Influence of Audit Committee Effectiveness on Earnings Conservatism of Malaysian Public Listed Firms

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Abstract

The study's primary objective is to examine influence of audit committee effectiveness on the extent of earnings conservatism amongst Malaysian publicly listed firms. Drawing on agency theory, supplemented by tenets of key corporate governance reforms undertaken in Malaysia since the Asian financial crisis in 1997, it is expected that audit committee effectiveness is positively associated with earnings conservatism. Aside from considering audit committee effectiveness through a holistic lens, the influence on earnings conservatism of three key components underlying audit committee effectiveness (independence, expertise, and diligence) is also examined. Conservatism is defined in terms of timeliness, and measured using models developed by Basu (1997). Analysis is based on annual data collected from 100 Malaysian firms (selected using stratified random approach) listed continuously on the Bursa Malaysia from January 1, 2002 till December 31, 2011. Following exclusions for missing data, empirical analysis is based on a final useable sample of 938 firm-year observations. Findings suggest a lack of association between audit committee effectiveness and the earnings conservatism within the Malaysian capital market setting. Overall, findings provide valuable insights and understanding, not only in respect to the audit committee effectiveness/earnings conservatism linkage, but the significance of corporate governance and earnings conservatism concepts.

Keywords Audit committee effectiveness, earnings conservatism

INTRODUCTION

Conservatism is considered by some (e.g., Sterling, 1970; Basu, 1997) as the most influential principle underpinning accounting valuation with a history of influence exceeding five centuries. Nonetheless, conservatism faces major vocal criticism by capital market regulators, standards-setters and academics who argue conservatism leads to the understatement of net assets in the

current period that can lead to the overstatement of earnings in future periods due to the understatement of future expenses (LaFond & Watts, 2008). Despite the heavy criticism empirical research indicates conservatism has increased during the past decades. Conservatism's lengthy persistence and resilience to criticism is an intriguing empirical dilemma with a number of important questions that remain largely unanswered.

The importance of conservatism to accounting is thought to have various facets but particular in respect to earnings quality. Kung *et al*., (2008), for example, argue conservatism is an important underlying attribute of reporting quality often used by capital market participants to benchmark the quality of a firm's earnings. Ball & Shivakumar (2005), meanwhile, suggest conservatism is an important attribute of earnings quality because it makes financial statement more informative and useful; therefore, stakeholders are better able to monitor company's performance. Also, conservative accounting practices is thought to provide more timely information giving shareholders and creditors better opportunities to make key decisions on loss making projects (Ball *et al*., 2003).

It is increasingly recognized conservatism is an effective mechanism for constraining managerial opportunistic behavior (Kung *et al*., 2008). It is argued pressure to adhere to the underlying tenets of conservatism provides an important disincentive for corporate management to actively seek to manipulate earnings. Whilst it may be argued conservatism acts as a natural deterrent to earnings manipulation, the mere existence of this principle is unlikely in practice to be a complete constraint. Rather, the degree to which conservatism constrains managerial opportunistic behavior is likely to be a function of pivotal 'human-driven' corporate governance mechanisms that enact and enforce the principle.

The past decade has witnessed unprecedented discussion on the role of numerous mechanisms for enhancing a firm's corporate governance structure and financial reporting system. From this intense debate it is increasingly recognized that audit committee are the most direct and immediate custodians with the pivotal role of enacting and enforce key financial reporting principles including conservatism. Respective corporate governance codes or best practices enacted in numerous nations have highlighted the growing role and responsibilities of the audit committee for monitoring and oversight of a firm's financial reporting system.

Scholars have a lengthy history of supporting the importance of audit committees to the financial accounting process including influencing earnings quality (e.g., Beasley & Salterio, 2001). Klein (2002a), for example, stated the central role of the audit committee is to "reduce the magnitude of positive or negative abnormal accruals", thereby, enhancing earnings quality. The audit committee's ability to accomplish any required and/or perceived roles and responsibilities in monitoring the financial reporting process will depend primarily upon the sub-committee's effectiveness. Despite extensive debate there is little empirical research surrounding the issue of an audit committee's effectiveness. Aside from studies focusing on earnings management, very few

empirical studies have sought to determine the influence of audit committee effectiveness on other aspects of financial accounting such as conservatism.

The conservatism concept is an effective governance mechanism. Watts (2003a), for example, suggests that the use of conservative accounting figures in contractual arrangements amongst various parties associated with the firm reduces information asymmetry and moral hazard problems derived from agency conflicts. A growing number of researchers (Ahmed & Duellman, 2007; Beekes *et al*., 2004; Lara *et al*., 2005) argue other corporate governance mechanisms may provide an additional layer of conservatism important in determining earnings quality. Actions by regulators affecting corporate governance mechanisms, therefore, could inadvertently affect conservatism and earnings quality.

Given the unprecedented and ever increasing interest in earnings by investors, combined with escalating demands for higher quality earnings, there is an urgent need to identify influential factors and the resulting impact on earnings. As discussed above, both the conservatism principle and the audit committee are alleged to have a significant bearing on earnings (Beasley & Salterio, 2001; Klein, 2002a; Watts, 2003b). Currently the influence of an audit committee and its effectiveness on conservatism (and ultimately earnings quality) remains an open empirical question that has not been formally investigated. A pivotal aim of this study is to address this void in the extant literature surrounding conservatism and audit committees by investigating the following main research question.

MRQ: Is there an association between audit committee effectiveness and the extent of earnings conservatism amongst Public Listed Companies in Malaysia?

This study provides several contributions to the extant accounting conservatism literatures. First, it provides evidence of the influence of audit committee effectiveness on earnings conservatism. Despite mounting importance of corporate governance, previous analysis has not considered the influence of such key corporate governance features on conservatism. Also, much of the prior research focuses on determining the benefits of conservatism with little attention to factors influencing conservatism. Therefore, this study provides new insights into factors that may determine conservative accounting practices by Malaysian public listed companies. Third, this study is conducted using data from an emerging market country (i.e., Malaysia). Prior research has focused heavily on developed countries such as United States and United Kingdom in investigating conservatism. Thus, this study provides insights into conservatism through an alternative national lens. Given the large focus during the past decade of Malaysian regulators seeking to improve the nation's corporate governance standards, results of the study assist in determining if any changes have had possible direct and indirect benefits. The results will also be informative to Malaysian regulators (e.g., Securities Commission, Bank Negara Malaysia, Bursa Malaysia) on impact future rules regulating audit committees may have on accounting conservatism.

OBJECTIVES

In line with the major research question, the primary objective is to examine the association between audit committee effectiveness and earnings conservatism of Malaysia publicly listed companies. There is currently a lack of consensus in the extant literature of a precise definition or factors determining audit committee effectiveness. Corporate governance advocates generally argue structural and operational composition factors influence an audit committee's effectiveness. For example, in respect to structural composition, Klein (2002a) argues more independent audit committees are effective in constraining managerial opportunism, thereby, leading to greater quality of reported earnings. In the case of operational composition, Abbott & Parker (2000) and Abbott *et al*., (2003) state more diligent audit committees (i.e., those that meet more frequently) are better able to address key financial reporting issues such as earnings management and financial misstatement. In line with prior literature this study focuses on three prime components underlying audit committee effectiveness: (a) sub-committee independence; (b) financial expertise; and (c) diligence. Whilst the main objective of the study is the composite impact of the three prime components of audit committee effectiveness on earnings conservatism, secondary research objectives will involve an examination of the individual association of each of the three prime audit committee effectiveness components and earnings conservatism. These secondary objectives are addressed in investigating the following (condensed) major secondary research question:

MSQ: Is there an association between key audit committee effectiveness components (i.e., (a) audit committee independence, (b) independent audit committee member financial expertise, and (c) audit committee diligence) and earnings conservatism of Malaysian publicly listed companies?

LITERATURE REVIEW AND HYPOTHESES TESTING

Earnings Conservatism

Generally, accounting conservatism is defined as an action of accelerating expenses and deferring revenue recognitions. Textbooks commonly present conservatism as the choice (by regulators or by firms) of an accounting treatment that least likely overstates assets and income when selecting among two or more reporting alternatives (e.g., Kieso *et al*., 2004; Revsine *et al*., 2005). Researchers, however, have sought to define conservatism in a more definitive manner. Basu (1997), for example, defined conservatism as earnings reflecting bad news more quickly than good news, where higher degree of verification is preferred by accountants to recognize good news as gains than to recognized bad news as losses. Watts (2003a), meanwhile, defined accounting conservatism as the application of a higher standard of verification for favourable information. Finally, Beaver & Ryan (2005) defines conservatism

as the average understatement of the book value of net assets relative to their market value, which is the existence of expected unrecorded goodwill. Like the majority of prior empirical based earnings conservatism studies (eg. Lobo & Jian, 2006; Ruddock *et al*., 2006) this study adopts the definition of Basu's (1997).

Prior research indicates earnings conservatism has increased in the past decades (e.g., Kim & Ross, 2005; Lobo & Jian, 2006). Aside from documenting changes, some studies have sought to provide explanations for earning conservatism and factors determining conservative practices. DuCharma *et al*., (2004), for example, show aggressive financial reporting is more likely to be associated with shareholder litigation than conservative financial reporting. According to Ahmed *et al*., (2002) accounting conservatism plays an important role in mitigating bondholder – shareholder conflicts over dividend policy, and reducing firms' debt costs. While contracting considerations appear to explain the origin of conservatism, tax, litigation, political process and regulatory forces may also influences the degree of conservatism (Watts, 2003a). According to Watts (2003a), the right of shareholders to sue for financial statement misrepresentation creates a demand for conservative accounting to limit litigation losses stemming from allegations of overstated net assets or income. Watts (2003b) further observed courts generally punish overstatement more than understatement because stakeholders (especially shareholders) are more likely to suffer losses when earnings/assets are overstated than earnings/assets understated. Klein & Marquardt (2006) report firm characteristics influence conservative. They find firm size a dominant factor influencing accounting conservatism in determining losses.

Theoretical Perspective

Corporate governance research has relied extensively on agency theory. Similarly, prior research has consistently drawn on the tenets of agency theory as a theoretical framework to explain earnings conservatism practices. Briefly, agency theory suggests that, owing to the separation of corporate management and ownership, shareholders require protection because managers may have agendas different from their owners (shareholders), and thus may not always act in the owners' best interests (Jensen & Meckling, 1976; Fama,1980; Fama & Jensen, 1983). For instance, managers may manipulate earnings or commit financial fraud at the shareholders' expense. To deal with this agency problem, the audit commitee effectiveness contributes to greater monitoring capabilities in order to provide greater assurance to users and investors on the quality of information provided. Given the common application of agency theory to corporate governance issues and earnings conservatism this study uses agency theory as the underlying theoretical perspective.

Earnings Conservatism and Audit Committee Effectiveness

Recent studies highlight the link between earnings conservatism and corporate governance structures. Beekes, Pope and Young (2004) find firms with a higher proportion of outside members are more likely to recognize bad news in earnings. Similarly, Ahmed and Duellman (2007) find a negative relationship between the percentage of the inside directors on the board and earnings conservatism. They also find a positive relationship between the ownership percentage of outside directors and earnings conservatism. Similarly, Lafond and Watts (2008) find firms with lower managerial ownership report more conservative earnings. Ruddock *et al*., (2006), meanwhile, find that the provision of non-audit services is positively associated with a reduction in the extent to which earnings reflect bad news on a timelier basis than good news (i.e., earnings conservatism). Finally, Hamilton *et al*., (2005) find a significant increase in the asymmetrically timeliness of economic losses when a firm changes an audit partner.

Of various corporate governance mechanisms discussed in the popular press and scholarly research during the past decade, audit committees have been a central focus in debates about how to assure and enhance the quality of financial reporting and corporate accounting. Despite the acknowledged role of the audit committee, studies have yet to consider the relationship to earnings conservatism. Research does, however, provide evidence of the linkage between audit committees and earnings quality (DeFond, *et al*., 2005; Klein, 2002a). Various incentives exist to suggest why an audit committee is motivated to ensure the credibility of the financial reporting process and that quality of earnings is preserved. For example, independent directors on the audit committee have a strong incentive to ensure the sub-committee's roles and responsibilities are fulfilled so as to ensure their (i.e., the independent directors) reputational capital and opportunities for appointment to other boards. As high quality earnings will likely be perceived as a key benchmark of an audit committee's success and reputation (and that of its members), this provides strong motivation for the sub-committee to undertake actions that enhance earnings quality. As noted earlier, greater earnings conservatism is thought to enhance earnings quality. Consequently, it follows that an audit committee will actively engage in conservative earnings practices with the aim of improving earnings quality.

Despite incentives to engage in greater earnings conservatism, the mere presence of the audit committee does not automatically mean such practices will be undertaken. Rather, as highlighted in the extant literature, the effectiveness of the audit committee will determine whether the sub-committee actively seeks to conserve earnings or not. A more effective audit committee will be better able to mitigate opportunities for corporate management to engage in opportunistic behaviour that can affect earnings quality. Furthermore, a more effective audit committee will have greater ability to override aggressive financial accounting policy choices initiated by corporate management that could promote less conservative earnings results. Finally, if an audit committee

is more effective in its arbitration role, this will aid in the development of more systematic compromises between corporate management and external parties (such as the external auditor). Improved resolution of conflicts, therefore, will likely enhance the acceptance of conservative earnings practices. Based on the above discussion, therefore, the general hypothesis tested is postulated as:

GP_{ACE}: *Malaysian publicly listed companies with more effective audit committees are more likely to have higher levels of earnings conservatism.*

Components of ACE and Influence on Conservatism

There is currently no consensus on a definition of audit committee effectiveness. Rather, a number of determinants have been detailed in the extant literature that researchers propose affect the effectiveness of the audit committee. DeZoort *et al*., (2002), for example, suggest that audit committee effectiveness occurs when audit committees comprise qualified members who have the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, strong internal controls and comprehensive risk management practices through diligent oversight efforts.

Broadly three main categories of audit committee effectiveness determinants are identified as: (1) arrangement (i.e., sub-committee independence, size and duality); (2) resources (i.e., financial expertise, committee experience); and (3) diligence (i.e., active meeting of sub-committee) (DeZoort *et al*., 2002). The first two categories relate to structural composition whilst the latter two to operational composition features. Whilst postulated above that overall audit committee effectiveness is positively associated with earnings conservatism, different components underlying an audit committee's effectiveness could have differing degrees of influence. This study is extended to examine this proposition with, hypotheses developed below in respect to three key components (i.e., independence, financial expertise and diligence) frequently cited as central determinants of audit committee effectiveness.

Audit Committee Independence

Corporate governance advocates, regulators and scholars frequently argue an audit committee with a higher proportion of outside directors is less likely to be compromised in undertaking the sub-committees roles and responsibilities. Furthermore, a more independent audit committee is likely to be better able to constrain opportunistic behavior of corporate management (Beasley & Salterio, 2001; Klein, 2002a, 2002b). Empirical findings have generally supported the perception independent audit committees are more effective in constraining corporate management and improving earnings quality. Klein (2002a) and Van der Zahn & Tower (2004), for example, observed a significant positive relationship between earnings management and audit committees with less than a majority of outside directors. Bedard *et al*., (2004), meanwhile,

determined audit committees comprising solely of non-related directors had a positive association with the quality of the firm's financial reports. McMullen & Raghunandan (1996) also found that firms with reporting problems were less likely to have audit committees composed solely of outside directors. Similarly, Abbott & Parker (2000) concluded that firms with audit committees composed of independent directors were less likely to be sanctioned by the SEC for fraudulent or misleading financial reporting compared to firms whose audit committees did not comprise of independent directors. Additionally, Beasley *et al*., (2000) found fraud firms had less independent audit committees than no-fraud industry benchmarks. Overall, prior theoretical and empirical research provides a sound foundation to imply that independent audit committee members are more likely to (perhaps) require the recognition of bad news sooner and delay the reporting of good news (i.e., actions that support earnings conservatism) in order to protect their reputational capital, reduce contracting and mitigate litigation costs. Thus, more independent audit committees are likely to support more actively actions promoting earnings conservatism. To test this assertion, the following hypothesis is proposed:

GP_{Ind}: *Malaysian publicly listed companies with a majority of independent directors on the audit committee are more likely to have higher levels of earnings conservatism.*

Audit Committee Financial Expertise

As new corporate governance regulations continue to expand an audit committee's role and responsibilities, there is growing pressure on members to develop greater financial expertise to counter the escalating complexity and sophistication of the financial reporting. Theoretical and applied views have been forwarded in the extant literature suggesting greater financial expertise amongst audit committee members enhances effectiveness. McDaniel *et al*., (2002) argue the presence of a financial expert on the audit committee will improve the quality of the firm's financial statements. DeZoort *et al*., (2003) state financial experts on an audit committee will provide the sub-committee with greater resolve to support the external auditor during auditor-management disagreements. Abbott *et al*., (2004), meanwhile, argue audit committees with greater financial expertise are better able to prevent occurrences of financial misstatements. Finally, Defond *et al*., (2005) suggest greater audit committee financial expertise enhances the firm's overall internal control. Empirical research has generally supported the notion the audit committee's effectiveness is enhanced with the presence of a financial expert (or experts) as a member. Therefore, the following hypothesis is proposed to test this assertion:

GP_{Exp}: *Malaysian publicly listed companies with audit committees comprising members with financial expertise are more likely to have higher levels of earnings conservatism*.

Audit Committee Diligence

It is strongly argued in the extant literature (Abbott *et al*., 2004; Bedard *et al*., 2004) that an effective audit committee meets regularly; thus, is more capable of ensuring the financial reporting process is functioning properly. A more active audit committee is thought to be able to detect and prevent opportunistic behaviour by management and to ensure the integrity of reported earnings. Past research provides evidence of this link. Farber (2005), for example, find the audit committees of fraud firms met less often than audit committees in firms not experiencing fraud. Similarly, Abbott and Parker (2000) report firms with audit committees meeting at least biannually were less likely to be sanctioned by the SEC for financial reporting problems. Others such as Abbott *et al*., (2004) and Vafeas (2005) find firms with reporting problems had less frequent audit committee meetings. Xie *et al*., (2003), meanwhile, find the number of audit committee meetings is negatively associated with discretionary current accruals implying diligence is an important factor in constraining the management's propensity to manage earnings. Finally, Krishnan & Visvanathan (2007) show that audit committees meeting more regularly were more likely to detect internal control weaknesses.

Prior literature considering audit committee diligence literature clearly demonstrates the importance of having sufficient audit committee meetings per year and its impact on the financial reporting process. Based on the prior empirical findings, therefore, it is likely more diligence audit committees will be better able to ensure the adoption of conservative earnings practices to ensure greater earnings quality. To formally test this assertion, the following hypothesis is forwarded:

GP_{Dil}: *Malaysian publicly listed firms with more diligent audit committees (i.e., meet more frequently) are more likely to have higher levels of earnings conservatism*.

Conceptual Schema

Figure 1 provides a diagrammatical overview of the study and the respective testable hypotheses based on discussion of Section 3.3 and 3.4.

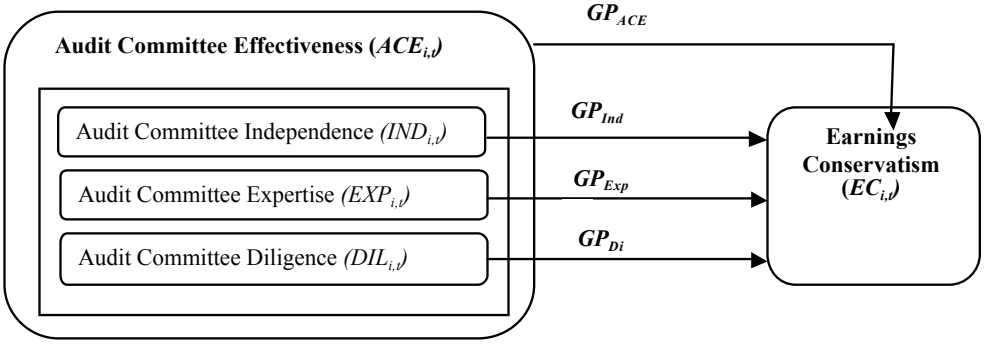

Figure 1 Conceptual schema

METHODOLOGY

Sample Selection and Data Source

The initial sample will comprise all companies listed continuously on the Main Board of Bursa Malaysia from 1 January 2002 to 31 December 2011. Consistent with prior research bank and finance companies are excluded as these firms are regulated by the Central Bank of Malaysia. From the resulting sample pool, 100 firms will be selected for each year using a stratified-random approach. This will involve stratifying each year into quartiles by market capitalisation and randomly selecting a sample of 25 firms within each quartile. After exclusions for missing documentation and data the final useable sample to be used in the analytical component of this study, is 938 firm-year observations.

Statistical Analysis

The measures of earnings conservatism focusing on timeliness draw on the methodology developed by Basu (1997). *Equations 1* details the basic models underlying the measures of earnings conservatism:

$$OPI_{i,t} = \alpha_0 + \alpha_1 NEGRET_{i,t} + \beta_0 RET_{i,t} + \beta_1 RET_{i,t} * NEGRET_{i,t} + \sum \gamma_t + \varepsilon_{i,t} \quad (1)$$

Where:
$OPI_{i,t}$=Operating income firm *i* scaled by market value of equity of firm *i* at the beginning of the fiscal year *t*;
$RET_{i,t}$ = Buy-and-hold return over fiscal year *t* of firm *i* (i.e., $(P_t - P_{t-1})/P_{t-1}$ where P_t is the price of shares for firm *i* at the end of the fiscal year *t* and P_{t-1} is the price of shares for firm *i* at the start of the fiscal year *t*);
$NEGREi_{i,t}$= Indicator variable with firm *i* scored one (1) if RET_t is negative, otherwise firm *i* scored zero (0);$\sum \gamma_t$ = Represent fiscal year indicator variables;
α_k, β_k = Coefficients; and
ε_{jt} = Error term.

To formally test the general hypothesis (GP_{ACE}), *Equations 1* is extended to incorporate intercept and slope coefficients for the interactive effects of an audit committee's effectiveness. Thesemodels are defined in *Equations 2.*

$$OPI_{i,t} = \alpha_0 + \alpha_1 NEGRET_{i,t} + \alpha_2 ACE_{i,t} + \alpha_3 NEGRET_{i,t} * ACE_{i,t} + \beta_0 RET_{i,t} + \beta_1 RET_{i,t} * NEGRET_{i,t} + \beta_2 RET_{i,t} * ACE_{i,t} + \beta_3 RET_{i,t} * NEGRET_{i,t} * ACE_{i,t} + \sum \gamma_t + \varepsilon_{i,t} \quad (2)$$

Where:
$ACE_{i,t}$ = Composite score index where firm *i* in time period *t* is scored one (1) for each of following criteria met: (a) audit committee of firm *i* in time period *t* is comprised solely of non-executive independent directors; (b) at least on of the non-executive independent directors on the audit committee of firm *i*

in time period *t* is suitably qualified and accredited to be deemed a financial accounting expertise (i.e., a degree in accounting and member professional accounting body); and (c) during the time period *t* the audit committee of firm *i* met 3 times or more. If a criteria not met then firm *i* in time period *t* is scored zero (0) for that criteria. The range of the composite score is from zero (0) to three (3);

While, to formally test the general preposition for individual components of audit committee effectiveness (i.e. $GP_{IND,}$ $GP_{EXP,}$ GP_{DIL}), *Equations 2*is extended to incorporate intercept and slope coefficients for the interactive effects of audit committee effectiveness' components. Thesemodels are defined in *Equations 3 –5*:

$$OPI_{i,t} = \alpha_0 + \alpha_1 NEGRET_{i,t} + \alpha_2 IND_{i,t} + \alpha_3 NEGRET_{i,t}*IND_{i,t} + \beta_0 RET_{i,t} + \beta_1 RET_{i,t}*NEGRET_{i,t} + \beta_2 RET_{i,t}*IND_{i,t} + \beta_3 RET_{i,t}*NEGRET_{i,t}*IND_{i,t} + \sum\gamma_t + \varepsilon_{i,t}.; \quad (3)$$

$$OPI_{i,t} = \alpha_0 + \alpha_1 NEGRET_{i,t} + \alpha_2 EXP_{i,t} + \alpha_3 NEGRET_{i,t}*EXP_{i,t} + \beta_0 RET_{i,t} + \beta_1 RET_{i,t}*NEGRET_{i,t} + \beta_2 RET_{i,t}*EXP_{i,t} + \beta_3 RET_{i,t}*NEGRET_{i,t}*EXP_{i,t} + \sum\gamma_t + \varepsilon_{i,t}; \quad (4)$$

$$OPI_{i,t} = \alpha_0 + \alpha_1 NEGRET_{i,t} + \alpha_2 DIL_{i,t} + \alpha_3 NEGRET_{i,t}*DIL_{i,t} + \beta_0 RET_{i,t} + \beta_1 RET_{i,t}*NEGRET_{i,t} + \beta_2 RET_{i,t}*DIL_{i,t} + \beta_3 RET_{i,t}*NEGRET_{i,t}*DIL_{i,t} + \sum\gamma_t + \varepsilon_{i,t}; \quad (5)$$

Where:
$IND_{i,t}$ = a dichotomous indicator variable whereby firm *i* is given a score of one (1) if at the end of time period *t* a majority of the members of the audit committee are classified as independent directors; otherwise, firm *i* is scored zero (0);
$EXP_{i,t}$ = a dichotomous indicator variable whereby firm *i* is given a score of one (1) if at the end of time period *t* at least one member of the audit committee is deemed to have suitable financial expertise; otherwise, firm *i* is scored zero (0); and
$DIL_{i,t}$ = a dichotomous indicator variable whereby firm *i* is given a score of one (1) if during the period *t* the audit committee met five (5) or more times; otherwise, firm *i* is scored zero (0).

See *Equation 1*and *Equation 2* for definitions of other variables.

FINDINGS

As shown in Table 5.1 Column I, the coefficient on $NEGRET_{i,t}$ for regression involving the pooled sample is positive and statistically significant at

conventional levels (i.e. p<0.05). In respect to $RET_{i,t}$, coefficients of this variable for the pooled sample is also positive and statistically significant (i.e. p<0.01). Meanwhile, as for the two-way interaction term $RET_{i,t}$*$NEGRET_{i,t}$, coefficients on this variable is also positive and statistically significant (i.e. p<0.10). This suggests the existence of earnings conservatism (timeliness of earnings) amongst Malaysian publicly listed firms.

It has been proposed earlier that a more effective audit committee (as defined by independence, financial expertise and diligence of sub-committee) is more likely to be able to enhance the quality of reported earnings, thus encouraging greater earnings conservatism. Table 5.1 Column II presents the statistical result for the modified Basu(1997) timeliness model, testing the association of audit committee effectiveness and the timeliness of earnings conservatism. As reported in Table 5.1 Column II, the coefficient on $NEGRET_{i,t}$, $RET_{i,t}$ and $RET_{i,t}$*$NEGRET_{i,t}$ is positive for the pooled sample. However, none of these variables is statistically significant at conventional level. With regards to variable for testing audit committee effectiveness and earnings timeliness, (i.e., $ACE_{i,t}$, $NEGRET_{i,t}$*$ACE_{i,t}$ and $RET_{i,t}$*$ACE_{i,t}$) the coefficients for all three variables are negative and reported statistically insignificant from zero for the pooled sample. Among other variables in the Basu (1997) modified earnings timeliness model,$RET_{i,t}$*$NEGRET_{i,t}$*$ACE_{i,t}$variable is of major interest to this research. However, unlike the expected direction, the coefficient of this variable is shown negative instead of positive sign. Nevertheless, it is also statistically insignificant from zero. Therefore, $GP_{ACE}$is rejected.

Information tabulated in Column III, IV and V relates to empirical analysis testing the association between three individual features of audit committee effectiveness (that made up the associated composite score) and the timeliness of earnings conservatism. The three audit committee attributes are audit committee independence, financial expertise and committee diligence. Based on the results shown in Table 5.1 for individual components of ACE, none of the variables of major interest to this research ($RET_{i,t}$*$NEGRET_{i,t}$*$IND_{,t}$, $RET_{i,t}$*$NEGRET_{i,t}$*$EXP_{,t}$ and$RET_{i,t}$*$NEGRET_{i,t}$*$DIL_{,t}$) shown positive coefficient except for financial expertise component. Moreover, all of these variables are statistically insignificant from zero. Thus, GP_{IND}, GP_{EXP}, $GP_{DIL}$are rejected.

CONCLUSION

In conclusion, this study investigates if Malaysian publicly listed companies with more effective audit committees are more likely to have higher levels of earnings conservatism. Based on agency theory and given the corporate governance reforms undertaken in Malaysia since the Asian financial crisis in 1997, it is expected that audit committee effectiveness will be positively associated with conservatism amongst Malaysian publicly listed companies. Findings from this study will have important implications. It will assist to determine if moves by Malaysian policy-maker to relax rules governing conservatism would have detrimental outcomes if conservatism is considered

to have benefits. Findings however, suggest a lack of association between audit committee effectiveness and the earnings conservatism within the Malaysian capital market setting. Overall, findings provide valuable insights and understanding, not only in respect to the audit committee effectiveness/ earnings conservatism linkage, but the significance of corporate governance and earnings conservatism concepts.

This study is not without limitations. As there is lack of research done using data of emerging or developing countries, this study make a lot of reference from studies using data from developed countries which hypotheses developed are based on. Thus, the generalizations of findings will be problematic. Moreover, definition of audit committee effectiveness is unclear and has no specific definitions. Thus, proxies used might be inaccurate which lead to questionable findings. Time frame of the study is another limitation due to the data availability. As this study is using Malaysian data, findings cannot be readily generalized to other countries.

Table 5.1 Regression analysis of Basu timeliness, $ACE_{i,t}$ and individual components of $ACE_{i,t}$

	Column I: Basu model		Column II: ACE		Column III: Independence		Column IV: Financial expertise		Column V: Diligence	
	B	***t-stat***	***β***	***t-stat***	***β***	***t-stat***	***β***	***t-stat***	***β***	***t-stat***
(Constant)	0.098	3.343	0.034	0.488	0.025	0.670	-0.013	-0.042	-0.006	-0.054
$NEGRET_{i,t}$	0.044	2.234**	0.055	0.629	0.029	0.772	0.084	1.290	0.158	0.734
$RET_{i,t}$	0.061	3.747***	0.096	1.184			0.165	2.747**	-0.104	-0.739
$RET_{i,t}$*$NEGRET_{i,t}$	0.067	1.770*	0.197	1.386						
$ACE_{i,t}$			-0.011	-0.469						
$NEGRET_{i,t}$*$ACE_{i,t}$			-0.006	-0.190						
$RET_{i,t}$*$ACE_{,t}$			-0.013	-0.447						
$RET_{i,t}$*$NEGRET_{i,t}$*$ACE_{i,t}$			-0.058	-0.031						
$IND_{i,t}$					-0.027	-0.826				
$NEGRET_{i,t}$*$IND_{i,t}$					0.011	0.260				
$RET_{i,t}$*$IND_{i,t}$					0.007	0.159				
$RET_{i,t}$*$NEGRET_{i,t}$*$IND_{i,t}$					-0.094	-1.175				
$EXP_{i,t}$							0.018	0.363		
$NEGRET_{i,t}$*$EXP_{i,t}$							-0.043	-0.640		
$RET_{i,t}$*$EXP_{i,t}$							-0.113	-1.809*		
$RET_{i,t}$*$NEGRET_{i,t}$*$EXP_{i,t}$							0.015	0.136		
$DIL_{i,t}$									0.015	0.139
$NEGRET_{i,t}$*$DIL_{i,t}$									-0.117	-0.540
$RET_{i,t}$*$DIL_{i,t}$									0.168	1.190
$RET_{i,t}$*$NEGRET_{i,t}$*$DIL_{i,t}$									-0.261	-0.523
Adjusted R^2	**0.025**		**0.024**		**0.024**		**0.027**		**0.025**	
F-Value	**3.017*** **		**2.465*** **		**2.441*** **		**2.596*** **		**2.496*** **	
N	**938**		**938**		**938**		**938**		**938**	

*,** and ***= significant at the 0.10, 0.05 and 0.01 confidence levels.

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