INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN ACCOUNTING, FINANCE AND MANAGEMENT SCIENCES

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To Link this Article: http://dx.doi.org/10.6007/IJARAFMS/v12-i3/14962 DOI:10.6007/IJARAFMS /v12-i3/14962

Received: *19* July 2022*, **Revised:*** *21* August 2022*, **Accepted:*** *03* September 2022

Published Online: *24* September 2022

In-Text Citation: (Ghazali et al., 2022)

To Cite this Article: Ghazali, A. W., Shafie, N. A., Sanusi, Z. M., & Zakaria, N. B. (2022). Political Influence, Governance Mechanisms and Financial Reporting Quality: A Study on The Earnings Management Practices of Malaysian Listed Firms. *International Journal of Academic Research in Accounting Finance and Management Sciences*, *12*(3), 474–496.

Vol. 12, No. 3, 2022, Pg. 474 - 496

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Political Influence, Governance Mechanisms and Financial Reporting Quality: A Study on The Earnings Management Practices of Malaysian Listed Firms

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Abstract

Accounting loopholes coupled with rooms for managerial discretion provide the opportunities for earnings management to be exploited. Earnings management usually reflects the managerial opportunism and without proper and effective governance mechanism, it could be detrimental to the firms. Among the governance mechanisms heavily relied upon is the function of the board of directors. However, the quality of the boardroom could be tainted by the intervention of political influence. Thus, the current study examines the impact of political influence and governance mechanisms on the financial reporting quality among Malaysian listed firms. Financial reporting quality is proxied by the measurement of real earnings management. This study uses pool data consisting of 3,255 firm-year observations. The research sample comprises firms listed on the Main Board of Bursa Malaysia from 2014 to 2018. The findings are robust after controlling for the endogeneity. In particular, it was found that boardroom diversity, audit quality and proxies for political influence affect the quality of financial reporting. From the findings, it can be observed that one proxy of political influence (government ownership) positively affected the level of financial reporting quality though earlier expectations proposed for a negative relationship. Since political influence is not a single construct, current findings show that firms behave differently according to the type of political influence being exerted. Future studies may include AEM and REM for comparative purposes. Focusing and including other indicators, such as audit committee and risk management, may also enhance the corporate governance literature.

Keywords: Political Influence, Financial Reporting Quality, Real Earnings Management, Earnings Manipulation

Introduction

In the case of emerging economies such as Malaysia, political influence or ties have long been a significant issue for investors concerned about the performance and integrity of the capital market. Due to the emergence of several relationship-based economies throughout

Asia and the rest of the world, political ties have become frequent in developing countries attempting to establish market economies (Masum and Parker, 2020; Chen et al., 2013; Rajan and Zingales, 1998). Malaysia, for example, has a disproportionately high share of politically connected firms in relation to the size of its capital market, with politically related firms accounting for around 20% of total capital market capitalization (Benjamin et al., 2015; Faccio, 2006). Apart from that, Malaysia has a long history of crony capitalism and government cronyism. The Economist (2016) rated Malaysia second in its 2016 crony capitalism index study. Moreover, the governing political party in Malaysia has been unchanged since its independence in 1957 until 2018. This provides a unique chance to evaluate the function and level of political influence in the domain of financial reporting by using Malaysia as a case study, which is rare in academic circles. The high level of government ownership in the Malaysian capital market, the appointment of directors with political connections to the board of directors, and the exclusivity of ethnicity within individual companies and the industry as a whole are some of the most distinguishing characteristics of the market. As Kamarudin et al (2021) point out, there is a possibility that different types of political ties could have unique implications on the quality of financial reporting in different ways.

Previous research on the relationship between political ties and financial reporting quality has been inconclusive and inconsistent. Political influence is perceived to provide significant benefits, such as improved access to government procurement contracts (Barrett and Fazekas, 2019; Goldman et al., 2013) and a better chance of receiving a bailout in the event of economic difficulties (Blau et al., 2013; Duchin and Sosyura, 2012). According to Hasnan et al (2013), although political connections and fraudulent financial reporting are positively associated in Malaysian firms, the relationship is not statistically significant. On the other hand, Abdul Wahab et al (2014) refuted the former findings and demonstrated that political connections and accounting misstatement are significantly correlated and move in the same direction. Even though Abdul Wahab et al (2014); Hasnan et al (2013) investigated the direct relationship between political ties and proxies of financial reporting quality, their findings were somewhat disparate. Previous research (Song et al., 2016; Kostovetsky, 2015; Mohamed et al., 2007; Ball et al., 2003) has suggested that political influence has a negative impact on the quality of financial reporting. For example, Abdul Wahab et al (2020) discovers a negative and significant association between political ties and earnings quality. They discovered that appointing directors with political links in Malaysian firms led to poor management oversight and hence poor earnings quality. Likewise, politically connected firms, particularly government-linked companies (GLCs), according to a study by Kamarudin et al (2021), were shown to be related to aggressive reporting and low-quality accruals making it harder for analysts to produce accurate and less scattered earnings predictions. Also, GLCs reported more aggressive results and were shown to be more likely to use earnings management measures than other non-politically affiliated firms.

It is intended that corporate governance mechanisms positively impact the quality of earnings and, as a result, discourage firms from manipulating financial outcomes. According to Cohen et al (2017), an effective financial reporting process includes diligence in preparing and monitoring parties such as the audit committee and auditors to ensure that financial statements and supporting disclosures are accurate and transparent. Despite this, the regularity with which fraud, distress, and bankruptcy are discovered has impacted the quality of financial reporting (Olowokure et al., 2016). Although audit quality has been quantified in various ways, empirical evidence indicates that higher-quality external auditing leads to higher-quality financial reporting in the vast majority of cases. Zehri and Shabou (2011) assert that a high-quality audit is more receptive to discovering and uncovering mistakes and inconsistencies than a low-quality audit. According to DeFond and Zhang (2014), an excellent audit provides "a higher confidence that high-quality financial reporting is being generated." Therefore, improved audit quality is viewed as more dependable in monitoring and limiting earnings management, ultimately increasing the overall quality of financial reporting (Alzoubi, 2018). External auditors of higher calibre can, among other things, aid in improving the accuracy of financial reporting, limiting earnings manipulation, and preventing accounting misstatements. Indeed, according to the findings of Yuen and Lento (2020), external audit functions are inversely associated with earnings opacity, in which opaque earnings lack transparency, as earnings opacity raises agency costs by diminishing the relationship between unobservable, true earnings and reported accounting earnings. Prior research, however, did not include a measure of actual earnings management in their analyses.

Another crucial corporate governance factor that contributes to the board's monitoring role and helps to improve the overall quality of financial reporting is the composition of the board of directors. There is evidence that firms with a more gender-diverse board of directors perform better on social, environmental, and financial indicators (Lopatta et al., 2020; Bzeouich et al., 2019; Ye et al., 2019). Firms with a more gender-diverse board of directors had higher financial reporting quality (Wahid, 2019) and fewer internal control problems (Chen et al., 2016). Despite this, most research on boardroom diversity has concentrated on corporate performance rather than financial reporting quality, although both are essential variables. According to Ghazali et al (2019), organisations that lack a well-organised boardroom are more vulnerable to accounting fraud or malpractice. Prior research such as by Orazalin (2019); Kyaw et al (2015) investigated the relationship between various corporate governance practices relating to board diversity and the occurrence of earnings management. Their studies, however, have yielded contradictory and equivocal results. Furthermore, because these studies were based on data from developed countries, it is unclear whether these conclusions apply to the Malaysian setting, with its corporate climate and financial reporting standards.

This study was prompted by the inconsistency and scarcity of earlier research, and it sought to determine whether political influence, boardroom diversity, and audit quality influence the quality of financial reporting (earnings management). Consequently, the current study seeks to determine if firms with greater political influence, a more diverse board of directors, and excellent audit quality have an impact on the quality of financial reporting.

The remainder of this paper is structured as follows. Section 2 discusses the literature review, Section 3 underlines research hypotheses, Section 4 explains the research methodology, Section 5 presents the findings and discussion, and Section 6 concludes the study with a summary of the main themes covered here.

Literature Review

A financial report, also known as a financial statement, has long been the primary means by which management communicates any new information to shareholders and other stakeholders about the performance and financial situation of a company. Important stakeholders would be able to make informed decisions based on the financial report, which would, in theory, distinguish between organisations with a good track record and those with a poor track record. Management discretion may still be required in certain situations, despite the fact that accounting standards and frameworks are exhaustively comprehensive in their coverage. Managerial discretion is intended to allow the financial report to be more comprehensive and honest by broadening the scope and length of the report (Hazarika et al., 2012). In contrast, an excessive amount of managerial discretion would increase the likelihood of earnings manipulation. In a situation where there is a conflict of interest, managers are found to fulfil their own interests by manipulating accounting loopholes (Klein, 2002). Baruch Lev (2018) observed that, as a result of earnings manipulation, the ability of financial information, and earnings in particular, to reflect and predict future performance of a company, as well as to explain share prices and returns, is diminished. Because of this, financial reporting has devolved into a time-consuming compliance exercise rather than an effort to inform stakeholders about business operations.

Earnings management (EM) appears when the management has the intention to fabricate the underlying actual economic performance by manipulating the ambiguities within the GAAP and altering the accounting figures. Existing studies (Gunny, 2010; Roychowdhury, 2006) contend that managers use their managerial discretion both in accrual earnings management (AEM) and real earnings management (REM) for opportunistic and informative purposes. To date, there is yet no exclusive and conclusive definition about what specifies EM. While there are a variety of definitions for EM, one element was evident: firstly, company management has the power and control over the financial reporting process; and secondly, it may abuse such power if the need arises to protect their self-interest (Ghazali and Shafie, 2019).

Following the reported corporate failures in recent years, EM has been identified as the origin of financial manipulation, which has simply amounted to large-scale fraud over the years. In general, fraud results in damaging scenarios such as tarnished reputation, erosion of market confidence, and significantly undermining financial reporting credibility, quality, transparency, and integrity. These consequences have renewed investigations into the legality of earnings management practices. Some studies (Gunny, 2005; Healy, 1999) suggest that EM is a subset of financial fraud. Others (Jones, 2011; Nelson et al., 2002;) argue that although EM is unethical and sometimes illegal, it is not in some circumstances considered to be a fraud.

Principally, EM can be categorized into two methods, namely, AEM and REM. Referring to the earlier definitions, EM is the alteration of financial information resulting from management judgments for various possible reasons. Thus, the distinction between both AEM and REM lies in the applicability and operation of both methods. Among the fundamentals of accounting is the accrual principle, and AEM sits within the accrual principle. Under the accrual principle, there are non-discretionary (normal) accruals and discretionary (abnormal) accruals.

The core difference between the two categories is that REM is accomplished by modifying the underlying business operations, while AEM is accomplished by adopting the most feasible accounting choices (Ghazali & Shafie, 2019; Gunny, 2010). Another important distinction between the two methods is that REM has direct cash flow consequences, but AEM has no direct cash flow effects. The timing is also significantly different for both methods, and AEM provides more timing discretion for managers to structure and control the reported earnings. Specifically, the timing for AEM may take place anytime (before, during or after fiscal year-end) when the need arises (Nia, Huang & Mohd Sanusi, 2015; Gunny, 2010). However, the decisions and employment of REM have to be made before or during the fiscal year-end and not after (Gunny, 2010).

In the post-SOX period, more and more firms are shifting from AEM to REM (Zang, 2012; Gunny, 2010; Cohen et al., 2008). They also argued that SOX has made it very costly for firms to engage in AEM since detecting that kind of manipulation is uncomplicated (Cohen et al., 2008). Compared to AEM, REM involves manipulating the timing or structuring of actual business transactions, making it more strenuous to detect. Several studies (Piosik & Genge, 2019; Zang, 2012) further assert that REM is layered down before AEM, making it further undetectable. Moreover, in REM, the trade-off between current and future firm value is more prominent since real business activities manipulations such as overproduction and cutting of discretionary expenditures are costly. They may significantly reduce the long-term value of the business (Braam et al., 2015). Thus, the severity of REM is far greater than AEM.

Several studies have suggested that inferior quality of financial reporting is usually affected by weak corporate governance, which in turn has been associated with political influence. However, there is limited empirical evidence that provides conclusive evidence on such an association. It has been debated that political influence may also influence the outcome of financial reporting quality. In Malaysia, specifically, the financial reporting practice is substantially affected by extensive "crony capitalism" (Ball et al., 2003). However, political influence on EM practices is still very much vague, well-hidden or not reported. Amara and Khlif (2020) for one noted that there are mixed effects of political connections of EM, as measured by AEM or REM practices.

Firms with political connections are less likely to practice earnings management to conceal the connection from public knowledge. Therefore, firms with political connections are less likely to manage earnings to achieve target earnings than those without political affiliations (Braam et al., 2015). Companies with political connections are motivated by other incentives to manage their earnings (Chi et al., 2019; Braam et al., 2015). Likewise, Alshirah et al (2021) found that political connection play an important role in maximising the agency problem which affect the financial reporting quality. Most firms with political connections succumb to earnings management practices due to political pressure (Li et al., 2016; Chaney, Faccio & Parsley, 2011; Ramanna & Roychowdhury, 2010; Riahi-Belkaoui, 2004). In another study by Tee (2018), the political connection is exacerbated in older Malaysian family firms. The finding contrasts with another study of Pakistani firms where Hashmi, Brahmana and Lau (2018) find that family firms have higher earnings quality regardless of political connections' level, type, or influence.

The inclination of financial misreporting has raised queries regarding the corporate governance effectiveness in protecting shareholders' interests and controlling managerial opportunism. Among the highlights of the recent global corporate governance reform is concerning the board of directors' quality. The board of directors are central in monitoring managerial opportunism and mitigate inherent agency problems (Byoun *et al*., 2016). Board oversight functions and efficiency are also contingent on its collective features as a team. Platt and Platt (2012) observe that maintaining a firm's survival is the most critical responsibility of the board of directors.

Specifically, as the shareholder's envoy, the board of directors have two primary obligations: (1) to supervise and discipline the management and (2) to provide guidance and advice (Armstrong *et al*., 2010), as the board has the ultimate responsibility on behalf of the stakeholders for the company's performance, well-being, and sustainability, the directors are also responsible for making sure that the internal control and monitoring mechanisms are effective (Amstrong *et al*., 2010). Srinidhi *et al* (2011) also suggested that the board may affect decisions regarding financial reporting matters. Among the valued attributes of a board are expertise, experience, network and reputation. According to Conger and Lawler (2001), "the best boards are composed of individuals with different skills, knowledge, information, power, and time to contribute".

Within the corporate governance framework, the external auditors significantly influence the management's accountability and financial reporting integrity. External audit, in its position as the public "watchdog," is critical in eliminating the agency problems that arise as a result of the conflict of interest that exists between management and their shareholders. Since the external audit has been the conventional method to obtain assurance over the quality of the information in corporate reports, it is expected that a higher quality audit produces higher-quality corporate annual reports. A higher audit quality can contribute to better company financial performance since large-scale audit firms are always perceived to have higher audit quality, increasing investors' confidence (Cheong et al., 2015). Moreover, most prior studies have provided significant evidence that external auditors with higher audit quality are associated with higher earnings quality by providing greater independent assurance of the credibility of financial report and lower accounting manipulation (Tessema, 2020; Soliman & Ragab, 2014; Zgarni et al., 2012). However, recent findings by Habbash and Alghamdi (2017) suggest that external auditors are ineffective towards opportunistic managerial activities.

Corporate governance is expected to mitigate opportunistic accounting method choice significantly. However, the current evidence is restricted to AEM and therefore neglects REM's potentially more hazardous effects. Research in the context of REM is still lacking, while the existing empirical evidence is conflicting and incongruous. Moreover, prior studies on REM are based on developed economies, such as the UK and the US Studies in recent years on Malaysian samples (Jamil, 2020; Tee, 2018; Abdul Wahab et al., 2014; Hasnan et al., 2013) have examined the direct relationship of political connections, corporate governance and proxies of financial reporting quality, but they documented different findings.

Hypotheses Development

Following the agency theory, corporate governance is seen as part of the controlling and monitoring mechanism in deterring managerial opportunism. Conventionally, the effectiveness of corporate governance is always reflected in its characteristics, such as the board of directors' attributes and the quality of external audits. The current study takes a different approach in investigating the board of directors' attributes, considering the

diversification of demographic and cognitive factors in the boardroom. Porter (1996) argues that boardroom diversity reflects organizational effectiveness. Furthermore, a survey by Heidrick and Struggles (2014), which traverses 230 board members across Europe, suggested that the board of directors needs to embrace new thinking about agile, dynamic governance to keep up with the ever-changing business environment. Charas (2015) also suggested that firms ditch the 'old way' of recruiting directors and managing the board's interactions to generate economic value. Thus, the following hypothesis is developed:
H1: There is a significant and negative relationship between boardroom diversity and real earnings management among Malaysian listed firms.

As part of the corporate governance framework, external audit acts as the mechanism to reduce conflict of interest between the management and stakeholders of firms. Although audit quality has been measured in different terms previously, the empirical evidence supports the contention that better quality external auditing improves the overall quality of financial reporting. Zehri and Shabou (2011) emphasize that a high-quality audit is more adept at detecting and discovering any errors and irregularities. DeFond and Zhang (2014) professed that audit quality is "greater assurance of high financial reporting quality." Thus, it is perceived that higher audit quality is more reliable in monitoring and constraining EM, which improves the financial reporting quality. Findings of existing literature demonstrate the link between external audit function and higher financial reporting quality. A higher quality of external auditors may improve the financial reporting quality, reduce earnings manipulation and aids in avoiding accounting misstatements. However, measuring the quality of the external audit is complex and challenging (Basiruddin, 2011). This study uses audit traits such as auditor reputation, auditor independence and auditor effort as audit quality measures. Thus, the following hypothesis is developed.

H2: There is a significant and negative relationship between audit quality and real earnings management among Malaysian listed firms.

Past researchers have suggested some significant influence of the political influences on EM (e.g. Batta et al., 2014; Gul, 2006; Yatim et al., 2006; Johnson & Mitton, 2003). Previous studies found that firms with more politicians on their company boards are more likely to engage in EM. Politicians on company boards, particularly government-linked ones, influence the business environment, which eventually increases the regulators' and public's scepticism about the quality of their financial reporting. Given the increasing attention paid by regulators and the public on this issue, it is claimed that in the current business environment where there is fierce competition, firms are likely to be more cautious in their decisions and less likely to engage in EM. Nevertheless, recent studies revealed an increase in EM practice due to political connections in the board (Batta et al., 2014). However, the results of Haniffa and Cooke (2005, 2002) found results very contradictory from those of (Johnson and Mitton, 2003). While the results of Johnson and Mitton (2003) suggest a positive relationship between politics on the board and poor-quality financial reporting, Haniffa and Cooke (2005, 2002) suggest there is a negative relationship between the political connection on the board and financial reporting quality. Thus, the following hypothesis is developed.

H3: There is a significant and positive relationship between political influence and real earnings management among Malaysian listed firms.

Research Methodology

Research Sample

The research population for the current study comprises Malaysian firms listed on the Main Board of Bursa Malaysia from 2014 to 2018. However, several industries are excluded due to differences in regulations and incomparability in terms of size. Firms with incomplete and extreme data are also excluded. These precautions may prevent influential outliers and data abnormalities (Ismail et al., 2010). Financial data are collected from the Thomson Reuters Datastream database. Meanwhile, non-financial data are obtained from published annual reports that are compiled on the Bursa Malaysia website. The data collected were run using SPSS to test for normality, collinearity, descriptive and regression analysis for hypothesis testing.

Dependent Variables

Following Roychowdury (2006); Zang (2012), REM is represented by three individual models, namely the abnormal level of cash flow from operations (ABCF), abnormal level of discretionary expenses (ABDE), and abnormal level of production costs (ABPC). Differences between the normal level of economic events and the actual level of the three individual models are used to determine REM activities for a firm in a particular year. The models are listed below:

Model 1: Normal levels of CFO

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

Model 2: Normal levels of DE

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

Model 3: Normal levels of PC

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

where,

CFOt	=	Cash flows from operations (current year)
DSEt	=	Discretionary expenses (current year)
PRCt	=	Production costs (current year)
TAt-1	=	Total assets (previous year)
St	=	Sales (current year)
ΔSt	=	Change in sales (current year)
St-1	=	Sales (previous year)

Independent Variables

Boardroom diversification is measured by the Board Diversity Index (BDI). The indexes were constructed to investigate the cumulative effect of diversification in the boardroom concerning financial reporting decisions. Following Hafsi and Turgut (2013), the index was developed using the terciles split method. The Board Diversity Index was constructed using 10 board variables: board size, founder on board, board independence, gender diversity, age diversity, ethnicity diversity, board experience, board expertise, board ownership and board remuneration. Duplicating the method used by Hafsi and Turgut (2013), the index's composition involves accumulating the discrete values of each variable.

As some of the variables are continuous variables, the values are categorised into terciles representing below average, average and above average. The terciles scores for continuous variables are denoted by 0, 1, and 2, respectively (Hafsi and Turgut, 2013). For dichotomous variables, the scores are 0 and 1 (Hafsi and Turgut, 2013). In addition, the development of the index also considers corporate governance best practice as per Md Salleh (2009). The assessment of the corporate governance best practice is based on MCCG 2012 and Bursa Malaysia Listing Requirement.

Audit quality is operationalised into three empirical indicators: audit reputation (AQF), audit independence (AQN) and audit effort (AQR). Audit reputation (AQF) is measured by the dichotomy of Big 4 versus non-Big 4 auditors. A dummy variable of "1" and "0" was assigned for Big 4 auditors and non-Big 4 auditors, respectively. Audit independence (AQN) is measured by the proportion of non-audit fees over audit fees. The percentage of audit report lag measures audit effort (AQR). Meanwhile, the audit report lag is measured by the number of days from fiscal year-end to the date of the audit report.

Following prior studies (Gul, 2006; Johnson & Mitton, 2003; Yatim, Kent & Clarkson, 2006), Malaysian political influence is measured using two proxies: the presence of politician directors on the board (Chaney et al., 2011); and the percentage of government ownership (Chen et al., 2010; Bushman & Piotroski, 2006). For the current study, politician directors include both active and non-active politicians sitting in the boardroom.

Findings and Discussion

Real Earnings Management Estimation Models

Table 1 presents the regression coefficients being applied to estimate the normal levels of real earnings management proxy by cash flow from operations, discretionary expenses and production costs (as discussed in Section 4.1). The models were employed for the entire sample of 3,255 firm-years in detecting real earnings management activities. The mean coefficients across industry-years and t-statistics from standard errors across industry-years are specified in Table 1.

The estimated parameters presented in Table 1 are derived from the following regressions:

1. $\frac{ABCF_t}{TA_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{t-1}} + \beta_1 \frac{S_t}{TA_{t-1}} + \beta_2 \frac{\Delta S_t}{TA_{t-1}} + \varepsilon_t$
2. $\frac{ABDE_t}{TA_{t-1}} = \alpha_0 + \alpha_1 * \frac{1}{TA_{t-1}} + \beta_1 \frac{S_{t-1}}{TA_{t-1}} + \varepsilon_t$
3. $\frac{ABPC_t}{TA_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{t-1}} + \beta_1 \frac{S_t}{TA_{t-1}} + \beta_2 \frac{\Delta S_t}{TA_{t-1}} + \beta_3 \frac{\Delta S_{t-1}}{TA_{t-1}} + \varepsilon_t$

The regressions were performed on a yearly basis for every industry. The firm-year observations are categorised into seven industries. The mean coefficient across all industry years and the t-statistics were derived from the standard error of the mean across industry-years. Adjusted R^2 refers to the mean of the R^2 for each of the regressions.

Generally, this study's estimated coefficients of real earnings management align with the earlier findings of Roychowdhury (2006) and Dechow *et al*. (1998) for all three models. The average explanatory power (Adjusted R^2) of the regressions across the industry-years observations are 7.2% for abnormal cash flow from operations (CFO), 8.5% for abnormal discretionary expenses (DISEXP) and 89.3% for abnormal production costs (PROD). The explanatory power shows a wide discrepancy between abnormal production costs (PROD) and both abnormal cash flow from operations (CFO) and abnormal discretionary expenses (DISEXP). However, Subekti (2012) has encountered a similar finding on a sample of Indonesian firms[1].

For abnormal cash flow from operations, the average estimated coefficients for sales (S_t/ A_{t-1}) is positive and is statistically significant (t-value=13.606) at the 1% level; the average estimated coefficients for the change in sales (ΔS_t/ A_{t-1}) is also positive and is statistically significant (t-value=1.063) at the 10% level. A higher sales imply a higher cash flow from operations and vice versa. This indicates that, on average, Malaysian listed firms are more eager to accumulate proceeds from previous sales in the current period, displaying better performance and growth.

According to Roychowdury (2006); Dechow *et al* (1998), the estimated coefficients for abnormal production costs can be explained from two perspectives: the cost of goods sold (COGS) and change in inventory. Perceptibly, COGS is a direct element of the contemporaneous sales (Roychowdhury, 2006); thus, the estimated coefficients of sales (S_t/ A_{t-1}) are expected to be positive. As such, the estimated coefficients of sales (St/ At-1) for this study is also positive and is statistically significant (t-value=12.686) at the 1% level. Meanwhile, the change in inventory is a linear function of change in sales (Dechow *et al*., 1998). A negative coefficient is expected for the change in sales (ΔS_t/ A_{t-1}); the current study corresponds with the expectation whereby the estimated coefficients in the change in sales (ΔS_t/ A_{t-1}) are negative and is statistically significant (t-value=-2.003) at the 5% level. The estimated coefficient changes in the prior year's sales (ΔS_{t-1}/ A_{t-1}) are also negative. This indicates that similar to developed markets such as the UK and US, the firms in developing markets such as Malaysia also adjust their inventory targets according to budgeted sales.

On the other hand, for abnormal discretionary expenses, the average estimated coefficients for sales (S_t/ A_{t-1}) are negative and statistically significant (t-value=-2.119) at the 1% level. According to Roychowdury (2006), discretionary expenses, including advertising expenses, sales, general and administrative expenses, and research and development expenses, also form part of the contemporaneous sales; thus, the expected coefficient would be positive. However, this is inconsistent with the earlier expectation as proposed by (Roychowdury, 2006). This indicates that Malaysian listed firms may downplay their discretionary expenses to portray better earnings. This can also be explained by the context of managerial opportunism whereby managers may accelerate sales, cut down the cost of sales and discretionary expenses, which would result in higher abnormal cash flow from operations, lower abnormal discretionary expenses and lower abnormal production costs. The findings are consistent with an income-decreasing real earnings management.

[1] Abnormal cash flow from operations = 4.1%, Abnormal discretionary expenses = 6.3%, Abnormal production cost = 72.5%

Table 1
Real Earnings Management Estimation Models

	$ABCF_t/A_{t-1}$	$ABDE_t/A_{t-1}$	$ABPC_t/A_{t-1}$
Intercept	0.033	0.148	-0.088
t-statistics	9.952***	5.770***	-14.216***
$1/A_{t-1}$	-16.170	428.412	-803.772
t-statistics	-5.242***	17.338***	-1.409*
S_t/A_{t-1}	4.293	-5.636	88.406
t-statistics	13.606***	-2.485***	149.4***
$\Delta S_t/A_{t-1}$	0.875	Not applicable	-4.373
t-statistics	1.063*		-2.870**
$\Delta S_{t-1}/A_{t-1}$		Not applicable	-4.199
t-statistics	Not applicable		-3.287***
Adjusted R^2	0.072	0.085	0.893

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

Normality Assumption

In testing the normality assumption, each observed variable, both skewness and kurtosis values, are employed. By reviewing the skewness and kurtosis statistics in Table 2, several variables exhibit non-normality of the data distribution. Therefore, the Central Limit Theorem (CLT) and the law of large numbers was then employed. Since the current study utilizes more than 3000 firm-year observations, it is reasonable to assume that the sampling distribution is regarded as having a normal distribution[2].

Table 2
Normality Test – Skewness and Kurtosis

	N Statistic	Skewness Statistic	Kurtosis Statistic
ABCF	3215	0.400	2.971
ABDE	3215	1.460	8.383
ABPC	3215	-0.719	9.033
BDI	3215	0.463	0.019
PBD	3215	0.933	-1.130
PGV	3215	0.621	-1.615

[2] According to Tabachnick and Fidel (2007), the value of skewness and kurtosis will not make a substantive difference in the analysis provided that the sample size is large (200+ cases).

AQB	3215	-0.103	-1.991
AQN	3215	1.821	3.109
AQR	3215	-1.362	6.014
FS	3215	0.866	0.903
FP	3215	0.064	6.177
FL	3215	1.240	3.777
Valid N (listwise)	3215		

Table 3 presents the autocorrelation test of Durbin-Watson on Real Earnings Management models. According to Gujarati (2003), the regression model is presumed to be free of autocorrelation issues if the Durbin-Watson statistic is between the value of DW $_{Upper}$ and the value of DW $_{Upper}$ – 4. It can be observed that DW $_{Statistics}$ of all three models of real earnings management lie between accepted values and thus indicates there is no autocorrelation issue.

Table 3
Autocorrelation Test of Durbin-Watson on Real Earnings Management Model

	DW $_{Lower}$	DW $_{Upper}$	DW $_{Statistics}$	DW $_{Upper}$ - 4
ABCF	1.728	1.799	1.951	2.201
ABDE	1.738	1.789	2.035	2.211
ABPC	1.718	1.809	1.887	21.91

The values of DW $_{Lower}$ and DW $_{Upper}$ were excerpted from the Durbin-Watson Table

Descriptive Statistics

Table 4 presents the descriptive statistics of the research sample. Following Table 4, it can be implied that political influence among Malaysian listed firms is quite significant. 35.18% of the sample firms have government shareholding, and another 28.86% of the sample firms have politicians on their boards of directors.

Table 4
Descriptive Statistics of the Research Sample

Research Sample	Frequency	Percentage (%)
Sample firms by political influence:		
Firms with Politicians on the board	928	28.86
Firms with Government ownership	1131	35.18
Sample firms by industry:		
Construction	195	6.06
Consumer Products	560	17.42
Industrial Products	1000	31.10
Plantation	185	5.75
Properties	385	11.96
Technology	150	4.66
Trading and Services	710	22.08

Univariate Analysis

A summary of the estimates of the correlation between independent and dependent variables is reported in Table 5. ABCF is significant in a negative correlation with ABPC ($r = -0.427$, $p < 0.01$). The negative relationship may be due to the manipulation of sales, cost of sales and changes in inventory, which can transpire by increasing sales and reducing the cost of sales. ABCF shows a positive correlation with BDI at r=0.132, and ABPC negatively correlates with BDI at r=-0.107. Meanwhile, ABPC shows an insignificant correlation. This indicates that diversification in the boardroom still influences accounting policies and financial reporting matters that would accumulate to real earnings management.

In terms of political influence and REM, the correlation of PBD is not significant with all three models of REM. Meanwhile, PGV is positively significant with ABDE at r=0.087; and is negatively significant with ABPC at r=-0.036. The result suggests that political influence does affect the board's decisions concerning financial reporting matters, but the political influence may not be necessarily derived from the active politicians serving on the board.

Regarding the external audit quality and REM, the correlation of AQF is significant and positive with both ABCF and ABDE r=0.082 and r=0.93, respectively. However, AQN is not significant with all three models of REM. AQR is significantly and negatively correlated with both ABCF and ABDE at r=-0.146 and r=-0.113, respectively. However, it was found to be significant in a positive correlation with ABPC at r=0.086. The negative correlation may suggest that auditors exert extra effort to detect any material misstatements within their audit scope. Although most of the correlations testing are significant at least at the 5% level, the variables' variance inflation factors (VIF) are less than 2.0, as shown in Table 6. Hence, no multicollinearity problem is reported.

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Table 5
Bivariate Correlation Analysis between the Independent Variables

	ABCF	**ABDE**	**ABPC**	**DIB**	**PBD**	**PGV**	**AQB**	**AQN**	**AQR**	**FS**	**FP**	**FL**
ABCF	1	0.10	-0.427**	0.132**	-0.027	0.026	0.082**	0.018	-0.146**	0.042*	0.397**	-0.233**
ABDE		1	-0.011	0.032	0.017	0.087**	0.093**	0.029	-0.113**	0.230**	0.069**	0.048**
ABPC			1	-0.107**	0.003	-0.036*	-0.026	-0.020	0.086**	0.010	-0.401**	0.181**
DIB				1	-.021	.045**	.114**	.055**	-.140**	.137**	.094**	-.006
PBD					1	.149**	.022	.002	.024	.126**	-.034	.043**
PGV						1	.178**	.071**	-.163**	.408**	.088**	.024
AQB							1	.150**	-.243**	.296**	.108**	-.007
AQN								1	-.060**	.102**	.091**	.023
AQR									1	-.245**	-.164**	.062**
FS										1	.155**	.240**
FP											1	-.179**
FL												1

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

Table 6
The Tolerance Coefficients and the VIF for Multiple Regression

	Tolerance	VIF
DIB	0.921	1.086
PBD	0.911	1.097
PGV	0.788	1.268
AQF	0.855	1.169
AQN	0.965	1.037
AQR	0.857	1.167
FS	0.621	1.610
FP	0.526	1.903
FL	0.770	1.298

Multiple regression for Corporate Governance, Political Influence and Real Earnings Management

The analysis for examining the relationship between corporate governance, political influence and REM are employed as per the following regression model:

$$REM_{i,t} = \alpha_0 + \beta_1 BDI_{i,t} + +\beta_2 PBD_{i,t} + \beta_3 PGV_{i,t} + \beta_4 AQF_{i,t} + \ \beta_5 AQN_{i,t} + \beta_6 AQR_{i,t} + \beta_7 FS_{i,t} + \beta_8 FP_{i,t} + \beta_{10} FL_{i,t} + \varepsilon_{i,t}$$

Table 7 shows that the R2 values for the three models of REM, are significant at the 1% level (0.222; p value = 0.000 for ABCF; 0.086, p value = 0.000 for ABDE; and 0.198, p value = 0.000 for ABPC, respectively).

BDI shows a positive and significant relationship with ABCF at the 1% level (t-value=4.838, p-value=0.000). In contrast, BDI shows a negative but significant relationship with ABPC also at the 1% level (t-value=-4.636, p-value=0.000). The contradictory findings might be due to the ambiguity of the net effect on abnormal cash flow. Likely, positive and significant regression may not reflect the true outcome. The results partially support H1.

Concerning audit quality, AQF, measured by "Big 4" and "non-Big 4" audit firms, is statistically insignificant with all the measurement models of REM. However, the positive directional sign of the relationship is observed. This shows that the "Big 4" status does not necessarily constrain real earnings management. The current findings align with the findings of related prior studies (Huang et al., 2012; Yuniarti, 2011; Dehkordi & Makarem, 2011; Boone et al., 2010). AQN represents the non-audit services provided by the same auditor who audits the firm's financial statements. AQN is statistically insignificant with all the measurement models of REM.

AQR, denoted by audit report lag, is negatively significant with ABCF with t-value=-3.826, p-value=0.000 at the 1% level. Similarly, AQR is also significant with ABDE (t-value=-2.636, p-value=0.008) at the 1% level in a negative direction. However, AQR is statistically significant with ABPC with t-value=1.471, p-value=0.142) at the 10% level in a positive direction. On average, the findings suggest that auditors are more likely to allocate additional resources when there is a higher probability of REM regarding cash flows and discretionary expenses. Meanwhile, referring to production costs, auditors are less likely to allocate additional resources.

The reason for this may be due to the method of detecting cash flow and discretionary expenses manipulation being less complicated than the manipulation of production costs. Furthermore, production costs are easier to manipulate as compared to cash flow and discretionary expenses. In addition, internal and private and confidential information such as firms' production activities and production costs are not fully disclosed to the auditors. Thus, it would be a waste of additional resources for the auditors to perform an extensive audit on production costs without receiving factual information on production activities and costs. Another possible reason is the managers' baiting tactics, whereby the auditors were intentionally directed to error-free accounts. In this situation, the auditors were unlikely to uncover earnings management errors elsewhere in the financial statements. Collectively, the results partially support H2.

The current study finds that PBD is statistically insignificant with all the measurement models of REM. The findings suggest that having a politician on the board of directors does not necessarily impair the board's monitoring function and does not negatively affect the financial reporting quality. PGV is statistically significant at the10% level (t-value=-1.307, p-value=0.191) with ABDE; and at the 10% level (t-value=-1.366, p-value=0.172) with ABPC. However, PGV is not statistically significant with ABCF. The current study's findings are not consistent with the findings of other analyses (Boubakri et al., 2013; Boubakri et al., 2012; Faccio, 2010; Charumilind et al., 2006). The current findings support the earlier findings of Eng and Mak (2003); Salleh (2009), suggesting that government ownership improves financial reporting quality. Overall, the results partially support H3.

Table 7
Multiple regression for Corporate Governance, Political Influence and Real Earnings Management

	ABCFO			ABDISEXP			ABPROD		
	Coefficient	t-Value	sig. Value	Coefficient	t-Value	sig. Value	Coefficient	t-Value	sig. Value
(constant)		1.477	0.140		-1.041	0.298		-0.501	0.616
DIB	0.080	4.838***	0.000***	-0.015	-0.830	0.407	-0.077	-4.636***	0.000***
PBD	0.008	0.465	0.642	-0.016	-0.890	0.374	-0.018	-1.056	0.291
PGV	-0.016	-0.889	0.374	-0.025	-1.307*	0.191	-0.024	-1.366*	0.172*
AQF	0.019	1.129	0.259	0.017	0.936	0.350	0.013	0.761	0.447
AQN	-0.020	-1.240*	0.215*	0.000	0.017	0.987	0.012	0.729	0.466
AQR	-0.065	-3.826***	0.000***	-0.048	-2.636***	0.008***	0.025	1.471*	0.142*
FS	0.054	2.363***	0.018***	0.152	6.090***	0.000***	0.012	0.515	0.607
FP	0.458	21.203***	0.000***	0.021	0.900	0.368	-0.427	-19.478***	0.000***
FL	-0.109	-6.084***	0.000***	-0.005	-0.262	0.793	0.065	3.608***	0.000***
R^2		0.222			0.086			0.198	
Adjusted R^2		0.217			0.081			0.193	
F-Stat		47.861			15.829			41.565	

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

Conclusion

Specifically, the study focuses on the effect of boardroom diversity, audit quality and political influence on financial reporting quality (real earnings management). With regard to the diversification of the boardroom, it emerged that it is relevant to financial reporting quality since it is relevant to further improved firms' performance. Unexpectedly, the current findings suggest that government ownership has indirectly served as an effective control mechanism, deterring the incidents of real earnings management while improving financial reporting quality. This means that government ownership diminishes the costs of political influence and challenges the misconception that political connection in terms of government ownership reduces the motivation of the firms to properly report their business activities and performance as they would find it all too easy. Using the robust methodology and having an extensive dataset, diversification in the boardroom and political influence remains relevant in relation to real earnings management. Furthermore, this is the first study to analyse the nexus between financial reporting quality in terms of real earnings management and political influence in Malaysia.

Regarding the diversification of the boardroom, it was found that it is relevant to financial reporting quality as it is relevant to further improving the firm's performance. However, too much diversification might result in the boardroom being ineffective for monitoring and controlling mechanisms. In terms of real earnings management occurrences, an appropriately diverse Board is linked with lower real earnings management activities. On the other hand, audit quality in terms of the size of the audit firm is unimportant to signify their quality of work in detecting both real earnings management. However, audit report lag is enormously significant with real earnings management. This indicates that the auditor would increase their audit effort in line with any threats of low-quality financial reports.

Despite the rigorous testing, the findings are subjected to several limitations and should be interpreted with caution. Earlier studies have focused on specific earnings management practices individually. Therefore, future studies may include AEM and REM for comparative purposes. Focusing and including other indicators, such as audit committee and risk management, may also enhance the corporate governance literature.

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