The Journal of Social Sciences Research
ISSN(e): 2411-9458, ISSN(p): 2413-6670
Special Issue. 6, pp: 951-957, 2018
URL: https://arpgweb.com/journal/journal/7/special_issue
DOI: https://doi.org/10.32861/jssr.spi6.951.957

Academic Research Publishing Group

Original Research Open Access

Board of Directors, Audit Committee and the Financial Performance of Listed Companies in Malaysia

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Abstract

The purpose of this study is to examine the relationships between selected components of corporate governance and financial performance of listed companies in Bursa Malaysia. In this study, the most critical components of corporate governance including board independence, board size, board expertise, audit committee size, audit committee independence, and audit committee expertise, have been examined as the independent variables that influence the financial performance of companies listed on Bursa Malaysia. This study used a sample of 150 non-financial listed companies in Malaysia. This study differs than previous studies that separately study the effect of either the board characteristics or the audit committee characteristics. This study concerns on the combined effect of both, board of directors and audit committee, about return on equity. The study is based on companies' data for the year 2014. Regression analysis is conducted using Statistical Package for Social Science Version 22 (SPSS 22), and the outcomes of this study show significant and positive relationships between all the independent variables and financial performance of companies listed on Bursa Malaysia. The study ended up with positive suggestions based on the limitations that have been faced while conducting this study.

Keywords: Corporate governance; Board Characteristics; Audit Committee Characteristics; Firm Performance..

1. Introduction

In the last decade, the world has witnessed several financial scandals and corporate collapses. Thus, corporate governance has gained a significant concern in the corporate sector. Researchers, academicians, and practitioners also show a significant concern about these events. Financial crisis of Asia in the past years has affected several countries and Malaysia was not far from this crisis. Major corporate frauds were in Malaysia including Bank Bumiputra, Perwaja Steel, and Bank Islam (Haniffa and Cooke, 2002); (Alarussi *et al.*, 2009); (Puthenpurackal and Upadhyay, 2013). The government of Malaysia started paying attention to corporate governance in 1993, and since that year, Malaysian government made compulsion of all listed companies to have an Audit Committee. In March 2002, a major initiative was taken when Malaysian Code of Corporate Governance (MCCG) was implemented (Haniffa and Hudaib, 2006); likewise, in 2001, when the government set up Minority Shareholders Watchdog Group (MSWG) (Ameer and Rahman, 2009). Later, for more improvement, in 2007 and 2012, the government revised versions of the code of corporate governance that were issued. The key aim of implementing MCCG was to toughen the role of the board of directors as well as audit committee by increasing their accountabilities (Saad, 2010).

Previous studies highlighted that board characteristics have a significant impact on performance (Johl *et al.*, 2015; Shukeri *et al.*, 2012). On the other hand, certain studies identified that audit committee has a significant impact on performance (Aldamen *et al.*, 2012; Puasa *et al.*, 2014). The impact of board characteristics and audit committee characteristics has already been analysed but independently. However, there is a gap in the body of knowledge whether this significant impact remains the same if both (board of directors and audit committee) are examined collectively.

Therefore, this study combines the two to identify the significant factors among them as in reality; audit committee is a part of the board of directors. Thus, it would be right to say that boards of directors have a substantial role in protecting the rights of the shareholders (Shukeri *et al.*, 2012). Similarly, audit committee protects the rights of the shareholders (Aldamen *et al.*, 2012).

Considering the importance of board of directors and audit committee in refining the performance of listed companies of Bursa Malaysia (Johl *et al.*, 2015; Puasa *et al.*, 2014); the current study aims to give an empirical evidence regarding the impact of selected components of corporate governance like board size, board independence, board expertise, audit committee size, audit committee independence, and audit committee expertise, on financial performance of companies listed on Bursa Malaysia. Therefore, it is expected that this study will bring a new approach for academicians on the importance of estimating board of directors and audit committee on the performance of companies listed on Bursa Malaysia. The remainder of the paper is organised as follows: The next section discusses the relevant literature on issues about corporate governance components and the role of board monitoring together with audit committee which lead to the development of hypotheses. The third section explains

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the research method followed by a discussion of the results in section four. The paper ends with the conclusion of the study.

2. Literature Review

The literature on corporate governance is very vast. Many scholars have conducted research on the relationship between corporate governance practices and corporate performance (Haniffa and Cooke, 2002; Puthenpurackal and Upadhyay, 2013; Shukeri *et al.*, 2012). Corporate governance has gained vital importance worldwide particularly after big corporate collapses. Board of directors plays an important role in corporate governance (Haniffa and Hudaib, 2006). In corporate governance, the board of directors form committees (Peters and Romi, 2015); and audit committee is among these committees which is measured as the most important committee.

Board of directors is responsible for monitoring, maintaining discipline, and removing ineffectiveness in the organisation (Baber *et al.*, 2012). If the board of directors are under any influence, then it will be difficult for them to perform their responsibilities. Therefore, it is considered that independent board of directors are fundamental to have a high-performance board. Independent directors at times have the least interest in the company, at the same time when the board size is enormous then there are chances that decision making may become difficult.

Large board size is closely linked with a large number of outside directors (Bai, 2013). It is argued that independent board should be free from commercial or personal ties (Kim *et al.*, 2014). Therefore, outside directors being free from influence are considered the best for the board.

Along with independence, the large size of the board is also important because more brains can produce better results, but beside their importance and advantages, there are some disadvantages. In general, it is difficult to determine the ideal size for the board. The studies on board size as an indicator of the performance of the companies have different arguments. Several researchers revealed that larger board size is good for the financial performance of the company (Li *et al.*, 2012). It is argued that in companies with a small board, the performance of CEO is better as compared to those with a large board size. Likewise, researchers have also shown an unfruitful effect of board size on the performance of companies (Haniffa and Cooke, 2002). Therefore, there are studies for the large and independent board (Bai, 2013); at the same time, several researchers argued that there be an adverse effect of independent directors and large board size. Also, few studies claim that independent or non-independent board has no impact on performance of the company.

Another important aspect besides board size and board independence is the expertise of board of directors. It is argued that board of directors should have the competence to deal with ambiguous situations. Board of directors can only perform well if they have good knowledge of accounting, finance and auditing. Therefore, the board expertise is also a vital feature of the corporate governance and have the responsibility of board performance, and consequently the performance of the company (Abidin *et al.*, 2009).

The corporate scandals in Malaysia have given rise to the need for financial and accounting expertise of the board of directors. This will ensure higher accountability by the board of directors. The qualitative study conducted by Wan and Armstrong (2011) highlighted that board expertise are essential for getting the better financial performance of the companies. Knowledge of accounting and finance helps the board of directors in having an oversight on the performance of management for the best interest of the company.

Therefore, it would be right to say that there are three major components of the board of directors; independence, size and expertise. For independence, non-executive directors are important. For size, sufficient members of the board are necessary whereas for expertise, the diversified board is important. In line with that when non-executive directors are considered, it is also argued that non-executive directors have an only part-time commitment with the company, non-executive independent directors may have the deficiency of expertise required for better understanding of technicalities of the company. This problem may occur especially in developing countries (Aguilera and Jackson, 2010). The addition of non-executive directors may only be because of legal requirements which may have an adverse effect on the performance of the company. However, contrary to this, several researchers argued that independent non-executive directors usually have a positive effect on the performance of the company (Chen and Jaggi, 2001).

Another important pillar of corporate governance is audit committee. In audit committee, there are three important things which have supreme importance. The foremost is audit committee independence, the next is audit committee size, and the third one is audit committee expertise. The audit committee is considered as a significant component which has a significant effect on the financial performance of the companies (Aldamen *et al.*, 2012). Therefore, all the three variables are important for the effective performance of audit committee and as a result good financial performance of the companies.

Audit committee independence has been discussed by several researchers. Audit committee independence is considered crucial for the effective performance of audit committee (Baber *et al.*, 2012). It has become a major concern among academicians and practitioners. Audit committee to produce unbiased results can only perform if it is independent of any influence (Klein, 2002). The level of integrity in the financial statements can be improved by increasing the number of independent directors (Aldamen *et al.*, 2012).

An independent audit committee is more likely to conduct effective monitoring on the management. Several researchers have argued that there be a positive relationship between audit committee independence and financial performance of companies. Audit committee independence, in somehow, depends on the size of the audit committee; the larger the size of the audit committee, the greater are the chances to have independent directors (Xiea *et al.*, 2003). Audit committee size ensures that audit committee has a unique importance in the board (Xiea *et al.*, 2003). There is a strong positive relationship between audit committee size and performance of audit committee

(McMullen, 1996); the larger size, the better performance of audit committee. Larger audit committee usually has better monitoring which is the main function of an audit committee. Therefore, there is no harm in saying that audit committee size has a positive influence on the financial performance of the companies (DeZoort *et al.*, 2002). Larger size increases the number of meetings which ultimately improves performance by reducing the chances of errors and frauds. However, if the audit committee becomes too large, then it may suffer because of diffusion of responsibilities.

Independence and size both become immaterial if the members do not have required expertise. The members of the audit committee must be independent so that they may not be under any influence but they can only detect frauds and errors if they have financial, accounting and auditing expertise. It is imperative that the members of the audit committee must have the skills to correctly comprehend and deduce the financial information. Theoretically, the financial accounting expertise is required for audit committee members (Saleh *et al.*, 2007). This is important if the corporation wants to convey the correct financial information to the shareholders. It is also crucial to reduce the agency cost. This expertise improves the effectiveness of the audit committee. If the audit committee members do not have accounting sophistication, they cannot fulfil the responsibilities that are expected from them. The expertise of members of the audit committee is the most important dimension of audit committee quality for enhancing internal control mechanism.

Therefore, for an audit committee to be operative in an important way, the majority of the members of the audit committee should be independent and should have proper knowledge of accounting and finance. If they are independent but lack financial accounting expertise, they cannot fulfil the responsibilities. Likewise, if they are expert but are under the influence, then they cannot perform well. Agency theory is the main theory that sustains the argument built in this study. According to agency theory management is self-interested. Therefore, more independent directors on the corporate board can resolve the issue of agency cost. Secondly, resource dependency theory sustains the argument that if the board members and the audit committee members have required knowledge of financial accounting, they can perform well. In short, this study is built on the combined approach of agency theory and resource dependency theory (Zajac, 2013). Based on the literature reviewed and the theories that support the argument in the study that board independence, board size, board expertise, audit committee independence, audit committee size, audit committee independence, and audit committee expertise may have a far-reaching effect on the financial performance of the companies. Therefore, the hypotheses drawn are as follows:

H_{a1}: There is a positive relationship between board independence and financial performance of companies.

H_{a2}: There is a positive relationship between board size and financial performance of companies.

H_{a3}: There is a positive relationship between board expertise and financial performance of companies.

H_{a4}:There is a positive relationship between audit committee independence and financial performance of companies.

H_{a5}: There is a positive relationship between the size of the audit committee and financial performance of companies.

H_{a6}: There is a positive relationship between audit committee expertise and financial performance of companies.

3. Research Methodology

The scope of the current study is to non-financial companies listed on Bursa Malaysia. The data of 150 non-financial companies have been taken. As the study is cross-sectional, year 2014 has been taken because the financial data of 2015 for several companies was not available at the time of the study. Return on Equity (ROE) can be defined as the rate of return on equity of the shareholders. It indicates how sound the company utilise the shareholders' investment to make more profits. This captures the efficiency of making more profits from the equity of the shareholders. Higher ratio signifies a higher return. ROE can be calculated using the following formula:

$$\text{ROE}=\frac{Profit\ after\ tax}{Shareholders'\ funds}$$

Board Composition /Independence: A widely used approach to operationalizing the board structure of non-executive directors to overall directors (Kiel and Nicholson, 2003; Laing and Weir, 1999; Leng, 2004; Nahar, 2004). Furthermore, Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) indicated that boards with a higher proportion of external directors are associated with positive firm performance. It is based on the assumption that a higher proportion of non-executive directors in the board will enhance independent decision making. This leads to improved performance which is in line with agency perspective theory. To make sure the board of directors are effective, the principle A 5.2 code of best practices on corporate governance and Cadbury code issue by ICASL in 2003 and 2008 recommended that non-executive directors should not be less than two or not less than one-third of the board, which is higher. In case the same person holds the position of CEO and chairman, it is highly suggested that non-executives should include the majority of the board.

Board size: We incorporate board size as a variable to measure the impact of corporate practices and firm performance. It is accepted that firm and board size are correlated (Dalton *et al.*, 1999; Yermack, 1996) and simultaneously board size is interrelated to firm performance (Kiel and Nicholson, 2003). Using agency viewpoint, bigger companies require bigger boards to control and monitor the actions of the managements (Kiel and Nicholson, 2003). As recommended by agency theorist (Jensen, 1993), a limit should be set which is to around eight directors while Lipton and Lorsch (1992) indicated that the maximum size of the board should revolve around ten members, In another recommendation, they assumed that the board size is not that important rather the number of external directors (Dalton *et al.*, 1999). Thus, this variable can be computed using the total number of directors (Kiel and Nicholson, 2003; Nahar, 2004).

Audit Committee: This refers to the importance of audit committee in enhancing the quality of financial reporting. Stakeholders believe that better quality in financial reporting might improve market performance. Over the years, the role of the audit committee has grown and has also progressed well. This involved re-defined from a voluntary monitoring mechanism employed in high agency cost conditions to improve the quality of information flows to shareholders. It is now regarded to as a significant component which involves oversight function and the focus of increased public and regulatory curiosity. The current function of the audit committee is to oversee the accounting, financial reporting procedures of the company and audit (Sarbanes-Oxley Act 2002, Section2). The implied prospects are that a suitably qualified and dedicated independent audit committee acts as a dependable guardian of the public interest (Abbott, 2002); (Alarussi *et al.*, 2011).

Audit Committee Independence: Under this category, we measured the independence of the audit committee by the proportion of the independent directors over the total number of directors sitting in an audit committee. The word ''independent directors'' is usually used interchangeably with the term '' non-executive director'' we can say not all non-executive directors are independent.

Audit Committee Financial Expertise: The last category of an audit features that might affect the performance relates to the financial expertise which comprises of education and experience. Current research indicates that accounting expertise within the boards that are branded by strong governance to greater monitoring by the audit committee and leads to improve conservatism. The performance has been measured by measuring Return on Equity (ROE) which is an actual determinant of financial performance of the company. To find the impact on the dependent variable, the independent variables are Board Independence (BIND), Board Size (BZISE), Accounting Expertise of Board of Directors (BEXP), Audit Committee Independence (ACIND), Audit Committee Size (ACZISE) and Audit Committee Financial Expertise (ACEXP), which seems to have a substantial effect on the financial performance of the companies listed on Bursa Malaysia. However, following model has been developed to analyse the impact of board independence, board size, accounting expertise of board of directors, audit committee independence, audit committee size, and audit committee financial expertise on the financial performance of companies measured by return on equity:

$$ROE=\beta 0+\beta BSIZ+\beta BIND+\beta BEXP+\beta ACZISE+\beta ACIND+\beta ACEXP+Uit \qquad (1)$$

Where,

Y represents a return on equity. β0 shows the constant,

β is the coefficient of the independent variables (board characteristics, audit committee characteristics),

µit is the error term.

ROE= Return on Equity

β0= Constant

βBIND = Board size

βBIND = Board Independence

βBEXP= Accounting Expertise of Board of Directors

βACZISE = Audit Committee Size

βACIND = Audit Committee Independence

βACEXP = Audit Committee Financial Expertise

Uit =Error Term

We will proceed to run our model using ordinary least square (OLS) regression as suggested in the literature.

4. Data Analysis

In this study, initially the descriptive have been found to ensure that the data is normal, the results of the data analysis show that the descriptive statistics are in the range of normal values. The descriptive results of the data are mentioned in Table 1.

Table-1. Descriptive Statistics

	Mean	**Standard Deviation**	**Skewness Statistic**	**Kurtosis Statistic**
Return on Equity	5.356	3.658	1.258	5.358
Board Size	8.227	1.967	.564	.151
Board Independence	0.466	0.119	.788	.498
Board Expertise	0.327	0.149	.789	.834
Audit Committee Size	3.467	0.739	1.634	2.279
Audit Committee Independence	0.852	0.163	.550	.632
Audit Committee Expertise	0.386	0.209	.384	.503
Valid N (list wise)				

Table 1 presents the descriptive summary of our sample firms regarding board characteristics and firm performance. The mean and standard deviation of return on equity are from 5.356 to 3.658. Audit committee size, audit committee independence and audit committee expertise indicate a mean of 3.467, 0.852 and 0.386 while the standard deviation ranges from 0.739, 0.163 and 0.209 respectively. Also, on the other hand, board size, board independence and board expertise recorded a mean 8.227, 0.4666 and 0.327 respectively while the standard deviation recorded 1.967, 0.119 and 0.149 respectively.

After ensuring that the data is normal and is ready for further analysis, regression analysis was conducted by using SPSS 22. The tests that are used to check the issues of autocorrelation, multicollinearity, the goodness of fit, explained variation and have also been conducted along with the regression analysis. The problem of autocorrelation is detected with Durbin-Watson, for which the reference values is 2.011. For multicollinearity VIF is calculated, the result of VIF below 10 is considered as good because the VIF result is below 5. The result of the data is under the threshold level. F test shows the goodness of fit of the data (see Table 2). If the value of F test is above five the model is considered as a good fit, the calculated value is above 5 so the model is considered as a good fit. Others are the beta values that show the slope and nature of the relationship. If the t statistics are above 1.96, the variable is considered to have a significant impact on the dependent variable (Bryman and Bell, 2015).

In the regression analysis, all the variables are significant which shows that all the variables taken in the study have a significant impact on the dependent variable. Furthermore, the value of r square shows explained variation means the extent to which the independent variables are capable of expressing return on equity. Here, the calculated value is 0.31 which shows that 31% change in return on equity is because of board independence, board size, accounting expertise of board of directors, audit committee independence, audit committee size, and audit committee financial expertise. The statistics are mentioned in the table below. The model is statistically fit and significant with the given significance level of F-statistics denoting 0.000, and therefore we cannot reject the alternative hypothesis. It signifies that variables used in the regression can joint predict the financial performance in the context of Malaysia companies. A one-unit increase in board size will lead to an increase in return on equity by 0.275. Large board size will lead to improvement in decision making.

One unit increase in the board independent will lead to an increase in return on equity by 0. 44. This indicates that once the board is independent, the performance of firm will tend to increase due to the fact the monitoring effectiveness of the board will be enhanced. One unit increase in the board expertise will lead to an increase in the return on equity by 0.030. This denotes that audit committee expertise regarding specialisation will improve the financial oversight functions of the Board determining whether the accounting standards and accounting policies have applied consistently by the management. The larger the audit committee size, the higher the performance of the company.

Similarly, audit committee independence was found to be positive, and statistically, significance denoting that one-unit increase in audit committee independence will lead to an increase in the return on equity.

Table-2. Summary of Regression Analysis

Predictors	Nature of Relationship	Beta Values	t-statistics	VIF
BSIZ	+	.275	2.803 ***	1.121
BIND	+	.044	2.492***	1.224
BEXP	+	.030	2.328**	1.292
ACZISE	+	.208	2.452**	1.100
ACIND	+	.129	1.974**	1.191
ACEXP	+	.108	1.984**	1.334
Constant				
ANOVA		0.000		
Durbin-Watson		2.011		
Std. Error		10.87		
F Statistics		6.735		
Significance level of F		0.000		
R2		0.31		
Adjust R2		0.30		

*** represent significance level at 1%
** represent significance level at 5%
* represent significance level at 10%.

5. Conclusions

The aim of this study was to investigate the effect of board independence, board size, accounting expertise of board of directors, audit committee independence, audit committee size, and audit committee financial expertise on return on equity. The calculated values of the statistical analysis have been drawn from the data gathered from the annual reports of 150 companies listed on Bursa Malaysia. The results have shown that board independence, board size, accounting expertise of board of directors, audit committee independence, audit committee size, and audit committee financial expertise have a significant and positive impact on the return on equity. Therefore, larger the board sizes with majority of the independent directors have a fruitful effect on financial performance of the companies listed on Bursa Malaysia

This study adds significant contributions in research and practice; in research, the study fills the gap and empirically provides evidence that the characteristics of the board of directors and audit committee combining have a positive effect on the financial performance of companies listed in Malaysia. The results also theoretically support the agency theory and resource dependency theory. In practice, it is known now that shareholders should give more consideration to both boards of directors and audit committee to get better financial performance, regulators may also consider the results of this study to enhance individually the financial performance of companies, which will boost the economy for the whole country.

Even though the model is a good fit, this study has certain limitations. Initially, this study has not focused on all the companies. Secondly, the financial performance has been measured by only one variable i.e. return on equity; there are other ways of measuring financial performance as well. In future studies, the authors may identify other measures for estimating the financial performance of the companies.

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