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Political Influence on Financial Reporting Quality of Public Listed Firms in Malaysia

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ABSTRACT

This study investigates the relationship between financial reporting quality and political influence in listed firms in Malaysia after the financial crisis. By utilizing 824 firm-year observations comprising large listed companies over a period of four years after the implementation of new corporate governance framework, the results show some evidence concerning financial reporting quality, featured by accounting conservatism (bad news being recognized earlier than good news) in Malaysia. The findings demonstrate that politically connected directors on the boards is negatively associated with financial reporting quality. This negative association is more pronounced in firms where the level of government ownership is higher. The result demonstrates that the accounting manipulation among public listed firms is still very much influenced by political connections even with the new enhancement of corporate governance initiatives after the financial crisis.

JEL Classification: L15, P16, P26

Keywords: Accounting Conservatism, Financial Reporting Quality, Corporate Governance, Political Influence, Financial Crisis

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INTRODUCTION

This study features financial reporting quality from the view of accounting conservatism because this measure of accounting quality currently receives massive attention from researchers and it is regarded as one of the most intensively examined over the last decade (Artiach and Clarkson, 2011; Ruch and Taylor, 2015). Accounting conservatism is a fundamental feature of quality financial information because it enhances the reliability of financial statements by facilitating effective monitoring of managers and contracts as part of corporate governance mechanisms (Ball & Shivakumar, 2005; Basu, 2005; R. L. Watts, 2003). Conservative accounting has been shown to be an important feature of financial statement in developed markets (Givoly and Hayn, 2000; Pope and Walker, 1999; Raonic *et al*., 2004). On the contrary, the absence of this feature in the financial statements in East Asian countries is revealed in an earlier study by Ball, Robin, and Wu (2003), which arguably may be attributed to the political influence in businesses in this region. However, after the corporate governance reforms in post 1997 Asian financial crisis, the trend of accounting conservatism in East Asian countries seems to be increasing (Vichitsarawong *et al*., 2010), initiating the exploration of the issue within this region.

This study investigates this issue by employing a large sample of publicly listed companies in Malaysia where political influence is evident in corporate operations and is institutionalized through government policies. Although the Malaysian government has taken initiatives to reform the corporate governance framework in the country, it is argued that the effectiveness of corporate governance is adversely affected when firms are found to be politically connected and directors with political connections are appointed on the board (Johnson and Mitton, 2003; Kazemian and Mohd Sanusi, 2015; Faccio, 2006; Gul, 2006). Politically connected firms enjoy systematic exchange of favors between politicians and firms, and though these firms, on average, gain from political ties, they suffer from severe agency problems, which results in lower earnings quality (as measured by accruals) (Chaney *et al*., 2011). Although a positive association has been empirically found between stronger governance mechanisms and accounting quality, the way in which politically connected directors on the corporate boards affect accounting quality after the enhancement of the corporate governance framework has yet to be assessed.

In Malaysia, firms operating in an open market are subject to substantial political influence despite the country adopting the Anglo-American corporate governance system and International Financial Reporting Standards (IFRS). Additionally, the Malaysian market provides a unique setting to examine accounting conservatism, where the capital market not only involves substantial government ownership, firms can also be clearly differentiated with divisional ethnic lines and the appointment of politically connected directors on board. Hence, the main objective of this study is to examine the relationships between financial reporting quality and political influence in Malaysia.

In this study, the political influence proxies are the proportion of politically connected directors, the proportion of Bumiputera-Malays on the board of directors, and the government ownership. They are chosen based on the following arguments. The first form of politically favoured firms in Malaysia is the firms that have close connections with politicians who can exert political power; these firms are run by both Bumiputera-Malays and Chinese (Gomez &

Jomo, 1997). In addition, political favouritism also exists in Malaysia for firms with official status being awarded and run by ethnic Bumiputera-Malays (Gomez & Jomo, 1997; Johnson & Mitton, 2003). Political influence in terms of government ownership is documented as being related to financial transparency in a cross-country study Bushman *et al* (2004). They demonstrate that firms with a higher government share ownership are associated with a lower level of financial transparency because firms with political connections may suppress firm-specific information to avoid public scrutiny on their business dealings with their cronies (Bushman *et al*., 2004).

Further, financial reporting quality is proxied by asymmetric timeliness measure (also known as conditional conservatism) (Basu, 1997), modified by (Roychowdhury & Watts, 2007), as the primary measure of accounting conservatism. Ruch and Taylor (2015) contend that conditional conservatism dominates the area of research in accounting, prompting this paper to utilize the measure of conditional conservatism. The importance of conservatism is confirmed as the International Accounting Standard Board (IASB) has released an exposure draft of its new conceptual framework, complete with a reference to prudent accounting, a similar concept with conservatism; this term was excluded from the conceptual framework in 2010. [1] Basu (1997) defines accounting conservatism as a concept where accountants tend to require a higher degree of verification for recognizing good news relative to bad news in earnings.

Utilizing 824 firm-year observations drawn from listed firms on Bursa Malaysia (Malaysian Stock Exchange) over 2004-2007, we find evidence of a negative association between the proportions of politically connected directors on the board and accounting conservatism. The findings of this study are important as it shows the effect of political influence in shaping financial reporting in an environment in which political influence is institutionalized. The remainder of this paper is organized as follows: The next section describes the literature review and hypotheses development; the third section explains the research methodology; the fourth section provides the analysis; the fifth section discusses the results from the analysis: and the final section concludes.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

The impact of politics on accounting has been investigated by several cross-country studies. For example, Picur (2004) and Riahi-Belkaoui (2004) found positive relationships between the elements of politics and earnings opacity. A more recent cross-country study examining political influence on reporting quality undertaken by Chaney *et al*., (2011), demonstrates that political connections are associated with poor reporting quality. In Malaysia, politically connected firms are found to pay higher audit fees, while firms with better governance demand a higher audit quality, leading to higher audit fees (Wahab *et al*., 2011). In a similar view, Wahab *et al*.,(2015) contend that political connections impair audit independence, suggesting this issue to be researched further. The above findings of prior studies contribute to the notion

[1] Retrieved on 19th July 2016 from http://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/world-watch/iasb-prudence-conceptual-framework.html

that the political economy matters in financial reporting. Therefore, the concerns regarding the quality of reported earnings in politically-connected firms are justifiable. This paper argues that the effect can be seen in the different levels of accounting conservatism with a variation of political influences in corporate governance mechanisms; in this case, board of directors and government ownership.

Accounting conservatism enhances the verifiability of accounting information by offsetting the information bias supplied by the management, thus assisting the board to monitor the contracts (Watts, 2003a). It assists in contract efficiency by reducing the probability of inappropriate distribution of resources (Watts, 2003). These potential benefits suggest a positive relationship between financial reporting and the effectiveness of corporate governance (LaFond and Roychowdhury, 2008; García *et al*. 2009). According to Li (2015), accounting conservatism has been shown to be an important feature in developed markets; however, this issue is yet to be explored in an emerging capital market such as Malaysia.

According to Ball *et al*. (2003), prior to the 1997 financial crisis, accounting conservatism was not a feature of the Asian financial reporting models despite having a high quality of accounting standards.[2] The absence of accounting conservatism in their findings indicates that the market (i.e. underlying economic and political factors in one country) predominates accounting practices. Ball *et al*.'s (2003) study on Malaysia is interesting because they specifically identified political influence as a factor contributing to the low quality reporting. However, this factor is not directly tested in their study.

In a related study, Vichitsarawong *et al*. (2010) argue that the implementation of corporate governance measures to stabilize financial systems and improve regulation in four countries (Hong Kong, Thailand, Singapore, and Malaysia) should enhance conservatism. They found that during the crisis period, accounting quality was low but had improved in the post-crisis period. Building up from Ball *et al*. (2003) and Vichitsarawong *et al*. (2010), this paper intends to examine specific political influence factors in relation to accounting conservatism during the later period.

The Malaysian market provides a unique setting for examining accounting conservatism, where the capital market not only involves substantial government ownership, but also firms can be clearly differentiated along ethnic lines and the appointment of politically connected directors on company boards. As such, it is essential to review the institutional background of Malaysia and the related prior studies of political influence and accounting in order to find the proxies for political influence.

The government policy of protecting one ethnicity against other ethnicities in business and economic dealings is also believed to result in differential in accounting practices (Ball, Robin, & Wu, 2003), thereby impacting financial reporting quality in financial statements. In addition, Ball *et al*. (2003) suggest that the extent of political influence may be a factor contributing to the low quality of financial reporting in Malaysia, despite complying with International Accounting Standards (later, the International Financial Reporting Standards (IFRS). Based on the above arguments, examining the issue of accounting conservatism as a feature of quality financial statement in the Malaysian context is potentially useful.

[2] For negative return sample, Hong Kong and Singapore show evidence of more timely recognition of loss than Malaysia and Thailand, which is consistent with markets having more frequent shareholder litigation, larger professional bodies, and greater market orientation (Ball et al., 2003).

Political influence in firms can arise through connection with politically powerful government representatives (Faccio, 2003; Johnson & Mitton, 2003; Riahi-Belkaoui, 2004), significant government ownership in firms (Bushman *et al*., 2004; Chen *et al*., 2010) and in the case of Malaysia, Bumiputera status firms (Johnson and Mitton, 2003; Gul, 2006). Resource dependency explains how connections to political leaders result in them influencing firms' decision-making (Pfeffer & Salancik, 1978), which may be in the form of manipulating reported financial performance statistics to minimize the expected political costs of reporting adverse news (Shleifer & Vishny, 1994). The connections through the appointment of politically connected directors on board and heavy reliance on government ease the access to resources which contributes to these firms' prosperity, suggesting the reduced demand for and reliance on quality financial statements (Chaney *et al*., 2011; Chen *et al*., 2010). The lack of reliance on quality financial statements provides less incentive for the preparers to recognize bad news earlier than good news in avoiding overstatements of assets and earnings.

The negative influence of politically connected firms is also highlighted by Gul (2006) in Malaysia and Chaney *et al*. (2010) in a cross-country study. These firms are said to be related to the greater likelihood of business failure, misreporting, overstatement of earnings, and arguably lower accounting conservatism. Further, Chaney *et al*. (2010) found that firms with political connections have a poorer quality of reporting, but they do not suffer less negative consequences as a result of it. Since accounting conservatism relates to the release of good or bad news, consistent with the arguments above, political connections lead to lower accounting conservatism. Accordingly,

H1: Ceteris Paribus, financial reporting quality that is proxied by conservatism is negatively related to the proportion of politically-connected directors on board.

As a politically-favoured ethnicity, Bumiputera-Malays have been given, among other privileges, priority for government contracts, increased access to capital, opportunities to buy assets that are privatized, and other subsidies. This reduces the need for these firms to produce high quality reporting in order to compete for the resources and finance. Additionally, with a resource dependency theory background, since these firms (Bumiputera-Malays and government owned firms) rely heavily on the government, there is less difficulty in obtaining resources should the firms run into financial trouble, which is the norm under a soft budget constraint (Chen, Chen, Lobo, & Wang, 2010) and thereby demanding for less accounting conservatism in financial statements. Furthermore, accounting choices are influenced by the expected political cost associated with the given financial reporting outcomes (1978). Less incentive to report losses timely is also motivated by the fact that this ethnic group suffers less political costs from reporting large profits as they are protected by the government (Ball *et al*., 2003).

Accordingly,

H2: Ceteris Paribus, financial reporting quality, which is proxied by conservatism, is negatively related to the proportion of Bumiputera-Malay directors on the board.

Firms with higher government ownership are subject to a similar entrenchment effect with the ability to manipulate and report uninformative earnings (Abdul Rahman *et al*, 2016).

Incentives are available for firms under the influence of the government to suppress accounting information flow to potential entrants in order to protect their political agenda and economic interests (Bushman *et al*., 2004). This suggests poorer quality of reporting for firms with more government ownership. Although there are also incentives for firms with more government ownership to adopt less aggressive accounting practices as reported in Eng and Mak (2003), due to public accountability and large monitoring ability, the literature on negative influence of government ownership in reporting dominates the literature.

Based on the arguments above, the hypothesis is stated as follows:

H3: Ceteris paribus, financial reporting quality, which is proxied by conservatism, is negatively related to the percentage of government ownership.

RESEARCH METHODOLOGY

Sample

The study selects 206 public listed firms with top market capitalization from the fiscal years of 2004 to 2007. Large firms have been chosen because, according to Roe (2003), these firms are more likely to be affected by political factors. The years 2004 to 2007[3] have been chosen in order to examine the impact of the code of corporate governance a few years after the incorporation of the code into Bursa Malaysia's listing requirements in 2001-2003. The selection period is consistent with Ahmed and Duellman (2007), who examined the period after the formal corporate governance framework was introduced. The period from 2004 to 2007 also represents a period of economic and political stability for Malaysia.

Regression model and variables definition

In measuring the asymmetric timeliness of earnings, Basu (1997) uses a reverse regression of returns and earnings, whereby the dependent variable, namely earnings per share, is regressed on a dummy variable indicator scheme using one, if the return is negative, and zero if otherwise; a return variable and an interacting variable between the dummy and the return.[4] The stock price return is used as a proxy for good or bad news incorporated in earnings. The coefficient on stock returns (β2) measures the sensitivity of earnings to positive stock returns (a proxy for economic gains). A positive coefficient (β3) on the return interacting with the dummy variable indicates accounting conservatism. This coefficient measures the incremental sensitivity of earnings to the incorporation of bad news relative to good news. Basu's (1997) approach is the most widely used measure of conservatism and attracts the most validity tests.

Following Roychowdhury and Watts (2007), returns and earnings are accumulated over the three years to provide better measurement of aggregate conservatism. Meanwhile, earnings are deflated by the market value of equity at the beginning of the period to control for heteroscedasticity. The basic model used in this study is stated below as equation (1).

[3] We did not include 2008 because of the Global Financial Crisis, which saw government interventions in corporate affairs and monitoring in the country. In addition, the Malaysian Code on Corporate Governance was revised on 1 October 2007 (see www.bursamalaysia.com), which is not expected to affect the sample.

[4] Dietrich, Muller, and Riedl (2007) discuss the limitations of Basu's (1997) approach to estimating asymmetric timeliness as yielding bias when earnings information affects returns. However, Ryan (2006) contends that the measurement error of this model is likely to be small.

$$\frac{E_{t,t-j}}{P_{t,t-j-1}} = \alpha_0 + \beta_1 D_{t,t-j} + \beta_2 R_{t,t-j} + \beta_3 D_{t,t-j} * R_{t,t-j} + \varepsilon, \quad \textbf{(1)}$$

Where,

$E_{(t,t-j)}$: income before extraordinary items cumulative from year t-j to year t, and j is equivalent to 2, $P_{(t,t-j-1)}$: the market value of equity at the beginning of the year t-j,
$R_{(t,t-j)}$: the accumulated annual returns of year t-j to year t (calculated annually from the price starting four months after the end of the fiscal year t-j-1 and ending four months after the end of year t),
$D_{(t,t-j)}$: a dummy variable indicator equivalent to one, if the return is negative, and zero if otherwise,
$D_{(t,t-j)}*R_{(t,t-j)}$: an interaction variable consisting of the firm's stock return and return dummy variable. This coefficient captures the response of bad news compared to good news. A positive coefficient represents conservative financial reporting.

Equation (1) is then interacted with other independent variables to examine the relationship between these factors and accounting conservatism. The model based on Basu (1997) and modified by Roychowdhury and Watts (2007) and Ahmed and Duellman (2007)[5] to ascertain the relationship between accounting conservatism and political influence. Accordingly, this

$$\begin{aligned}\frac{E_{i,t-j}}{P_{t,t-j-1}} = {} & \alpha_0 + \beta_1 D_{t,t-j} + \beta_2 R_{t,t-j} + \beta_3 D_{t,t-j} * R_{t,t-j} + \sum_{i=1}^{3} \beta\,(POL\,)_{i,t} \\ & + \sum_{i=1}^{3} \beta\,(POL\,)_{i,t} * D_{t,t-j} + \sum_{i=1}^{3} \beta\,(POL)_{i,t} * R_{t,t-j} \\ & + \sum_{i=1}^{3} \beta\,(POL)_{i,t} * D_{t,t-j} * R_{t,t-j} + \ (other\ control\ variables) \\ & + \ \varepsilon, \qquad \textbf{(2)}\end{aligned}$$

relationship is modelled as:

Where, Political (POL) variables are POLCON, MALDIR, and GOVOWN. Since there are concerns for bias in the regressions when extending Basu's (1997) model into many variables, the analysis is to test the regressions by including only one operating variable. This is done while controlling for firm-specific characteristics that are likely to affect conservatism (market-to-book ratio, firm size, and leverage). This approach was used by Beekes *et al*., (2004) and LaFond and Roychowdhury (2008).

Prior studies on accounting and political factors in Malaysia include studies by Johnson and Mitton (2003) and Gul (2006). Both studies used politically connected firms based on the list of politically connected firms from Gomez and Jomo (1997) as proxy for political connection. Following Gomez and Jomo (1997), there are two types of favored firms in Malaysia. The first type is firms run by both Bumiputera-Malays and Chinese having informal ties with politicians (proxied by POLCON), and the second type of politically favored firms in Malaysia includes firms with an official status awarded to firms operated by ethnic Malays, with a percentage of Bumiputera-Malay directors (MALDIR) (Gomez and Jomo, 1997).

[5]This approach, sample size, and number of variables are comparable with 747 firm-year observations in Ahmed and Duellman (2007). The sample size in this study is 824 firm-year observations.

POLCON is the ratio of politically connected directors to the total number of directors on the board of a company. A politically connected director may be a member of parliament, a minister, a head of state, a state assemblyman (Chaney *et al*., 2010), or a person who is either currently or was formerly a government bureaucrat (Agrawal and Knoeber, 2001). In addition, the list of cabinet members and parliamentarians and state legislators were also reviewed (www.pilihanraya.com.my/melayu/parliamentlist.asp). This measure captures the changes of political influence in firms over time. This variable has not been tested in any prior studies on accounting conservatism.

MALDIR is the proportion of Bumiputera-Malay directors to total number of directors. Following the approach in Yatim *et al*. (2006), the directors' ethnicity is determined by examining their names. The third measure is the percentage of government ownership (GOVOWN). This information was obtained from the annual reports where, in compliance with the Companies Act 1965, all listed companies disclose their substantial shareholders in their annual reports. The percentage of government ownership is determined, based on shares held by the 30 largest shareholders with government backgrounds. These shareholders are either government agencies or trusts.

Control Variables

Following Khan and Watts (2009), the firm specific control variables are the ratio of growth, firm size, leverage, industry and year. The variables growth, firm size, and leverage are also interacted with $D_{(t,t-j)}*R_{(t,t-j)}$ following the approach in prior studies (Ahmed & Duellman, 2007; Chen *et al*., 2010; LaFond & Roychowdhury, 2008). According to Roychowdhury and Watts (2007), differences in firm growth opportunities have also been controlled. This is measured by market to book ratio (MTB). Positive relationship is expected between MTB and accounting conservatism. Firm size (FSIZE) is measured as the natural log of the market value of equity at the end of the financial year (Khan and Watts (2009). Khan and Watts (2009) argue that large firms have lower information asymmetry, and therefore a lower demand for conservatism. This has also been noted by Givoly *et al*., (2007) and LaFond and Watts (2008); all of them found that the asymmetric timeliness of earnings for large firms is significantly smaller. Therefore, it is expected that firm size is negatively associated with accounting conservatism. Leverage (LEV) is measured as the amount of total long-term debt divided by average total assets. Highly leveraged firms were found to have more conflicts between bondholders and shareholders (Ahmed and Duellman, 2007), and higher agency costs (Dey, 2008).

ANALYSIS

Descriptive statistics

Table 1 presents the descriptive statistics of the variables for accounting conservatism and the explanatory variable. Panel A of Table 2 reports that the mean (median) of earnings is 0.340 (0.312) and the mean (median) of returns is 0.306 (0.368). The returns and earnings exhibit similar patterns, consistent with the existence of conditional conservatism in prior studies (Basu, 1997; García Lara, García Osma, & Penalva, 2009; García Lara, Osma, &

Penalva, 2007). Consistent with García Lara *et al*. (2009a), the standard deviation of returns is greater than the standard deviation of earnings, which indicates returns are more volatile than earnings. The average percentage of politically connected directors on board is 22.3% and Bumiputera-Malay directors comprise 43.8% of the total number of directors. The existence of Bumiputera-Malays on a board and in the ownership structure is a result of the government's political agenda. Despite the politics of favoritism, the non-Bumiputera directors (mostly Chinese) still comprise a larger proportion of the total number of directors in the listed firms on Bursa Malaysia. The average level of government ownership is 11.31%, with the range being 0 to 67% (not reported). Apparently, some firms do have high government ownership as is evident from the maximum of 67%.

Table 1 Descriptive statistics for accounting conservatism measures and explanatory variables

	Returns	Earnings	
Panel A: Accounting conservatism measures			
N	824	824	
Mean	0.306	0.340	
Median	0.268	0.312	
Standard deviation	0.617	0.585	
	Polcon	Maldir	Govown
Panel B: Political Influence proxies			
N	824	824	824
Mean	0.223	0.436	0.113
Median	0.222	0.375	0.579
Standard deviation	0.162	0.258	0.169
	Fsize	MTB	Lev
Panel C: Firm specific variables			
N	824	824	824
Mean	13.143	1.341	0.124
Median	12.979	0.977	0.074
Standard deviation	1.376	1.219	0.141

E/P is income before extraordinary items cumulative from year t-j to year t, and j is equal to 2 divided by the market value of equity at the end of the year t-j. R is the buy and hold return starting four months after the end of the fiscal year t-j-1 and ending four months after the end of year t.. POLCON: the proportion of politically connected directors on the board; MALDIR: the proportion of Bumiputera-Malay directors on the board; FSIZE is the natural log of market equity; MTB is market to book ratio; LEV is the amount of total long-term debt divided by average total assets.

The proportion of Bumiputera-Malay directors on board (MALDIR) and the percentage of government ownership are both significant and negatively correlated to earnings (E/P), suggesting firms run by more Bumiputera-Malay directors and firms with more government ownership perform poorer than their counterparts. The proportion of Bumiputera Malay directors on board (MALDIR) is significant and negatively correlated to earnings (E/P) (-0.076, $p<0.05$), suggesting firms run by more Bumiputera Malay directors perform poorly. POLCON is positively correlated to GOVOWN and MALDIR. GOVOWN is positively correlated to MALDIR. This is not surprising, since most government-owned firms have Bumiputera-Malay directors, who also dominate Malaysia's political scene.

Accounting Conservatism and Political Influence

As documented in Table 2, there is a positive association between earnings and returns as predicted by the theory. Further, the results in Table 2 demonstrate that the presence of more politically connected directors on the board (POLCON) is significant and negatively related to accounting conservatism. However, the percentage of government ownership (GOVOWN) and the proportion of Bumiputera-Malays on board (MALDIR) is unrelated to conditional conservatism. Our finding supports the argument of the resource dependency theory, which states that having influential leaders or resource providers on the board could influence firms' decision-making and financial reporting. The results support the explanation of the 'political view' that its influence can be negative as evidenced by the significant negative coefficient for the proportion of politically connected directors on a company's board. Aggarwal (1999) and Chen *et al*. (2010) argue that politically connected directors on a board enable a firm to gain access to assistance, resources, and contracts that have their origins in government directions and political connections. Such easy access to resources provides less incentive for the preparers to produce quality reporting (Ball *et al*., 2003). Political influence proxied by the proportion of Bumiputera-Malay directors on board is unrelated to accounting conservatism, suggesting that government-favored policies towards some ethnicities do not influence the financial reporting outcome. Our result is consistent with the result of Johnson and Mitton (2003). There is no evidence that government-owned firms are more conservative; a plausible reason for the insignificant association between government ownership and accounting conservatism is due to competing incentives that exist for government-owned firms in financial reporting.

Table 2 Results of Regressions Using One Operating Variable of Political Influence

Dependent variable: income before extraordinary items divided by the market value equity at the beginning of the period

Variables	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
	(4)		(5)		(6)	
C	0.146	0.489	0.205	0.695	0.026	0.081
D	0.090	1.692	0.075	1.415	0.078	1.463
R	0.071*	1.706	0.073*	1.764	0.081**	1.929
D*R	0.537***	5.370	0.493***	5.006	0.481***	4.809
POLCON	-0.107	-0.578				
POLCON*D	-0.845**	-2.425				
POLCON*R	0.135	0.532				
POLCON*D*R	-1.653**	-2.655				
MALDIR			-0.059	-0.520	-0.003	
MALDIR*D			-0.156	-0.791	0.001	
MALDIR*R			0.143	0.901	0.005*	
MALDIR*D*R			0.635	1.635	0.004	
GOVOWN					-0.003	-1.422
GOVOWN*D					0.001	0.139
GOVOWN*R					0.005*	1.820

Table 2 (Cont.)

GOVOWN*D*R			0.004	0.537
Control variables	Yes	Yes		Yes
N	824	824		824
Adjusted R-square	0.256	0.271		0.257
VIF	5.356	5.116		6.122
F-statistic	11.903	12.747		11.951
Significance	0.000	0.000		0.000

The regression being estimated is

$$E_{(i,t-j)}/P_{(t,t-j-1)} = \alpha_0 + \beta_1 D_{(t,t-j)} + \beta_2 R_{(t,t-j)} + \beta_3 D_{(t,t-j)}{*}R_{(t,t-j)} + \beta_4 POL_{(i,t)} + \beta_5 POL_{(i,t)}{*}D_{(t,t-j)} + \beta_6 POL_{(i,t)}{*}R_{(t,t-j)} + \beta_7 POL_{(i,t)}{*}D_{(t,t-j)}{*}R_{(t,t-j)} + \text{(other control variables)} + E,$$

where alternate POL variables are POLCON and MALDIR. Refer to Table 4 for definitions of the variables. POLCON and MALDIR, POLCON is the proportion of politically connected directors on the board, MALDIR is the proportion of Bumiputera-Malay directors on the board. The control variables are MTB, FSIZE, LEV and Industry and Year Controls. MTB is market-to-book ratio. FSIZE is the natural log of market equity. LEV is the amount of total long-term debt divided by average total assets. Notes: ***, ** and * represent statistical significance at 1, 5 and 10 per cent levels respectively (using two-tailed tests).

The Effect of Politically Connected Directors on Accounting Conservatism in Firms with a High Percentage of Government Ownership

Further analysis is done by partitioning firms with high and low percentage of government ownership based on the median value to see whether government ownership affects accounting conservatism via politically connected directors. The results in Table 3 show that there is a strong positive correlation between earnings and returns; however, the coefficient appears higher in the firms having more government ownership. The coefficient for the interaction between dummy variables for negative returns and returns (the coefficient for accounting conservatism) is significant and positive for firms with less government ownership. The coefficient for accounting conservatism is negative and insignificant for firms with more government ownership. Although the earlier analysis provides no evidence of influence by government ownership on accounting conservatism, the results of the portfolio analysis in this section provide some support for the resource dependency theory.

The coefficient of interest in this analysis is the interaction among the proportions of politically connected directors on boards, dummy variables for negative returns, and returns. Apparently, more politically connected directors on company boards with higher government ownership contribute to the lower accounting quality as evidenced by stronger negative coefficient in Table 3. This result is also consistent with the findings in earlier regressions reported in Table 2. The coefficient on politically connected directors in firms with high government ownership is higher (-3.164, t-statistics -3.057) compared to earlier regressions using the whole sample (-1.585, t-statistics -2.056). This suggests that firms with lower government ownership do not adopt lower conservatism in the presence of politically connected directors. The negative association between management ownership and accounting conservatism is consistent with results using the whole sample and does not differ due to government ownership.

Table 3 Results of Relationship between Accounting Conservatism and Political Influence characteristics by partitioning sample, according to High and Low Government Ownership (above and below median)

Dependent variable: income before extraordinary items divided by the market value equity at the beginning of the period				
	GOVOWN Above median (6)		GOVOWN Below median (7)	
	Coefficient	t-Statistic	Coefficient	t-Statistic
Intercept	-0.330	-0.776	0.451	0.623
D	0.136	1.587	-0.098	-0.755
R	0.595***	8.580	0.320***	3.474
D*R	-0.721	-0.367	7.296***	2.603
POLCON	-0.208	-0.846	0.084	0.193
POLCON*D	-0.505	-1.036	0.016	0.020
POLCON*R	0.532	1.359	-0.255	-0.467
POLCON*D*R	-3.164***	-3.057	-0.865	-0.654
Control variables		Yes		Yes
N		412		412
Adjusted R-squared		0.321		0.320
VIF		5.783		6.972
F-statistic		5.621		5.604
Significance		0.000		0.000

$(E_{i,t-j})/P_{t,t-j-1} = \alpha_0 + \beta_1 D_{t,t-j} + \beta_2 R_{t,t-j} + \beta_3 D_{t,t-j}*R_{t,t-j} + \beta_{0,pol} POLCON_{i,t} + \beta_{1,pol} POLCON_{i,t}*D_{t,t-j} + \beta_{2,pol} POLCON_{i,t}*R_{t,t-j} + \beta_{3,pol} POLCON_{i,t}*D_{t,t-1}*R_{t,t-j} + (other\ control\ variables) + \mathcal{E}, \quad (2)$

Notes: ***, ** and * represent statistical significance at 1, 5 and 10 per cent levels respectively (using two-tailed tests). Refer to Table 4 for definitions of the variables. All control variables are interacted with $D_{t,t-j}$, $R_{t,t-j}$ and $D_{t,t-j}*R_{t,t-j}$.

DISCUSSION

After the 1997 financial crisis, Malaysia had implemented several corporate governance modeled on the systems in developed western countries with a view to improve the quality of financial reporting and thus to enhance investors' confidence. The country's unique institutional setting and formal recognition and favoritism of Bumiputera over other ethnic groups since the 1970s have resulted in a significant political influence on businesses. Indeed, businesses and companies being subject to more political influence is an important institutional difference between Malaysia and the US or the UK. This provides us the motivation to examine the role of political influence in the accounting policy choice. We used accounting conservatism as the proxy for reporting quality. Accounting conservatism is a fundamental attribute of quality financial reporting because by recognizing bad news earlier than good news, firms are able to prevent managers from being overpaid (Kothari, Ramanna, & Skinner, 2009), to avoid inappropriate distribution of dividends (R. L. Watts, 2003), and to reduce the incentive to undertake negative present value projects (Ball & Shivakumar, 2005). Examining the issue of accounting conservatism in Malaysia is important because the capital market is becoming more open and evolving as a result of further economic development and growth. Our results show that conditional conservatism exists in Malaysian firms measured by the reverse regression of returns and earnings.

The results reveal that the political influence aspect has an impact on the quality of reporting, defined as accounting conservatism, though this influence depends on the measures of political influence. It appears that the proportion of politically connected directors is negatively associated with accounting conservatism. This result is more pronounced in government owned firms. The findings support the explanation of the resource dependency theory on the influence of resource providers (in this case, the politically connected directors) on firms' decision-making (in this case, the outcome of financial reporting). However, political influence proxied by the proportion of Bumiputra-Malay directors and the percentage of government ownership reveal insignificant results. The insignificant result for Bumiputera-Malay directors' influence demonstrates that a more direct impact emanates from connections with politicians rather than ethnicity and government ownership.

Politically connected directors on boards benefit the firm such as in the allocation of more subsidies and capital funding from the government (Johnson and Mitton, 2003). Further political connection also gives firms more opportunities to access government controlled information, participate in government projects, which are assumed be with less business uncertainties, for example in terms of payments and the likelihood of contract cancellation, and reduce transaction costs through exemption of government taxes and fees (Faccio, 2006). Since political influence is recognized in this theory as a tool that can enhance firms' performance, the close connection with politicians alleviates any difficulties in accessing resources, thereby reducing the demand for good quality reporting (Chaney *et al*., 2011). This is evidenced from the finding of this paper as summarized in Table 4.

Table 4 Hypotheses and results

Hypotheses	Prediction	Result
H1: Ceteris Paribus, financial reporting quality which is proxied by conservatism is negatively related to the proportion of politically-connected directors on board.	-ve	Accepted
H2: Ceteris Paribus, financial reporting quality which is proxied by conservatism is negatively related to the proportion of Bumiputera-Malay directors on the board.	-ve	Rejected
H3: Ceteris paribus, financial reporting quality which is proxied by conservatism is negatively related to the percentage of government ownership	-ve	Rejected

CONCLUSION

The paper examines the relationships between financial reporting quality, featured by accounting conservatism and political influence in an emerging market where substantial government influence is exercised, Malaysia. The results indicate that politically connected directors on company boards significantly reduce accounting conservatism, and that the negative association between accounting conservatism and politically connected directors is more pronounced in firms where the level of government ownership is higher. The findings in this paper offer insights and additional guidance for regulators and policy makers in emerging economies like Malaysia in determining the level of government and politicians' participation in businesses as well as in devising the financial reporting frameworks.

While this study has several strengths, it is not without some limitations. Our model is drawn from Basu's (1997) model, which has been criticized by many scholars for its misspecification. However, the use of the model, modified by Roychowdhury and Watts (2007), is believed to have reduced the measurement error. This study also acknowledges that political connections can arise through close friends and relatives. However, due to data availability, these political connections are unable to be detected. Further extension of this work can be done via in-depth qualitative analysis about politically connected directors, such as director remuneration, frequency of political meetings, and amount of political donations.

Overall, the findings are consistent with arguments that political influence plays a significant role in affecting the quality of financial reporting. By directly examining the impact of political connection on accounting manipulation, this study provides understanding of the effectiveness of board of directors as a monitoring tool in an emerging market setting where the market is substantially influenced by political elements. Indeed the investigation of these issues has several implications for future research, which could enhance our knowledge of the subject.

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