CORPORATE GOVERNANCE AND ACCOUNTING QUALITY IN MALAYSIA

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CORPORATE GOVERNANCE AND ACCOUNTING QUALITY IN MALAYSIA

by

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TABLE OF CONTENTS

CHAPTER 4 RESEARCH FRAMEWORK AND METHODOLOGY

LIST OF TABLES

TABLE OF FIGURES

Page

TADBIR URUS KORPORAT DAN KUALITI PERAKAUNAN DI MALAYSIA

ABSTRAK

Malaysia menghadapi persaingan dari negara-negara di rantau ini dan dari negara-negara sedang membangun seperti India dan China dalam menarik pelabur. Bukan sahaja sumber-sumber semula jadi, kualiti tenaga kerja dan kestabilan politik yang menarik pelabur ke negara kita. Kualiti perakaunan, kebolehpercayaan, ketelusan dan tadbir urus korporat turut sama penting. Oleh itu, objektif utama kajian ini adalah untuk mengkaji perubahan dalam kualiti perakaunan sebelum dan selepas pelaksanaan Piawaian Laporan Kewangan (FRS) pada 1 Januari, 2006. Kajian ini juga mengkaji hubungan antara pelbagai mekanisme tadbir urus struktur lembaga, jawatankuasa audit dan kualiti perakaunan di Malaysia. Kajian ini akan menggunakan data semua syarikat awam yang tersenarai di papan utama (PLC) dari tahun 2003-2008 sebagai populasi untuk mendapatkan sampel. Data yang lengkap daripada 397 syarikat bukan kewangan telah terkumpul untuk kajian ini. Keputusan menunjukkan bahawa kualiti perakaunan telah merosot dari pengurusan perolehan yang lehih tinggi dan pengurangan pegiktirafan kerugian untuk jangka masa selepas perlaksanaan jawatan Standard Pelaporan Kewangan Antarabangsa (IFRS) dan Kod Tadbir Urus Korporat (MCCG). Tambahan pula, keputusan juga menunjukkan bahawa ciri-ciri tadbir urus korporat seperti kepakaran urus tadbir dalam jawatankuasa lembaga, saiz lembaga, pemilikan saham, peranan berbelah pengarah atau kebebasan pengerusi, kepakaran kewangan jawatankuasa audit, kebebasan jawatankuasa audit sangat berkaitan dengan kualiti perakaunan dalam tempoh selepas perlaksanaan IFRS dan MCCG. Keputusan boleh digunakan oleh peserta pasaran saham dalam membuat penilaian terhadap peranan tadbir urus korporat dan struktur pemilikan dalam meningkatkan kualiti pendapatan dilaporkan. Hasil kajian juga akan membantu penguatkuasa untuk menentukan sifat-sifat tadbir urus korporat yang berkesan dan menilai keperluan dalam pendedahan amalan tadbir urus korporat pada masa depan.

CORPORATE GOVERNANCE AND ACCOUNTING QUALITY IN MALAYSIA

ABSTRACT

Malaysia faces increased competition from countries in the region and from emerging economies such as India and China in attracting investors. It is not just the natural resources, quality of labour force and political stability that attract investors to its shores. Equally important is the accounting quality, its reliability, transparency and corporate governance. Therefore, the main objective of this research is to examine the changes in accounting quality before and after the implementation of Financial Reporting Standards (FRS) on January 1, 2006. This research also examines the relationship between various governance mechanisms of board structure, audit committees and accounting quality in Malaysia. This study will be conducted by using the entire main board public-listed companies (PLCs) as population for the year of 2003 to 2008 in order to obtain the sufficient samples for analysis. The final sample for this study comprised 397 non-financial companies with complete data for accounting quality and corporate governance variable. The overall results in this study find that accounting quality has reduced in terms of higher earnings management and lesser timely loss recognition during the post IFRS and post MCCG period. Furthermore, the results also suggest that corporate governance attributes of governance expertise in board committee, directors' ownership, role duality or chairman independence, audit committee financial expertise, audit committee independence are associated at significant levels with accounting quality during the post IFRS and post MCCG period. Its results are useable by stock market participants in their evaluation of the roles of corporate governance and ownership structure in enhancing the quality of reported earnings. The findings will also help regulators to define effective corporate governance attributes and to assess the requirements for disclosure of corporate governance practices in future.

CHAPTER 1

INTRODUCTION

1.0 Introduction

This research examines the relationship between various governance mechanisms ~~of~~ – board structure, audit committees and accounting quality – in Malaysia. The chapter is ~~organised~~organized as follows: Section 1.1 explains the background of the research and Section 1.2 discusses the problem statement. Section 1.3 provides justifications for the research objectives while Section 1.4 develops the research questions. Section 1.5 explains the significance of this research, and, finally, Section 1.6 concludes the chapter by ~~summarising~~summarizing the ~~organisation~~organization of the thesis.

1.1 Background of the research

The International Accounting Standards Board (hereafter, IASB) is — -the independent, -accounting standard-setting body of ~~the~~ the International Financial Reporting Standards (thereafter IFRS) Foundation. The IASB was founded on April 1, 2001 as the successor to ~~the~~ the ~~International Accounting Standards Committee~~ International Accounting Standards Committee (IASC).

Stemming from the IASB's plan to produce a single set of high-quality global reporting standards and thereby ~~eliminating~~ eliminate incomparability, the new implementation of IFRS ~~is~~ aim~~ed~~s at achieving convergence in the world of

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accounting (Lazar *et al.*, 2006). To date, more than 100 countries have agreed to require, or allow adoption of IFRS (Jeanjean and Stolowy, 2008). Improved accounting quality will reduce information asymmetry by disclosing relevant and timely information~~–~~, which will ~~and this would~~ enable global comparisons of financial statements, increase transparency and boost investor confidence in the marketplace (Soderstrom and Sun, 2007).[1]

Malaysia is also eyeing ~~for~~ full convergence with IFRS by 2012. As we are aware, Malaysia faces increased competition from countries in the region and from emerging economies, such as India and China, in attracting investors. It is not just the natural resources, quality of ~~labour~~labor force and political stability that attract investors to its shores. Equally important is the accounting quality, its reliability, transparency and corporate governance (Lazar *et al.*, 2006). Therefore, the accounting standards need to be changed to best adapt to the demands of the continuously evolving environment. ~~And~~ In addition, there is a growing consensus around the world that financial reporting quality in any marketplace should be of high accounting quality in order to serve the needs of investors and facilitate the achievement of an effective global market (Lazar *et al.*, 2006). The following section will discuss accounting quality, and, thereafter, corporate governance in more detail.

1.1.1 Accounting quality

[1] This research adopts the accounting standards perspective of accounting quality. This perspective was defined by Barth *et al.* (2007), who state~~s~~ that "… higher accounting quality will exhibit less earnings management, more timely loss recognition, and higher value relevance."

Consistent with the predictions in ~~this~~ prior research, higher~~-~~ accounting quality exhibits less earnings management, more timely loss recognition, and higher value relevance of earnings and equity book value (Barth, Landsman and Lang, 2008, Barth *et al.*, 2010). Since this research only using multivariate analyses~~Following prior research~~, therefore it ~~this research also~~ ~~operationalises~~operationalizes accounting quality using earnings management and ~~,~~ timely loss recognition~~, and value relevance~~ metrics. These two~~hree~~ aspects are especially relevant to the research question because accounting quality can also be affected by opportunistic discretion exercised by managers~~,~~ and~~,~~ ~~are~~ therefore, is likely to be influenced by the incentives of those who prepare the financial statement~~-~~ rather than changes in the accounting standards~~-~~. The incentives are even higher for a developing country like Malaysia, ~~that~~ which has different institutional characteristics, and in which ~~and where~~ the legal protection of outside investors is weak, and, ~~thus~~hence~~,~~ the accounting quality is questionable. The following section ~~with~~ will discuss~~ion~~ the two~~hree~~ accounting quality metrics.

1.1.1.1 Earnings management

Earnings management has been defined by Healy and Wahlen (1999) as:

Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

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Similarly, Schipper (1989) defined earnings management as: a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain.

IFRS may limit management opportunistic discretion~~s~~ by reducing available accounting alternatives. ~~—~~Hence,~~–~~ IFRS earnings ~~to~~ will be less managed than domestic based earnings (which are MASB Standards) because IFRS limits management's discretion to report earnings that are less reflective of the firm's economic performance (Barth *et al.*, 2010), and, therefore, accounting quality should increase. The following section will discuss timely loss recognition.

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1.1.1.2 Timely loss recognition

Turning to timely loss recognition, this research ~~assumed~~ assumes that higher quality earnings exhibit a higher frequency of large losses. This is consistent with Basu (1997), Basu Ball, Kothari, and Robin (2000), Lang, Raedy, and Yetman (2003), Leuz, Nanda, and Wysocki (2003), Watts (2003a, b), ~~–~~Ball and Shivakumar (2005, 2006) Lang, Raedy, and Wilson (2006), and Barth *et al.*~~,~~ (2010), ~~that~~ who suggest that one characteristic of higher quality earnings is that large losses are recognized as they occur rather than being deferred to future periods. This characteristic is closely related to earnings management in that if earnings are managed, large losses should be relatively rare. Thus, the firms applying IFRS report large losses with higher frequency than those applying domestic standards.

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Accounting quality is closely linked ~~with~~ to financial reporting and earnings quality. As mentioned, accounting quality uses~~ing~~ earnings management, timely loss recognition and value relevance as metrics. Whereas, earnings quality ~~using~~ uses

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various measures to measure the quality of the earnings numbers. As such, accounting quality and earning quality are proxies' for financial reporting quality, which is explained next.

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1.1.2 Financial reporting quality

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Jonas and Blanchet (2000) described the two general ~~proxy~~ proxies that are widely used in assessing financial reporting quality. The first proxy is based on the needs of users. Under this proxy, financial reporting quality is determined relative to the usefulness of the financial information to the users of the information. The Malaysian Accounting Standards Board (MASB) Conceptual Framework explains the qualitative characteristics that make financial~~;~~ reporting information useful to users. These are the understandability, relevance, reliability, and comparability. The second proxy of financial reporting quality ~~is focussed~~focuses on the notion of shareholder/investor protection. This proxy defines quality financial reporting as "full and transparent financial information that is not designed to obfuscate or mislead users" (Jonas and Blanchet, 2000). Consistent with this proxy, ~~the~~ Bursa Malaysia (Kuala Lumpur Stock Exchange) has a statutory obligation to ensure that their markets are fair, orderly and transparent. There is a fundamental distinction between these two proxies of financial reporting quality. The user needs proxy is mainly concerned with providing relevant information to users for making decisions,

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whereas the shareholder/investor protection proxy aims to ensure the information provided to users is sufficient for their needs, transparent and competent (Jonas and Blanchet, 2000). In the next section, earnings quality will be discussed in more detail.

1.1.3 Earnings quality

A number of methods have been used in the research literature to empirically measure financial reporting quality. One broad method has been to use a variety of approaches to measure the quality of the earnings numbers reported in firms' financial reports. Under this method, the higher the quality of earnings, the higher ~~is~~ the overall financial reporting quality. As noted by Schipper and Vincent (2003), there is neither a widely agreed meaning given to the term "earnings quality"[2], nor a generally accepted approach to measuring this concept.

There are two methods to measure earnings quality ~~namely:~~. The first method is the modified version of the Jones (1991) model of discretionary accruals. This method

[2] Earnings quality has been defined as "…the extent to which reported earnings faithfully represent Hicksian income." (Schipper and Vincent 2003). Hicksian income is:

The amount that can be consumed (that is, paid out as dividends) during a period, while leaving the firm equally well off at the beginning and end of the period. (Schipper and Vincent 2003).

The specific earnings quality constructs developed in this research are derived from the relations among income accruals and cash. Schipper and Vincent (2003) argued that the portion of accruals that is not manipulated and error free increases the extent to which accounting earnings faithfully represents Hicksian income.

has been widely used in the literature to capture earnings management (one of the ~~proxy~~ proxies for accounting quality, which is viewed as an inverse measure of earnings quality (e.g. DeFond and Jiambalvo, 1994; Subramanyam, 1996; Teoh, Welch and Wong, 1998a; Francis, Maydew and Sparks, 1999; Kasznik, 1999; Bartov, Gul and Tsui, 2001; Chung, Firth and Kim, 2002; Frankel, Johnson and Nelson, 2002; Balsam, Krishnan and Yang, 2003; Chung and Kallapur, 2003; Gul, Chen and Tsui, 2003; Krishnan, 2003; Dowdell and Krishnan, 2004; Samarasekera *et al.*, 2012).

The above definitions take an opportunistic view of earnings management, whereby the intent of management is to obtain some private gain by misleading stakeholders or influencing contractual outcomes. Therefore, under this perspective, earnings management negatively impacts on the quality of earnings, i.e.~~,~~ the greater the earnings management, the lower the earnings quality and vice versa. If earnings were managed opportunistically, the reported earnings number and the overall financial reports would be of a lower quality. This relates to both perspectives of financial reporting quality from Jonas and Blanchet (2000), as opportunistic earnings management ~~both~~ decrease~~s~~ the usefulness of the financial information for users (the user needs perspective) and mislead~~s~~ users (the shareholder/investor protection perspective). An alternative view is that earnings are managed to allow managers to reveal more private information to users about the financial reports (Schipper 1989; Healy and Wahlen, 1999). Consequently, earnings management should be negatively associated with the information content of earnings. The association is empirically established in the literature (Ali and Hwang, 2000; Wang, 2006; Cheng *et al.*, 2011). When managers manage earnings for opportunistic purposes, accounting earnings become a less reliable measure of a firm’s financial performance. The less reliable earnings are the less informative and useful they become.

The second method used to measure earnings quality is the Dechow and Dichev (2002) model. This model argues that estimation errors in accruals, and, that subsequent corrections of these errors~~,~~ decreases the quality of accruals and earnings. However, unlike the Jones (1991) type model~~s~~ of discretionary accruals that~~:~~ focuses on the opportunistic use of accruals to window-dress and mislead users of financial statements, no attempt is made to separate the intentional from the unintentional accrual estimation errors (Dechow and Dichev, 2002). This is because both types of error~~s~~ imply low quality accruals, and, therefore, earnings. Therefore, while the Jones (1991) model assumes that accruals and earnings quality ~~is~~ are only affected by management intent to manipulate, the Dechow and Dichev (2002) measure of earnings quality incorporates both intentional and unintentional estimation errors in accruals. Intentional errors arise from the incentive~~s~~ to manage earnings and would be similar to the opportunistic earnings management proxy by the Jones (1991) model. Unintentional errors arise from management lapses and environmental uncertainty (Francis *et al*., 2009). The following section will discuss the relationship between corporate governance and accounting quality.

1.1.4 Corporate governance and accounting quality

Corporate governance ~~as~~ is defined by the Finance Committee on Corporate Governance in Malaysia ~~is~~ as “the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders" (Report on Corporate Governance 1999).

One of the most important functions that corporate governance can play is in ensuring high accounting quality (Cohen, Krishnamoorthy, and Wright, 2004; Fredersiksson *et al.*, 2012). Based on agency theory, issues associated with the separation between ownership and control will lead managers (agents) to act in an opportunistic manner by increasing their personal wealth at the expense of the owners (principal) of an ~~organisation~~organization (Jensen and Meckling, 1976). As financial statements provide value-relevant information to the external parties of the ~~organisation~~organization, the heavy reliance placed on accounting numbers create a powerful incentive~~s~~ for managers to manipulate earnings to their own advantage. The incentive~~s~~ for managers to manipulate reported earnings may be influenced by job security, contractual agreements between managers and the external stakeholders, self-interest in the presence of compensation schemes or the need to achieve target earnings and to meet market expectations (Healy and Wahlen, 1999). In these firms, failure to monitor the management may lead to inefficient resource allocation, and, to some extent, corporate scandals like Enron and Worldcom. These acts are often followed by non-transparent and misleading reporting to camouflage the effect of the scandals from becoming known by the shareholders (Johari, Salleh and Hassan, 2008). Hence, it is crucial for an organization to have an effective corporate governance mechanism to safeguard the rights of the investors in getting the true and fair information of the company.

The 1997 economic crisis in Malaysia ~~has~~ exposed serious weaknesses in the corporate governance practices, namely, weak financial structure, over-leveraging by companies, lack of transparency, disclosure and accountability (Rahman and Ali, 2006). Together with other recent high profile scandals as mentioned and some other firms in the U.S, Transmile and Megan Media in Malaysia, followed by revelations of misrepresentation of financial statements, lead many stakeholders to question the effectiveness of monitoring mechanisms on the management. These have drawn attention to corporate governance reform around the world and the need to improve accounting quality,~~–~~ as the capital market needs precise and unbiased financial reporting to value securities and encourage investor~~s'~~ confidence (Mahenthiran, 2008).[3]

In response to the risks posed by corporate governance breakdowns, many countries have taken a proactive approach in strengthening the corporate governance systems currently employed (Hashim and Devi, 2008; Fredersiksson *et al.*, 2012). The main focus is to enhance the quality of the board of directors so that shareholders' interest can be better protected, enhancing shareholder value so that they will receive an appropriate return based on their investment. In the Malaysian Code on Corporate Governance 2000 (hereafter, MCCG 2000), directors, directors remuneration, shareholders, accountability and audit are the four main principles for effective corporate governance mechanisms for Malaysian public-listed companies (hereafter, companies).

MCCG 2000 recommends that companies have a well-balanced and effective board to take the lead role in establishing best practice in corporate governance. A well-

[3] Transmile Group Bhd overstated its revenue by RM622 million for the years 2004 to 2006 (*The Star*, ~~,~~*2007*). Megan Media Holdings Bhd reported ~~a whopping~~an enormous net loss of RM1.14 billion for the fourth quarter ended 30 April 2007 as a result of accounting fraud at its subsidiary (*The Edge, 2007*)

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balanced board is defined as having a balance of executive directors and non-executive directors, ~~which~~ including independent non-executive directors, to ensure effective decision making by the board with no domination from an individual or small groups of individuals (Rahman and Haniffa, 2005; Rahman and Ali, 2006; Hashim and Devi, 2008). Additionally, MCCG 2000 also requires non-executive directors to have the necessary skills and experience and be a person of ~~calibre~~caliber and credibility in order to bring independent judgment to the board.

Furthermore, recent changes in the revised Malaysian Code on Corporate Governance (Revised 2007) (hereafter, MCCG 2007) are ~~aims~~ aimed at strengthening the board of directors and audit committees.[4] MCCG 2007 shows greater clarity of the role of nominating a committee that consists exclusively of non-executive directors, a majority of whom are independent, to recommend candidates for directorship.[5] MCCG 2007 requires among other factors, the skills, knowledge, expertise and experience of candidates so that the appointed directors will be able to discharge their functions more effectively (MCCG 2007, Part 2AA, paragraph VIII).

MCCG 2007 also strives to strengthen the role of audit committees by requiring the committees to be comprised fully of non-executive directors. In addition, all of the audit committee members should be financially literate – ~~by~~ be able to read,

[4] An independent audit committee serves to implement and support the oversight function of the board in several ways. Such a committee provides a means for a review of the company's processes for producing financial data, its internal controls, and the independence of the company's external auditor, and a forum for dialogue with the company's external and internal auditors. (Malaysian Code on Corporate Governance 2000, p.44)

[5] MCCG 2007 places importance on the process carried out by the nominating committee in evaluating members of the board, including the independent non-executive directors and chief executive officer. A nominating committee should also ensure that its assessments and evaluations are properly documented (MCCG 2007 Part 2AA, paragraph X)

~~analyse~~analyze and interpret financial statements – so that they will be able to effectively discharge their functions (MCCG 2007 Part 2BB, paragraph I). MCCG 2007 also increases the frequency of meetings to at least twice a year between the audit committee and the external auditor without the executive board members present (MCCG 2007, Part 2BB, paragraph III).[6] Those key amendments will serve to improve ~~to~~ accounting quality.

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Although there ~~are~~ is ~~numerous~~abundant literature on corporate governance issues studied in Malaysia, discussion on the relationship between corporate governance and accounting quality has not been extensively explored. Other studies in the Malaysian context investigate the relationship between corporate governance and performance (Abdullah, 2004b; Rahman and Haniffa, 2005; Haniffa and Hudaib, 2006; Wahab, How and Verhoeven, 2007), corporate governance and earnings management[7] (Abdullah, 2004; Rahman and Ali, 2006) and corporate governance and audit quality (Yatim, Kent, and Clarkson, 2006; Wahab and James, 2011) and ~~non~~ do not examine the relationship between corporate governance and accounting quality. Despite the fact there are many prior studies that have investigated the issue of earnings management (one of the ~~proxy~~ proxies in accounting quality) and board independence (Peasnell *et al*., 2005; Klein, 2002; Chtourou *et al*., 2001; and Park and

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[6] Furthermore, other amendments included~~-~~ internal audit function will be mandated for all PLCs, and the board of directors will be responsible for ensuring ~~the~~ adherence to the scope of internal audit functions (MCCG 2007 Part 2BB, paragraph VII).

[7] Healy and Wahlen (1999) define~~d~~ earnings management as occurring when: Managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying performance of the company or to influence contractual outcomes that depend on reported accounting numbers

Earnings management is viewed as having an inverse association with earnings quality (Schipper and Vincent 2003): the greater the extent of earnings management, the lower the quality of earnings and vice versa.

Shin, 2004), CEO duality (Bowen *et al*., 2010; and Carapeto *et al*., 2005), board competency (Xie *et al*., 2003; and Agrawal and Chadha, 2005) and manager share ownership (Gul and Wah, 2002; Kim and Yu, 2006; and Cheng and Warfield, 2010; Fredersiksson *et al*., 2012), only a few studies, such as Mohd Salleh *et al*. (2008), and Abdul Rahman and Mohamed Ali (2006) have investigated the issue in the Malaysian context. This research extends prior research by making an in depth investigation between the link between ~~the~~ corporate governance and accounting quality.

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Motivated by these potential benefits from changes in accounting standards, policy concerns on corporate governance, and building on earlier work, as mentioned above, the present research addresses the link between corporate governance focusing on board structure, expertise[8], and effectiveness of audit committee with accounting quality. Furthermore, with the implementation of MCCG 2007, firms with stronger corporate governance in terms of board structure and audit committee will serve as a more effective monitoring mechanism, may lead to a higher increase of accounting quality from pre IFRS to post IFRS period.

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The importance of adopting ~~of~~ IFRS is that it appears to reduce information asymmetry between managers and shareholders. Prior literature finds a reduction of information asymmetry, as evidenced by lower earnings management. Barth *et al*. (2010) suggest that accounting quality could be improved with the elimination of

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[8] This research assigns accounting expertise to audit committee members who currently have (or have previously had) work experience as certified public accountants, chief financial officers, vice presidents of finance, financial controllers, or any other major accounting position.~~s~~

alternative accounting methods (as previously used in pre-IFRS period) that are less reflective of firm's performance and are used by managers to manage earnings.

Given that audit committees are the principal liaison between management and auditors, and are mainly responsible for reporting on accounting quality to the board of directors, this research anticipates that their monitoring performance should determine the extent of earnings management by managers. Moreover, the quality of the audit committee is fundamentally linked to the quality of the corporate board because all audit committee members are also members of the board, and are appointed by the board itself, while audit committee decisions have to be ratified by the board as a whole (Vafeas, 2005; Frediksson *et al.*, 2012). Accordingly, this research also hypothesizes that well-structured and functioning corporate boards are associated with improved accounting quality.

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1.2 Problem Statement

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Financial reporting must be done in a way that is relevant and meaningful. It is thus incumbent on the accounting profession and regulators ~~like~~ to be vigilant in safeguarding the quality of financial information disseminated to investors. In view of this, compliance with high accounting quality is ~~an~~ imperative. Information derived from the ~~utilisation~~utilization of high quality accounting standards, in turn, instils confidence among public investors ~~public~~. This contributes to capital formation and helps ensure that capital is allocated efficiently in securing long term economic growth (Accountant Today, 2007).

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Driven by this motivation, the Malaysian capital market has embraced the new or revised FRS issued by the Malaysian Accounting Standards Board (hereafter, MASB), which ~~become~~ became effective on ~~1~~ January 1, 2006.[9] The new or revised FRS, which are in line with the International Financial Reporting Standards issued by IASB, facilitate the convergence of global accounting standards or the birth of a common language in accounting standards.

To further boost the investors' confidence and improve the~~d~~ credi~~ta~~bility and accountability of financial information ~~produces~~ produced by PLCs, the Malaysian Code on Corporate Governance, first issued in March 2000, marked a significant milestone in corporate governance reform in Malaysia. It codified the principles and best practices of good governance and described optimal corporate governance structures and internal processes. Since the release of the Code, the Malaysian corporate scene has made significant strides in corporate governance standards. The mandatory reporting of compliance with the Code has enabled shareholders and the public to assess and determine the standards of corporate governance by listed companies.

While significant improvement has been achieved, it is now timely to review the Code to further strengthen corporate governance practices in line with developments in the domestic and international capital markets. In this respect, the Prime Minister, Dato' Seri Abdullah Ahmad Badawi ~~had~~ announced in the Budget 2008 speech that "*the Code is being reviewed to improve the quality of the board of public listed companies (PLCs) by putting in place the criteria for qualification of directors and strengthening the audit committee, as well as the internal audit function of the PLCs….*" To ensure the effectiveness of the audit committee of PLCs, executive directors will no longer be allowed to become members of the audit committee.

[9] To the best of my knowledge, Astro Asia Networks plc is the only company ~~has~~ that voluntary

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Accordingly, members of the audit committee must ensure high standards of financial reporting quality.

MCCG 2007 ~~just came in~~was timely, as 2007 marked a critical year for the accounting profession in Malaysia. The high level of negative publicity connected with the financial scandals of Transmile and Megan Media ~~has~~ had left little doubt that the accounting profession in Malaysia ~~is~~ was facing a~~n~~ ~~accusation~~ crisis. ~~These~~ The continuance of such corporate scandals ~~still happening~~ right after the implementation of IFRS in Malaysia raised the question:

"~~Whether~~ Has ~~our~~ the accounting quality and corporate governance in Malaysia ~~do not~~has improved at all?"

These corporate scandals ~~also~~ have ~~again~~ also raised the question~~s~~

"~~Whether~~ Do ~~do the~~ better governed firms report more credible earnings numbers?"

Therefore, whether or not ~~the~~ board structure, expertise and effectiveness of audit committee, as highlighted in MCCG (2000 and 2007), to ensure compliance with the accounting standards, as well as the choice of accounting method~~s~~ and estimate~~s~~ that best reflects the underlying economic events~~,~~ and ~~thus~~ improved accounting quality, is still an empirical question. Moreover, from studies conducted ~~on~~ in other countries, there has been sufficient evidence to conclude that the change in accounting standards alone does not ensure an improvement in accounting quality (Soderstrom and Sun, 2007; Lin *et al.*, 2012).

This research investigates whether various corporate governance characteristics are associated with the~~firm's~~ accounting quality of firms before and after the

adopted IFRS before ~~1~~ January 1, 2006 in Malaysia.

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implementation of IFRS. The improvement in accounting quality after the implementation of IFRS is also investigated.

The level of accounting quality could increase due to several reasons. First, actions by standard setters limit management's opportunistic discretion in determining accounting amounts, e.g.~~,~~ managing earnings (Barth *et al*., 2010). Second, accounting quality ~~also~~ could also increase because of changes in the financial reporting system contemporaneous with the ~~firms'~~ adoption of IFRS by firms, e.g. more rigorous enforcement ~~,~~(Barth *et al*., 2010).

However, according to Barth *et al*. (2010), there are two reasons why this prediction ~~on~~ of an increase in accounting quality may not be borne out. First, IFRS may be of lower quality than the MASB standards. For example, limiting managerial discretion relating to accounting alternatives could ~~eliminate~~ restrict the firm's ability to report accounting measurements that are more reflective of the firm's economic position and performance. In addition, the inherent flexibility in principles-based standards could provide greater opportunity for firms to manage earnings, thereby decreasing accounting quality. Second, the effects of features of the financial reporting system other than the standards themselves could ~~eliminate~~eradicate any improvement in quality arising from higher quality accounting standards. This could occur, for example, if the enforcement of accounting standards is lax. (Barth *et al*., 2010). Therefore, this research will investigate whether the implementation of IFRS is able to improve accounting quality in Malaysia.

Previous research by Ball, Robin, and Wu (2003) examines timely loss recognition for firms in Hong Kong, Malaysia, Singapore, and Thailand. In these countries, accounting standards are largely derived from common law, and, therefore, are likely

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~~are~~ similar to the International Accounting Standards (IAS), which ~~is~~ are generally viewed as high quality. They find that timely loss recognition for firms in these countries is no better than for firms in code law countries, ~~and they attributes this finding~~which they attribute to the differing incentives of managers and auditors. Therefore, Malaysia will provide a useful setting for testing ~~on~~ the relation between accounting standards and accounting quality with a unique institutional setting~~s~~.

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By observation, there is a wide cross-sectional variation in how audit committees and boards are structured and operate. Given such variation, the nature of the relation between audit committees, board structures and accounting quality is a fundamental research question with clear policy implications. The empirical evidence addressing this question has been mostly consistent with the view that more appropriately structured audit committees and boards produce earnings information of higher quality (Vafeas, 2005).

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Furthermore, this is an institutional environment ~~where~~ in which there is both considerable accounting discretion and fewer governance regulations (Bradbury, Mak, and S.M. Tan, 2004). The accounting standards for Malaysia are based on International Accounting Standards, which are less stringent than the US GAAP. U.S. GAAP is considered by many to be the most stringent set of accounting standards because of the more constrained measurement standards and the number of required disclosures relative to IFRS or country-specific accounting principles (Barth *et al.*, 2010). Bhattacharya *et al.* (2003) compare~~s~~ earnings management across countries in terms of increasing earnings, negative earnings avoidance and earnings smoothing, and report that Malaysia is among the countries with the greatest earnings management. Therefore, this research will also investigate whether implementing ~~of~~

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IFRS in Malaysia and MCCG 2007 is able to reduce earnings management, and, thus, higher accounting quality.

1.3 Research Objectives

As mentioned, adopting IFRS appears to reduce information asymmetry between managers and shareholders Prior literature finds a reduction of information asymmetry as evidenced by lower earnings management, lower costs of capital and lower forecast errors (Soderstrom and Sun, 2007). Barth *et al.* (2010) suggest that accounting quality could be improved with the elimination of alternative accounting methods that are less reflective of firms' performance and are used by managers to manage earnings. They compare earnings management for firms that voluntarily switch to IFRS with firms that use domestic accounting standards. They find that after IFRS adoption, firms have lower frequency of small positive net income, and higher frequency of large losses.

Therefore, the main objective of this research is to examine the changes in accounting quality before~~,~~ and after the implementation of FRS on ~~1~~ January 1, 2006, To be more specific, this research ~~is~~ will examine and compare the accounting quality reporting under MASB standards from 2003 to 2005 (pre IFRS period), FRS in 2006 (mandatory IFRS period) and 2007 plus 2008 (post IFRS period). This research focuses on accounting quality because investors obviously need accurate and reliable accounting information to make investment decisions, and higher accounting quality enhances investment efficiency by reducing information asymmetry (Biddle and Hilary, 2006; Chang and Sun, 2009; Samarasekera *et al.*, 2012).

Furthermore, the passage of MCCG 2007 marks the improvement in the quality of the board by putting in place the criteria for the qualification of directors, strengthening the audit committee and other corporate governance functions. ~~With this~~Accordingly, MCCG 2007 should improve firms’ corporate governance functions in monitoring the accounting quality. Therefore, this research will investigate ~~is~~ if ~~there any impact by~~ MCCG 2007 (using data from 2006 to 2008) had any impact on accounting quality.

This research examines the relationship between various governance mechanisms of board structure, audit committees and accounting quality in Malaysia. Therefore, the other objective of this research is to investigate whether various corporate governance characteristics are associated with the accounting quality of firms~~’s~~ ~~accounting quality~~ before and after the implementation of FRS, which ~~are~~ converged ~~/~~in line with IFRS. ~~To c~~Consistent with the above research objectives, the specific research objectives are set as follows:

1. To examine the level of accounting quality in the period prior and leading to the implementation of IFRS.

2. To investigate the relationship between board structure (in the pre and post MCCG 2007) and accounting quality in the period prior and leading to IFRS implementation.

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3. To investigate the relationship between expertise and effectiveness of audit committee (in the pre and post MCCG 2007) and accounting quality in the period prior and leading to IFRS implementation.

In this research, the board structure and composition include~~:~~ type of expertise, independence, board size, directors' ownership and role duality. Whereas ~~for~~ expertise and effectiveness of audit committee include~~:~~ quality of financial expertise, proportion of members with financial expertise, independence, size and number of meetings. In addition, according to the corporate governance and financial reporting literature, the corporate governance structures and accounting quality may be affected ownership structure. Thus, institutional investors, bumipurta shareholders and foreign shareholders will serve as an additional governance mechanism on this research.

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1.4 Research Questions

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Undoubtedly, the transition to IFRS represents one of the biggest challenges to Malaysian reporting entities, especially issues relating to the changeover, which must be confronted to ensure that during the transition period continued integrity of the financial reporting process is maintained. (Lazar *et al*., 2006; Tang *et al*., 2012)

PricewaterhouseCoopers senior executive director and corporate reporting leader, Ng Mi Li (2005), said the new rules would result in greater volatility of company results, changes in the presentation of financial statements and also a greater need for specialist valuers. According to Stephen Ong (2005), Ernst and Young technical partner, the biggest impact on listed firms would come from FRS 139, 140, 2 and 3.

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Companies must therefore fully understand ~~fully~~ the new requirements and be comfortable about their impact before attempting to communicate their effects. Thus, ignoring or understanding the issues involved in changing from MASB to FRS, ~~that~~ could have serious negative consequences for the firm, as companies that have not yet engaged in the transition process could face a significant challenge to meet not only their reporting deadlines and high reporting quality, but also the financial effects on the company share prices.

Given the problem statement and research objective described in the preceding section, this research attempts to investigate whether the application of IFRS in Malaysia after ~~1~~ January 1, 2006 and MCCG 2007 which ~~take~~ took effect on ~~1~~ October 1, 2007 is associated with higher accounting quality than the application of MASB standards. Specifically, the following research questions have been developed:

1. ~~Whether~~ Is there ~~is~~ a difference in the level of accounting quality in the period prior and leading to the implementation of IFRS?

2. ~~Whether~~ Does board structure (in the pre and post MCCG 2007) ~~has~~ have an influence on accounting quality in the period prior and leading to IFRS implementation?

3. ~~Whether~~ Do expertise and effectiveness of audit committees (in the pre and post MCCG 2007) have an influence on accounting quality in the period prior and leading to IFRS implementation?

1.5 Significance of the Research

This research contributes to the literature ~~on~~ concerning the association between corporate governance and accounting quality in several ways. First, while most prior studies on board of director~~'s~~s' characteristics mainly focus ~~mainly~~ on the role of board independence, this paper also examines their expertise to effectively monitor the financial reporting process. Although MCCG 2007 does not state specifically the criteria for skills and expertise, this research attempts to gather evidence through various proxies ~~of~~ for expertise, such as financial expertise, governance expertise and firm-specific expertise. ~~Therefore, b~~Board expertise and accounting quality are currently very topical issues.

Secondly, by including ~~of~~ more recent data and ~~investigate~~ investigating the effects of the mandatory adoption of FRS since 2006 on accounting quality. Prior research has shown that Malaysia has accounting standards that are generally viewed as high quality, but due to institutional structures ~~that give~~ preparers have an incentive~~s~~ to issue low quality financial reports (Ball *et al.*, 2003).

Thirdly, this research contributes to our understanding about corporate governance characteristics that are effective ~~to~~ in ~~minimize~~ minimizing agency costs in an East Asian country like Malaysia. This research uses Malaysia as the setting because the country has a pyramidal, concentrated and dominated by family ownership structure (Claessens *et al.*, 2000). It also has relatively weak legal protection for ~~in~~ minority shareholders ~~legal protection~~ compared to developed nations (La Porta *et al.*, 2000), stronger political connections (Johnson and Mittion, 2003; Gul, 2006), and government ownership in publicly listed companies (Mak and Li, 2001; Dogan and Smyth, 2002; Lemmon and Lins, 2003). Additionally, company directors in Malaysia are not as independent as those in developed countries (Mak and Kusnadi, 2005). Some observe that Big 4 firms operate in Malaysia (through link-ups with local

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firms), ~~but~~ however, there has been no litigation against auditors within Malaysia (Johl~~,~~ *et al.*, 2007) This background provides a stronger incentive~~s~~ for the management to expropriate minority shareholder's wealth in Malaysian firms compared to their counterparts in more developed nations. However, Mitton (2002) suggests that in the case of weak legal protection for minority interests, corporate governance becomes one of the important mechanisms to preclude expropriation of wealth. Therefore, this research fills a gap in the literature by investigating whether corporate governance plays its role ~~that~~ in ~~satisfies~~ satisfying the expectation of minority shareholders in a country with inadequate legal protection. The following section will discuss the theoretical and practical contributions.

1.5.1 Theoretical contribution

From the perspective of theory development or theoretical contribution, this research will contribute to the literature examining the quality of IFRS-~~-~~based accounting amounts in three ways. First, this research uses a broad sample of ~~firms listed~~ companies listed on the main board~~,~~ of Bursa Saham Kuala Lumpur over several years. In contrast, there is a lack of prior research focus on an emerging market like Malaysia ~~but~~ as typically the focus is~~es~~ on individual developed countries like the UK and the US. Furthermore, the mandatory nature of change across all public listed companies removes any sample selection bias~~es~~.

Secondly, most of the prior studies only used ~~only~~ cross-sectional data in their analysis of board structure, audit committees and accounting quality. Such tests potentially encounter the problem of omitted variables associated with board structure, audit committees and accounting quality. This research sought to overcome

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