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The management motives in analysing accounting misstatements of Malaysian public listed companies (PLCs)

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Abstract

This paper discusses issues concerning management motives and situational pressures that lead to financial reporting misstatements. The situational pressures and management motives are measured using financial distress, family ownership, founders on board and earnings management of Malaysian public listed firms (referred to as PLCs) that influence the occurrence of accounting misstatements. Results show that founder on board (FOUNDER) is positively significant while family ownership (FAMOWN) is negatively significant determinants of the accounting misstatement proxy financial statement restatements. Two other variables namely financial distress (DISTRESS) and earnings management (EM) interact significantly and positively to affect accounting misstatements. Additionally, family ownership interacts with EM to positively affect accounting misstatements. Findings reveal that the extent of earnings management and financial distress and family-ownership of affect the likelihood of financial statement restatements by Malaysian PLCs.

Keywords: Management motives, accounting misstatements

1. INTRODUCTION

The accounting framework states that the main objective of financial statements is to fairly reflect information concerning the financial position and performance of an entity, and to ensure its comparability for the purpose of economic decision making (European Commission, 2011: 1 & 3). Nevertheless, based on the latest U.S. Government Accountability Office (GAO) report, the cumulative totals of misstatements cases were 6,436 for the fiscal years 2005 through 2011, (GAO, 2013). This shows that the issue of misstatements remains an imminent threat to the firms and regulators even in developed countries. In Malaysia, although the scale is small, the corporate landscape is scattered with several bad accounting scandals such as Transmile Group Berhad, Megan Media Holdings Berhad, and MEMS Technology Bhd, [see Salin, Kamaluddin & Manan, 2011]). According to Hasnan, Rahman and Mahenthiran (2013) Malaysia's weak regulation enforcement by relevant authorities is the leading reason for these widespread fraudulent financial reporting.

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2. CONCEPTUAL OF ACCOUNTING MISSTATEMENTS

2.1. Definition of Accounting Misstatement

A formal definition of financial statement restatements provided by International Federation of Accountants (IFAC) refers misstatement as:

“a difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework” (p. 370).

Generally, accounting misstatements are viewed as manipulation, alteration or falsification of financial statement disclosure which often are fiction and do not fairly present the firm's financial condition to investors (Ettredge, Scholz, Smith & Sun, 2010; Dechow, Ge, Larson & Sloan, 2011).

2.2. Accounting Misstatements Measured by Financial Restatements

Richardson, Tuna and Wu (2003) emphasized that “it is reasonable to assume that earnings restatement firms can be characterized as firms who knowingly and intentionally engaged in earnings manipulation”, since restatements are only undertaken when misstatements are detected. Thus, the incidence of restatements acknowledges the fact that previously issued financial statements were misstated. The GAO classifies financial restatements into nine categories (i.e. acquisition and merger, cost or expense, in-process research and development, other, reclassification, related party transactions, restructuring assets or inventory, revenue recognition and securities valuation related). However, we adopt the classification scheme developed by academics (i.e. Zoe-Vonna Palmrose and Susan Scholz), and latest GAO report (2013) classifies financial restatements into six categories (i.e. revenue recognition, core expenses, noncore expenses, reclassifications and disclosures, underlying events and other). Prior studies document that the most common types of misstatements involve revenue, cost of goods sold or operating expenses (Dechow et al., 2011), which are classified as “core restatements” as it involves the main operation of firm.

3. MANAGEMENT MOTIVES THAT INFLUENCE ACCOUNTING MISSTATEMENTS

Most of the accounting misstatements are attributed to the top management, because they have significant influence in managing firm's financial and operational activities of their firm. Management's unwillingness to disallow aggressive financial reporting practices influences the likelihood of accounting misstatements. Studies have proposed many factors that influence accounting misstatements. This study focuses on the factors that are unique to the Malaysian market as highlighted by Hasnan et al. (2013), and goes deeper into understanding the influence of founders and family ownership that is prevalent in many developing countries.

3.1. Financial Distress

Financial distress refers to the situation where firm cash flow is insufficient to cover the current obligation (Wruck, 1990). Prior study document that financial distress is often accompanied by comprehensive changes in management, governance and organizational structure. Besides those negative impacts, Kinney and McDaniel (1989) suggest that poor financial condition of a firm is often an indicator of erroneous financial statements. Managers are motivated to engage in accounting misstatements as a result of pressure to meet shareholders' and analysts' expectation, particularly, when firms are facing poor financial performance and/or financial distress. Since poor firm performance can also affect their job security of the top management team (TMT), it can motivate the TMT to take unethical actions that help to improve the appearance of the firm's financial condition and the stock market valuation (Kinney & McDaniel, 1989). Smith, Kestel and Robinson (2001) state that financially distressed firms, in order to maintain their reputation, are prone to switch their accounting policies to more opportunistic and aggressive methods to inflate the firm's profit. Chen, Chen and Huang (2010) find that most financially distressed firms employ income-increasing manipulation techniques to avoid a delisting threat. In Malaysia, Hasnan et al. (2013), find significant positive relationship between financial distress and fraudulent financial reporting. Therefore, we hypothesized that:

H₁: There is a positive association between financial distress and accounting misstatements.

3.2. Family Ownership

Claessens, Djankov and Lang, (2000) posit that Asian firms have more concentrated ownership structure where family ownership is common in both small and established firms. Although there are several characteristics that

may align the interest between managers and shareholders in family firms, severe entrenchment effect may arise between controlling (majority) and non-controlling (minority) shareholders when family members hold significant ownership and control over the firm management and decision policies (Cheng, Su & Zhu, 2012). Arguably, these firms may be less efficient as concentrated ownership creates incentive for the controlling shareholders to expropriate wealth from other shareholders (Fama & Jensen, 1983). This may lead to unmerited situations to minority owners as the controlling owners tend to maximize their wealth rather than the wealth of all owners. Family ownership arrangement is one of the factors that motivate the occurrence accounting misstatements. In a family controlled firm that is dominated by their descendants, the agency problem is less likely to be less severe since the family members are greatly concerned about the reputation and provide greater support for the firm's wellbeing (Cascino, Pugliese, Mussolino & Sansone, 2010). On the other-hand, eccentric familial bond can create incentives for certain family members to behave opportunistically that affect the quality of earnings (Fama & Jensen, 1983). Beasley, Carcello and Hermanson (1999) provided evidence that family relationships exist among the directors and/or officers of fraud firms. Based on Malaysian family firms, Munir, Saleh, Jaffar and Yatim (2013) reported that although some level of family ownership may contribute to high financial reporting quality, beyond some threshold, significant family ownership appear to negatively affect the quality of financial reporting. Hence, given this conflicting results on family ownership, we state the following non-direction hypothesis:

H₂: There is a significant association between family ownership and accounting misstatements.

3.3. Founders On Board

The existence of founders on firm's board can also influence accounting misstatements occurrence. Founders are the architects who built the business, which leaves a deep imprint on the culture of the business (Hasnan et al., 2013). Prior studies provide mixed findings with regards to the effect of founders on the firm's board and financial reporting. Based on the agency theory a view states that; as the firm creators, founders have a vision for the success of the firm (Fama & Jensen, 1983). However, an opposing view suggests that founders may have special interest in nurturing the firm (Davis, Schoorman & Donaldson, 1997). Beasley et al. (1999) find that firms which tolerate accounting misstatements are more likely to be managed by their founders or are greatly influenced by the organizational culture created by the founder. Thus, findings prove that founders are trapped to committing illegal acts due to the pressure to maintain the firm's reputation for being successful (Ranft & O'Neill, 2001). Donoher (2009) also found a positive and significant relationship between the presence of a founder-CEO and the incidence of financial reporting restatements. Such positive association supports the view that founders face extreme pressure to report expected results to ensure the survival of their firms. Such powerful stress may cause a founder to "turn-a-blind-eye" to misstate financial statements and ignore the negative consequences. Thus, it is hypothesized that:

H₃: There is a significant association between existence of founders on firm's board and accounting misstatements.

3.4. Earnings Management

If the selection of aggressive financial reporting standards to fraudulent financial reporting is viewed as a continuum, then arguably the variable that influences the occurrence of accounting misstatements is the level of earnings management and the willingness of the TMT to waive ignore it despite the chosen standards push-the-envelope of the Generally Accepted Accounting Principle (GAAP). GAAP allows some level of judgment to be exercised in choosing the financial reporting standards, which is commonly referred to in the literature as "earnings management" or "income smoothing" (Biedleman, 1973). Healy and Wahlen (1999) state that earnings management occurs when:

"...managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." (p. 368).

Besides, firms that tolerate the exercise of earnings management in their financial reporting will likely increase the probability of accounting misstatements. Earnings management may start small without the intention to deceive investors or regulators, but then grow over time to exceed the limits of GAAP and result in full-blown "cooking the books" causing the financial statement to be fraudulently misstated that leads to fraudulent reporting (Hasnan et al., 2013). Thus, without the monitoring of professional judgment in exercising the flexibility given by GAAP, misstatements and fraudulent reporting is possible (Olsen & Zaman, 2013). Hence, it is hypothesized that:

H₄: There is positive association between earnings management accounting misstatements.

Moreover, the motivation and situational pressures for earnings management as perceived by the TMT may influence the severity of misstatements. And over time, a higher level of aggressiveness of earnings management practices within GAAP will become constrained and lead firms to consider non-GAAP financial reporting to window-dress their financial reporting that can eventually go out of hand. Therefore, it is hypothesized that

H_{5a}: The level of earnings management moderates the relationship between financial distress and the occurrence of accounting misstatements.

H_{5b}: The level of earnings management moderates the relationship between the level of family ownership and the occurrence of accounting misstatements.

H_{5c}: The level of earnings management moderates the relationship between founders on the board and the occurrence of accounting misstatements.

4. METHODOLOGY

The sample consists of PLCs on Main Board of Bursa Malaysia between 2004 and 2011, but excludes finance, investment, trust and fund firms since these industries are regulated differently by the Bank and Financial Institution Act 1989. The 1997-1998 financial crisis was declared over in 1999, thus, the immediate five years after the crisis are excluded from the sample. Additionally, since the data collection in this study includes two years prior (i.e. t-1 and t-2) to the restatement year (t), selection of sample is made by excluding the period of three years after the crisis. The sample selection is up to 2011, because the Economic Crime Survey by PWC revealed that fraud in Malaysia was critically high with 44 percent compared to the global average of: 34 percent in 2011, and started to decline in the following year. Further, Malaysia was categorized as one of the territories with lowest percentage of economic crime in 2014 with only 24 percent compared to global average of 37 percent (PWC International, 2014).

4.1 Dependent Variable

Following prior research, the occurrence of accounting misstatements proxy for financial statement restatements are measured using a dummy variable coded “1” for restating firms and “0” for non-restating firms. The categorization of financial restatement will be based on GAO financial statement restatement category descriptions (see GAO, 2013). Final sample consists of 83 restatement firms and 83 non-restatement firms. Sample of non-restatement control group is formed using a match-pair procedure based on financial year-end, firm size, and the industry group to which each pair of restatement and non-restatement firm belong.

4.2 Independent Variables

There are four independent variables, which consist of financial distress, family ownership, founders on board, and earnings management. The financial distress variable is measured using Altman’s Z-score that is used to predict the possible bankruptcy of a firm (Abdullah et al., 2010). We use the threshold used by Hasnan et al. (2013) that classify firm with Z-score smaller than 2.073 as financially distressed firms. Financially distressed firms were coded as “1” while firm with Z-score higher than the threshold value were coded as “0”. The linear equation of Altman’s Z-score model is as follows:

$$Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5$$

Where:

X₁ : working capital to total assets

X₂ : retained earnings to total assets

X₃ : earnings before interest and taxes to total assets

X₄ : market value of equity to total liabilities

X₅ : net sales to total assets, and

Z : overall index, the lower a firm’s Z-score the higher its probability of bankruptcy

For family ownership, the study employed the measurement used by Munir et al. (2013) that measures family ownership as the percentage of the top ten largest shareholders where a higher percentage indicates higher family ownership. Prior to the aggregation the percentage of family ownership, the family relationship was first identified using keywords such as “family”, “relate” and “relation” to trace for any family relationships stated in the corporate annual reports. Hence, only the 10 largest shareholders with familial relationship are cumulated to measure family ownership.

Founders on the board are measured dichotomously where “1” is coded for the existence of founder’s on firm’s board and otherwise it is coded as “0”. This measure is similar to the measurement used by Donoher (2009). To

determine the existence of founder's, each of the director's profile in the corporate annual report is scanned using keywords such as "found", "founder" and "incorporate" to identify the existence of founders on the board. Earnings management is measured using working capital accruals as used in Dechow et al. (2011). The calculation of working capital accrual for each firm is as follows:

WC accruals = [(Change in current assets – Change in cash and short-term investments) – (Change in current liabilities – Change in short-term debt) – Change in taxes payable]/ Average total assets

4.3 Model and Analysis

In this study, a logistic regression model is developed to analyse the relationship between various management motives used as determinants of financial restatements. The following regression model was also employed to determine the extent of the influence of each of the variable in current study on the incidence of financial restatement. In order to test the hypotheses, the logistic regression was conducted in the year immediately preceding the restatement years, it is presented as:

Model 1:

$$FR_{it} = \beta_0 + \beta_1 DISTRESS_{i(t-1)} + \beta_2 FAMOWN_{i(t-1)} + \beta_3 FOUNDER_{i(t-1)} + \beta_4 EM_{i(t-1)} + \varepsilon_{i(t-1)}$$

Besides examining the direct relationship between the independent variables and the dependent variable, we also examine the moderating effect of earnings management affecting the relationship between them and the probability of misstatement. The regression model is as follows:

Model 2:

$$FR_{it} = \beta_0 + \beta_1 DISTRESS_{i(t-1)} + \beta_2 FAMOWN_{i(t-1)} + \beta_3 FOUNDER_{i(t-1)} + \beta_4 EM_{i(t-1)} + (\beta_1 DISTRESS_{i(t-1)} * \beta_4 EM_{i(t-1)}) + (\beta_2 FAMOWN_{i(t-1)} * \beta_4 EM_{i(t-1)}) + (\beta_3 FOUNDER_{i(t-1)} * \beta_4 EM_{i(t-1)}) + \varepsilon_{i(t-1)}$$

Where:

FR : the incidence of financial restatement as proxy of accounting misstatement.

DISTRESS : the level of financial distress measured using the Altman's Z-score.

FAMOWN : the percentage of family ownership.

EM : earnings management using the Dechow et al's (2011) model.

5. RESULTS AND DISCUSSION

Table 1 show the correlation among all of the variables. There is significant positive correlation between existence of founders on firm's board (FOUNDER) and financial statement restatements (RESTATEMENTS) at $p < 0.05$. The correlation indicates that, an increase in founders (FOUNDER) will also result an increase in financial statement restatements (RESTATEMENTS). This result is consistent with Donohue (2009) who evidence that founder positively relate with the incidence of financial restatements. Besides, there is significant positive correlation between family ownership (FAMOWN) and founder on board (FOUNDER), which is significant at $p < 0.05$ level. The significant positive correlation between family ownership and founders on board indicate that an increase in the family ownership (FAMOWN) will increase the founders (FOUNDER) being on board too. In developing countries it is common that family-owned firms are operated by the founders or the second generation family members who are the children of the founders (Grand Thornton, 2002). This finding is also consistent with Hasnan et al. (2013) who found that family-owned firms were controlled by their founders who initially incorporate and manage the firms. Since the highest correlation coefficient which is between family ownership and founders on board is only 0.241, we believe multi-co linearity is not a significant issue.

Table 1: Pearson Correlation Matrix of Independent Variable

	RESTATEMENTS	DISTRESS	FAMOWN	FOUNDER	EM
RESTATEMENTS	1	-0.068	-0.050	.155*	-.052
DISTRESS	-0.068	1	-0.059	-.108	.011
FAMOWN	-0.050	-0.059	1	.241*	-.015
FOUNDER	.155*	-.108	.241*	1	.017
EM	-.052	.011	-.015	.017	1

Notes: All p-value are 2-tailed. *Correlation is significant at the 0.05 level.

Table 2 shows the results on logistic regression analysis. It shows that two variables are significant determinants of financial statement restatements. Founders on board (FOUNDER) is positively and significantly associated with restatements at $p < 0.01$ level, and family ownership (FAMOWN) is negatively and significantly associated with restatements at $p < 0.10$ level. Further, since financial distress and earnings management are not significantly

associated with restatements we conclude that there is no support for hypotheses H₁ and H₄. The insignificant association between financial distress and accounting misstatements may indicate that, financial distress is not the motivating factor for accounting misstatements in Malaysian PLCs. However, this finding is inconsistent with Selahudin, Zakaria, Sanusi and Budsaratragoon (2014) who studies the earnings management in both Malaysia and Thailand. They found that financial distress measured by the Altman's Z-score has the highest standard deviation, and they conclude that financial distress has the largest dispersion among other variables which influences the likelihood of earnings management. Although our study predicts positive association between earnings management and accounting misstatements, result indicates otherwise. Thus, we conclude that while earnings management and financial distress may affect each other, individually these two variables do not influence financial statement restatements.

H₂ predict a significant association between accounting misstatements and family ownership (FAMOWN). Table 2 shows that coefficient of FAMOWN is negatively and significantly associated with accounting misstatements at the 10 percent level, which provides marginal support H₂. The negative coefficients of FAMOWN variable with the accounting misstatements reveal that the existence of higher family ownership reduces the likelihood of financial statement restatements. The finding is in line with prior study by Minichilli, Corbetta and MacMillan (2010) and Miller, Minichilli and Corbetta (2013) which suggest that family owners are greatly concerned about their reputation that comes from their business wellbeing, which discourages them from aggressively manage earnings. Further, this finding is consistent with Hasnan et al. (2013) who examine fraudulent financial reporting in Malaysia, but it contradicts with Munir et al. (2013) which found that significant family ownership negatively affect the earnings quality of Malaysian PLCs.

The existence of founders on firm's board (FOUNDER) is found to be positively and significantly associated with accounting misstatements at p < 0.01 level. This finding is consistent with Donoher (2009) and Hasnan et al. (2013) which support the view that a founder has a strong emotional commitment to the firm's survival and it motivates them to engage in aggressive financial reporting practices that can lead to accounting misstatements. Thus, we conclude that are results support hypothesis H₃ that predicted an association between founders on the firm's board and accounting misstatements

Table 2: Logistic Regression Analysis Results

	B	S.E.	Sig.	B	S.E.	Sig.
DISTRESS(1)	0.247	0.278	0.375	0.302	0.297	0.308
FOUNDER(1)	1.119	0.423	.008*	0.885	0.445	.047**
FAMOWN	-0.896	0.605	.069***	-1.021	0.637	.109***
EM	0.396	0.454	0.383	6.736	3.247	.038**
DISTRESS*EM				6.191	3.236	.028**
FOUNDER*EM				6.36	5.18	0.22
FAMOWN*EM				26.809	12.433	.031**
Constant	0.944	0.243	0.00	1.139	0.279	0.00
R ²	0.07			0.12		
N	165			165		

Notes: * significant at the 0.01 level, ** significant at the 0.05 level and *** significant at the 0.10 level

Logistic regression analysis shows the results of the interaction between all independent variables (i.e. financial distress, family ownership and founders on board) and earnings management (EM) too. The findings reveal that EM moderates the relationship between financial distress and accounting misstatements as hypothesized by H_{5a}. The main effect of the financial distress (DISTRESS) variable is insignificant, but the interaction term DISTRESS*EM is positive and significant at p < 0.05 level. This finding suggest that it not financial distress parse but the reaction to it via the level of earnings management that significantly positively influences the probability of accounting misstatements. The pressure to avoid bankruptcy and meet the shareholders' expectations seems to motivate managers of financially distressed firms to engage in aggressive financial reporting practices by Malaysian PLCs. According to Dechow et al. (2011), even in the US, the poorly performed firms manipulate earnings with the aim of covering up their slowdown and to maintain high stock price. This indicates that financially distressed firms create an incentive for managers to manage earnings and thus, increase the likelihood of accounting misstatements.

The main effect of the family ownership (FAMOWN) variable is a negative association with accounting misstatements. However, its interaction with EM turns positive and significant (FAMOWN*EM) at p < 0.05 level. This implies that when family owners begin to engage in aggressive financial reporting to up hold their reputation it increases the likelihood of misstatements increases significantly. This result provides support for hypothesis H_{5b}. As suggested by Ishak and Napier, (2006) the families' strong bond with TMT creates the incentives for them to behave opportunistically and engage in EM. Recent study by Chi, Hung, Cheng and Lieu

(2015), who examined family-owned firms in Taiwan documented that family firms have higher abnormal accrual than non-family firms after controlling for the influence of board independence. Thus, they argue that family firms involve in more extreme earnings management due to the lack of independence of board. This supports the view that family-owned firms are associated with higher accounting misstatement, which results from engaging aggressive earnings management.

However, although existence of founders on firm's board (FOUNDER) has direct positive relationship with accounting misstatements, the result of the interaction with earnings management (FOUNDER*EM) is not significant. Thus, we conclude that there is no support for H_{5c}. This result simply suggests that founder-led firms do not manage their earnings using working capital accruals. Perhaps, they might use other methods of misstating earnings, such as the use of related-party transactions (RPT) as evidence in Gordon and Henry (2005). Gordon and Henry (2005) who examined RPTs and earnings management document that misstating firms with founder-led managers tend to involve in higher RPTs as compared to non-founder-led firms.

6. CONCLUSION

Exploitation of financial statements was common in Malaysian PLCs as evidenced by high-profile fraud cases such as Transmile Group Berhad, Megan Media Holdings Berhad, MEMS Technology Bhd. Hence, in order to regain public trust on Malaysian PLCs, firms need to be more transparent to report their actual performance and establish sound corporate governance mechanisms to mitigate initiatives for accounting misstatements. Firms need to convince public that appropriate action has been taken to ensure high quality financial statements been prepared. Perhaps, Malaysia's regulatory enforcement should be strengthened as a means to deter future wrongdoing.

Current study attempts to investigate the association between management motives measured using financial distress, family ownership, founders on board and earnings management with the likelihood of accounting misstatements. Specifically, this study examines the moderating effect of earnings management on the relationship between the other three independent variables and accounting misstatements. The empirical evidence shows that founder on board (FOUNDER) and family ownership (FAMOWN) have significant direct relationships with accounting misstatements. Founders on board (FOUNDER) variable are positively related while family ownership (FAMOWN) negatively related. The other two (2) variables namely financial distress (DISTRESS) and earnings management (EM) are not significant at any level. Nevertheless, when interact with earnings management (EM), the financial distress (DISTRESS*EM) shown positive significant association with accounting misstatements and family ownership (FAMOWN*EM) turn to be positively associated with accounting misstatements. Such findings reveal that the extent of earnings management exercised by the management may influence the likelihood of accounting misstatements in certain financially distressed and family-owned firms. Besides, the interactions also improve the R squared value from seven percent to 12 percent. This study contributes to the body of knowledge in financial reporting and accounting misstatement literature, as well as the growing literature on forensic accounting. The findings may help regulatory bodies such as Securities Commission of Malaysia, Bursa Malaysia and the accounting profession in formulating clear guidelines, specifically regarding the exercise of earnings management, to improve the law enforcement in detecting accounting misstatements. Besides, result from this study may assist firms, particularly by family-owned firms and firm that is managed by their founders, in formulating the best strategies to improve their internal control systems in combating accounting misstatements. However, there are several limitations in this study. First, there may be other factors that can influence the likelihood of accounting misstatements which are not included in this study, such as RPTs (see Gordon & Henry, 2005) and board independence (see Chi et al., 2015). Second, proxy used to measure financial distress and earnings management variables are mainly depend on study from develop country, this could be the reason for insignificant findings. Thus, we encourage similar studies be conducted to include other variables and also to verify appropriate measures that significant to developing countries.

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