THE ROLE AND INFLUENCE OF CORPORATE LEADER VALUES ON CORPORATE GOVERNANCE MECHANISMS AND FINANCIAL REPORTING QUALITY

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By

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BEIM	Business Ethics Institute of Malaysia
BMF	Bumiputra Malaysian Finance
BNM/GP1	*Bank Negara Malaysia/Garis Panduan 1*
BRC	Blue Ribbon Committee
CEO	Chief Executive Officer
CPI	Corruption Perception Index
EPF	Employees Provident Fund
FASB	Financial Accounting Standards Board
FRS	Financial Reporting Standards
GAAP	Generally Accepted Accounting Principle
GCB	Global Corruption Barometer
GLCs	Government Linked Companies
IIM	Institute of Malaysian Integrity
IPOs	Initial Public Offerings
ISIS	Institute of Strategic and International Studies
JPI/GP1	*Jadual Panduan 1/Garis Panduan 1*
KLSE	Kuala Lumpur Stock Exchange
LTAT	*Lembaga Tabung Angkatan Tentera*
LTH	*Lembaga Tabung Haji*
MACA	Malaysian Anti Corruption Academy
MASB	Malaysian Accounting Standard Board
MCCG	Malaysian Code of Corporate Governance
MD	Managing Director
MICG	Malaysian Institute of Corporate Governance
MICPA	Malaysian Institute of Certified Public Accountant
MSWG	Minority Shareholders Watchdog Group
NIP	National Integrity Plan
NYSE	New York Stock Exchange
PLCs	Public Listed Companies
PNB	*Permodalan Nasional Berhad*
SC	Securities Commission
SEC	Securities Exchange Commission
SGX	Singapore Exchange
SOCSO	National Social Security Organization of Malaysia
UK	United Kingdom
USA	United States of America
U.S.	United States

PERANAN DAN PENGARUH NILAI PEMIMPIN KORPORAT TERHADAP MEKANISMA TADBIR URUS KORPORAT DAN KUALITI PELAPORAN KEWANGAN

ABSTRAK

Walaupun selepas dua puluh tahun sistem tadbir urus korporat dilaksanakan, skandal dan kegagalan korporat masih terus berlaku. Kebanyakan kajian empirikal menunjukkan penemuan yang tidak konsisten dan tidak menyakinkan mengenai kesan mekanisma tadbir urus korporat seperti ciri-ciri lembaga pengarah dan jawatankuasa audit serta struktur pemilikan terhadap kualiti pelaporan kewangan. Keberkesanan tadbir urus korporat ini juga dipengaruhi oleh faktor institusi yang dibentuk oleh sejarah dan konteks politik. Kebanyakan syarikat di negara yang sedang membangun termasuk Malaysia menunjukkan pemilikan tertumpu yang tinggi, campur tangan kerajaan dan pengaruh keluarga. Keadaan ini mendorong kepada ketelusan yang rendah, pendedahan yang tidak mencukupi dan rampasan pemegang saham minoriti disebabkan pemegang saham majoriti cenderung untuk memaksimumkan faedah peribadi mereka. Penguatkuasaan prinsip tadbir urus korporat yang diamalkan oleh syarikat-syarikat tidak mencerminkan kualiti pentadbir korporat yang mentadbir syarikat-syarikat tersebut. Dengan itu, adalah penting untuk mengkaji peranan nilai pemimpin korporat memandangkan sesebuah organisasi itu biasanya dibentuk oleh sikap, nilai dan visi pemimpin korporat. Visi, falsafah, hala tuju masa depan yang dikongsi bersama oleh Ketua Pegawai Eksekutif amat penting kepada syarikat dalam memastikan semua urusan pentadbiran dikendalikan dengan secekap dan seberkesan yang mungkin. Nilai-nilai

yang dipegang dan dikongsi oleh pemimpin akan membentuk tahap kualiti pelaporan syarikat. Oleh itu, kajian ini akan memenuhi kekosongan ini melalui pemeriksaan peranan dan pengaruh nilai pemimpin korporat terhadap mekanisma tadbir urus korporat dan sejauh mana pengurusan perolehan berlaku. Pelaporan kualiti 120 buah syarikat bukan kewangan yang tersenarai di Bursa Malaysia pada tahun 2010 telah diperiksa. Kajian ini menggunakan model Jones (1991) yang telah diubahsuai untuk mengukur pengurusan perolehan melalui pengiraan *'discretionary accruals (DA)'* dan *'discretionary current accruals (DCA)'* manakala nilai pemimpin korporat diukur dengan pendekatan spiritualiti di tempat kerja sepertimana yang dikemukakan oleh Ashmos and Duchon (2000). Soal selidik berasaskan penilaian diri diedarkan kepada pemimpin korporat terutamanya Ketua Pegawai Eksekutif untuk mengenalpasti persepsi nilai pemimpin korporat bagi sesebuah syarikat. Penemuan kajian menunjukkan bahawa kesedaran keteguhan kerohanian mempunyai potensi untuk menguatkan sistem tadbir urus korporat melalui kerjasama dan sokongan pengarah bebas dalam mengurangkan aktiviti pengurusan perolehan. Penemuan kajian ini mencadangkan bahawa integriti dan etika pemimpin korporat adalah penting untuk membangunkan budaya korporat yang baik dalam mengekalkan manfaat jangka panjang kepada pihak berkepentingan terutamanya apabila membentangkan laporan kewangan korporat berkualiti baik.

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ABSTRACT

Even after twenty years of implementing corporate governance system, corporate scandals and failures are still happening. Most empirical studies show inconsistent and at best, inconclusive findings regarding the effects of corporate governance mechanisms such as board and audit committee characteristics and ownership structure on a quality of financial reporting. The effectiveness of corporate governance is also affected by institutional factors that are shaped by history and political contexts. Most corporations in developing countries including Malaysia demonstrate high concentration ownership, government intervention and family dominance. This would lead to low transparency, inadequate disclosure and minority shareholder expropriation as majority shareholders tend to maximise their private benefits. The enforcement of corporate governance principles practised by corporations does not reflect the quality of corporate people who actually govern the corporations. Hence, it is important to study the role of corporate leader values as an organization is typically shaped up by the attitude, values and vision of a corporate leader. The vision, philosophy, future direction shared by the CEO is important to corporations in ensuring all governance related matters are handled as efficiently and as effectively as possible. The values held and shared by the leader will shape the extent of reporting quality by the corporation. Thus, this study will fill the void by examining the role and influence of corporate leader’s values on corporate governance mechanisms and the extent of earnings management. Reporting quality of 120 non-financial companies listed on Bursa Malaysia is examined for the year 2010. The study employs Modified Jones Model to measure earnings management through the calculation of discretionary accruals (DA) and discretionary current accruals (DCA) whilst the corporate leader values are measured using workplace spirituality approach as proposed by Ashmos and Duchon (2000). The self-evaluated questionnaire has been distributed to corporate leaders, particularly CEOs, to determine the sense of corporate leader values for each company. The findings of the study show that sense of spiritual values of corporate leader has potential to strengthen the corporate governance system through cooperation and support of independent directors in mitigating earnings management activities. The findings suggest that the integrity and ethics of corporate leader are important to develop a good corporate culture in sustaining long-term benefits to stakeholders, particularly when disclosing good quality corporate financial reports.

CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION

The purpose of this study is to investigate the influence of corporate leader values as measured by a sense of spirituality at the workplace, as a potential determinant to explain the relationship between corporate governance mechanisms and earnings management. This study concentrates on the crucial function of corporate management and corporate governance in preparing and monitoring the financial reporting process. Corporate leaders, mainly top management and corporate directors, have significant responsibility for the improvement of financial reporting quality. This chapter contains several important sub-topics related to the study. Section 1.2 discusses the background of the study and introduces the problem statements which are explained in Section 1.3. Section 1.4 highlights the research questions and is followed by the objectives of the study in Section 1.5. Section 1.6 describes the scope of the study while Section 1.7 offers the significance of the study. This chapter ends with the chapter organisation in Section 1.8.

1.2 BACKGROUND OF THE STUDY

In the current economic environment, corporate governance is one of the most important topics discussed amongst the business community and society at both the national and international levels. The main focus is the efficiency of corporate governance function in sustaining the corporation. Before the 1990s, the importance of corporate governance was ignored by most corporations around the world. However, it became a debate among researchers, academicians, regulators, practitioners, policy makers and even society after the biggest economic crisis occurred around the world in the late 1990s. The consequences of corporate failure have not only affected the related companies but also the capital market. It influences the economic stability, social development and the well-being of both shareholders and stakeholders.

The signal of corporate failure is marked by the declining stock market. The earliest corporate failure was the South Sea Bubble in the 1700s which revolutionised business laws and practices in England (Grant, 2003). In 1984, the Bank of Credit, Commerce International and Barings Bank collapsed due to corporate governance crisis. In the early 2000s, the biggest corporation in the United States, Enron Corporation, also collapsed, followed by the failure of WorldCom, HIH, OneTel, Parmalat and other big companies due to the same issue. Following these corporate scandals, the US government approved the Sarbanes-Oxley Act in July 2002 with the objective to protect investors by improving the accuracy and reliability of corporate disclosures. However, these government regulations have been proven ineffective (Grant, 2003).

Evidently, corporate failures are still occurring as shown by the recent corporate collapses of Northern Rock, Bear Stearns, Bernard L. Madoff Investment Securities and Dynegy. It is argued that the proposed rules and regulations alone are not able to solve the corporate governance issues effectively without the support from ethical corporate people. Experiences of corporate scandals and failures reveal that company management, especially top management, acted not for the best interest of their shareholders (Staubus, 2005). They tended to manipulate earnings reports with an intention to show good company performance in order to get better compensation or cash bonuses (Baker *et al.*, 2000; Efendi *et al.*, 2007).

The role of a corporate leader is the prominent issue in corporate governance. A corporate leader has more opportunity and potential to influence the corporate behaviour and the corporate culture. The above events informed that the character and values of a corporate leader are the most important factor to sustain a corporation. It means that whatever values practiced and shown by the corporate leader will determine the corporate value which in turn will influence the pattern of corporate culture and the direction towards corporate goals. The corporate leader who has a sense of values and meaning tends to be soulful and mindful in governing corporation because he has a clear vision to achieve. The ultimate goal is the sustainability of corporate performance through sharing and presenting a quality financial reporting. The benefits can be shared with the internal user, external user and economic growth as well. Table 1.1 provided evidence on the person responsible for and were directly involved in the corporate failures. Most of them were top corporate leaders, especially Chief Executive Officers (CEOs), Chief Financial Officers (CFOs) and corporate directors.

Table 1.1
Summary and Examples of Corporate Failure

Year	Company	Country	What Went Wrong	Responsible Person
2001	Enron	USA	Off balance sheet contrivances, inflated earnings.	CFO
2001	HIH Insurance	Australia	Failed with debts of $3.1 billion after consistently understating claims liabilities, spent A$340,000 on gold watches in 1 year; criminal and civil charges pending against several directors.	CEO & Directors
2001	Aldephia Com	USA	Off balance sheet loans to senior officers.	CFO
2002	WorldCom	USA	$3.8 billion fraud - loans to CEO, expenses booked as capital expenditure.	Director & CEO
2002	Xerox	USA	Accounting overstates profits by $1.4 billion – accelerated revenue recognition.	CFO
2003	Parmalat	Italy	False transactions recorded.	CFO
2003	Ahold	Netherlands	Stock price collapsed after American subsidiary was found to have falsely reported earnings.	CEO
2005	Refco	USA	CEO and chair had concealed $430 million of bad debts.	CEO
2008	Bear Steams	USA	The business collapsed as more people were unable to meet mortgage obligations.	CEO
2008	Northen Rock	USA	As more and more people defaulted on their home loans in the US, the Rock's business was collapsed.	Directors
2009	Nortel	Canada	Following the 2007-2008 financial crisis, and allegations over excessive executive pay, demand for products dropped.	CEO
2009	Arcandor	German	After struggling to maintain business levels at its brand names Karstadt and KaDeWe, Arcandor sought help from the German government, and then filed for insolvency.	CEO
2012	Dynegy	USA	After a series of attempted takeover bids, and a finding of fraud in a subsidiary's purchase of another subsidiary, it filed for bankruptcy.	Directors
2012	Schlecker	German	After continual losses mounting from 2011 with 52,000 employees, it was forced into insolvency, though continued to run.	Directors
2014	Banco Espirito Santo	Portugal	An uncovered severe financial irregularities and a precarious financial situation and then revealed of €95 billion losses.	CEO

In the emerging market, the financial and economic crisis hit Asian countries around 1997. It gives a signal of weak corporate governance as financial problems faced by most large companies in those countries. In the Malaysian context, unanimous agreement on the role of private debt by listed companies caused distress to the banking system, thus triggering the collapse after July 1997 (Thomas, 2002). Following the crisis, the Malaysian government established the Finance Committee on Corporate Governance on 24 March 1998 to quickly formulate a code of corporate governance known as the Malaysian Code on Corporate Governance (MCCG) in 2000. The Security Commission (SC) was established as a watchdog to improve the legal and regulatory framework governing the capital market. Public listed companies should comply with the MCCG 2000 as well as meet the Kuala Lumpur Stock Exchange (KLSE) Requirement in order to enhance the transparency of public listed companies' disclosure. The code was brought into full effect in January 2001 with the amendment to the Bursa listing requirement.

Unfortunately, the percentage of corrupt companies after the implementation of MCCG (2000) and National Integrity Plan (NIP) (2004-2008) is still high. It is shown by the Transparency International's Corruption Perception Index (CPI) 2007 where Malaysia ranked 43rd in 2007 which is down from the 33rd place in 2002. Transparency International's Global Corruption Barometer 2007 (GCB) also showed that 6% of Malaysian respondents had paid a bribe, with 13% as the total sample average. The police, political parties and the business sector were perceived to be the most corrupt sectors in Malaysia in the GCB 2007. About 63% of Malaysian respondents felt that corruption would increase in the next three years.

In 2005, a comparative survey was conducted by the Business Ethics Institute of Malaysia (BEIM) in collaboration with Binary University College and the University of Nottingham Malaysia on the subject of "tell the truth" among Malaysian and United Kingdom (UK) occupations. The survey shows that business leaders were ranked at 14th in the list of 15 groups of occupations that did "not tell the truth". It was the second last in the ranking before the politicians group listed as the last. Half of the Malaysian respondents (50%) and 46% from the UK respondents agreed that business leaders did "not tell the truth" compared to 16% and 37% of Malaysian and UK respondents respectively who indicated that business leaders did "tell the truth". These findings show the current perceptions and beliefs of our community on our business leaders today.

The revised MCCG (2007) was extended to improve the rules and regulations related to the board of directors, shareholders, accountability and audit. However, the same scenario as in developed countries, the corporate scandals, was also repeated in Malaysia such as Transmile Group Bhd, Megan Media, NasionCom Berhad, United U-Li Corporation Berhad and OCI Berhad in 2007 and Oilcorp Bhd in 2008. In 2011, SC released the Corporate Governance Blueprint 2011 (Blueprint) in order to achieve excellence in corporate governance through strengthening self and market discipline and promoting good compliance and corporate governance culture. In 2012, the Malaysian Code on Corporate Governance 2012 (MCCG 2012) was introduced which consistently supports the Blueprint 2011 to strengthen the board structure and composition and also recognizes the role of directors as active and responsible fiduciaries.

1.3 PROBLEM STATEMENT

The main issue to be highlighted is why, despite an aggressive implementation of rules and regulations, the issues of corporate governance are still not resolved. Failure and frauds are recurring despite reformation and the enforcement of rules and regulations by most regulators around the world. Each country has already established several enforcement authorities to monitor the implementation of rules and regulations like Securities Commission, Stock Exchange, Company Registrar and Central Bank. Does this phenomenon signal the ineffectiveness of corporate governance system implemented in the current economics today? Corporate governance is developed by two interrelated elements, namely the corporate governance structure and corporate governance behaviour. Corporate governance behaviour is the actions of corporate leaders who are responsible for governing corporations. The implementation of current rule-based governance would result in a solid corporate governance structure but may neglect the element of corporate governance behaviour. It shows that the corporate governance structures are easy to put into practice but the implementation of these structures does not guarantee the desired corporate leader behaviour; i.e. quality financial reporting.

Effective corporate governance structure and mechanisms will drive appropriate corporate behaviour in achieving corporate goals and improving the desired financial reporting quality. The quality information is needed by corporate users in order to facilitate them in making a quality decision. According to Habib and Jiang (2015), one of the desirable properties of an effective corporate governance system is to ensure a high-quality financial reporting regime for efficient resource allocation and economic growth. In reality, corporate scandals and failures are continuously occurring both in developed and developing countries. Rule-based governance is found not to be influential in determining the quality of financial reporting (Norman *et al.*, 2005; Abdul Rahman and Mohamed Ali, 2006; Hashim and Devi, 2008; Ghosh *et al.,* 2010; Germain *et al.*, 2014). These studies which reported a contradictory finding have been conducted in developing countries particularly in Malaysia. Due to the different context of business practices and the nature of the business environment, the effectiveness of corporate governance system in these countries is expected to differ from those corporations in developed countries.

Ahrens *et al.* (2011) suggested that the corporate governance practices in developing countries are less efficient to be resolved by forcing rules based on foreign governance model particularly the Anglo-American system as practiced by most developing countries including Malaysia. This foreign model is developed based on agency theory which seems to be less practical to overcome the corporate governance issues in developing countries. Moreover, according to Arfah and Aziuddin (2008), the current practices of corporate governance are not able to bring the desired behavioural conduct among the trustees of public interest. This trend indicates that something is missing as a potential explanation for the inconclusive pattern. This is so because the implicit assumption of all of these studies is that by having a proper structure and mechanisms, the intended corporate behaviour (outcome) will almost automatically be attained. Thus for, the evidence presented does not support such assumption.

This study, therefore, intends to contribute to the extant body of knowledge in this area by proposing that having the appropriate structure and mechanisms alone is not enough to induce good corporate behaviour. The action must be implemented by people with high sense of spirituality and values within the conducive corporate culture in order to achieve good corporate behaviour. Mehra (2005) argues that the current corporate governance practices which are imposed by legislation is concerned only with a ticking boxes approach but ignored the substance of the law. He stressed that the issues of corporate governance is less sense of soulful governance. Thus, it requires solutions that are based on hearts (Taib, 2009) which need a soulful stewardship by the corporate leader. Yeo Lian Sim, Executive Vice President of the Singapore Exchange (SGX), stated that "good corporate governance does not depend on just rules and regulations or institutions and infrastructure, human beings play the major role and human integrity is critical" (p. 1) (Ping, 2006). Some researchers (Mitton, 2002; Saudagaran, 2003; Singam, 2003) investigated the factors behind weak corporate governance and concluded that it was caused by lack of due care by the board of directors, non-functioning audit committees, lack of transparency on financial arrangements between senior executives and the company, and between affiliated entities and the corporation. This argument is consistent with Haniffa and Cooke (2002).

Furthermore, Adam (2003) argued that the root cause of corporate governance failure is not the rule itself but the behaviour of corporate leaders, especially the board of directors. Less sense of meaning and values at work amongst corporate leaders leads to more cronyism scandals occurring in corporations (Johnson and Mitton, 2003), political connections in managing corporations (Gul, 2006; Bliss *et al*., 2011, Miles and Salim, 2013), and misrepresentation of financial reports particularly in CEO duality companies (Saleh *et al.*, 2007; Zahra *et al.*, 2007; Bouten, 2012). Effectively, the real cause of corporate scandals or failures is due to greed and lack of integrity (less sense of meaning and values at work) as occurred in the United States (US) corporations like Enron Corporation, WorldCom, Xerox, Bear Steams and Northen Rock. It is known that the US has the best regulation and the most efficient capital market in the world. Thus, the solution to the above problem should also focus on the real cause of the problem. At present, many of the good corporate governance practices put an extra emphasis on improvement the corporate governance structure and mechanisms. The greed and lack of integrity problems are not addressed directly. Instead, the assumption of these good corporate governance practices is that everything depends on the structure and mechanisms. Yet, these structures and mechanisms depend on the person(s) that implement the structures. In fact, the spirituality and values of these people evidently determine the quality of the corporate behaviour.

In this respect, it is suggested that the value-based solution can only be driven by leaders with a high sense of spirituality operating in a conducive workplace culture. In summary, good corporate governance structures and mechanisms would not lead to good corporate behaviour because the attainment of good corporate behaviour depends heavily on the leaders' spirituality and values embedded or inculcated in them. To support the above contention, the study analyses the trend of research findings in the developing countries. The corporations in that countries demonstrate highly concentrated ownership, highly government intervention, political connection and family dominance (Singam, 2003; Madah Marzuki *et al*. 2003; Gul, 2006; Miles and Salim, 2013). The majority control of corporations often leads to low transparency, inadequate disclosure and minority shareholder expropriation as majority shareholders are in a position to maximise their private benefits. These nature of business practices and environment are expected to be meaningful in study of the role of corporate leader values in governing the corporation.

1.4 RESEARCH QUESTIONS

In relation to the problem statement discussed above, it is crucial to study the role and influence of corporate leader values on the current corporate governance system and financial reporting quality. Therefore, this study aims to answer the following questions:

1) What is the present level of corporate leader values among the leaders of Malaysian listed companies?

2a) What is the relationship between the corporate governance mechanisms and earnings management (financial reporting quality)?

2b) What is the relationship between the corporate leader's values and earnings management?

3) Do corporate leader values moderate the relationship between corporate governance mechanisms and earnings management?

1.5 RESEARCH OBJECTIVES

Generally, the main objective of this research is to determine the role and influence of corporate leader values on corporate governance mechanisms and financial reporting quality. Specifically, this study hopes to answer the above research questions through the following objectives. The objectives are to:

1) determine the present level of corporate leader values among the leaders of Malaysian listed companies.

2a) examine the relationship between the corporate governance mechanisms and earnings management (financial reporting quality).

2b) examine the relationship between the corporate leader's values and earnings management.

3) examine the influence of corporate leader values on corporate governance mechanisms and earnings management.

1.6 SCOPE OF THE STUDY

This study focuses on the influence of corporate leader values on corporate governance mechanisms and earnings management (financial reporting quality). The corporate leader values are measured using the sense of workplace spirituality approach and spiritual leadership theory which were introduced by Ashmos and Duchon (2000) and Fry (2003, 2005). It is categorised into five basic elements: inner life (sense of spirituality), meaning at the workplace, sense of community, team values and corporate values. Ashmos and Duchon (2000) and Fry (2003, 2005) are among the pioneers of the workplace spirituality and spiritual leadership concepts. Subsequently, many studies such as Milliman *et al.* (2003), Rego and Cunha (2008), Pawar (2009), Abdul Ghani (2009), Petchsawanga and Duchon (2012), Kazemipour and Mohd Amin (2012), and Beheshtifar and Zare (2013) have used similar approach. They used this approach to measure the sense of spirituality of leaders and employees and then relate to the positive outcomes of an organisation (e.g. employees commitment, teams effectiveness and organizational performance).

The sample of study comprises non-financial companies listed on Bursa Malaysia's Main market for the year 2009 and 2010. The study uses the secondary data specifically the corporate annual reports for collecting data pertaining to corporate governance mechanisms and financial reporting quality while the primary data are collected through a structured questionnaire for getting the perception of a corporate leader. The selected corporate leaders are Chief Executive Officer (CEO) or Managing Director (MD). The study concentrates on three parts of corporate governance mechanisms: (i) board characteristics consisting of board independence, board size and CEO duality; (ii) audit committee characteristics comprising of audit committee independence and audit committee expertise; and (iii) ownership structure consisting of insider ownership, outsider ownership and institutional ownership. The proxy of financial reporting quality is earnings management through the calculation of discretionary accruals (DA) and discretionary current accruals (DCA). The research model includes four control variables such as company size, company leverage, return on assets and audit quality. The main data analysis is a hierarchical regression. It is used to test the proposed hypotheses regarding the moderating effects of corporate leader values on corporate governance mechanisms and earnings management.

1.7 SIGNIFICANCE OF THE STUDY

Theoretically, the findings of this study are expected to enhance the quality corporate governance system by integrating corporate leader values. The corporate governance structure has potential to be strengthened through the function of corporate leadership in the financial reporting process. It means that the corporate leader who has a sense of integrity tends to support and help corporate directors and managers to provide quality information in financial statements. In the current context, the Securities Commission Malaysia already takes the initiative by releasing the Corporate Governance Blueprint 2011 and the Malaysian Code on Corporate Governance 2012. It reveals the importance of corporate leader values and quality of governance structure in strengthening the Malaysian corporate governance system. The code suggests that boards and management must be mindful of their duty and soulful in governing for the best interest of stakeholders. It is hoped that the quality and accurate financial information can be produced for informed decision making by corporate investors and creditors.

The corporate governance model in developed countries is based on agency theory. The theory focuses on the relationship between the board of directors as an agent and shareholders as the principal of the corporation. However, developing countries including Malaysia tend to follow and adopt the foreign model specifically Anglo-American model in their corporate governance system even though they have a different institutional context. The Malaysian corporations have a high concentrated ownership, government intervention, political connection, and family dominance (Singam, 2003; Miles and Salim, 2013). According to Ahrens *et al.* (2011), it is not practical to use the foreign model of corporate governance in developing countries due to different institutional settings. It is argued that the foreign model which is based on agency theory argument is less efficient to resolve the corporate governance issues in developing countries. Thus, the study suggests a significant foundation for attainment of good corporate culture in developing countries by applying spiritual leadership and stewardship theory.

A spiritual leader as well as a sense of spirituality in the organisation is necessary to the success of an organisation. It is a fundamental need for corporate leaders and members to be committed and productive in an organisation (Fry, 2003; Fry *et al.*, 2011). A corporate leader is viewed as a steward or trustee of corporate resources, not as an agent for the corporation. He tends to optimise these corporate resources, in order to promote the interest of shareholders and stakeholders (Donaldson and Davis, 1991; Davis *et al*., 1997). Thus, it is expected that the interest gap between corporate managers and shareholders can be reduced by practicing a soulful stewardship.

The results of this study provide a significant information for regulators and policy makers on the importance of corporate leader values in governing the corporation. The rules and regulations enacted should be integrated with the principle values to be practiced by the corporate leader as well as other corporate members. Currently in Malaysia, there is a positive effort by Securities Commission Malaysia to enhance values, ethical and discipline of a corporate leader by introducing the Corporate Governance Blueprint 2011 and the Malaysian Code on Corporate Governance 2012. The code emphasis on the role of corporate leadership to ensure good compliance with the law, ethical value and market discipline besides good practices in corporate governance structure and mechanisms.

The study also provides important information to corporate management in enhancing the corporate achievement by practicing positive values. This good corporate culture is important to prepare a conducive environment for organisational commitment (Milliman *et al.*, 2003; Rego and Cunha, 2008), physical and mental health of employees (Sprung *et al.*, 2012), job satisfaction (Pawar, 2009) and organisational performance (Duchon and Plowman, 2005; Marques, 2008; Fry *et al.*, 2011). Finally, the aspirations of the Malaysian government for Vision 2020 “to establish a fully moral and ethical society whose citizens are strong in religious and spiritual values and imbued with the highest ethical standards” will hopefully be achieved.

1.8 CHAPTER ORGANISATION

The study is organised into six chapters. The first chapter discusses the background of the study which leads to the problem statement, research questions and research objectives. The scope and significance of the study are also discussed in this chapter. The second chapter concentrates on a literature review. It begins with a discussion on financial reporting, financial reporting quality, earnings management concept, corporate governance and the role of corporate governance in monitoring the financial reporting process. It is followed by a comprehensive discussion of corporate governance studies in relation to the financial reporting quality, the role of corporate leader values in a corporation, and the importance of good corporate culture to a corporation. The third chapter explains the research framework and development of the hypotheses. The fourth chapter concentrates on research methodology. The fifth chapter reports on the findings of the study. The last chapter focuses on discussion and conclusion of the study.

CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

An effective corporate governance system is crucial as it will drive appropriate corporate behaviour in achieving the desired financial reporting quality for efficient resource allocation and economic growth. However, the effectiveness of corporate governance structures and mechanisms actually depends on the person(s) that implement the structures as inconclusive findings are documented by some of corporate governance studies. In fact, the spirituality and values of these people actually determine the quality of the corporate behaviour. It is argued that good corporate governance structures and mechanisms would not lead to good corporate behaviour because the attainment of good corporate behaviour depends heavily on the leaders' spirituality and values embedded in them. Therefore, the purpose of this chapter is to discuss the importance of corporate leaders' values to corporate governance system in order to achieve high quality financial reporting. This chapter reviews the role of corporate governance in monitoring the financial reporting process, empirical studies about corporate governance and the influence of corporate leader in strengthening the function of corporate governance. The chapter is divided into several sub-sections as follows. Section 2.2 explains the concept of financial reporting including financial reporting quality and earnings management concept. Section 2.3 elaborates the corporate governance concept and its related issues in developed and developing countries, including Malaysia. Section 2.4 discusses the importance of corporate leader values. Section 2.5 reveals the function of corporate governance system and financial reporting process. Section 2.6 comprehensively discusses the effective mechanisms of corporate governance. Section 2.7 discusses the role of corporate leader values in corporate governance. Section 2.8 reveals the sense of spirituality as the basis of corporate leader values. Section 2.9 documents the positive impact of the sense of spirituality on the corporation. Section 2.10 concludes the role of corporate leader values to corporate governance and financial reporting quality. Lastly, the Section 2.11 ends with a summary and conclusion of the overall discussion of this chapter.

2.2 FINANCIAL REPORTING

Financial reporting is an important information about corporate activities disclosed to external users especially shareholders and creditors. It reflects the corporate image and credibility. According to Sundaraman (2001), financial reporting is the process to inform and give understanding to users about financial information or what is written up in the account books of the company in a certain accounting period. The related financial report should be reliable and relevant to the current context in order to assist users in making a quality decision.

According to Habib and Jiang (2015), the main role of the financial reporting system is to provide shareholders with relevant and reliable information that aids in the effective monitoring of management and directors. Thus, the role of corporate governance is crucial to the process of financial reporting. However, past studies show inconsistent and inconclusive findings regarding the effective function of good practices of corporate governance in enhancing the quality of financial reporting. The responsibility and accountability of management and directors will determine the level of financial reporting quality. The trend of business practices in developing countries provides a challenge to corporate leaders in preparing a quality report.

The Conceptual Framework for Financial Reporting 2010 issued by the International Accounting Standards Board (IASB) specifically states in Chapter 1: The Objective of General Purpose Financial Reporting:

> "The objective of the general purpose of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit" (OB2, p. 9)

The standard also mentions the reason why users need to financial information in the following paragraph:

> "To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources" (OB4, p. 10)

Financial reporting provides important information about a company's performance for a certain period to external and internal users. This useful information is needed by external users particularly investors in facilitating them to make the best decision related to their investment activities. Another important role of financial reporting is to facilitate contracting between the related parties like management incentive contracts to management parties and dividend payment to investors (Beaver, 1998). It provides the primary source of independently verified information to capital providers about the performance of managers (Sloan, 2001).

In the Malaysian context, after independence in 1957, the first rules and regulations that governed the corporate financial reporting practices are the Companies Act 1965 specifically stated in the Ninth Schedule. The Ninth Schedule prescribes the basic requirement for disclosure of financial reports for Malaysian companies. As stated in Section 169 and 326 of the Companies Act 1965, the listed companies should provide at least income statements, balance sheets and the director's report of companies (Muniandy and Ali, 2012). In the 1990s, Malaysian listed companies also need to comply with Securities Commission Act 1993 and Bursa Malaysia Listing Requirements. After the Financial Reporting Act was enacted in 1997, two important independent bodies responsible for improving the quality of financial reporting were created, namely Financial Reporting Foundation (FRF) and the Malaysian Accounting Standards Board (MASB). In August 2008, the FRF and MASB announced their plan to bring Malaysia to full convergence with International Financial Reporting Standards (IFRSs) by 1 January 2012[1].

2.2.1 Financial Reporting Quality

Financial reporting quality is a topical issue being discussed by academicians, researchers, practitioners and regulators. It relates to the quality of information disclosed by a corporation either in the form of financial or non-financial information. The

[1] In November 2011, the MASB pronounced the new IFRS-compliant Financial Reporting Standards, known as the Malaysian Financial Reporting Standards (MFRS) Framework. It comprises standards issued by the IASB. It is to be applied by all entities, other than private entities, for annual periods beginning on or after 1 January 2012.

qualitative characteristics of useful financial information will determine the quality of financial reporting as stated by IASB in its Conceptual Framework in 2010.

The Conceptual Framework for Financial Reporting 2010 issued by the IASB specifically states in Chapter 3: Qualitative Characteristics of Useful Financial Information:

> "If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable". (QC4, p. 16)

This conceptual framework highlights two fundamental qualitative characteristics such as relevance and faithful representation. Relevant financial information means users are capable of making a difference in their decisions. It means that the financial information should have predictive value, confirmatory value or both. The financial information has predictive value if users are able to predict future outcomes whereas the financial information has confirmatory value if it provides feedback about previous evaluations. The financial information is faithful representation when it is complete, neutral and free from error.

According to Rezaee (2003), the main criteria of a quality financial report is reliable financial statements or, in other words, it is free of material misstatements due to errors and/or fraud. It can be achieved when there is a well-balanced, functioning system of corporate governance as well as the integrity of corporate leaders. An effective corporate governance system has potential to produce a high-quality financial reporting for efficient resource allocation and economic growth (Habib and Jiang, 2015). Integrity, quality and transparency of corporate financial reporting will enhance investors' confidence in the capital market (BRC, 1999).

It is argued that the quality of financial reporting depends on the quality of earnings because earnings are the ultimate financial figure concern by users in making a decision (Schipper and Vincent, 2003). It is a key component or summary indicator of financial reporting quality (Francis *et al.*, 2006) and is a function of firm fundamental performance (Dechow *et al.*, 2010). Earnings consist of cash flows and accruals, and the accruals can be divided into discretionary and non-discretionary accruals. According to Ronen and Yaari (2008), a crucial role of earnings information is informativeness and stewardship. The informativeness role is important to investors in predicting future cash flows and to assessing risk. The second role of stewardship is important because of the separation between ownership and management of the corporation. Thus, some researchers used a proxy of earnings quality in determining the quality of financial reports (Francis *et al*., 2004; Francis *et al*., 2005; Aboody *et al.*, 2005; Baxter and Cotter, 2009).

However, there is no agreed approach to measure quality of financial reports because its qualitative characteristics are subjective and difficult to observe directly. Many researchers measure the quality of financial reporting indirectly by focusing on attributes that decrease/compromise the quality of financial reports such as financial restatements (Abbott *et al*., 2004, Abdullah *et al*., 2010), earnings management (Davidson *et al.*, 2005; Kothari *et al.*, 2005; Norman *et al*., 2005; Baxter and Cotter, 2009), fraudulent financial reporting (Beasley *et al.*, 2000; Goodwin and Seow, 2002; Chen *et al.*, 2006) etc. Low level of financial restatements, earnings management, and fraudulent financial reports means high quality of financial reporting.

From the perspective of earnings management, there are two types of general earnings management usually practiced by managers either through discretionary accruals and/or real earnings management. Accruals earnings management happens when managers exploit accounting discretion within the flexibility of accounting regulations in order to show improved reported earnings (Sun and Rath, 2010). This manipulation of earnings is through accounting estimates and accounting choices with no direct effects on cash flow. For the second type of earnings management, real earnings management occurrs when managers manipulate reported earnings by altering nature of economics activities in terms of financing, investment or operating activity in order to achieve income targets (Roychowdhury, 2006). It involves manipulation of earnings through real business operations that deviate from normal practices with direct cash flow consequences. It also provides an opportunity for managers to manipulate earnings upwards or downwards.

The study uses discretionary accruals approach as more management discretions are made through accruals (Abdul Rahman and Mohd Ali, 2006; Teoh *et al.*, 1998; Sun and Rath, 2010). It is simply being used because under the accrual accounting system which complies with GAAP, managers are allowed to make adjustments to cash flows through accruals. They are more likely to exploit this flexibility to shift earnings between periods by changing accruals rather than by changing accounting policies. In addition, managing earnings through accruals manipulation is more subtle and does not require disclosure. From the perspective of researchers, the real earnings management is difficult to detect compared to discretionary accruals because there is no benchmark for determining the right actions that managers have taken (Sun and Rath, 2010). Beside the calculation of discretionary accruals (DA), the study also uses the discretionary current accruals (DCA) or working capital accruals consistent with Peasnell *et al.* (2001), Xie *et al.* (2003) and Abdul Rahman and Mohd Ali, (2006) as it is more sensitive to detect earnings management compared to DA. Both formulas are used to be more consistent in measuring earnings management.

2.2.2 Earnings Management Concept

The issue of earnings management is widely discussed by researchers and academicians around the world. Earnings management is an activity which relates to manipulation of reported earnings in the financial statements with the intention to show an increasingly good company performance within the Generally Accepted Accounting Principle (GAAP) compliance. Schipper (1989, p. 92) defined earnings management as "the process of taking deliberate steps within the constraints of GAAP to bring about the desired level of reported income". It may reduce the quality of financial reporting and increase information asymmetries (Hadani *et al.* 2011). Transaction costs also increase due to an increase of management activities in manipulating earnings report (Hazarika *et al.*, 2012). More importantly, earnings management can also affect the credibility of financial information, which can lead to major financial scandals (e.g. Enron, World.com), and the capital market may crash.

Earnings management is different from the financial reporting fraud because fraudulent reporting does not comply with GAAP as documented by Beasley (1996), Beasley *et al.* (2000) and Abbott *et al.* (2004). However, firms which have experiences in earnings