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Political Elites and Earnings Management in Malaysian Public Listed Companies

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ABSTRACT

This paper aims to focus on earnings management and the influence of political connection towards this practice. This research was made on a total of two hundred thirty-one (231) firm-year observations, in which these comprises of Malaysian public listed companies with at least one politically connected personnel present in the Board of Directors, over a period of three (3) years. The empirical results of this study show that political connection does not have a significant influence on the earnings management practice in Malaysian public listed companies.

Keywords: Earnings Management, Firm Value, Political Connection, Political Influence.

1. OVERVIEW

Earnings or profits is important and the ultimate purpose of every company in order to continue running their business. The financial statements produced by a company is a tool in which the earnings value are made known (Griffin, Kilgore & Putman, 2003), and these financial statements are prepared by managers, who are also the salaried employees. The managers are intensely interested in presenting growth in the earnings figure, as their remuneration are tied to the profits of a company (Chan, Chan, Jegadeesh & Lakonishok, 2001).

Therefore, the level of earnings quality becomes doubtful because managers have financial and economic incentive to manage the earnings aggressively. Under the agency theory, separation of ownership and control between shareholders and managers has provided managers with additional advantage for greater control of the information (Kazemian & Sanusi, 2015), and this has encouraged managers to be opportunists by exploiting the flexibility of accounting principles.

"Earnings Management" is a well-known phrase in the corporate world, in which the mention of this term itself raises eyebrows from many parties. The earnings management practice can prolong and turn into a serious issue as continuous manipulation of accounting information will lead to massive financial consequences (Alexander, 2010). Ever since the trigger of many infamous cases such as Enron, Tyco International, and WorldCom that led to the firms' downfall over time due to fraud, the earnings management practice has caused financial reporting quality to be increasingly doubtful (Daghsni, Zouhayer, & Hadj Mbarek, 2016), in addition to shaking the confidence of the public in the securities market (Karim, Shaikh, & Hock, 2015).

Therefore, there is a high focus on this subject matter over the last few decades (Mohd-Ali, Hassan, & Mohd-Saleh, 2007) because continuous earnings management can lead to corporate fraud and corruption (Jones, 2013; Almahrog, Marai, & Knežević, 2015). Prior literature works have exposed that there have been many factors that can influence earnings management. For instance, firstly, the ownership structure of a company can impact the level of earnings

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management practised. Ownership structure refers to whether the organization is family-owned, a partnership or public listed corporation.

Next, the characteristics of the board of directors can also be one of the influencing factors for a company to practice earnings management. Some of the characteristics discussed were on the independence of the directors, the gender diversity of the board composition, as well as the size of the board, whereas some literature has linked the company's CEO or executive manager's compensation to earnings management.

There are also a handful of prior studies that had shown the possibility of a link between political connection and earnings management. A few studies had exposed a corporate governance scandal that happened a few years back in Malaysia. Perwaja Steel Sdn Bhd was a government-owned company that became the successor to Perwaja Terengganu, which is its parent company that had been declared bankrupt. Perwaja Steel's aim was to recover the national steel company (Mohamad & Sori, 2011) but an audit after many years had revealed that a director has made a payment of RM74.6 million to a Japan entity, NKK Corporation, by going through a fictional Hong Kong-based company (Norwani, Mohamad & Chek, 2011). There were also unauthorized high-value contracts between Perwaja and other companies and there were incidences of financial records being modified. The mentioned case describes the elements of political influence on the quality of earnings.

Additionally, within the context of earnings management under the political influence, a study done by Johnson and Mitton (2001) pointed out that politically connected firms apparently have weaker corporate governance practices and stronger agency problems (Yen, Chun, Abidin & Noordin, 2007). Furthermore, Kim and Limpaphayom (1998) and Derashid and Zhang (2003) mentioned that large politically connected companies are found to pay considerably lower taxes, and thus raises the possibility of political cost (Yen *et al.,* 2007). The political process forces costs on companies that are assumed to be making use of the public and generating extreme revenues (Yen *et al.,* 2007). This suggests that if a company is generating excessive profits, there is a risk of being scrutinized and pressured to reduce their prices. When it comes to political cost theory, it is understood that big sized corporations choose to use accounting techniques that reduce their reported earnings.

2. LITERATURE REVIEW

Studies had been done to learn why companies resort to this manipulative practice. Earnings management happen because of many reasons, and among the few well-known reasons are first, to achieve the profits forecasts set by market analysts, and secondly is to preserve the stock value of the public listed entity. Thirdly, earnings management also happens to accomplish personal benefits, such as better remuneration due to good financial performance (Martinez, 2005; Hamid *et al.,* 2012; Bhasin, 2015).

Prior literature works have indicated various techniques for firms to conduct earnings management. There is a technique highly preferred by accountants, which is to boost up the value of the asset in the balance sheet. This can be done by recording faster-growing receivables or inventories (Karim, *et al.,* 2015), or capitalizing expenditures instead of recognizing them as expenses (Amat, Blake, & Dowds, 1999). Using Cookie Jar reserves is another well-known manner preferred by companies to manage their financial statements (Bhasin, 2015). This author has also pointed out few other creative accounting techniques such as abusing the materiality concept, manipulating the inventories' quantity or value, being liberal with bad debts, as well as using the "Big Bath Accounting" scheme. Under this method, many costs will be written off as much as possible so that the financial presentation of upcoming years will look better.

Marinakis (2011) has noted that earnings management and financial reporting fraud have the same accounting manipulation technique, differing by just to a certain degree. Both are done with the effect of misleading the financial statement users and were conducted with a purposeful intention causing damage to the shareholders who depend on the provided false information (Marai & Pavlovic, 2013; Marinakis, 2011; Beneish, 2001).

Malaysia is one of the very few countries in which a political party is allowed to be the owner of corporate enterprises (Gomez, 2012). The ownership can be in forms of direct control, indirect shareholdings, or even direct and indirect interferences of political persons in the corporate business division (Gomez, 2012). Companies would also be open for them, as their availability can strengthen the corporation's position due to the presence of stronger influencing power. According to Gomez (2012), this insinuates the term 'political business'.

Tan (2014) demonstrated how the New Economic Policy (NEP) affected the money politics situation in Malaysia, starting with ethnic politics, then overlapping into cronyism, and eventually turning into political business. Cronyism was seen when the business elites began pulling in political elites into their company as directors, with a motive to obtain government support (Yusoff, Md. Salleh, Ahmad, & Idris, 2015b).

Previous researchers had mentioned that this political-business relationship is not a bad affiliation. They withstand the idea of politically connected personnel not willing to take the risk of practising earnings management to maintain their reputation (Chi, Liao, & Chen, 2015). These researchers supported their findings based on the governmental connection rationale since they can have easier access to capitals and resources as they do not need any reason to practise earnings management.

But in contrast, Chaney, Faccio, & Parsley (2011) mentioned that if a corporation has politically connected personnel, it can place heavy reliance on the government for easier access to resources, and therefore may signify that it does not need to rely on high-quality financial statements. Furthermore, as politically connected personnel have an image to maintain, the chances are high for them to resort to earnings management as a system to represent a stronger company, financial wise.

3. HYPOTHESIS DEVELOPMENT AND RESEARCH METHODOLOGY

This paper will base on the agency theory to study on the earnings management practices caused by the information irregularities raised from the inconsistency of interests between politically connected personnel as agents, and shareholders as principals. Politically connected personnel will desire to gain higher authority and influencing power, and at the same time receive higher remuneration from the company. This causes a conflict of interest between them and the organization's owners (shareholders), whose motive is to reduce expenses of the company, to increase the stock value, and at the same time increase the firm's value.

There was a study conducted by Mohammed, Sanusi, Noordin & Harjito (2016), in which their research concerns the political influence on earnings management and the quality of the financial report, on large Malaysian public listed firms. Similarly, the connection between a politically related Malaysian company and the tax aggressiveness practised by that corporation has also been examined by Wahab, Ariff, Marzuki, & Sanusi (2017).

Therefore, based on the cases shown in previous studies in Malaysia, the following hypothesis have been generated.

H1: Politically connected personnel positively influence earnings management in Malaysia.

The population of this study consists of all public listed companies in Malaysia. The lists of public companies were obtained from the Kuala Lumpur Stock Exchange, or also known as Bursa Malaysia. Narrowing down, only companies related to politically connected personnel are selected. With further constriction, these companies with fiscal years ending 2014 to 2016 are selected to be the final observation years of this research.

There are two types of accruals, non-discretionary accrual and discretionary accrual. Non-discretionary accruals are expected and arise out of normal business conditions, while discretionary accruals reflect management choices and are not expected in normal business conditions. Discretionary accruals are usually used to fine-tune the corporation's cash flow, thus, for this reason, the discretionary accruals will be used as a proxy of measuring the level of earnings management practised in the company.

The Modified Jones Model has been the most frequently used model in studies related to earnings management. Therefore, this study adopts the Modified Jones Model as the procedure to detect discretionary accrual.

$$\frac{TA_{i,t}}{A_{i,t-1}} = \frac{\Delta CA_{i,t} - \Delta CL_{i,t} - \Delta CCE_{i,t} + \Delta DT_{i,t} - \Delta DEP_{i,t}}{A_{i,t-1}} \quad [1]$$

Where,

$A_{i,t-1}$ = the total asset of firm *i* in year *t-1*

$\Delta CA_{i,t}$ = the change in current assets from the preceding year of firm *i*

$\Delta CL_{i,t}$ = the change in current liabilities from the preceding year of firm *i*

$\Delta CCE_{i,t}$ = the change in cash and cash equivalents from the preceding year of firm *i*

$\Delta DT_{i,t}$ = the change in current liabilities debts from the preceding year of firm *i*

$DEP_{i,t}$ = the depreciation and amortization of firm *i* in year *t*

Next, for the purpose of this study, the definition of political connection has been adapted from Faccio (2002). As such, this study will look at the companies' board of directors, to see if they are currently or previously a minister or a member of parliament. If the director has a close relationship with the minister or a member of parliament, their company will be shortlisted into this study as well. For the purpose of this study, the close relationship denotes a person who is a family member, and the family member relationship is limited to the spouse, siblings and children of the minister. In addition, the directors' association and linkage to any political body will also be taken into account. From this, if this individual holds at least 5% of the shareholding in the public company, then the firm will be included as part of this study's observation.

In accordance with prior works of literature, there will be some control variables used in this study. The first control variable will be the growth ratio of a company, whereby it is determined by the market-to-book ratio (Wahab *et al.,* 2017). This is "defined as the market value of equity divided by the book value of equity" (Pérez, Sánchez, & Martín 2014). The next control variable is the size of the company, and the measurement is straight forward using the total assets value (Fontaine, Ioualalen, & Khemakhem, 2015).

Thirdly, Return on Assets, or ROA, will be the next controlling element. ROA is the earnings before interest and tax divided by the total assets held as at the same year-end (Alqatamin, 2018). Moving on to the final controlling variable, the leverage of a listed company will be used.

The study by Xiao (n.d.), describes leverage "*as the long-term liabilities divided by the total assets*".

4. RESULTS

Figure 1 below shows that earnings management represented by discretionary accruals (DA), has a minimum value of -0.761 and a maximum value of 0.852. In addition, the mean for political connection (PC) is 0.286. Besides that, the standard deviation for this variable is 0.453. Looking at the growth ratio of a company (GRW), this control variable has an average value of 61.29%. The company size (SIZE) on the other hand has an average value of 9.26 with a minimum value of 7.490 and a maximum value of 10.970.

Additionally, the average value for return on assets (ROA) is 0.59 while having a standard deviation of 0.098. Lastly, the leverage variable (LEV) shows a minimum value of 0 and a maximum value of 0.690, with an average value of 0.194 only. These statistics explain that independent variable PC could have a low impact on DA. Furthermore, among all the control variables, SIZE could have the strongest impact on DA and LEV might have the least connection to DA.

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. sum DA PC GRW SIZE ROA LEV
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Variable	Obs	Mean	Std. Dev.	Min	Max
DA	231	.0070375	.1390362	-.7609288	.8516613
PC	231	.2857143	.452735	0	1
GRW	231	.6128571	.8061614	.01	6.27
SIZE	231	9.263723	.770688	7.49	10.97
ROA	231	.0592208	.0982822	-.63	.4
LEV	231	.1914286	.1572346	0	.69

Figure 1. Descriptive Statistics.

Figure 2 displays a positive coefficient value of 0.030 that illustrates the possibility for the political connection (PC) to have a significant impact on earnings management (DA). But, the p-value of 0.247 is higher than the significant level of 0.05, which means that PC does not have a significant relationship with DA. These results explain that public listed companies in Malaysia that has political connection will not have a significant impact on the level of earnings management carried out by these firms.

Upon running this regression, it is also noted that the control variables do not contribute to the influencing power of earnings management. The statistically insignificant relationship is growth ratio of the public listed companies (GRW), the size of the company (SIZE), the firm's return on assets (ROA), and its leverage (LEV), in which all of these has its p-value higher than the significant level of 0.05.

DA	Coef.	Robust Std. Err.	z	P>|z|	[95% Conf. Interval]	
PC	.0303071	.0261538	1.16	0.247	-.0209534	.0815675
GRW	.0271493	.0146259	1.86	0.063	-.0015169	.0558155
SIZE	.0283556	.0261058	1.09	0.277	-.0228108	.0795221
ROA	.1585431	.1067561	1.49	0.138	-.050695	.3677811
LEV	-.0983346	.1515594	-0.65	0.516	-.3953856	.1987165
_cons	-.2715041	.2307598	-1.18	0.239	-.7237851	.1807768
sigma_u	.03380099					
sigma_e	.13305122					
rho	.0606261	(fraction of variance due to u_i)				

Figure 2. Regression for Earnings Management and Political Connection.

5. DISCUSSION AND CONCLUSION

The results in Section 4 stated that having politically connected personnel in a company does not impact the level of earnings management either. This result, therefore, rejects the hypothesis of this study. However, this result is consistent with the study carried out by Mahardhika & Fitriana (2019) on public listed companies in Indonesia. These researchers argued that it is easy for a person involving in politics to be under the limelight should there be any disclosure on their unethical activities with regard to earnings management. The power held by them as well as the trust placed on them by the society will be dropped.

Another study by Fan (2017) also supports the idea that companies with politically connected CEOs engage in fewer earnings management activities. This could be due to the resource dependency theory, whereby it is easier to get access to funding and capitals, thus the obligation to report a high income is not the firm's top priority. Therefore, the financial report does not have to be modified to show a healthy financial status, which means that earnings are not manipulated or managed.

The findings of this study are expected to provide feedback on the effectiveness of rules and regulations set by the various governing bodies such as the Malaysian Anti-Corruption Commission (MACC), Companies Commission of Malaysia (SSM), and Securities Commission Malaysia (SC). This could be especially beneficial for the Malaysian Code on Corporate Governance (MCCG). In terms of significance to literature and theoretical implication, this study will provide a platform of evidence in relation to politically connected personnel under the widely talked about agency theory relationship.

The paper by Yusoff *et al.* (2015a) revealed that there is a value of political connection to Malaysia's business tycoons, whereas the study by Goldman, Rocholl, & So (2006) exposed the value of political connections to major companies in the United States. Therefore, they are just countable studies on business elites, and to our knowledge, none of it relates business tycoons to the earnings management practice in Malaysia. Thus, this could be a new research gap for further research in this field of study.

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