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Impact of the Amendments of Malaysian Code of Corporate Governance (2007) on Governance of GLCs and Performance

Azmi Hamid, and Rozainun Aziz

Abstract**—**The study aims to investigate the impact on board and audit committee characteristics and firm performance before and after the revision of MCCG (2007) on GLCs over the period 2005-2010. We used Return on Assets (ROA) as a proxy for firm performance. The data consists of two groups; data collected before and after the amendments of MCCG (2007). Findings show that boards of directors with accounting / finance qualifications (BEXP) are statistically significant with performance for period before the amendments. As for audit committee members with accounting or finance qualifications (ACEXP), correlation results indicate a negative association and non-significant results for the years before amendments. However, the years after the amendments show positive relationship with highly significant correlations (1%) to ROA. This indicates that the amendments of MCCG 2007 on the audit committee members' literacy in accounting have impacted the governance structures and performance of GLCs.

Keywords**—**BOD and Audit Committees, firm performance, GLCs.

I. Introduction

GLCs is defined as a company in which the government owns at least 20% of the issued and paid-up capital [1]. The formation of GLCs was carried out progressively through the process of privatization and corporatization beginning 1980s. Many government departments were first privatized and later transformed into separate wholly-owned government companies [2]. The privatization policy was based on two major objectives. First, the policy would speedily achieve the New Economic Policy's (NEP) goal of providing more avenues for bumiputra businessmen to participate in the economic activities. Second, privatization would reduce the government's burden in providing essential services to the public (for example road constructions, health services, energy and power). This would allow the government to have more time and funds to focus efforts on other much more important tasks. Subsequently, many of these privatized companies were corporatized through the issuing of a portion of their shares on Bursa Malaysia. As the government maintained substantial ownership in these companies, these corporatized entities have come to be known as Government-Linked Companies or GLCs. GLCs have a significant impact on the development of the country's economy [3]. It plays an important role in nation building in which they are involve in executing government policies and initiatives in building capabilities and have expertise in the main sectors of the economy [4].

Azmi Hamid is with the Faculty of Accountancy, Mara University of Technology, Malaysia (phone: 603-5544-4974; fax: 603-5544-4921; e-mail: azmi226@ salam.uitm.edu.my).

Rozainun Aziz is with the the Faculty of Accountancy, Mara University of Technology, Malaysia (phone: 603-5544-4920; fax: 603-5544-4921; e-mail: rozainun@ salam.uitm.edu.my).

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Although GLCs have always been given full support and generous benefits from the government such as priority of tenders and government projects, they are still unable to perform well. Several GLCs were involved in fraud and incurred massive losses. For example, the government had to spend a hefty amount of money to get back the control of MAS (Government-owned Airline) due to mismanagement and losses. As such, Malaysia released its first Malaysian Code of Corporate Governance (MCCG) in year 2000 [5]. It was expected that the issuance of the Code would facilitate better corporate governance practices in GLCs. However, even though the Code has been in place for several years, some GLCs still underperformed and incurred massive losses. For example, Sime Darby showed massive losses up to a sum of RM 1.6 billion due to cost overrun in 2006. In addition, based on the Auditor General's Report (2010) [6], 19 GLCs were reported to have positive performance for three consecutive years from 2006 until 2008 but another 11 were reported to have loss a sum of RM 1.49 billion in the same period.

Due to the importance of corporate governance in instilling shareholders' confidence, the MCCG (2007) was revised and amended. The objectives of the amendments were to strengthen the board and audit committee's roles and responsibilities. The amendments emphasized on specific criteria for the appointment of directors and audit committee members including composition and appropriate skills of members and the frequency of meetings. As such, the objective of this study is to ascertain to what extent does the amendments of MCCG (2007) has impacted on the governance structures of GLCs and their firm performance. Although there were many studies on corporate governance in Malaysia, there were no prior studies that have explored the issues on boards and audit committees' characteristics of GLCs in Malaysia for the pre and post amendments of MCCG (2007) [7], [8], [9], [10] and [11] . This empirical study would certainly provide significant impact to corporate governance literature in emerging economy.

II. The Research Objective and Research Questions

The paper attempts:

1) To examine whether the composition of board and audit committee members have any relationship to firm performance before and after the amendments of MCCG (2007).
2) To examine the relationship between financial literacy of board and audit committee members and firm performance before and after the amendments of MCCG (2007).
3) To identify the association of financial expertise of board and audit committee to firm performance before and after the amendments of MCCG (2007).

As such, the research questions are;

1) Does board and audit committee composition give any impact on firm performance before and after the amendments of MCCG (2007)?
1) What are the significance of having board and audit committee members with financial literacy on firm performance before and after the amendments of MCCG (2007)?
2) How do the above factors namely, board composition, financial literacy of board and audit committee members affect firm performance before and after the amendments of MCCG (2007)?

III. Literature Review

A. Audit Committee

The Malaysian Code of Corporate Governance (MCCG) 2000 requires that the composition of audit committee should comprise a minimum of three directors and majority should be independent non-executive directors and at least one member should be financially literate. However, the revised MCCG (2007), it was deliberately pointed out that all the members should be financially literate and comprise of non-executives and majority of whom are independent. The intention is to strengthen the role of audit committees so that they are able to carry out their duties effectively and efficiently. In order to ensure there is a continuous communication with management as well as external auditors, audit committee is given full mandate in monitoring the financial statements and audit process with internal accounting system and control. As such, audit committees play a vital role in monitoring the audit process and financial functions [12]. In general, this committee is needed in ensuring that a company is well-managed and also to protect the stakeholder's interest.

B. Non-Executive/ Outside Director

The Cadbury Report (1992) stated that the monitoring role of non-executive directors is their key responsibility as directors [13]. The Report recommended that there should be at least three non-executive directors be placed on the board of quoted companies. In addition, they are said to be independent because they are not an employee of the company, having no interest in term of shares and therefore can provide greater oversight function and shareholder protection because their interest are aligned with the interest of shareholders and investors [14], [15]. They are able to monitor board decision to ensure that directors implement policies which is consistent with the maximization of shareholders' interest [16]. It was also suggested that high proportion of independent directors have positive relationship with excess return [17]. Similarly, Mark and Kusnadi (2005) discover that higher proportion of independent director on the board is linked to greater firm value.

However, it was also found that there were no differences in the proportion of non-executive directors on the boards of failed and non-failed companies [18]. The reasons behind the negative result were due to the limitations on the effectiveness of non-executive directors as they are only employed on part time basis and they also have other commitment such as act as executive director or non-executive directorship in other companies which make them difficult to fully concentrate their time and effort in order to really understand the needs of the company.

C. Independent Director

Independent directors are those who have no relationship with the company and are not full time employee, family members of employee and company lawyers, bankers and consultant [19]. The roles of independent directors are very crucial, monitoring and controlling the opportunistic behavior of the management as well as evaluating the management more objectivity [20]. The absence of independent directors in board committee will have a tendency for managers to emphasize more in their interest rather than shareholders' interest. Due to this, it explicitly portray that a board of directors which comprise majority of independent directors will make a healthier decision making without having any conflict of interest since they are free from any influence. Majority of the corporate governance reform emphasized the importance of comprising independent directors in forming a balance board of committee.

Various studies had been done to see the relationship between independent non-executive directors and firm's performances showed mixed results. A study done in Belgium companies found that there is a positive relationship between the number of independent directors and return of equity [21]. Other findings also present identical result such as in UK, investors' view the appointment of independent outside directors signifies good news and this is reflected in the announcement period stock returns [22]. Other study also found that the appointment of outside directors is associated with positive abnormal returns among medium size firms [23]. This is because their appointments have no financial or conflict of interest and definitely would protect the interest of shareholders. However, there were also several studies that showed negatives relationship between independent non-executive directors and firm performance. For example, a study done by Agrawal and Knoeber (1996) discovered that there is a negative relationship between board outsiders and firm performance [24]. Bhagat and Black (1999) also found that firms with majority of outside directors perform worse than other firms [25].

D. Financial Literacy

The success of board committees as well as audit committees depends on the expertise of the board members who are financially literate and conversant in financial reporting, internal control and auditing [26]. The reasons are, they are able to thoroughly understand, evaluate and assess the financial statements. Thus, the amended corporate governance code (2007) requires all members of audit committees to be financially literate and at least one should be a member of a professional accounting association. The rationale behind this requirement is to ensure that they are able to effectively perform their function in term of scrutinizing and interpreting financial statements. Boards of directors who have accounting and financial expertise will be more valuable for business organization. Ruzaidah and Takiah (2004) found that the quality of Corporate Annual Report of Bursa Malaysia listed companies is significantly related to certain characteristics of audit committees, particularly financial literacy of the members [27]. It is expected that the audit committee literacy characteristics play an enhanced role in the corporate governance process.

IV. RESEARCH METHODOLOGY

The samples companies in this study consist of 33 Government Link Companies (GLCs) including financial and non-financial companies. All of them are listed on Bursa Malaysia from period 2005 until 2010. As at the end of year 2009, the total listed GLCs on Bursa Malaysia were were 33 GLCs (www.pcg.gov.my). Some GLCs were delisted out during the five year period from 57 GLCs to 33 GLCs (appendix A). However, during the collection period, annual reports for Axiata Group Berhad cannot be collected due to insufficient of information that is required in the study. Thus, only 32 GLCs were utilized for the purpose of this study. The data that will be analyzed consists of two groups. The first group is data collected before the revision of MCCG (2007) for period between 2005 to 2007 and the second group of data is collected after the amendments of MCCG 2007 from period between 2008 until 2010. For the purpose of analyzing, all the data will be processed and analyzed separately between the two groups by using Statistical Package for Social Science (SPSS) version 16.0 software.

A. Variable Measurement

We use return on asset (ROA) as the dependent variable as it could establish a clear relationship between corporate governance and firm performance. ROA is measured by the ratio of net profit or earnings before interest and taxes to the total assets (EBIT/TA). Independent variables in this study are non-executive directors, board independence, audit committee independence, board expertise and audit committee expertise.

V. THEORETICAL PERSPECTIVE ON BOARD INDEPENDENCE, BOARDS' AND AUDIT COMMITTEES' CHARACTERISTICS TO FIRM PERFORMANCE

Corporate governance is of rising importance, principally with regards to the monitoring function of the board of directors (BOD). BOD needs to be independent so as to adequately monitor the CEO and management. As such, much of the research on corporate governance derives from the perspective of agency theory. Since the early work of Berle and Means (1932), corporate governance has focused upon the principal-agent problems arising from the dispersed ownership in modern firms. They viewed corporate governance via board of directors as a mechanism in minimizing the problems brought about by the principal-agent relationship. In this context, agents are the managers, principals are the owners and the board of directors acts as the monitoring mechanism. The separation of ownership from management can lead to managers of firms making decision and action that may not enhance shareholders wealth, but could benefit them. Hence a monitoring mechanism is required to protect shareholder interests [14].

On the other hand, stewardship theory presents different outlook on management, where managers are considered good stewards who will act in the best interest of the shareholders [29]. The essentials of stewardship theory are based on social psychology, which focuses on the behavior of management in attaining personal satisfaction. Stewardship theory sees a strong relationship between managers' interests and the achievement of their firm, and therefore they act to protect and maximise shareholders' wealth. Therefore, monitoring and accountability of corporations can be enhanced by the adoption of good corporate governance principles and practices.

Apparently, to improve the good practices of corporate governance in Malaysia, the amendments of the MCCG (2007) were carried out by the regulatory agencies and Federation of Public Listed Companies (FPLC). The objective is to strengthen the corporate governance structures of Public Listed Companies (PLCs). Previous literature has proved that the boards' independence has an impact on the firms' financial performance. With regards to the emphasize on the audit committee members' knowledge of accounting and finance, it was specifically spelt out in the MCCG 2007 amendments that not only at least one member should be an accountant, but all the other members of the audit committees should be financially literate. They must be able to read, understand and analyze financial statements. The skills and knowledge in these areas would enhance their ability to carry out their monitoring oversight on management's activities and also for them to work effortlessly with internal and external auditors. Fig. 1 shows the theoretical framework on boards' independence; boards' and audit committees' expertise and accounting skills to firm performance.

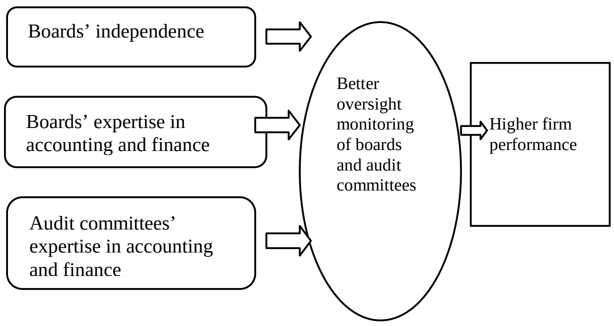

Fig. 1 Theoretical framework on boards' independence; boards' and audit committees' expertise and accounting skills to firm performance

VI. Hypothesis Development

The hypotheses in this study are developed based on the objective of study. The first objective is to examine the composition of board and audit committee members and its relationships to firm performance. Hence, the three hypotheses are as follows:

H1: There is a significant relationship between percentage of independent directors and firm performance in GLCs before and after the amendments of MCCG 2007

H2: There is a significant relationship between expertise of board members and firm performance in GLCs before and after the amendments of MCCG 2007.

H3: There is a significant relationship between expertise of audit committee members and firm performance in GLCs before and after the amendments of MCCG 2007.

VII. Results and Discussions

A. Board Variables

TABLE I reports the statistical average result of Board's Independent Directors (BIND) and Board's Expertise (BEXP) for all companies for the years of pre and post amendments of MCCG 2007.

TABLE I
Average Percentage of Bind and BEXP for Period, Pre and Post Amendments of MCCG 2007

Group	BIND (%)	BEXP (%)
Pre revised MCCG 2007	.4627	.3275
Post revised MCCG 2007	.5016	.3559

TABLE I shows that there is a higher percentage of average BIND during the years after the revision of MCCG (2007) which is around 50%. This indicates that there is a big impact of the amended MCCG Code 2007 on composition of independent directors in GLCs. However, there is a negligible increase of only 2.84% in the average BEXP from the years before the revised MCCG (2007) until the years after the amendments of MCCG (2007).

B. Audit Committee Expertise

TABLE II reports the statistical result average Audit Committee Expertise (ACEXP) for all companies for the years of pre and post amendments of MCCG (2007). ACEXP stands for audit committee member who has accounting and finance knowledge.

TABLE II
Average ACEXP For Period, Pre and Post Amendments of MCCG 2007

Periods	ACEXP %
Pre revised MCCG 2007	38.81%
Post revised MCCG 2007	49.59%

During the pre revision year of MCCG (2007) from year 2005 to 2007, statistical results show that the average ACEXP is 39% and 50% respectively for pre and after amendments of MCCG (2007) respectively. It shows a drastic increase for period after the amendments of MCCG (2007) by around 10% differences. The overall results show that in the years after the amendments of MCCG (2007), most companies have followed the recommendation made in the Revised Code. For example, suggestion to increase the number of audit committee members who have accounting and financial background has increased, and this clearly shows that GLCs have followed the recommendation in the amended MCCG Code 2007.

C. Univariate Analyses Board variables to ROA

TABLE III reports the correlation average Board's Independent Directors (BIND) and Board's Expertise (BEXP) and ROA which proxy for firm performance.

TABLE III
Correlation between Average BIND, BEXP And ROA

	BIND	BEXP
Pre revised MCCG 2007	-.046	-.412***
Post revised MCCG 2007	.149	-.125

*** Significant at 1%-level (2-tailed) ** Significant at 5%-level (2 tailed)

Average BIND and ROA show inconsistencies in the direction where correlation results indicate a negative relationship for the years before amendments of MCCG (2007). Whereas, the years after the amendments, show positive correlation. However, both groups are not statistically significant. Hence, hypothesis 2 is rejected. The correlation between average BEXP and ROA show that before and after the amendments of MCCG 2007 have the same direction of correlations with negative relationship. This indicated that less number of directors who has accounting and finance background could contribute to higher performance of company as well as ROA. Nevertheless, the years before the amendments of MCCG (2007) shows significant correlation between BEXP and ROA. Therefore, hypothesis 3 is supported only in the years before the amendments of MCCG 2007.

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D. Audit Committee Variables to ROA

TABLE IV reports the correlation average Audit Committee Expertise (ACEXP) and ROA in all companies groups pre and post revised MCCG 2007.

TABLE IV
CORRELATION BETWEEN AVERAGE ACEXP AND ROA

	ACEXP
Pre revised MCCG 2007	-.069
Post revised MCCG 2007	.416***

*** Significant at 1%-level (2-tailed) ** Significant at 5%-level (2 tailed)* significant at 10%-level (2-tailed)

The correlation between ACEXP and ROA for the years before and after the amendments of MCCG (2007) shows inconsistency in direction. Correlation results indicate that there is a negative association and non-significant for the years before amendments. Meanwhile, for the years after the amendments shows positive relationship and highly significant correlations (1%) between average ACEXP and ROA. Therefore, the hypothesis is supported only for the years after the amendments of MCCG (2007). This indicates that GLCs followed the recommendation of having more audit committee members with financial literacy and this resulted in better firm performance.

E. Regression Analysis

This section discusses the results of regression analysis relationships between board, audit committee characteristics and firm performance in GLCs for the periods, before amendments and after the amendments of MCCG (2007). Normally, to ensure regression model is able to operationalize and to ensure the results are reliable, there are certain assumption that needs to be met such as 1) no existence of multicolinearity issues and 2) data are normality distributed. All these assumptions are met in this study.

TABLE V
REGRESSION RESULT FOR THE RELATIONSHIP BETWEEN ALL INDEPENDENT VARIABLES AND DEPENDENT VARIABLES

Variables	Pre Revised MCCG 2007		Post Revised MCCG 2007	
	Coefficient (t-test)	P-value	Coefficient (t-test)	P-value
BIND	.221	.826	2.314	.023
BEXP	-3.535	.001 **	-1.876	.064
ACEXP	1.204	.232	4.787	.000 ***
R-Square	26%		27.5%	
Adjusted R-Squared	20.1%		21.7%	
F-Statistics	4.411 (.000**)		4.762 (.000***)	

TABLE V reports the R-square and adjusted R-squared for the two periods, before and after the amendments of MCCG (2007). Based on the rule of thumb, if R-square and adjusted R-square is near to 1, it will show that all variation in the dependent factor can be explained by the independent variables. On the other hand, if the result is close to 0, it indicates that the regression model could not explain the variation in the dependent variables [28]. The results show that, R-squared and adjusted R-squared are less satisfactory for both groups, both pre and post amendments. Nevertheless, R-squared and adjusted R-squared show an improvement and better results after the amendments.

The F-value is used to see whether the whole regression model has significant results and regression sum of squares is huge. From the table, the F-values for the models, the year's pre and post amendments are 4.411 and 4.762 respectively and indicate fairly well, even though it is just slightly higher F-value for the model after the amendments. Next, the P-value indicates the regression model's significant level. If P-value is greater than 10% confident level, it shows a weak prediction of the model. In other word, independent variables do not consistently forecast towards dependent variables. Overall regression results show that both models, pre and post amendments are considered as satisfactory models with statistically significant result. As such, the model's post amendments of MCCG (2007) outperform the pre-amendments MCCG (2007) model.

F. Audit Committee Variables to Performance

For the period before the amendments of MCCG (2007), all audit committee variables show positive direction and no statistically significant relationship to the performance except ACMEET reports negative link and less significant at 10% level. Meanwhile for the pre amendments' model, it signifies that all audit committee variables have negative and no significant relationship to performance except for ACEXP where there is a positive and statistically significant at 1% level. As a conclusion, ACMEET and ACEXP are variables which the most influencing variables for the regression models, pre and post amendments of MCCG (2007) respectively.

VIII. CONCLUSION AND RECOMMENDATION

The main objective of this study is to examine the relationship between board, audit committee characteristics i.e. independent directors, board financial expertise, audit committee financial expertise, with firm performance in GLCs. Statistical results signify that only BEXP support the hypotheses and show significant negative relationship with performance before the revised MCCG (2007). Meanwhile, ACEXP support the hypothesis after the amendments of MCCG (2007). Result of ACEXP shows that there is a significant positive correlation with performance. After the revised of MCCG (2007), the level of performance is being influenced by the existence of more audit committee members with accounting and financial background. This is in line with the MCCG (2007) suggestion that all members should be able to analyze and read financial statement so that they are able to monitor company financial situation aligned with their functions.

Based on the regression analysis, regression model after the amendments of MCCG (2007) is slightly better than the regression model before the amendments. As such, it shows an improvement after the revision of MCCG (2007). Consequently, recommendations made in revision of MCCG (2007) show effective result based on this analysis. Future study could add more variables on corporate governance structures such as government ownership in GLCs and multiple directorships of boards' members. Besides that, there are many issues including the interference from government and politician in GLCs' policy and decision making. Future research could be conducted and these variables tested in a more comprehensive way.

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