CORPORATE GOVERNANCE AND FINANCIAL RESTATEMENTS AMONG MALAYSIAN LISTED COMPANIES

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Abstract
The objectives of this research are to examine the extent of financial restatement in Malaysia; to reveal the reasons that had led to financial statements restatements; and to investigate whether the corporate governance characteristics are associated with financial restatement. Using the US Government Accountability Office’s definition on restatement, the study identifies firms that restated their financial statements during the period of 2002 to 2005 which totaled to only thirty-one companies. Our results show that the reason for misstating the accounts was to inflate earnings. Incorporating non-restating sub-sample firms, we find that the nomination committee of the firms that restated is less independent and managerial ownership is found be higher for the firms that restated their accounts. The logistic regression analysis indicates that the extent of ownership by outside blockholders is able to constraint managers from misstating accounts, consistent with Dechow, Sloan and Sweeney (1996). Our results also show that the firms with high level of debts and listed on Main Board of Bursa Malaysia are more likely to commit in financial misstatement, consistent with previous findings (Dechow et al., 1996; Kinney and McDaniel, 1989; Richardson et al., 2002). This research is significant as it provides evidence on the role of corporate governance, especially the ownership by outside blockholders, on the incident of financial misstatements in an emerging economy.

Keywords: Financial restatement; Board independence; Nomination committee; Ownership; Audit committee; Malaysia.

JEL Classification Codes: G34; M41; M42.

1. Introduction
The issue of financial restatements has gained prominence in recent years as investors’ losses from high-profile financial restatements 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 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 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. 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

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1 Financial restatement refers to correction of earlier misstated information found in the previous year’s annual reports.
to lose around US$100 billion. 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, was directed to restate its 1999 financial statements (Securities Commission, 2002). The Securities Commission (SC) also 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, Poxelent 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). 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.

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 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.

2. Hypothesis

Financial restatement is generally viewed as corrections made to the financial statements due to non-compliance with the GAAP (Palmrose and Scholz, 2000; 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).

\(^2\) 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).
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).

Efendi et al. (2004) show the likelihood of a restatement is significantly higher for firms that are constrained by debt covenants. 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. 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 (Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1997). 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 and recommends that independent non-executive directors make up at least one-third of the board memberships. 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. Thus, if the directors fulfill these duties effectively, the likelihood of errors in the financial statement is reduced.

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). In Malaysia, evidence by Mohd-Nasir and Abdullah (2004) shows that board independence is associated with greater voluntary disclosure levels among distressed firms. 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: 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. 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. 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:

\[ H_2: \text{The extent of the independence of the nominating committee is associated negatively with financial restatement.} \]

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 and objectivity. The MCCG recommends that an audit committee should consist of at least three directors and the majority of whom are independent\(^3\). Audit committee independence is also found to be associated with fewer incidents of accounting errors, irregularities and illegal acts (McMullen, 1993). 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.

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:

\[ H_3: \text{There is a negative association between audit committee independence and financial restatement.} \]

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). 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 than to protect the interest of the CEO. MCCG (2001) recommend firms to separate the top two roles. 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:

\[ H_4: \text{Separating the roles of the board chairman and CEO is associated with lower likelihood of financial restatement.} \]

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). 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

\[^3\] 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.
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 resemble 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:

H₅: 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). 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. 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. 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: The extent of ownership by outside blockholders is negatively associated with financial restatement.

3. 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. 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.

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.

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 (2002:7 companies; 2003:6; 2004:7; 2005: 11). Thus, it could be concluded that the incidence is not high. It is noted that almost half of the restatement companies were classified under trading and services (45%). Construction firms, on the other hand, made up the least number of restatement firms (6%).

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.

Results 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 between restatement and non-restatement firms 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 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. This evidence suggests that a possible reason for misstating the accounts was to inflate earnings, where eighty-seven percent of the restatement involved misstatement relating to costs or expenses (39%), revenue recognition (14%) and other types (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

\[ Z = 1.2 \left( \frac{\text{working capital}}{\text{total assets}} \right) + 1.4 \left( \frac{\text{retained earnings}}{\text{total assets}} \right) + 3.3 \left( \frac{\text{earnings before interest}}{\text{total assets}} + \frac{\text{and taxes}}{\text{total assets}} \right) + 0.6 \left( \frac{\text{market value of equity}}{\text{book value of total liabilities}} \right) + 0.999 \left( \frac{\text{sales}}{\text{total assets}} \right) \]

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.
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 1. 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-score6.

Results show that only Hc 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.

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.
Table 1: Logistic regression results
Panel A: Without control variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Predicted sign</th>
<th>Coefficient</th>
<th>Standard error</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>?</td>
<td>2.530</td>
<td>2.121</td>
<td>0.233</td>
</tr>
<tr>
<td>BDIND</td>
<td>Negative</td>
<td>-1.944</td>
<td>2.810</td>
<td>0.245</td>
</tr>
<tr>
<td>NOMIND</td>
<td>Negative</td>
<td>-0.004</td>
<td>1.267</td>
<td>0.497</td>
</tr>
<tr>
<td>ACIND</td>
<td>Negative</td>
<td>2.503</td>
<td>1.227</td>
<td>0.020*</td>
</tr>
<tr>
<td>DUAL</td>
<td>Positive</td>
<td>0.002</td>
<td>0.871</td>
<td>0.499</td>
</tr>
<tr>
<td>MGOWN</td>
<td>Negative</td>
<td>-0.038</td>
<td>0.074</td>
<td>0.319</td>
</tr>
<tr>
<td>MGOWN²</td>
<td>Positive</td>
<td>0.001</td>
<td>0.001</td>
<td>0.304</td>
</tr>
<tr>
<td>OUTBLK</td>
<td>Negative</td>
<td>-0.043</td>
<td>0.023</td>
<td>0.033*</td>
</tr>
</tbody>
</table>

Overall percentage of correct prediction: 80.6%
Nagelkerke R-square: 0.579

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

Panel B: With control variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Predicted sign</th>
<th>Coefficient</th>
<th>Standard error</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>?</td>
<td>1.802</td>
<td>2.507</td>
<td>0.472</td>
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<tr>
<td>BDIND</td>
<td>Negative</td>
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<tr>
<td>NOMIND</td>
<td>Negative</td>
<td>-0.004</td>
<td>1.34</td>
<td>0.499</td>
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<tr>
<td>ACIND</td>
<td>Negative</td>
<td>4.933</td>
<td>2.288</td>
<td>0.016*</td>
</tr>
<tr>
<td>DUAL</td>
<td>Positive</td>
<td>0.002</td>
<td>9.698</td>
<td>0.499</td>
</tr>
<tr>
<td>MGOWN</td>
<td>Negative</td>
<td>-0.022</td>
<td>0.033</td>
<td>0.255</td>
</tr>
<tr>
<td>OUTBLK</td>
<td>Positive</td>
<td>-0.029</td>
<td>0.026</td>
<td>0.127</td>
</tr>
<tr>
<td>AUDQ</td>
<td>Negative</td>
<td>-0.092</td>
<td>1.045</td>
<td>0.455</td>
</tr>
<tr>
<td>Z-score</td>
<td>Negative</td>
<td>-0.587</td>
<td>0.498</td>
<td>0.123</td>
</tr>
<tr>
<td>GRG</td>
<td>Positive</td>
<td>1.680</td>
<td>0.799</td>
<td>0.017*</td>
</tr>
</tbody>
</table>

Overall percentage of correct prediction: 87.1%
Nagelkerke R-square: 0.720

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

Model: log (R/1-R) = \( \alpha_0 + \beta_1 \text{BDIND} - \beta_2 \text{NOMIND} + \beta_3 \text{ACIND} + \beta_4 \text{DUAL} + \beta_5 \text{MGOWN} + \beta_6 \text{OUTBLK} - \beta_7 \text{AUDQ} + \beta_8 \text{Z} + \beta_9 \text{GRG} + \varepsilon \), 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.

In further logistic regression analyses, three control variables, namely firm’s size, type of auditor’s opinion and board listing on Bursa Malaysia been tested. It is found that firm’s size does not have any significant association with the probability of financial restatement. Meanwhile, 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, board listing is found 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.

4. 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,
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 Speech7 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 and other corporate governance variables, such as the frequency of audit committee meetings, and the effectiveness of internal control system, can also be tested. 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.

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References

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**

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisitions and mergers</td>
<td>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.</td>
</tr>
<tr>
<td>Cost or expense</td>
<td>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.</td>
</tr>
<tr>
<td>In-process research and development</td>
<td>Restatements resulting from instances in which improper accounting methodologies were used to value in-process research and development at the time of an acquisition.</td>
</tr>
<tr>
<td>Other</td>
<td>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.</td>
</tr>
<tr>
<td>Reclassification</td>
<td>Restatements due to improperly classified accounting items. These include restatements due to improprieties such as debt payments being classified as investments.</td>
</tr>
<tr>
<td>Related-party transactions</td>
<td>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.</td>
</tr>
<tr>
<td>Restructuring, assets, or inventory</td>
<td>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.</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>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.</td>
</tr>
<tr>
<td>Securities related</td>
<td>Restatements due to improper accounting for derivatives, warrants, stock options and other convertible securities.</td>
</tr>
</tbody>
</table>

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