restatement refers to correction of earlier misstated information found in the previous year's annual reports.

2 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).

3 In the Malaysia 2008 Budget speech, the Prime Minister of Malaysia announced on the requirement for audit committee be composed solely of independent directors, effective from 2008.

4 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).

5 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.

6 The GRG and Z-score variables were transformed to reduce the skewness using rank transformation by employing the Van der Waerden procedure in SPPS.

7 In the 2008 Budget Speech, the Prime Minister of Malaysia announced on the formation of the Public Companies Accounting Oversight Board (PCAOB) and the requirement for the audit committee comprising solely of independent directors. The PCAOB is established under the auspices of the Securities Commission.

Appendix 1: 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, FINANCIAL STATEMENT RESTATEMENTS Trends, Market, Impacts, Regulatory Responses, and Remaining Challenges

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Table 1: Sample Selection Processes

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 Restatement Companies	440	560	391	269
less Restatement Not within GAO's Definition of Restatement	433	554	384	258
Total Restatement Companies	**7**	**6**	**7**	**11**
Percentages from the population	**0.8%**	**0.7%**	**0.8%**	**1.2%**

Table 2: Restatements based on Bursa Malaysia sectorial classification

Industrial classification	**Number of restatement companies (%)**
Trading and services	14 (45%)
Consumer products	3 (9.7%)
Properties	5 (16%)
Industrial products	7 (23%
Constructions	2 (6%)
Total	31 (100%)

Table 3: Reasons of restatements

Year	**2002**	**2003**	**2004**	**2005**	**Total incidents**	**Percentages**
Acquisitions and mergers	1	0	0	0	1	2%
Cost or expense	2	8	2	5	17	39%
In-process research and development	0	0	0	0	0	0
Other	3	2	5	5	15	34%
Reclassification	0	1	0	0	1	2%
Related party transaction	0	0	0	0	0	0
Restructuring, assets, or inventory	1	1	0	2	4	9%
Revenue recognition	0	5	0	1	6	14%
Securities related	0	0	0	0	0	0
Total Number of Restatements	7	17	7	13	44	100%

Note: The number of incidents (i.e. 44) is different from 31 (in Table 1) because certain companies gave more than one reason for restatement.

Table 4: Descriptive statistics (n=62) and T-test results

Panel A: Continuous variables

Variable	Mean	Std. Deviation	Kurtosis	T-test		
				Mean (restate)	Mean (non-restate)	T-value
BDIND	0.43	0.15	0.89	0.45	0.42	0.73
MGOWN	25.03	23.08	-0.88	29.63%	20.43%	1.59
OUTBLK	34.70	24.98	-0.71	27.07%	42.33%	-2.51*
Z score	4.75	18.72	53.58	0.77	8.73	-1.70†
GRG	0.61	0.55	9.919	0.82	0.38	-3.38*

* $p<0.05$; † $p<0.10$

Panel B: Dichotomous variables

Variable	Frequency with "0"	Frequency with "1"	T-test		
			Mean (restate)	Mean (non-restate)	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†

* $p<0.05$; † $p<0.10$

Table 5: Logistic regression results

Panel A: Without control variables

Variable	Predicted sign	Coefficient	Standard error	P-value
Constant	?	2.530	2.121	0.233
BDIND	Negative	-1.944	2.810	0.245
NOMIND	Negative	-0.004	1.267	0.497
ACIND	Negative	2.503	1.227	0.020*
DUAL	Positive	0.002	0.0.871	0.499
MGOWN	Negative	-0.038	0.074	0.319
$MGOWN^2$	Positive	0.001	0.001	0.304
OUTBLK	Negative	-0.043	0.023	0.033*
Overall percentage of correct prediction	80.6%			
Nagelkerke R-square	0.579			

* $p<0.05$, two-tail test; † $p<0.10$, two-tail test

Panel B: With control variables

Variable	Predicted sign	Coefficient	Standard error	P-value
Constant	?	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	Positive	-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-square	0.720			

* $p<0.05$, two-tail test; † $p<0.10$, two-tail test

Model: $\ln (R/1-R) = \alpha_0 - \beta_1.BDIND - \beta_2.NOMIND - \beta_3.ACIND + \beta_4.DUAL + \beta_5.MGMOWN - \beta_6.OUTBLK - \beta_7.AUDQ - \beta_8.Z + \beta_9.GRG + \varepsilon$; 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 two 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; and GRG: ratio of total debt to total assets.

Table 6: Further logistic regression results

Variable	Predicted sign	Model 1 (coefficient)	Model 2 (coefficient)	Model 3 (coefficient)
Constant	?	-2.580	6.339	2.577
BDIND	Negative	-2.605	0.268	-3.7617
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	-.000	0.001
OUTBLK	Positive	-0.04†	-0.059†	-0.047†
AUDQ	Negative	-0.295	-1.258	-0.741
Z-score	Negative	-.492	-1.623†	-1.013*
GRG	Positive	1.592*		
LNASSET^	Negative	0.265	-	
AUDOPIN@	Negative		-5.136*	-
BRDLISTξ	Negative			2.135†
Percentage with correct prediction		87.1%	91.9%	91.9%
Nagelkerke R-square		0.727	0.875	0.757

* p<0.05, two-tail test; † p<0.10, two-tail test

^ LnAsset: log natural of total assets

@ AUDOPIN: 1 if “unqualified auditor’s report”; 0 if “otherwise”.

ξ BRDLIST: 1 if “Main Board”; 0 if “otherwise”.