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CONTENTS

The Relationship between Audit Committee, Political Influence and Financial Reporting Quality: Malaysian Evidence

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ABSTRACT

This paper examines the relationship between audit committee, political influence and financial reporting quality of Malaysian listed companies. This study consists of pool data of 3,215 firm-year observations listed on the Main Board of Bursa Malaysia from year 2010 to 2014. The study uses logistic regression to test the association between audit committee, political influence and financial reporting quality. The results are also robust with the inclusion of Firth logit analysis. The current findings indicate that audit committee's independence and the frequency of audit committee meetings are effective in controlling for both real earnings management and accounting misstatements. Nonetheless, in terms of audit committee size and audit committee' audit expertise, the relationships are still insignificant. It is important to note that there is some improvement after the corporate governance reforms in 2010 since studies prior to the reforms found audit committee's variables are ineffective towards a higher quality of financial reporting. Meanwhile, political influence is still relevant in a Malaysian business environment with regard to financial reporting quality, however, the aggressiveness of the influence may have been diluted by the improvement of recent corporate governance reform.

Keywords: *Financial Reporting Quality, Political Influence, Audit Committee, Earnings Management, Accounting Misstatement, Corporate Governance*

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INTRODUCTION

The erosion of financial reporting quality is often associated with significant accounting irregularities and manipulations such as earnings management, accounting misstatements, and fraudulent financial reporting (Boon, Tze & Lau 2017; Abdul Rahman, et al., 2016). These financial accounting irregularities are perceived to be related to managerial opportunism. Earnings management occurs when financial figures are manipulated within the accounting framework – Generally Accepted Accounting Principles (GAAP) and is often described as the practice of "bending the rules". Compliance with the GAAP is a criterion for differentiating types of accounting irregularities (Stolowy & Breton, 2003). However, when figures are severely manipulated by which rules have been broken, the GAAP are violated. The violation of GAAP may constitute both unintentional (accounting errors) and intentional (fraud) misstatement (Dechow, Ge & Schrand, 2010).

Earnings management occurs when the management has the discretion to exploit the accounting choices that would alter the reported earnings and falsify the true economic performance of the firm with the intention to deceive the stakeholders. Meanwhile, accounting misstatements are initially an earnings management, which often happens when the firm underperforms, this cover-up would eventually go down a "slippery slope," resulting in layers of accounting manipulation leading to accounting misstatement. Accounting misstatement would have resulted in a financial restatement, which is the correction of any non-compliance with the GAAP in terms of recognition, measurement and disclosure in the financial statement that have been issued previously (European Commission, 2009: 2011; Abdullah et al., 2010; Efendi et al., 2007; Palmrose, Richardson & Scholz, 2004).

The consequences for the accounting misstatement would have caused a series of severe penalties for the individual firms, particularly when the restatement embroils in an income-decreasing manipulation scheme and past performance of those firms are relatively far worse off (Rotenstein, 2011). The disclosure of accounting misstatements or restatements would usually be followed by a rapid decline of the firms' market value (Dechow, Sloan, & Sweeney, 1996). They argued that since investors perceived the firms have been overvalued, thus the announcement of restatement will help to adjust the firm's share price accordingly (Dechow et al., 1996). Furthermore, stakeholders such as the investors and the regulatory bodies may even pursue with the necessary legal action (Rotenstein, 2011; Zhizhong et al., 2011; Cornil, 2009; GAO, 2006; Palmrose et al., 2004).

To date, accounting misstatement is still an issue that is ignored and disregarded both by the firms and the public in Malaysia. Suspected firms are only required to issue a restatement of the financial statements (especially when the misstatements have been proven as not fraudulent). Meanwhile, individual wrongdoers (directors, managers, and other employees of the firm) would be prosecuted separately, mostly receiving inadequate punishment or penalties. Perols and Lougee (2011) suggested that firms with a history of managing earnings are more predisposed to commit fraud. Prior studies have shown that managers use their discretion to manipulate accounting numbers for both opportunistic and informative purposes. Merely adopting several rigorous and detailed framework of international accounting and auditing standards does not prove the assurance that financial reporting is free from errors, mistakes and manipulation (Pornupatham, 2006). As such, the issue of financial misreporting has attracted the attention of regulators, academics and collectively the informed investors.

The prospective view that corporate governance would enhance the efficiency of contracts and mitigate opportunistic accounting method choice has driven strings of accounting research in the corporate governance literature. However, existing literature have yet to consider the impression of political influence over the corporate governance framework, and financial reporting quality (proxy by earnings management and accounting misstatement) and its implications in a single study. Therefore, the objective of the study is to examine the relationship of audit committee traits (such as size, independence, frequency of meetings and audit expertise), political influence and financial reporting quality. Specifically, this study highlights the efficiency of audit committee of Malaysian firms in preventing possible opportunistic behaviour while improving the appropriate accounting choices and oversees the financial reporting quality.

LITERATURE REVIEW

Conflict of interest, temptations, self-validation and opportunity induce managerial opportunism. Ambiguities of accounting standards and framework as well as real-time operational manipulations offer greater managerial discretions (A. Rahman, et al., 2016; Tsitinidis & Duru, 2013) and would encourage managerial opportunism. Managerial opportunism ensues due to the conflict of interest between managers and shareholders where managers would preside the wealth transfer to themselves as the opportunity arise. Consistent with the agency theory, managers would have the advantage of having inside information thus creating information asymmetry with the shareholders. Thus, creating opportunities for the managers to take advantage over the information asymmetry, engaging in self-interest activities which would be detrimental to the shareholders' interest (Godfrey, Hodgson & Holmes, 2003). Among the moral hazard problems that are prevalent in the principal-agent relationship is the deception and misappropriation of fund. Inevitably, earnings being among the measure of operational performance of a company is subjected to the threat managers' moral hazard problem which would result in financial misreporting.

With different focus, the alignment of interests of both managers and shareholders is difficult without any intervention. Therefore, corporate governance mechanisms are established as the binding ingredient, while a Generally Accepted Accounting Practices (GAAP) were established to encourage consistency in financial reporting and to ensure financial statements are reliable, relevant, and truthful. Although numerous endeavours have been put in place to assist and oversee the financial reporting process, the financial reporting quality is yet to be free of financial misreporting. The collapsed of Enron, WorldCom, Adelphia, Bank of Credit and Commerce International (BCCI), Barings Bank, Global Crossing, Tyco, Parmalat, Royal Ahold and Socite General, and Toshiba are a few examples of severe corporate failures that have shattered the credibility and integrity of the financial reporting due to bad accounting scandals. Consequently, the merit of accounting practices and the effectiveness of corporate governance are in questions due to these accounting "cover-ups" (Abdullah et al. 2010). Although majority of the massive corporate failures taking the spotlight do not include those of Malaysian corporations, the pandemic lingers around.

Theoretically, financial information would aid and assist stakeholders to make informed decision making; while distinguishing between performing and non-performing firms. Although the standard setters such as International Accounting Standard Board (IASB) and Financial Accounting Standard Board (FASB) have provided detailed accounting standards and framework, there are still rooms for managerial discretions. Managerial discretions serve to provide additional and meaningful information (Perotti & Windisch, 2017; Hazarika, Karpoff & Nahata, 2012), however, managerial discretions may also lead to earnings manipulation. According to Ghazali, Shafie and Mohd Sanusi (2015), managers may manipulate the ambiguity in the accounting standards to manage earnings in fulfilling their self-interest motivation.

Existing literature has yet to offer an exclusive and conclusive definition for the term earnings management. Schipper (1989) defines earnings management as "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain". On a similar note, Mulford and Comiskey (1996) also asserted that "earnings management is the active manipulation of accounting results for the purpose of creating an altered impression of business performance". Similarly, Healy and Wahlan (1999) also described earnings management as "the management's judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers". Although the definitions of earnings management vary within the literature, one element was clearly evident – the management has the control over the financial reporting process and is likely to abuse that power if the need arises to protect their own interest.

Prior literature established two prevalent sides of earnings management, namely, informational view and opportunistic position (Tsitinidis & Duru, 2013; Jiraporn et al., 2008). From the standpoint of opportunistic purpose, earnings management is commonly referred to as a harmful accounting manipulation to achieve desired targets. Meanwhile, the informational perspective defines earnings management as a channel to foretell and portend financial information that would improve the outlook of firm performance (Tsitinidis & Duru, 2013; Jiraporn, et al., 2008). Informative earnings management would reduce volatility and improve the firm's earnings persistence (Stein & Wang, 2016; Dai, Kong & Wang, 2013). From the informational point of view earnings management is not used for personal benefit, rather serves as a communication channel for the management to disclose and widen the information content regarding future performance leading to informativeness of reported earnings.

However, due to the rise of corporate failures in recent years, earnings management has been seen as the malefactor at origin which escalates to fraud. Its side effects include tarnished reputation, erosion of market confidence, and significantly undermines the credibility, quality, transparency and the integrity of the financial reporting. The undesirable side effects of earnings manipulation have brought about the debate regarding the legality of earnings management practice. In both theory and practical, earnings management includes a wide variety of legal and illegal activities of managerial discretions. It has also been suggested that earnings management is a fraction of financial fraud (Kedia, Koh & Rajgopal, 2015). Respectively, Md Nasir et al. (2018) and Heinz, Patel and Hellman (2014) also argued that earnings management is a non-neutral accounting process thus it is illegal and unethical.

More recently, the issue of accounting misstatement as red flags of fraudulent financial reporting has taken the limelight of accounting research (e.g. Bishop, DeZoort and Hermanson, 2017; Ilter, 2014; Dechow et al., 2011; Firth et al., 2011). Therefore, it would be interesting to examine the relationship between corporate governance, political influence, earnings management, and accounting misstatement. In the context of the current study, accounting misstatement represents material accounting misstatement that is restated in succeeding year. Figure 1 identifies the phases of earnings management and accounting misstatements.

Prior cases of Malaysian corporate scandals' rulings (refer to Appendix A) exhibit a poor enforcement of regulations and unduly leniency of the judiciary system with regards to financial misreporting. The individual wrongdoers were not being adequately penalized for their wrongdoings. Furthermore, if the regulators are unable to provide evidence of fraud from the material misstatements, the implicated firms would only be required to restate their financial reports. A plethora of studies suggests that the announcement of accounting misstatement might adversely affect the firm's market valuation, especially when it involves income-decreasing earnings management (Hasnan, & Hussain 2015; Dechow et al., 2011; Rotenstein, 2011). Nonetheless, accounting misstatement or restatement does not affect the firm's operation nor listing status (Dechow et al., 2011; Rotenstein, 2011).

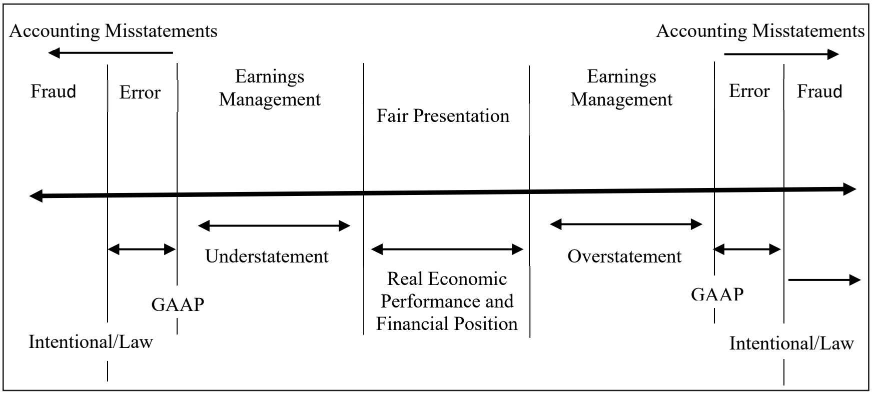

Figure 1: The Phases of Earnings Management and Accounting Misstatements

Adapted from: Stolowy and Breton (2004)

Despite, having a comprehensive corporate governance framework, the compliance and enforcement of these regulations are insufficient and ineffective as preventive tools (Duh, 2017; Abdullah et al., 2010; Gul, 2006). In a survey (CG Watch 2010) conducted by the Credit Lyonnais Securities Asia (CLSA), Malaysia only scored 38% for enforcement categories while scoring 60% for regulatory environment and 80% for accounting and auditing. The findings from the survey suggested that while Malaysia's corporate governance framework is comprehensive, the enforcement strategies are still lacking. A more recent survey by ACGA in 2016, concluded that several Asian markets including Malaysia are suffering from excessive political influence, corruptions and weak enforcements. According to Faccio (2006), politically connected firms in Malaysia in relative to the size of its capital market stand at nearly 20 per cent, making Malaysia among the top countries with high political influence.

Weak enforcement and exertion of political influence deteriorate the wellbeing of the overall corporate governance framework. While existing literature (Duh, 2017; Efendi et al., 2007; Agrawal and Chadha, 2005; Farber, 2005; and Abbot et al., 2004) have implied that misreporting firms are lacking in good corporate governance structure, there is yet evidence whether any changes or advancements in corporate governance framework improve the detection and correction of misreporting. It would be devastating to have the governance structure that looks good on paper but are less effective in its implementation.

With regards to firms' sustenance, political influence is often associated with power concentration, incompetency, weak corporate governance, and poor performance. It is also commonly perceived that directors with political connection enable its firm to receive preferential treatment such as gain access to assistance, resources and contracts from the government (Braam, et al., 2015; Chen et al., 2010). Thus, this kind of situation provides less motivation for the firm to produce a high-quality financial reporting (Ball et al., 2003). According to Chaney et al. (2011) and Houston et al. (2014), political influence adversely affects the quality of financial reporting. Chen et al. (2010) further argue that political influence hampers earnings forecast and are more severe in a corrupt environment.

Unfortunately, political connection may also induce double agency problems comprising self-interested behaviour of both the managers and the politician (Shleifer & Vishny, 1994) jeopardizing firms' accounting system (Tagesson, 2007). In particular, Shleifer & Vishny (1994) proposed a model depicting the relationship between politicians and managers. They suggested that politician on the Board may persuade the managers in pursuing their political objectives using their connection and power, and (ii) managers may reverse the situation if the control rights of the firms are held by the politicians. Political influence may also divert the firms' objectives of maximizing shareholders' wealth to political objectives (Boubakri et al., 2013).

Liew (2007) argued that current corporate governance reforms are inadequate to efficiently distinguish and come up with the solutions for the underlying political issues in Malaysia. Among the major cause for this is the effect of crony capitalism (Kang, 2003). Empirical studies on crony capitalism suggest that dominant political leaders use their power for their own advantage (White, 2004). Prior studies on political connection provide evidence that politically-connected firms received preferential treatment from their political ties and networks (Leuz & Oberholzer-Gee, 2006; Johnson & Mitton, 2003). In the recent Economist's crony-capitalism index 2014, Malaysia ranked third globally after Hong Kong and Russia.

An example of incidents regarding cronyism can be observed from the findings of Alfan (2010), which focused on the accountability of Tolled highway projects in Malaysia. Her findings provide evidence of government intervention through GLCs (a direct result of the Bumiputera policy). The study also found that the government are more biased towards GLCs as compared to its counterpart (Alfan, 2010). Meanwhile, Yusoff (2010) focused on the attributes and characteristics of the board of directors of Malaysian PLCs. Her findings show that the majority of board members in GLCs are Bumiputera and most the Bumiputera directors are retired high ranking government officials. Yusoff (2010) also found that corporate governance among the GLCs is less superior as compared to non-GLCs.

Firms with political connection are more inclined not to manage earnings in keeping the connection discreet from public knowledge. Hence, the motivation for firms with political connection to manage earnings are different from its counterpart and may involve other motives other than meeting target earnings (Braam et al., 2015). Existing literature suggested that firms with political connections are more susceptible to political pressure affecting the earnings management practices (Li et al., 2016; Chaney et al., 2011; Ramanna & Roychowdhury, 2010; Riahi-Belkaoui, 2004). It is argued that firms with political connection are less concern to maintain credible quality of financial reporting thus these firms are more susceptible to various incidents of financial misreporting such as earnings management which would result to accounting misstatement. Moreover, due to government intervention and close connection with high ranking profiles, if detected those firms with political connections who manages earnings are less susceptible towards being punished by accounting restatement.

Since accounting misstatement represents a significant financial reporting failure, understanding the contributing factors would be favourable for both the regulators and the public as a whole. The weaknesses of corporate governance mechanisms and political influence are suggested as two primary factors driving an occurrence of accounting misstatements and these factors are supported by previous empirical evidence (Abdul Wahab et al., 2014; Wuttichindanon, 2012). Even though, there has been some pioneering research which has focused on the determinants of accounting misstatement, most of the existing findings were derived from samples in developed economies such as the U.K. and the U.S. An interesting question is whether the findings of existing literature will generalise to developing economy such as Malaysia which is characterized by with high political influence.

THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

Agency Theory

Fundamentally, agency theory advocates that the principals and the agents have an imperfect relationship, and there would be frictions and conflict of interest. The theory is illustrated that when corporate management is independent from the influence of corporate ownership, the manager would swerve from only maximizing shareholders' wealth. The segregation of function creates a situation where managers would have the advantage in terms of inside information. Information asymmetry would spark agency conflicts between both the shareholders and managers.

Agency conflict also known as the agency problems occur when there is a divergence of interest between the principal and the agent. The situation would prompt the agent to not act in the best interest of the principal (Mallin, 2007). Opportunistic behaviour pursuing personal objectives and covets provides a strong motivation for the agent to make decisions that would maximize their self-interest rather than pursuing the principal's goals (Ghazali et al., 2015). Generally, the objectives behind the motivations, among others are, to report reasonable profit or avoid losses, to obtain bank loans and avoid debt covenant violation, to increase share prices, and to avoid regulatory actions. Meanwhile, the loopholes in the accounting system extended a greater possibility for opportunistic behaviour by manipulating and exploiting the GAAP resulting in earnings management.

Stewardship Theory

One of the important theoretical developments in sociological and management literature that would explain the assessment of the audit committee's effectiveness is the stewardship theory. Stewardship theory extends the agency theory literature in explaining the management behaviour but in a different direction. The theory assumes that people in general, are morally good and selfless, as long as a number of organizational and cultural preconditions are satisfied. Stewardship theory excludes the agency theory's depiction of a person to be individualistic, materialistic, and opportunistic, forcing both proactive "alignment of interests" and rigid monitoring. Instead, proponents of stewardship theory argue that the steward would always carry out their responsibilities diligently, maximizing financial performance and shareholder wealth.

Indirectly, the relationship between shareholders and directors (audit committee members) can also be observed as being the relationship between the principal and the steward; since shareholders employ those who have proven themselves to be independent, trustworthy and driven for accomplishment as the directors of the firm. Stewardship theory recognizes empowerment, participation and motivation in organizational behaviour. Effective stewardship focuses on the need for achievement and recognition, the intrinsic satisfaction of successful performance, respect for authority and the work ethic. Thus, grounded in the stewardship theory, it is assumed that the directors would be more motivated to incorporate and seek to attain the firm's objectives rather than fulfilling their personal interest. The operationalization of the stewardship theory is due to the combination of firm context and the psychological attributes of the directors being members of the audit committee (Davis, Schoorman, and Donaldson, 1997).

As the agency theory stresses more on the control and monitoring role of the audit committee, the stewardship theory puts more emphasis on the board's role in the strategic formulation (Lawal, 2012). According to stewardship theory, executive directors are deemed more effective as they are more familiar with the business operations; they also have the required knowledge, expertise and experience; and more importantly the insider knowledge to carry out their responsibility as compared to outside directors (Nicholson & Kiel 2007; Stiles, 2001; Donaldson and Muth, 1998;

Helmer, 1996). Additionally, the idea of Stewardship theory also suggests that firms would benefit more if they have a smaller board size. Donaldson and Muth (1998), suggested that a smaller board size would promote better cohesiveness and bonding among the directors. The delegation of power and responsibilities of executive directors would also facilitate effective monitoring and control (Lawal, 2012). Nevertheless, the stewardship theory is still in its emergent phase and would require further validation (Davis *et al.,* 1997). Based on the insights of agency theory and stewardship theory, the following conceptual framework as shown in Figure 2 is proposed for this study.

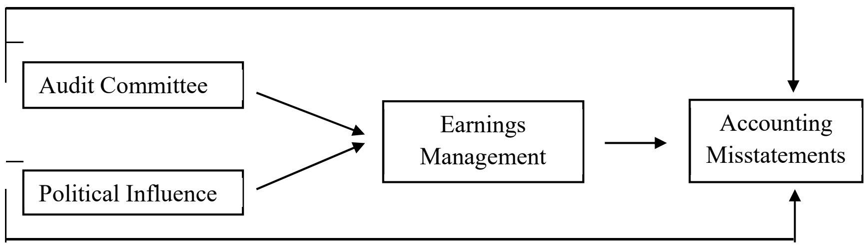

Figure 2: Conceptual Framework of Audit Committee, Political Influence and Financial Reporting Quality

Hypotheses Development

Existing literature on corporate governance and financial reporting quality in Malaysia has unfolded evidence on several aspects. In relation to earnings management, several studies such as debt renegotiation (Ahmed et al., 2008), reduction in corporate tax rates (Adhikari et al., 2005), initial public offerings (Ahmad-Zaluki et al., 2014), and audit opinions (Johl et al., 2007) have been undertaken. Meanwhile, there are studies that had investigate several attributes of corporate governance in relation to earnings management. These prior studies have been carried out to investigate earnings management by listed companies on the Main Board or by all listed companies on Bursa Malaysia in general. However, little research has been done in the area of earnings management and its relationship towards accounting misstatements from the corporate governance perspective particularly from the perspective of audit committee effectiveness.

Addressing the issue of financial reporting quality is crucial in ensuring an efficient function of capital markets. However, due to the obscurity of real earnings management, this would trigger a setback on the functionality of corporate governance. Although there are several studies investigating on the associations of accrual earnings management with accounting misstatements (Dechow et al., 2011), and with fraudulent financial reporting (Hasnan et al., 2017), the association of real earnings management and accounting misstatement is yet to be explored and determined. Furthermore, there are no statistics for financial misreporting of firms in the Malaysian corporate setting except for fraud firms.

The operationalization of the efficiency of audit committee is further explained below.

The Effect of Audit Committee Size on Earnings Management and Accounting Misstatement

Following the eruption of major corporate scandals, the NYSE and NASDAQ's have mandated that listed firms are required to have a minimum of three independent directors on the audit committee (Klein, 2002). Likewise, Malaysian listed firms have also been imposed of a similar requirement, however, only with regard to the size of the audit committee (MCCG, 2000). The MCCG also requires the composition of audit committee members to be non-executive directors without limiting the composition to include only independent directors. However, the MCCG's requirement for listed firms is not compulsory unless the requirement has also been sanctioned by other regulatory bodies. Since the Bursa Malaysia's Listing Requirement is silent with regards to the audit committee's composition, listed firms may not be in full compliance with the MCCG recommendation with regard to audit committee's composition.

Several studies found that audit committee size is irrelevant towards limiting the occurrences of earnings management and accounting manipulation (Mohd Saleh et al., 2007; Davidson et al., 2005; Xie et al., 2003). However, audit committees have been widely recommended as an important means of improving the quality of corporate financial reporting practices (MCCG, 2012; Ramsay, 2001), thus the audit committee size would be deemed to one of the contributing factors. Choi, Jeon and Park (2004) suggested that the size of the audit committee is imperative; having more members would bring in varied expertise enabling the committee to scrutinize and monitor financial reporting practices intensively.

It has been suggested that at least three members "… provides the necessary strength and diversity of expertise and views to ensure appropriate monitoring" (Bedard et al., 2004, p. 18). Nevertheless, Baxter (2007) posits that the size of audit committee would be less likely to have a linear relationship. Contradictly, Karamanou & Vafeas (2005, p. 458) asserted that "larger audit committees have a wider knowledge base on which to draw but are likely to suffer from process losses and diffusion of responsibility."

The Effect of Audit Committee Independence on Earnings Management and Accounting Misstatement

Audit committee independence has often been regarded as imperative toward the efficiency of the committee in its role of overseeing the financial reporting activities. Although the UK and the US regulated that the members of the audit committee are to consist of independent directors, developing countries such Malaysia, Singapore and China set the requirement that only the majority of audit committee members should be independent directors. Initially, MCCG (2000) sets out that audit committee members should consist of a majority of independent directors, however, after the revision in 2007, it is recommended that all the audit committee members consist of only non-executive directors.

Several studies have investigated whether the independence of audit committee influences the quality of financial reporting. Some studies found a negative link between greater audit committee independence and earnings management, suggesting that monitoring function is effective (Mohd Saleh et al., 2007; Davidson et al., 2005; Klein, 2002). Meanwhile, Abdul Rahman & Mohamed Ali (2008) did not find conclusive empirical evidence in ruling the relationship between audit committee independence and earnings management.

The Effect of Audit Committee Meeting on Earnings Management and Accounting Misstatement

Merely having an audit committee without any activity would not produce any outcome (Menon and Williams, 1994). To be effective, the audit committee should make efforts in performing their obligations and delivering the desired outcome. Thus, the audit committee meeting can be regarded as an attempt to make that effort. MCCG (2000) requires that the audit committee should have a private meeting (without the presence of executive directors) at least once a year. In the revised MCCG 2007, it has been highly recommended for the audit committee members have a private meeting (without the presence of executive directors) the external auditors at least twice a year. Additionally, the Bursa Malaysia Corporate Governance Guide (2009) emphasizes that at a minimum, the audit committee should meet at least four times a year (Para 2.6.2).

Baxter (2007) proposes that having a more frequent audit committee meeting would enable the committee members to convene and evaluates matters regarding financial reporting practices thoroughly. Xie et al., (2003) have established that both board of director and audit committee activities corresponds negatively towards earnings management. They suggested that having more boardroom's activities (meetings) would increase work commitment and reduce bad decision making. Likewise, Choi, Jeon and Park (2004, p. 41) indicate that "… actively functioning audit committee is more likely to detect earnings management than a dormant committee."

Even so, the frequency of boardroom activities does not signify the extent of work being accomplished (Menon and Williams (1994). Nonetheless, Menon and William (1994) also specify that the frequency of boardroom activities would be a good indicator of audit committee efficiency. On the other hand, both studies by Bedard et al. (2004) and Abdul Rahman and Mohamed Ali (2008) found that the relationship between the frequency of audit committee meetings and the occurrences of earnings management is insignificant.

The Effect of Audit Committee's Audit Expertise on Earnings Management and Accounting Misstatement

The inclusion of directors with financial and accounting background on the audit committee is essential as their main responsibility is reviewing the financial reporting aspect of the firm such as the adoption of accounting policies, compliance with accounting standards, and the going concern assumption. Based on this premise, it has been regulated by the Bursa Malaysia Listing Requirement that at least one of the audit committee members should be acquainted with sufficient knowledge of accounting, business and finance. Meanwhile, MCCG stipulates that the audit committee members are financially literate and are able to comprehend the financial reporting matters. Furthermore, the MCCG also recommend that at a minimum there should be at least one member of the audit committee member being attached to any accounting association or professional body. These requirements are deemed necessary in enabling the audit committee to function effectively in keeping tabs with matters of financial reporting integrity and internal control efficiency.

Previous studies, such as Abbott et al. (2004) and Bedard et al. (2004) indicates that having financial expertise on the audit committee could do better in relation to financial reporting quality. Both studies exhibit a significant, but a negative relationship between the occurrences of accounting misstatement and earnings management respectively. On the other hand, Xie et al. (2003) have identified that audit committee members from an investment banking background are more effective as compared to members from legal and commercial banking backgrounds. Using Malaysian firms as their study sample, Mohd Saleh et al. (2007) found that having more audit committee members with financial and accounting background do not lower the incidents of earnings management. Abdul Rahman and Mohamed Ali (2008) also arrived at the conclusion that the relationship between the audit committee's proficiency and earnings management are inconsequential. Therefore, the current study investigated a specific trait of accounting knowledge which is the auditing skills among the audit committee members. Table 1 presents a summary of the hypotheses developed.

Table 1: Summary of the Hypotheses

H1	There is a significant and negative relationship between audit committee and real earnings management among Malaysian listed firms.
H2	There is a significant and negative the efficiency of audit committee and accounting misstatement among Malaysian listed firms.
H3	There is a significant and positive relationship between political influence on audit committee and accounting misstatement among Malaysian listed firms
H4	There is a significant and negative relationship between political influence on audit committee and earnings management (accrual earnings management and real earnings management) among Malaysian listed firms.
H5	Earnings management (accrual earnings management and real earnings management) is less influential towards accounting misstatement in the presence of corporate governance and political influence.

RESEARCH METHODOLOGY

Since financial misreporting is a subset of fraudulent financial reporting involving ethical issue, observing the occurrence of financial misreporting via the secondary data (i.e. financial reports, annual reports and other publicly available information) is preferred since it is more practical and do not impose biases. Grounded on the positivist paradigm, this study applies a deductive approach and quantitative strategy.

Research Sample

The population of interest in this study is comprised of all Malaysian firms which are listed on the Main Board of Bursa Malaysia for the year 2010 continuously listed until 2014. Data from the year 2007 and 2009 are not chosen as it was the period of the global financial crisis thus reducing biasness and data abnormality. According to Copeland (1968) time horizon of four-to-six-year period is adequate to reduce classification errors, therefore the sample selection from 2010 to 2014 should be sufficient for the study. Table 2 presents the listing statistics on Bursa Malaysia's Main Board from 2010 until 2014. The companies listed on Bursa Malaysia are classified into 14 types of industry based on the nature of their business, such as Consumer Products, Industrial Products, Construction, Plantation, Property, Technology and Trading and Services.

Table 2: Listing Statistics on Bursa Malaysia's Main Board from 2010 until 2014

Year	No. of PLCs on Main Board
2014	812
2013	802
2012	809
2011	822
2010	844

To arrive at the total eligible population, the following types of firms are excluded from the population being considered for the study:

1. Initial Public Offerings Firms
   All initial public offerings firms from 2010 to 2014 are excluded from the sample because they do not provide data for the five years under study.

2. Financial corporations
   All companies that are classified under the financial sector, trusts and closed-end funds will not be included due to their incomparable features such as differences in compliance and regulatory environment (Abdul Rahman & Mohamed Ali, 2008; Peasnell et al., 2005; Xie et al., 2003).

3. Delisted Companies and Incomplete data
   Those companies being delisted during the study period as well as those with incomplete financial data or incomplete information on corporate governance data are also excluded from this study.

Table 3 presents the selection process, starting with all companies listed on Bursa Malaysia in 2014. Out of 812, 53 are excluded because they are classified under finance companies, trusts and closed-end funds; while another 91 companies which were delisted or with incomplete data are also excluded.

Table 3: Selection Criteria for Research Sample

Selection Criteria		Number of Companies
Listed Companies on Bursa Malaysia in the year 2014		812
Less:	Initial Public Offerings Companies	17
Less:	Financial institutions/ Companies	53
Less:	Companies with incomplete data	91
Research Sample		651
Less:	Extreme Outliers	8
Final Research Sample		643

Data Measurement Models

The main objective of study one is to determine the extent of corporate governance's effectiveness in suppressing financial reporting quality among Malaysian listed companies and the extent of the political influence over the corporate governance mechanisms. This study employs real earnings management and accounting misstatements to represent (proxy for) the financial reporting quality. The following section explains the data measurements and models for both dependent variables and independent variables for both studies.

Dependent Variable 1: Accounting Misstatement

Following prior studies (Wuttichindanon, 2012; Abdullah et al., 2010), accounting misstatement is measured by the announcement of financial restatement in the succeeding annual report (t+1). A dummy variable of "1" and "0" was assigned for firms with financial restatement and firms with no financial restatement, respectively. The announcement of financial restatement was looked up in each of the annual reports, searched using keywords of "restate", "restatement", "restated", "prior year adjustments" or "comparative figure".

Dependent Variable 2: Real Earnings Management

Based on prior research (Zang, 2012; Gunny, 2010; Roychowdury, 2006), real earnings management activities are captured by three models, namely the abnormal level of cash flow from operations (CFO), abnormal level of discretionary expenses (DISXEP), and abnormal level of production costs (PROD). In order to compute the abnormal levels of all the three models, the first step is to determine the normal levels of each model.

Normal levels of cash flow from operations (CFO) are expressed as a linear function of sales and change in sales in the current period. The cross-sectional regression for estimating the normal levels of CFO for every industry and year is shown in equation 4.1 below:

Equation 4.1: Normal levels of CFO

$$\frac{CFO_t}{TA_{t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \beta_1 \frac{S_t}{TA_{t-1}} + \beta_2 \frac{\Delta S_t}{TA_{t-1}} + \varepsilon_t$$

where,

CFO_t = Cash flow from operations of current year
TA_{t-1} = Total Assets of prior year
S_t = Sales of current year

ΔS_t = Change in sales of current year

For every firm-year, the abnormal levels of CFO are computed as the differences between the normal level of CFO and the actual figures of CFO reported in the financial statements.

Meanwhile, the regression for the normal level of DISEXP is estimated using the equation 4.2 below:

Equation 4.2: Normal levels of DISEXP

$$\frac{\mathrm{DISEXP_t}}{\mathrm{TA_{t-1}}} = \alpha_0 + \alpha_1 * \frac{1}{\mathrm{TA_{t-1}}} + \beta \frac{\mathrm{S_{t-1}}}{\mathrm{TA_{t-1}}} + \varepsilon_t$$

where,

$DISEXP_t$ = Cash flow from operations of current year
TA_{t-1} = Total Assets of prior year
S_t = Sales of prior year

This particular model was developed under the assumptions that discretionary expenditures are a linear function of sales (Roychowdury, 2006). Similarly, for every firm-year, abnormal DISEXP is the difference between the expected level of discretionary expenses and the actual discretionary expenses. Actual discretionary expenses comprise of both the selling, general and administrative (SGA) expenses; and research and development (R&D) expenses. Apparently, not every firm would have R&D expenses, thus the figures for R&D expenses can be set to zero provided that the figures for SGA expenses are present.

The third model, production costs consist of both cost of goods sold (COGS) and change in inventory. The normal level of production costs is estimated based on the following regression of equation 4.3:

Equation 4.3: Normal levels of PROD

$$\frac{\mathrm{PROD_t}}{\mathrm{TA_{t-1}}} = \alpha_0 \frac{1}{\mathrm{TA_{t-1}}} + \beta_1 \frac{\mathrm{S_t}}{\mathrm{TA_{t-1}}} + \beta_2 \frac{\Delta\mathrm{S_t}}{\mathrm{TA_{t-1}}} + \beta_3 \frac{\Delta S_{t-1}}{\mathrm{TA_{t-1}}} + \varepsilon_t$$

where,

$PROD_t$ = Production costs of current year
TA_{t-1} = Total Assets of prior year
S_t = Sales of current year
ΔS_t = Change in sales of current year
ΔS_{t-1} = Change in sales of prior year

Similar to the two previous models, the abnormal production costs are derived from the difference from the normal level of production costs and the actual production costs.

Independent Variable: Audit Committee

The second group of independent variables is the audit committee, which is operationalized into four empirical indicators. The four indicators consist of; audit committee size (ACS), audit committee meeting (ACM), audit committee independence (ACI), the audit committee's audit expertise (ACA). Audit committee size (ACS) is measured by the proportion of audit committee member to the size of the board of directors. Audit committee meeting (ACM) is measured by the number of meetings held in the financial year. Audit committee independence (ACI) is measured by the proportion of independent members in the audit committee. Audit committee's audit expertise (ACA) measured by the proportion of members with financial and auditing background. Specifically, the expertise of individual audit committee members was measured by professional accounting qualifications and experience or background in financial auditing. The logic behind this measure was that these directors should have a relatively higher level of accounting knowledge than those without such qualifications.

Independent Variable: Political Influence

Following prior studies on accounting and political factors in Malaysia (Mohammed, Mohd-Sanusi, & Alsudairi, 2017: Gul, 2006; Yatim et al., 2006; Johnson & Mitton, 2003), three proxies of political influence are used to represent the political elements that exist in Malaysia. The first variable is the direct measure of political influence which is defined as the presence of politically connected directors on the Board (PBD). PBD is a dummy variable that took a value of 1 if one or more politicians were members of the board and a value of 0 if otherwise. A politically connected director may be a member of parliament, a minister, a head of state or a state assemblyman (Chaney et al., 2011) or a person who is either currently or was formerly a government bureaucrat (Fan et al., 2007; Agrawal and Knoeber, 2001). Following Fan et al. (2007), data about politically connected directors were obtained by reviewing the profiles of the relevant directors in the company annual report, based on the definition mentioned before. In addition, the list of cabinet members and parliamentarians and state legislators were also reviewed (www.pilihanraya.com.my/melayu/parliamentlist.asp). This measure captures the changes of political influence in firms over time.

In the context of Malaysian business and political environment, it is important to include the indirect measure of political influence, by including the percentage of Bumiputera-Malay director, hereafter Bumiputera director (PMD) as the second measurement. PMD is the proportion of elite Bumiputera directors to a total number of directors. Following the approach in Yatim et al. (2006), the directors' ethnicity is determined by examining their names. If a director's name is either Muslim or Malay, it is assumed that he/she is a Bumiputera-Malay. However, if the director has a typical Chinese name, such as Wong, Tan, Chan or Lee, it is assumed the director is Chinese. The elite status of Bumiputera directors is then determined by their family and financial background.

The third measure is the percentage of government ownership (PGV). Prior studies on financial reporting quality that utilize similar variables are Chen et al. (2010) and Bushman and Piotroski (2006). This information was obtained from the annual reports. It is a requirement for all listed firms to disclose substantial shareholders in the annual reports, in compliance with the Companies Act 1965. Government ownership is determined, based on the percentage of shares held in the shareholder listing of the 30 largest shareholders with government backgrounds. These shareholders are either government agencies or trusts. Government ownership is represented by the percentage of shares held by government institutions and agencies which are, Khazanah Nasional Berhad (the investment arm of the Ministry of Finance), Employees Provident Funds (EPF), pilgrimage board funds (Lembaga Tabung Haji), the military pension funds (Lembaga Tabung Angkatan Tentera), Permodalan Nasional Berhad (manages various national unit trusts), State Economic Corporation Development (SEDC), Ministry of Finance Incorporated, Felda, Felcra, Social Security Organisation (Pertubuhan Keselamatan Sosial).

Control Variables

Consistency in findings of prior studies supports the evidence that certain firm-specific characteristics influence financial reporting quality. This study uses these firm specific characteristics as control variables in order to assess the relationship and the impact between corporate governance, political influence and financial reporting quality. Control variables chosen were firm size, profitability, firm leverage and related party transaction.

ANALYSES AND DISCUSSION OF FINDINGS

Statistical validity is undertaken to ensure that data analyses and research findings are impartial and that the interpretations and conclusions of the study are empirically reliable. Normality, autocorrelation, multicollinearity and homoscedasticity issues have been taken into consideration and tested. The current study used STATA statistical software to perform the required statistical analyses.

Descriptive Statistics

Initially, there was 3255 firm-year observation which includes 39 accounting misstatement cases from the year 2010 to 2014. However, due to extreme outliers eight firms were excluded from the sample, making the final sample to consists of 3215 firm-year observation. Apparently, there seems to be areas or items of preference in the financial information that is prone to be manipulated. The most common items that are easily exposed to accounting manipulation are revenues, accounts receivable and inventory (Dalnial, et al., 2014; Dechow et al., 2011). The interrelationship between these items and its discretion of judgment further subsidize the motivation for manipulation. For example, accounts receivable and inventory are directly related to revenue recognition and cost of goods sold, and both items eventually affect gross profit and net income. Due to these complex interrelationship between the items and managerial discretion, the management may take advantage of the situation, using it as the avenue for manipulation.

Table 4 below presents the breakdown of 39 restatement firms which have been categorized according to the GAO's descriptions for accounting restatement. Hee (2011) and Palmrose et al. (2004)affecting more accounts, decreasing reported income and attributed to auditors or management (but not the Securities and Exchange Commission have identified restatements such revenue recognition, reclassification and disclosure, core expenses restatement, restatements due to underlying events, restatements due to non-core expenses and restatements due to other reasons as “core restatement”. Based on Table 4, 38.46% of the misstatements were due to revenue recognition; 17.95% were due from reclassification and disclosure; 15.38% were due to misstated core expenses and underlying events respectively; meanwhile, misstatements which were due from non-core expenses is 7.69% and misstatements due to other reasons are 5.13%. The statistics show that among the reasons for accounting misstatements of Malaysian listed firms involves revenue recognition, reclassification and disclosure, core expenses and underlying events. On a similar note, Dechow et al. (2011), suggests that these items on the financial statements have a higher probability to be manipulated as it would directly affect the firm’s key performance metric, which is the gross profit.

Table 4: The Categorization of 39 Restatement Firms (2010-2014) According to GAO’s Descriptions on Accounting Restatement

Category	Restatement Firms	Percentage
Revenue Recognition	15	38.46
Core Expenses	6	15.38
Non-core Expenses	3	7.69
Reclassification and Disclosure	7	17.95
Underlying Events	6	15.38
Others	2	5.13
Total	39	100

The difference and similarities of corporate governance structure of both misstated firms and non-misstated firms are presented in Table 5. In terms of diversification in the Boardroom, both groups do not show significant differences, the characteristics are almost similar. However, some of the recommendations of MCCG are more likely to be adopted by the misstated firms as compared to non-misstated firms.

Table 5: Descriptive Statistics Comparing Misstated Firms and Non-Misstated Firms

Panel A: Continuous Variables (N: 39 misstatements and 3176 non-misstatement observation)

Continuous Variables	Minimum Statistics	Maximum Statistics	Mean Statistics	Std. Deviation Statistics
ACS				
Misstated firms	23	75	47.61	11.256
Non-misstated firms	2	100	46.12	11.986
ACI				
Misstated firms	67	100	93.08	13.026
Non-misstated firms	33	100	89.54	15.032
ACM				
Misstated firms	4	10	5.28	1.432
Non-misstated firms	3	10	4.93	1.040
ACA				
Misstated firms	25	100	59.36	27.012
Non-misstated firms	0	100	59.67	24.493
PMD				
Misstated firms	0	100	.3515	.25560
Non-misstated firms	0	100	.3163	.26222
FS				
Misstated firms	4.56	7.6	5.7992	.66846
Non-misstated firms	0	8.04	5.6174	.61805
FPROA				
Misstated firms	-22.95	23.55	4.3308	6.82143
Non-misstated firms	-46.8	50.52	5.0643	8.21688
FL				
Misstated firms	0	0.7088	.255279463	.1953190501
Non-misstated firms	0	3.2039	.198575086	.1678871695
RPT				
Misstated firms	0	5.84	3.6951	1.48969
Non-misstated firms	0	7.96	3.6195	1.53214

Following Table 6, it can be seen that between the misstated and non-misstated firms, there is not much different of the diversification in the Boardroom, the characteristics of the audit committee, the external audit attributes and between firms' characteristics. Among the distinctive features of the misstated firms are that the misstated firms are more likely to have a higher ratio of directors with accounting and financial background, and misstated firms are more likely to have abnormal and longer audit report lag (representing the external audit effort). For dichotomous variables, the descriptive statistics are presented in Table 6 under Panel B. Similar with the findings in Panel A, there is not much different between the characteristics of the misstated firms and non-misstated firms.

Panel B: Dichotomous Variables (N: 39 misstatement and 3176 non-misstatement observation)				
Dichotomous Variables	**% of 1**	**% of 0**	**Mean Statistics**	**Std. Deviation Statistics**
PBD				
Misstated firms			.31	.468
Non-misstated firms			.29	.453
PGV				
Misstated firms			.28	.456
Non-misstated firms			.35	.478

Univariate Analysis

Table 7 reports the Pearson correlation of the variables are reported in Table 5.3. Referring to Table 5.3, the highest being the correlation between government ownership (PGV) and firm size (FS) at r=0.408. This is, however, being anticipated as a larger firm size are usually government-linked companies with the majority shareholders being the government itself. Audit committee size (ACS) shows a negative and significant correlation with audit committee independence (ACI) with at r=-0.142, suggesting that as the audit committee size grows bigger, the members are less independent. Yet, the audit committee meeting (ACM) has a significant and positive correlation with audit committee independence (ACI) at r=0.052. This suggests that with more independent members on the audit committee, more discussions regarding accounting and financial reporting matters take place.

In terms of political influence, audit committee size (ACS) has a negative correlation with politician on the board (PBD) at r= -0.063; and with the presence of government ownership in the firm (PGV) at r=-0.090. However, audit committee size (ACS) shows a positive and significant correlation with Bumiputera on Board (PMD) at r= 0.077. On the other hand, audit committee independence (ACI) shows a negative and significant correlation with Bumiputera directors on Board (PMD) and the presence of government ownership in the firm (PGV) at r=-0.066 and at r=-0.066 respectively. Audit committee meeting (ACM) also has a positive correlation with politician on the board (PBD) at r= 0.099; with Bumiputera on Board (PMD) at r= 0.234; and with the presence of government ownership in the firm (PGV) at r=0.092. While audit committee accounting expertise (ACA) shows a negative and significant correlation with politician on the board (PBD) at r= -0.095. The results suggest that both politician directors and Bumiputera directors which are independent may have seats in the audit committee and that having them in the committee would also result in a higher number of audit meetings.

Regarding with firms' characteristics, audit committee size (ACS) has a negative correlation with firm size (FS) at r=-0.145; with firm profitability (FP) at r=-0.085; and with firm leverage (FL) at r=-0.035. Audit committee independence (ACI) and audit committee accounting expertise (ACA), on the other hand, have no significant correlations with all the variables of firms' characteristics. Audit committee meeting (ACM) also has a positive correlation with firm size (FS) at r=0.228; and with firm leverage (FL) at r=0.096 but a negative correlation with firm profitability (FP) at r=-0.085. Even though there are several significant correlations in this study, it is still below the threshold value and lies within the medium range of correlations. Therefore, the findings does not indicate any major multicollinearity problem. Thus, none of the variables is excluded from the analysis.

Table 7: Univariate Correlation Analysis between the Independent Variables

	ACS	ACI	ACM	ACA	PBD	PMD	PGV	FS	FPA	FL	RPT
ACS	1	-.142**	-.024	-.013	-.063**	.077**	-.090**	-.145**	-.085**	-.035*	.028
ACI		1	.052**	.001	.034	-.066**	-.066**	.018	-.030	.028	-.021
ACM			1	.021	.099**	.234**	.092**	.228**	-.085**	.096**	-.025
ACA				1	-.095**	.031	-.006	.021	.018	-.004	-.022
PBD					1	.226**	.149**	.126**	-.034	.043*	.009
PMD						1	.216**	.187**	-.075**	.089**	.048**
PGV							1	.408**	.088**	.024	.033
FS								1	.155**	.240**	.082**
FPA									1	-.179**	.033
FL										1	-.007
RPT											1

** Correlation is significant at the 0.01 level (2-tailed).
* Correlation is significant at the 0.05 level (2-tailed).

The Relationship among Corporate Governance, Political Influence, Earnings Management and Accounting Misstatement

In order to estimate the relationship among corporate governance, political influence, earnings management and accounting misstatement as well as to see whether earnings management intervene the relationship between predictors variables, multiple regression analysis and logistic regression analysis is applied. Baron and Kenny (1986) propose the following step in testing the intervention effect of variables on the outcome.

Step One: Show that corporate governance and political influence correlated with accounting misstatement by regressed accounting misstatement on corporate governance and political influence.

Step Two: Show that corporate governance and political influence correlated with earnings management by regressing accounting misstatement on corporate governance and political influence.

Step Three: Show that earnings management affects accounting misstatement while controlling for corporate governance and political influence by regressing accounting misstatement on corporate governance, political influence and earnings management. It is not sufficient to regress earnings management with accounting misstatement because they both may be affected by corporate governance and political influence.

By controlling the effect of earnings management, the relationship between corporate governance, political influence and accounting misstatement get weak suggesting that the weakening effect has a direct relation with earnings management. Initially, Baron and Kenny (1986) suggested that step 1 should produce the significant effect and only then the later step can be carried out. However, Kenny (2014) contended that the process can be carried out even though the preceding step shows an insignificant result. According to Kenny (2014) and Kenny et al., (1998), the essential steps in establishing the intervention effect is just Step 2 and Step 3. The current study run logistic regression analysis to test for Step 1 and Step 3, and multiple regression analysis to test for Step 2. The following section discusses the analyses undertaken.

Logistic Regression: Corporate Governance and Accounting Misstatements Step One

The analysis for examining the relationship between corporate governance, political influence and accounting misstatements employed in the following logistic regression model:

$$AM_{i,t} = \alpha_0 + \beta_1 ACS_{i,t} + \beta_2 AC_{i,t} + \beta_3 ACM_{i,t} + \beta_4 ACA_{i,t} + \beta_5 PBD_{i,t} + \beta_6 PMD_{i,t} + \beta_7 PGV_{i,t} + \beta_8 FS_{i,t} + \beta_9 FPA_{i,t} + \beta_{10} FL_{i,t} + \beta_{11} RPT_{i,t} + \varepsilon_{i,t}$$

Table 8 presents both the logistic regression examining the effectiveness of audit committee in relation to accounting misstatement in model 1. Model 1 shows a value of model Chi^2 of at 22.23 and is statistically significant (p-value < 0.0001) and also a lower McFadden's pseudo R2 of 0.0527. The model shows that audit committee independence (ACI) is positive and statistically significant with accounting misstatement at 10% level (z value = 1.45), whereas the other proxy for audit committee shows insignificant results. The significance and positive relationship between audit committee independence indicate that the higher the independence of the audit committee the higher will be the accounting misstatement. The reasons for the positive relationship might be due to multiple directorship of the member of the audit committee which reduce the suppose attention that the members need in monitoring the quality of the financial reporting (Emmanuel, Ayorinde and Babijide, 2014), hence support the notion that busyness of overstretched directors are not effective in monitoring the financial reporting quality. The results hence partially supporting H2.

In terms of political influence, only government ownership shows a negative and significant relationship with accounting misstatement at 10% level, thus partially supporting the hypothesis predicted for H7b. This finding indicates that firms with substantial government shareholding are more likely to be acquitted with accounting misstatements. The current findings align with the notion made by Watts and Zimmerman (1990), that politicians and governments would avoid negative news or announcement such as accounting misstatement. For control variables, only firms' size (FS) shows a positive and significant relationship with accounting misstatement at 1% level. The findings indicate that firms with higher leverage coupled with a poor corporate governance are more likely to have a higher probability of accounting misstatements.

Table 8: Logistics Regression Examining the Effect of Corporate Governance on Accounting Misstatements in Malaysia

Variables	Logistic Regression	
	Coefficient	Sig.
ACS	0.013	0.96
ACI	0.019	1.45*
ACM	0.152	1.11
ACA	-0.001	-0.14
PBD	-0.064	-0.17
PMD	0.368	0.57
PGV	-0.598	-1.48*
FS	0.562	1.86**
FPROA	0.005	0.16
FL	1.061	1.13
RPT	0.036	0.33
N		3215
McFadden's pseudo R		0.0527
Model chi-square		22.23

Note. ***: Significant at the 0.01 level; **: Significant at the 0.05 level, *: Significant at the 0.10 level

Multiple regression for Corporate Governance, Political Influence and Earnings Management – Step Two

The analysis for examining the relationship between audit committee, political influence and earnings management employed in the following regression model:

$$EM_{i,t} = \alpha_0 + \beta_1 \, ACS_{i,t} + \beta_2 \, ACI_{i,t} + \beta_3 \, ACM + \beta_4 \, ACA_{i,t} + \beta_6 \, PBD_{i,t} + \beta_7 \, PMD_{i,t} + \beta_8 \, PGV + \beta_9 \, FS_{i,t} + \beta_{10} \, FPA_{i,t} + \beta_{11} \, FL_{i,t} + \beta_{12} \, RPT_{i,t} + \varepsilon_{i,t}$$

Table 9 below shows the results for the direct effect of audit committee and political influence on earnings management. Table 5.5 shows that the R^2 values for the three models of real earnings management are significant at 1% level (0.222; p-value = 0.000 for the abnormal cash flow from operations (ABCFO); 0.086, p-value = 0.000 for the abnormal discretionary expenses (ABDISEXP); and 0.198, p-value = 0.000 for the abnormal production costs (ABPROD) respectively).

Audit committee size (ACS) shows a positive and significant relationship with abnormal production costs (ABPROD) at 5% level (t=2.206) but is insignificant with both abnormal cash flow from operations (ABCFO) and abnormal discretionary expenses (ABDISEXP). The findings from the analysis suggest that the bigger the size of the audit committee, the higher will be the manipulation of abnormal production costs in the firms. Bigger audit committee size provides more opportunity for the firms to manipulate their productions costs. In addition, the results also show that audit committee size has a negative and significant relationship with accrual earnings management (PMM) at 5% level (t=1.797). This indicates that bigger audit committee size significantly reduces the practice of accrual earnings management in the firms. Collective and superior monitoring and control power in bigger audit committee size successfully enhance the financial reporting quality in the firms.

Meanwhile, audit committee independence (ACI) is statistically significant with abnormal cash flow from operations (ABCFO) and abnormal discretionary expenses (ABDISEXP) at 10% level (t=-1.162, t=-1.308) respectively. The negative relationship between audit committee independence and both cash flow from operations and abnormal discretionary expenses suggests that, if there is more independence directors sit in the audit committee, manipulation of cash flow from operations and discretionary expenses eventually will be less. This means that a higher percentage of audit committee independence improve the quality of financial reporting. This may be due to stringent monitoring by collective independence directors in the audit committee reduce the opportunity of earnings management in the firms (Davidson et al., 2005; Bedard et al., 2004). The independence of audit committee is necessary in monitoring the financial reporting process in order to enhance the quality of financial reporting.

The results in Table 9 also shows that there is a significant and negative relationship at 10% level between audit committee meeting (ACM) with abnormal discretionary expenses (ABDISEXP, t=-2.304), abnormal production costs (ABPROD, t=-1.637) and accrual earnings management (PMM, t=-1.471). The frequency of audit committee meetings of three or more times per year exerts a significant positive impact on the financial reporting quality. In overall it can be said that frequent audit committee meeting reduces the practice of both real and accrual earnings management in the firms. The findings from this study are consistent with the studies by Sun, Lan and Liu (2014), Garcia et al. (2010) and Xie et al. (2003).

The current findings also show that audit committee expertise (ACA) does not affect both real and accrual earnings management practice in the firms. It shows that, though Bursa Malaysia listing requirements and MCCG guidelines require the firms to appoint a member with financial expertise to sit in the audit committee in order to improve the good governance and financial reporting quality, the results fail to support the assumption. It can be concluded that audit committee's audit expertise is not an important determinant in relation to real earnings management. The results hence partially support H1 which postulate that there is a significant relationship between audit committee and earnings management.

The findings from the study also find that politician on board (PBD) does not affect the real earnings management in the firms since the results show insignificant relationships between politician on board and all measurement for real earnings management. However, in terms of the relationship between politicians on board with accrual earnings management, there is a negative and significant relationship between both variables at 10% level (t=-1.570). The findings suggest that more politicians on board restrict and reduce the practice of accrual earnings management. The reasons might be due to the public image of politicians which require them to avoid any scandals thus necessitate them to pressure the management to improve the quality of their financial reporting.

Meanwhile, Bumiputera directors on board (PMD), shows a negative and significant relationship with abnormal cash flow from operations (ABCFO) at 5% level (t-value=-1.910) and positive and is statistically significant with both abnormal discretionary expenses (ABDISEXP) at 1% level (t-value=2.765). This means that more Bumiputera directors on board reduce the real earnings management in term of manipulation of cash flow from operations in the firms. Nevertheless, the political power of Bumiputera directors impaired the decision making of the board when it comes to discretionary expenses.

Government ownership (PGV) on the other hand is negative and statistically significant at 10% level with abnormal discretionary expenses (t-value=-1.307) and with abnormal production costs (t-value=-1.366) but have a positive and significant relationship with accrual earnings management (PMM) at 5% level (t=1.937). The current findings show that government ownership significantly reduces the practice of real earnings management which is consistent with the earlier study by Md Salleh (2009) and Eng and Mak (2003) which suggest that government ownership improve both good governance and financial reporting quality. However, the contradicting result for accrual earnings management can be justified due to the fact that accrual earnings management is less complex in term of the operationalization and due to the general assumption that there will be less scrutinization by the regulators when the government itself is the owner of the firm. The findings from the analysis partially support H4.

Table 9: Summary of Multiple Regression Analysis

ABCFO	B	t-Value	sig. Value
(Constant)	0.078	2.183	0.029
ACS	0.000	0.193	0.847
ACI	0.000	-1.506*	.132*
ACM	0.002	1.251*	.211*
ACA	0.000	-0.278	0.781
PBD	0.002	0.477	0.633
PMD	-0.011	-1.851**	.064**
PGV	-0.003	-0.907	0.365
FS	0.004	1.388*	.165*
FPROA	0.005	21.474***	.000***
FPROE	-0.011	-8.351***	.000***
FL	-0.061	-6.381***	.000***
RPT	-0.001	-0.776	0.438
R^2		0.218	
Adjusted R^2		0.214	
F-Statistic		55.812	
ABDISEXP	**B**	**t-Value**	**sig. Value**
(Constant)	-0.785	-2.581	0.01
ACS	-0.002	-1.521*	.128*
ACI	-0.001	-1.546*	.122*

ACM	-0.033	-2.734***	.006***
ACA	0.000	-0.664	0.507
PBD	-0.025	-0.91	0.363
PMD	0.155	3.120***	.002***
PGV	-0.036	-1.266*	.206*
FS	0.236	9.632***	.000***
FPROA	0.001	0.516	0.606
FPROE	0.009	0.801	0.423
FL	0.006	0.08	0.936
RPT	0.054	6.819	0
R^2		0.078	
Adjusted R^2		0.073	
F-Statistic		16.873	
ABPROD	**B**	**t-Value**	**sig. Value**
(Constant)	-0.094	-1.98	0.048
ACS	0.000	1.683**	.093**
ACI	0.000	0.042	0.966
ACM	-0.004	-2.093**	.036**
ACA	0.000	0.343	0.732
PBD	-0.005	-1.11	0.267
PMD	-0.002	-0.274	0.784
PGV	-0.006	-1.339*	.181*
FS	0.014	3.662***	.000***
FPROA	-0.006	-19.905***	.000***
FPROE	0.006	3.587***	.000***
FL	0.051	4.018***	.000***
RPT	0	-0.187	0.852
R^2		0.188	
Adjusted R^2		0.184	
F-Statistic		46.279	
PMM	**B**	**t-Value**	**sig. Value**
(Constant)	-0.267	-4.451	0
ACS	0.000	-1.797**	.072**

ACI	0.000	0.416	0.678
ACM	-0.004	-1.471*	.141*
ACA	0.000	-0.827	0.409
PBD	-0.003	-0.485	0.628
PMD	0.017	1.721**	.085**
PGV	-0.006	-1.166	0.244
FS	0.041	8.509***	.000***
FPROA	-0.001	-3.311***	.001***
FPROE	0.008	3.801***	.000***
FL	-0.011	-0.659	0.51
RPT	-0.001	-0.429	0.668
R^2		0.042	
Adjusted R^2		0.037	
F-Statistic		8.656	

Logistic Regression: Corporate Governance, Political Influence and Earnings Management towards Accounting Misstatement- Step Three

The analysis for examining the relationship between corporate governance, political influence and earnings management employed in the following logistic regression model:

$$AM_{i,t} = \alpha_0 + \beta_1 ACS_{i,t} + \beta_2 ACI_{i,t} + \beta_3 ACM_{i,t} + \beta_6 ACA_{i,t} + \beta_7 PBD_{i,t} + \beta_8 PMD_{i,t} + \beta_9 PGV_{i,t} + \beta_{10} FS_{i,t} + \beta_{11} FPA_{i,t} + \beta_{12} FL_{i,t} + \beta_{13} RPT_{i,t} + \beta_{14} ABCFO_{i,t} + \beta_{15} ABDISEXP_{i,t} + \beta_{16} ABPROD_{i,t} + \varepsilon_{i,t}$$

In Model 3, the relationship between audit committee, political influences, earnings management and accounting misstatement is examined. The overall results and the significance level of this model are composed of the combination of Model 1 and 2. The results show that after controlling the effect earnings management, the relationship between audit committee and political influences towards accounting misstatement is getting weaker signalling that the reasons for weakening might have a direct relation with earnings management. The findings in Model 3 shows insignificant relationship between the variables although the earlier model shows a significant relationship. This indicates that earnings management is intervening the relationship between the variables. In other words, after controlling for earnings management, audit committee (audit committee size and audit committee meeting) and political influences (politician on board and Bumiputera on board) no longer affected the financial reporting quality of the firms. This may be because even though the firms have a diversified board and bigger audit committee still do not effectively detect the earnings management practices.

On the other hand, since the effect of audit committee independence and government ownership remain significant even after controlling for earnings management, its means, besides earnings management there could be other variables which can intervene the relationship between audit committee, government ownership and accounting misstatement.

Table 10: The Effectiveness of Audit Committee, Political Influence and Earnings Management towards Accounting Misstatements

Variables	Logistic Regression	
	Coefficient	Sig.
ABCFO	1.838	0.86
ABDISEXP	-0.416	-1.3*
ABPROD	1.276	0.81
ACS	0.012	0.88
ACI	0.019	1.48*
ACM	0.142	1.03
ACA	-0.002	-0.23
PBD	-0.098	-0.26
PMD	0.457	0.7
PGV	-0.593	-1.44*
FS	0.659	2.11**
FPROA	0.004	0.14
FL	1.053	1.15
RPT	0.052	0.47
N	3215	
McFadden's pseudo R^2	0.0597	
Model chi-square	25.18	

Note. ***: Significant at the 0.01 level; **: Significant at the 0.05 level, *: Significant at the 0.10 level

Robustness Testing

It is important to note that the proportion of the accounting misstatement cases (i.e. the event) to the non-accounting misstatements observations in this study is quite low at 1.213% (39/3215). This imbalanced sample with a very wide gap for each group would be considered a rare event. Williams (2017) argues that a conventional logistic regression analysis may underestimate the probability of an event, P (Y=1), and overestimates coefficients of explanatory variables in the rare event situation. Thus as an alternative method to reduce the bias should be carried out. In analyzing rare event data, two methods seem outstanding among the others, namely the Firth logit (Firth, 1993) and the rare event logistic (King and Zeng, 2001). However, Williams (2017) suggests that the rare event logistics is somewhat overcorrecting bias in MLEs as n is getting small (<200).

Therefore, a Firth logit was employed as a robustness testing. Firth logit is a method where penalized likelihood is used to reduce small-sample bias in maximum likelihood estimation (MLE). Penalized likelihood method also benefits from producing finite, and provides a consistent estimate of regression parameters even when the maximum likelihood estimate do not even exist because of complete or quasi-complete separation (Williams, 2017). Heinz and Schemper (2002) suggest that Firth logit is a superior solution after comparing the Firth logit with ordinary MLE on small samples. Consistently, Allison (2012) also suggests the Firth logit in the case of penalized likelihood. The results of the Firth logit model are presented in Table 11.

Table 11: Firth Logistics Regression on the Effectiveness of Audit Committee Towards Accounting Misstatements in Malaysia

Firth Logistics Regression Examining the Effect of Corporate Governance on Accounting Misstatements in Malaysia		
Variables	**Coefficient**	**z-statistics**
ACS	0.0136	1.04
ACI	0.0168	1.35*
ACM	0.0971	1.6
ACA	-0.0003	-0.05
PBD	0.0517	0.96
PMD	0.3939	0.65
PGV	-0.5826	-1.48*
FS	0.5979	2.25**
FP	0.0092	0.31
FL	1.1749	1.33*
RPT	0.0282	0.26
N	3215	
McFadden's pseudo R	0.025	
Model chi-square	30.19	
Number of clusters (firms)	643	

Note. ***: Significant at the 0.01 level; **: Significant at the 0.05 level, *: Significant at the 0.10 level

Following Table 10, both models show a slight adjustments to the findings. Model 1 shows a model Chi^2 of 39.94 and is statistically significant (p-value < 0.0001) with McFadden's pseudo R2 of 0.0217. On the other hand, Model 2 shows a lower value of model Chi2 of 30.19 but is statistically significant (p-value < 0.0001) and also a slightly higher McFadden's pseudo R2 of 0.025. Interestingly, as compared to the findings in the conventional logistic regression, several variables have become significant after being regress using Firth logit.

In model 1, board remuneration (BDREM) shows a positive and significant relationship with accounting misstatement at 10% level. Similarly, audit committee meeting (ACM) has a positive and significant relationship with accounting misstatement at 10% level.

In model 2, the table shows that the audit committee meeting (ACM) has a positive and significant relationship with accounting misstatement at 10% level. While firms leverage (FL) also shows a positive and significant relationship with accounting misstatement at 10% level. In the conventional logistic regression model (Table 5.4), these two variables are insignificant towards the announcement of accounting misstatement.

CONCLUSION

Most firms within the research sample have shown compliance with the minimum requirements on the level of independent and financial knowledge of audit committee, as well as the meeting requirement, however, the findings are not as per expected. Audit committee as measured by audit committee independence is positively significant with accounting misstatements. This indicates that a higher percentage of independent auditor in the audit committee increase the occurrence of accounting misstatement in the firms. The situation can be related to busyness theory where independence directors are presumed to hold multiple directorships thus restrict them to properly monitor the firms making earlier detection of accounting misstatement is not possible (Emmanuel et al., 2014). The findings corroborate with the notion of forced compliance effect by the McMartin & Needles (2015). The finding of this study is consistent with the study by Sharma & Iselin (2012) whereby their study found a significant and positive relationship between the audit committee's multiple-directorships and accounting misstatements post-SOX.

The insignificant relationship between audit committee accounting expertise may relate to the findings of Abernathy et al., (2014). Their findings show that accounting expertise of audit committee members is less relevant towards financial reporting timeliness if the experience is gained from being a former CFO. Another possible explanation is the herding behaviour of the audit committee. Schöndube-Pirchegger & Schöndube (2011), offers an explanation of why the audit committee is ineffective within the corporate governance context. They introduced a model explaining the herding behaviour of the audit committee, in which the audit committee members are more inclined to submit to the auditor's judgment and ignore their personal insights when it comes to decisions regarding accounting practices and financial reporting matters.

In contrast to the predictions regarding the effectiveness of corporate governance in maintaining higher financial reporting quality, the present study finds minimal evidence that political factors influence the Boardroom towards accounting misstatements. Political influence is still relevant in a Malaysian business environment regarding financial reporting quality, however, the aggressiveness of the influence may have been diluted by the improvement of recent corporate governance reform. The monitoring characteristics of the board and audit committee coupled with the increased auditor quality may offset the aggressive political influence.

The findings of this study show that Malaysian firms prcatices earnings management. However, the aggressiveness of the earnings management is not being punished as evidenced by the low number of accounting misstatements (accounting restatements) that were being issued. However, there are still several issues regarding financial reporting quality and corporate governance that has not been covered by this study that could be relevant to the occurrence of earnings management, accounting misstatement and fraudulent financial reporting. Future studies may include AEM and REM for comparative purposes. A qualitative study may also provide in-depth understanding from the behavioural perspective.

The findings of the current study should be interpreted with caution as the study has several limitations. Firstly, the study only focuses on firms listed on the Main Board of Bursa Malaysia, excluding financial institutions. Secondly, this paper was based heavily on content analysis. Thus, the data collected are self-verified as true. Thirdly, the research sample is only based on Malaysian firms, and therefore, the findings might not be applicable to other countries.

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APPENDIX A: MALAYSIAN CORPORATE SCANDALS

Facts of Case	Sentence
A director of Kiara Emas Asia Industries Bhd (KEAIB), was charged with criminal breach of trust in relation to RM16,937,739.20 of the rights issue proceeds of KEAIB on three different occasions.	The accused was imposed a fine of RM200,000 for each charge (total RM 600,000).
Two former independent directors of Transmile Group Berhad authorized the furnishing of misleading statements involving RM622 million for the financial years ended 2004 to 2006.	The accused was sentenced to one year imprisonment and fined RM300,000 each.
The former Chief Executive Officer and Executive Director of Welli Multi Corporation Berhad (WMCB), was charged for knowingly authorised the furnishing of misleading statement in WMCB's Quarterly report for the financial period ended 30 September 2006 to the Bursa Malaysia Securities Berhad.	The accused was sentenced to one day jail and a fine of RM400,000 each.
A former Group Managing Director of Polymate Holdings Berhad (PHB) and Managing Director of ABI Malaysia Sdn Bhd (its wholly owned subsidiary), was charged for knowingly authorising the furnishing of false statements Bursa, namely the inflated revenue and trade receivables of PHB for the year ended 30 September 2003, as contained in PHB's 2003 Annual Report.	The accused was fined RM300,000, in default 1 year imprisonment.
The former Financial Controller of Megan Media Holdings Berhad (MMHB), have abetted MMHB who had with intent to deceive, furnished false statements to Bursa Malaysia. The false statements were in relation to MMHB's Revenue figures in its Financial statements for the year ended 30 April 2006 and Quarterly Reports on Consolidated Results for the Financial Period ended 31 July 2006, 31 October 2006 and 31 January 2007 respectively.	The accused was fined RM350,000 (in default 1 year imprisonment).
Two former Directors of Mems Technology Berhad, was charged for knowingly authorised the furnishing of a misleading statement to Bursa Malaysia Berhad. The misleading statement is in relation to Mems Technology Berhad group's revenue for year ended 31 July 2007 contained in its condensed consolidated income statements for the 12 month period ended 31 July 2007.	The accused was charged on 16 April 2009.
A former director of LFE Corporation Berhad was charged with nine charges including cheating and criminal breach of trust involving a total amount of RM24 million, and permitting the furnishing of misstated financial statements for all four quarters of year ended 31 December 2007.	The accused was sentenced to one year imprisonment and fined a total of RM1.2 million.
An executive director who was also a licensed fund manager of Metrowangsa Asset Management Sdn. Bhd. was charged for furnishing misleading financial statements by concealing funds received from two of its clients (Lembaga Tabung Haji and Mimos Berhad) in the amount of RM134 million (2000) and RM231 million (2001), respectively.	The accused was fined RM1 million (RM500,000 for each charge)