BOARD OF DIRECTOR'S NETWORKS AND EARNINGS QUALITY IN MALAYSIA

MOHD FAIZAL BIN JAMALUDIN

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BOARD OF DIRECTOR'S NETWORKS AND EARNINGS QUALITY IN MALAYSIA

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MOHD FAIZAL BIN JAMALUDIN

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LIST OF ABBREVIATIONS

AFC	-	Asian Financial Crisis
CMP	-	Capital Market Masterplan
FCCG	-	Finance Committee on Corporate Governance
GLCs	-	Government Link Companies
IS	-	Industrialisation Strategy
KLSE	-	Kuala Lumpur Stock Exchange
MATRADE	-	Malaysian External Trade Development Corporation
MCA	-	Malaysian Chinese Association
MCCG	-	Malaysian Code of Corporate Governance
MIC	-	Malaysian Indian Congress
MITI	-	Ministry of International Trade and Industry
MSWG	-	Minority Shareholder Watchdog Group
NDP	-	New Development Policy
NEP	-	New Economic Policy
PLC	-	Public Listed Companies
ROC	-	Registrar of Companies
SC	-	Securities Commission
SEC	-	Securities Exchange Commission
SMIDEC	-	Small and Medium Scale Industries Corporation
SMP	-	Second Malaysian Plan
SNA	-	Social Network Analysis
UK	-	United Kingdom
UMNO	-	United Malay National Organisation
US	-	United States

DEFINITION OF KEY TERMS

Corporate governance	-	A mechanism by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected.
Culture	-	Collective of human values, which shape behaviour as well as one's perception of the world.
Earnings quality	-	The level of quality and relevance of information reflecting firm's financial performance used by a specific decision-makers for a specific decision-making process.
Elite group	-	Firms that have connection with the well-connected directors in Malaysia
Family firms	-	Firms which are controlled by family
Political connection	-	Being closely-related to top politician
Social network	-	A set of actors or nodes along with a set of specific type of connections, such as friendship, that connects them together.
Social network analysis (SNA)	-	Tools to identify, capture, analyse and map the structural pattern of entire networks. SNA application is able to derive network centrality measures.

JARINGAN RANGKAIAN AHLI LEMBAGA PENGARAH DAN KUALITI PEROLEHAN DI MALAYSIA

ABSTRAK

Malaysia menerima kesan yang kritikal daripada krisis kewangan dunia pada tahun 1997 yang memberi kesan signifikan kepada pasaran modal negara- negara di rantau Asia. Krisis kewangan kepada pasaran baru seperti Malaysia mendedahkan keperluan kritikalnya untuk meningkatkan mekanisma tadbir urus korporat. Ciri-ciri ahli lembaga pengarah merupakan sebahagian daripada mekanisma tadbir urus korporat yang telah menjadi fokus utama untuk mempertingkatkan tadbir urus korporat sekaligus mengembalikan keyakinan pelabur ke arah kelestarian pasaran modal Malaysia. Kajian lepas telah mengenalpasti salah satu daripada ciri-ciri ahli lembaga pengarah merupakan komponen utama yang menjejaskan kualiti perolehan. Tadbir urus rangkaian ahli lembaga pengarah menjadi ciri tersirat utama yang kurang dikaji sebelum ini. Kajian ini secara mendalam meneliti hubungkait antara rangkaian ahli lembaga pengarah dan kualiti perolehan bagi 745 syarikat tersenarai awam di Bursa Malaysia termasuk 4416 ahli lembaga pengarah dalam tahun 2011. Kajian ini menggunakan model kualiti terakru Francis, Lafond, Olsson dan Schipper (2005) bagi mengukur kualiti perolehan. Kajian ini turut menggabungkan Analisa Rangkaian Sosial (SNA) bagi mengukur pemusatan rangkaian di peringkat pengarah dan firma. Melalui penggunaan SNA, kajian ini memetakan keseluruhan rangkaian pengarah dan firma serta menghasilkan ukuran pemusatan bagi menggambarkan kepentingan rangkaian berkenaan. Umumnya, kajian ini mendapati hubungkait negatif dan signifikan antara jaringan rangkaian ahli lembaga pengarah dan kualiti perolehan.

Analisa lanjut kajian ini ke atas ukuran pemusatan rangkaian mencadangkan kedua-dua pengarah Bumiputera dan bukan Bumiputera, pengarah lelaki, warganegara Malaysia dan pengarah yang mempunyai hubungan politik membina rangkaian yang mengurangkan kualiti perolehan. Kajian ini juga mendapati rangkaian pengarah wanita meningkatkan kualiti perolehan manakala rangkaian pengarah warganegara asing dan yang tidak mempunyai hubungan politik tidak memberi kesan yang signifikan kepada kualiti perolehan. Kajian ini berpendapat bahawa hubungkait negatif dan signifikan ke atas kualiti perolehan adalah disebabkan kepentingan status sosial yang menjejaskan nilai pemegang saham. Manakala, kesan positif dan signifikan adalah disebabkan pengiktirafan amalan etika dan tingkahlaku moral. Keseluruhannya, kajian ini menyumbang kepada kajian sedia ada di samping methodologi dengan menyediakan bukti serta menggabungkan keupayaan rangkaian pengarah dan firma yang menjejaskan amalan tadbir urus korporat sekaligus mempengaruhi kualiti pelaporan kewangan. Rangkaian ahli lembaga pengarah memerlukan penelitian lebih mendalam daripada kepelbagaian perspektif teori dengan mengambilkira konteks institusi serta mekanisma tadbir urus korporat yang lain.

BOARD OF DIRECTOR'S NETWORK AND EARNINGS QUALITY IN MALAYSIA

ABSTRACT

Malaysia critically suffered from the world financial crisis in 1997, which significantly effects the capital market of all Asian region countries. The financial crisis in emerging market like Malaysia revealed the critical need for firm to enhance corporate governance mechanism. The board of director characteristics is part of corporate governance mechanism, which has been major focus to strengthen firm's corporate governance, thus restore the investor's confidence towards a sustainable Malaysian capital market. Prior empirical had shown that one of the board of director's characteristics is identified as key component affecting the earnings quality. The governance of the board of director's networks becoming key unobservable characteristics, which has been less observed in past studies. This study investigates the association between board of director's networks and earnings quality of 745 public listed firms in Bursa Malaysia, which comprises 4416 directors in 2011. This study employs the Francis, Lafond, Olsson, and Schipper (2005) accruals quality model as to measure the earnings quality and incorporate the Social Network Analysis (SNA) to measure the network centrality both at director's and firm's level. Using the SNA, this study map the entire network of directors and firms and generate the network centrality measures to reflect the importance of such network. Generally, this study find negative and significant association between the board of director's network and earnings quality. This study extended analysis on network centrality measures based suggest that both Bumiputera and Non-Bumiputera, men, Malaysian and politically connected director's networks created networks which reduce earnings quality. This study finds women director's networks increases earnings quality while foreign and non-politically connected director's networks has no significant effects to earnings quality. This study argue that the negative and significant effects on earnings quality is due to the importance of social stature thus harm shareholders value. While the positive and significant effects is due to the recognition of ethical and moral behaviour. Overall, this study provide contribution to extant literature and methodology by evidencing and incorporating the ability of firm's and director's networks to affect corporate governance practices hence influence financial reporting quality. The board of director's networks need further investigations from diverse theoretical perspectives with take into consideration the institutional context as well as other corporate governance mechanism.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

The board of director's characteristics has become focal issues affecting firms' value. The role of the board of directors and its association with effective corporate governance practices has received considerable attention by not only practitioners and regulators but also academicians around the world. The establishment of board of director's in a firm reflect its status as the apex which oversight firm's strategic decisions (Fama & Jensen, 1983b; Jensen & Meckling, 1976).

The presence of quality directors in a firm is expected to be able to give advice to the firm's management in realising strategic decision. The directors also are in a strategic position to monitor firm's operations as well as management behaviour. Prior studies have examined the board of director's characteristics which lead to effective monitors and advisors (Mustapha & Che-Ahmad, 2011a, 2013) such as independence (Agrawal & Knoeber, 1996; Hoitash, 2010; Klein, 2002; Krishnan, Raman, Yang & Yu, 2011), accounting and finance expertise and experience (Dhaliwal, Naiker, & Navissi, 2006), gender (Agrawal & Knoeber, 2001; Burgess & Tharenou, 2002), ethnicity (Che-Ahmad, Houghton, & Mohamad Yusof, 2006; Haniffa & Cooke, 2002; Yatim, Kent, & Clarkson, 2006), nationality (Ruigrok, Peck, & Tacheva, 2007), and political connections (Abdul Wahab & Abdul Rahman, 2009; Agrawal & Knoeber, 2001; Gul, 2006; Johnson & Mitton, 2003).

In addition, prior studies also has associated the role of the board of directors with firm's ownership structure such as managerial ownership (Jensen & Meckling, 1976; Mustapha & Che-Ahmad, 2011b; Warfield, Wild, & Wild, 1995); institutional ownership (Abdul Wahab & Abdul Rahman, 2009; Choi & Seo, 2008; Velury & Jenkins, 2006) and family ownership (Jaggi, Leung, & Gul, 2009; Wan Hussin, 2009; Wang, 2006). The studies on the structure of firm's ownership relatively indicate the significant presence of directors able to influence the firm's strategic directions and performance.

Relatively, a large number of prior studies have focused on the board of directors and the role they play in governing firms. The board of directors is presumed theoretically as the highest authority in governing the firm (Barnea & Guedj, 2009). However, relatively not much about the board of director's networks has been explored. Therefore, established within sociological perspectives, the effect of the board of director's networks of the firms remains less resolute.

Specifically, Jensen and Meckling (1976) and Pfeffer and Salancik (1978) argued that director with multiple directorships are the most efficient directors which lead to a better firm performance. Firm with multiple directorships could utilise the director's various knowledge and skills shared from other successful firms via their shared directors. Therefore, the director with multiple directorships are motivated to give excellent service to all the connected firms effectively. This becomes an incentive for them to ensure firm's better achievement and performance (Vafeas, 2005).

However, the multiple directorships, to a certain extent, create a controversial debate among researcher. The main concern of multiple directorships is the measurable ability to be associated with firm's wealth and value creation (Etheridge, 2012). The multiple directorships are a direct measure between two or more firms via the shared directors. The direct measurement only manages to evaluate the effect of relationship or interlock at first degree (Hashim & Abdul Rahman, 2006; Omer, Shelley, & Tice, 2014a). This indicates that there is an existing condition, which limits the multiple directorship measurement to capture more rigorous connection among directors or firms.

Also, the direct measurement is argued to be insufficient in measuring the extent of more distant firm's relationships (Kirchmaier & Stathopoulos, 2008; McDonald & Westphal, 2003; Stuart & Yim, 2010). The inclusion of indirect network measurement is relatively useful and provide great insight on how the board of director's networks improve the firm's performance (Horton, Millo, & Serafeim, 2012).

The use of social network measurements are to enhance the ability to measure the effect of board of director's direct and indirect relationship with other firms (Borgatti & Halgin, 2011; Hanneman & Riddle, 2005). The rigorous social network measurements potentially sufficient to determine the effects of either direct or indirect relationships both at directors or firm's level. By having an effective relationships or connections, firms have the potential to utilise the critical resources which lead to increase the firm's value (Renneboog & Zhao, 2011).

Relatively, the board of director's networks is a less unobservable board of director's characteristic which potentially overcomes the limitations imposed by corporate governance studies, particularly on multiple directorships (Andres, Van den Bongard, & Lehmann, 2013; Fich & Shivdasani, 2006). The board of director's networks extensively considers the effect of firms' networks via the director's networks It was argued as the central feature of nearly all firms' economic activities (Larcker, Richardson, Seary, & Tuna, 2009; Larcker, So, & Wang, 2013; Renneboog & Zhao, 2011, 2013).

The board of director's networks causes certain impact to firm performance, as it is determined by fundamental economic, social, and political factors (Ball, Robin, & Wu, 2003). The board of directors network's appears to hold fundamental social embeddedness[1] which leads to the firm's value creation (Geletkanycz & Boyd, 2011; Granovetter, 1985). It is argued that the observations on governance practices among firms are contributed by the effect of board of director's networks (Bouwman, 2011). Therefore, the board of directors' network potentially generates direct and indirect effects to the firm performance.

In social network analysis, anecdotal evidence from the international business community reveals the value of connecting relationships established in the past regardless the period. For instance, the Malaysian capital market has considered Tan Sri Datuk Asmat Bin Kamaludin as a key individual with 35 years of experience serving both government and private sectors. His last position in the government was the Secretary General of the Ministry of International Trade and Industry (MITI).

[1] The concept introduced by sociologist Mark Granovetter which stated that embeddedness is the individuals or firms degree level involve in a social network. At firm's level, the embeddedness involves the overlap between social and economic connection both within and between firms (Granovetter, 1985).

During the period as a senior government officer, he has also held a position as Senior Economic Counsellor to the European Community in Brussels, committee member for Small and Medium Scale Industries Corporation (SMIDEC), Johore Corporation and the Malaysian External Trade Development Corporation (MATRADE). Extensive and recognised experience by industries, especially expertise in international trading, earned him several directorships in Malaysian firms in 2011.

Among high profile firms, which appointed him, mostly as chairman, were Compugates Holdings Berhad, Lion Industries Corporation Berhad, Malaysian Pacific Industries Berhad, Panasonic, Manufacturing Malaysia Berhad, Scomi Group Berhad, Scomi Marine Berhad, Symphony House Berhad, TASCO Berhad, UMW Holdings Berhad, and YTL Cement Berhad.

In addition, throughout his entire directorship period, he was acquainted with other prominent corporate leaders such as former Deputy Prime Minister of Malaysia, Tun Musa Hitam; Member of Parliament and former Finance Minister, Tan Sri Nik Mohamed Bin Nik Yaacob; Founder of YTL Corporation and 7th richest person in Malaysia in 2011, Tan Sri Dato' Seri (Dr.) Yeoh Tiong Lay. Likewise, the importance of past relationships from either the government or corporate sector shown in his successful career.

Nevertheless, the established connections between directors implies that it is obvious that network is necessary in business world (Barnea & Guedj, 2006). Prior studies have associate social networks concepts with firm performance (Dicko & Breton, 2010; Fracassi & Tate, 2012; Horton & Serafeim, 2012; Larcker, So, & Wang, 2012; Horton, Millo, & Serafeim, 2009; Smith, 2009; Kim, 2005; Larcker et al., 2005b;; Nicholson et al., 2004); career outcome (Horton & Serafeim, 2012); compensation and remuneration (Brown, Gao, Lee, & Stathopoulos, 2012; Engelberg, Gao, & Parsons, 2009; Horton et al., 2012; Larcker et al., 2005; Renneboog & Zhao, 2011); corporate policies (Fracassi, 2011); accounting standards regulations (Richardson, 2009); and other board of director's behaviour (Barnea & Guedj, 2009; Dey & Liu, 2011; Kim & Lu, 2011).

Additionally, this idea also supported by Fan *et al*. (2011), as current studies are establishing the understanding that emerging capital market are actually connected through various connections despite being legally independent entities (Allen, Babus, & Carletti, 2010). Malaysia, as one of the emerging capital market in Asia provides suitable environment to examine the presence and impact of board of director's networks among firms in Malaysia.

A network of firms or a business group is commonly found in a typical emerging capital market. The emerging market consists of diversified and legally independent firms or business groups of entities operating across industries (Khanna & Yafeh, 2007). Formally, these networks are created through firm's ownership structure, such as a parent firm that holds the majority shares which enables control of a subsidiary. A firms can also be informally connected through social relationships of the firm's key personnel, such as marriage (Bunkanwanicha & Wiwattanakantang, 2008), family relationships, university alumnus, or personal relationships at the workplace (Khanna & Thomas, 2008).

Hence, the central question of the corporate governance research agenda is to understand the impact of board of director's networks on the firm performance and its consequences (Kim, 2005; Nicholson *et al.*, 2004). The focus on new board of director characteristics, which is the board of director's networks, most likely to affect the firm's decision making process, hence affecting the firm's performance and outcomes (Barnea & Guedj, 2009). This shows that the success of any firm relies on the board of director's networks, directly or indirectly, which brings to the board member selection and finally appointed as executive or directors (Kirchmaier & Stathopoulos, 2008).

An example of one of the highest-profile accounting scandals in Malaysia was Transmile Group Berhad (Transmile), in which the major reason of its collapse was accounting irregularities (Zaimee, 2007). The firm was alleged to have overstated its sales revenue. The property, plant, and equipment (PPE) account also appears to be fictitious. There was no sufficient evidence to support the amounts in the PPE accounts. Regretfully, the payment made by the firm has no supporting payment vouchers.

Additionally, the directors were also fined a total of RM 1,888,200.00 and two directors were sentenced to jail because of failure to disclose accurate financial information on timely manner for year-end 2005 and 2006. Looking at the board composition in 2005, the convicted directors were executive directors and were not listed as directors in the firm's annual report in 2006.

The Transmile scandal was an anecdotal evidence which shows direct or indirect connections between directors supposed were rich with resources and information among them. However, these connections are perhaps seen to be ineffective, as Transmile's directors were finally reprimanded by Bursa Malaysia. Bursa Malaysia Securities Berhad publicly reprimanded four of its former directors in 2010.

This study observation identified that the Transmile board of directors consists of a key political party leader and federal minister, senior government officer, and directors from politically connected firms such as Shangri-La Hotels (Malaysia) Berhad, Lafarge Malayan Cement Berhad, PPB Group Berhad, and Focal Aims Berhad. Despite Transmile directly connected with resourceful and influential directors, it has appeared that little they have done in discharging their duties of monitoring and advisory role effectively.

After numerous trials of the convicted directors, Transmile, and authoritative agencies, this event finally ended with Transmile delisted from Bursa Malaysia in 2011. This episode is one example of how the board of director's networks may negatively affect firms. Anecdotally, it also shows that poor corporate governance not only leads to lower quality of financial reporting at a firm level, but also the national level as suggested by Norwani, Mohamad, and Tamby Chek (2011).

In the emerging market firm context, firms are actually linked to one another via a diversified form of professional and social connections (Fan et al., 2011; Pesämaa, Klaesson, & Haahti, 2011; Renneboog & Zhao, 2011). However, the need to understand how and why does these organisation connections are formed, governed, and evolve over time is less observed (Fan *et al.*, 2011). Still, the social connections are perceived to have value of the firms, as well-connected firms report relatively better economic performance (Fracassi, 2011).

As for corporate governance mechanisms, the rules and regulations stated that the board of directors is accountable to foster a culture that encourage better corporate governance (Securities Commission Malaysia, 2011d). However, the legislation only prescribed the minimum level of compliances. Even though the board of directors is claimed as an important internal governance mechanism, the empirical evidence related to the association of board of directors characteristics and firm performance are inconclusive (Bozec, 2005). Ideally, the rules and regulation emphasise that the existence of a board of directors is expected to promote better standards, eventually leading to a level where firms are able to incorporate it as part of corporate governance best practice.

Shareholder and public confidence reinforcement could be restored if the board of directors reflects the high level of assurance and accountability beyond the compliance of established rules and regulations. The board of director's integrity level further reflects the firm capability as business entities with sufficient information. The information secured capable of reducing firm business risks towards the creation of sustainable and ethical values.

This study, which could be categorised within a sociological approach, is considering the board of directors based on social and relational perspectives. This study also attempts to examine the association of board of director's networks on the firm's financial reporting quality. The board of directors will almost fully utilise their networks in assisting the firm acquire external resources efficiently and effectively (Dicko & Breton, 2010). Eventually, this would influence the quality of a firm's reported earnings.

The issue of effective corporate governance mechanism also has become more prominent due to the recent economic recession and scandals, which affected most countries as well as Asian region. The economic instability due to the Asian financial crisis (AFC) had a significant influence on most Asian countries, including Malaysia. In order to minimise the negative impact of the AFC, firms critically affected by the financial crisis were required to express positive information to investors (Johnson, Boone, Breach, & Friedman, 2000; Lemmon & Lins, 2003; Vichitsarawong, Eng, & Meek, 2010). Thus, the weaknesses of corporate governance practices are becoming more apparent and highly deliberated due to the AFC (Abdul Rahman & Mohamed Ali, 2006; Abdul Wahab, Zain, & James, 2011; Ariff, Ibrahim, & Othman, 2007). Additionally, Fan *et al.* (2011) and Claessens and Fan (2003), also found that the low level of transparency and disclosure quality among Asian publicly listed firms contributed to poor corporate governance.

Despite the negative impact of the AFC on Malaysian economy and public confidences, the argument is clearly shown that there is still a need for better awareness and emphasis of the importance of corporate governance best practices in Malaysia (Abd. Hamid, 2008; Abdul Rahman & Mohamed Ali, 2006; Finance Committee on Corporate Governance, 2000). There is also evidence that the board of directors failed to emphasize the ethical values when enforcing corporate governance practices. The board of directors has been found to focus on compliance with regulatory requirements explicitly (Securities Commission Malaysia, 2011d).

In Malaysia, there is a need to reinforce public confidence, due to continuous flows of funds to Malaysian firms as well as the board of directors, especially after the AFC (Haniffa & Hudaib, 2006). At the same time, by emphasizing observance of boards on the firm's corporate governance, it is crucial to safeguard firms against unethical conduct, mismanagement, and fraudulent activities (Ariff *et al.*, 2007; Securities Commission Malaysia, 2011d; Stuart & Yim, 2010). Therefore, the need for advanced study of corporate governance is increasing, especially in the Malaysian globalised capital market that is competitive and in which scrutiny is intense.

Furthermore, Malaysia, as stressed by Ball, Robin, and Wu (2003), among other East Asian countries, provides a useful setting which is generally viewed to have high-quality accounting standards. However, the institutional structures have created opportunity for firms to produce a low-quality financial report, which is embedded within the board of directors. Indeed, it suggests that the board of director's characteristics needs to be further examined. Additionally, the board of directors is also required to provide well-informed strategic advises and monitoring that cover more than short-term financial performance (Global Corporate Governance Forum, 1997).

1.2 Research Aims and Motivations

There are many reasons why the board of director's networks in Malaysia deserves further examination. First, this thesis aims to advance our understanding and perception of the board of director's networks characteristics and its outcomes. This study utilised a more comprehensive board of director's network dataset than similar studies in Malaysia. This is methodologically consistent with prior studies in the United States of America (U.S.) and United Kingdom (U.K.) settings, which focusing to a whole or large number firms on a network (Etheridge, 2012; Larcker et al., 2013; Renneboog & Zhao, 2011).

To date, the current requirements of board director nomination and appointment have less considered the governance of director's networks effects as suggested by Abd. Hamid (2011) and Bursa Malaysia Securities Berhad (2012b). In Malaysia, a director is permitted to hold a maximum of 25 directorships at a time[2].This is larger compared to U.S, nine; and Australia (11). In the U.K., the Listing Rules 2012 has not limited the number of directorships; however, the U.K. Code of Corporate Governance recommended a limit for executive directors of to only one FTSE 100 non-executive directorship and the code emphasises that all directors should be able to allocate sufficient time to discharge their responsibilities for the firms. The large number of directorships permissible in Malaysia relatively reflect the board of director's networks outcomes are ambiguous.

[2] The 25 directorships include 10 directorships in listed firms and the remaining is in private firms (Bursa Malaysia Securities Berhad, 2012b)

Even though the board of directors perceived to have the power or actually driving the firm, a director's network does perform a critical agenda that propels the Malaysian economic growth. Therefore, there is a need to distinguish the board of director's network structural patterns with regard to firm's earnings quality. The board of director's networks may be significantly affecting the corporate governance effectiveness as well as corporate decision making (Kiel & Nicholson, 2006; Renneboog & Zhao, 2011).

The second motivation is that Malaysia provides a unique institutional setting to examine the association of board of director's networks on earnings quality. Malaysia signifies an important and appealing platform to study the relationship-based economy (Fraser, Zhang, & Derashid, 2006). Information of the board of directors is readily available from the annual reports of listed firms in Malaysia, which require the disclosure of a profile of each of the directors and specifies the director's position in the firm (Mohamad Nor, Shafie, & Wan Hussin, 2010). The application of the latest social network measures and tools, specifically developed by the disciplines of sociology and graph theory, are employed to quantify board of director's networks.

While the studies on board of director's networks mostly carried out in developed countries, this warrant further examination of board of director's networks in emerging markets like Malaysia. The differences of prior studies are that each country is unique with regard to the regulatory and cultural frameworks, including Malaysia (Abdullah, Mohamad Yusof, & Mohamad Nor, 2010).

Prior study has focused on the U.K. and the U.S. firms regarding the association of corporate governance mechanisms, specifically board of directors. This thesis also aims to document the characteristics and structural pattern of the board of director's networks in Malaysia. This study also examines the practical implications of board of director's networks on firm performance, specifically earnings quality.

Recently, focus has been diverted into the Asian countries setting (Kim, 2005). One focus is on the importance of extensive social networks between management and board of directors (Fracassi, 2011). Therefore, the integration of social relationship studies with regard to board of directors is part of natural extension of corporate governance literature (Renneboog & Zhao, 2011; Stuart & Yim, 2010).

1.3 Problem Statement

The unclear consequences of board of director's networks regarding its economic impact are therefore an open empirical question. This is due to the fact that most empirical network studies emphasis on interpersonal relationships between a specific node in a unique setting, for example, between an executive director and chief executive director in securing their compensation; and a security analyst and director in acquiring information advantages (Engelberg, Gao, & Parsons, 2013; Horton & Serafeim, 2012).

The appointment of directors in a board indirectly generates network effects, as the nomination committee member is influenced by their interpersonal relationship to select a new director. For instance, a well-connected director acquainted with different corporate governance practices of other firms, relatively would lead the firm's corporate governance practices towards the practices of those other firms.

Consequently, there is probably that convergence of corporate governance practice could create unnecessary network effects that could detriment firm value (Bouwman, 2011). Corporate governance practices transfer across firms through the board of director's networks. The corporate governance practices are partly the consequences of network effects among firms through their shared directors. Thus, firms are most likely to appoint directors from other firms with comparable corporate governance practices.

The major collapse of Enron and WorldCom have brought the global attention to the consequences of poor corporate governance practice (Fich & Shivdasani, 2006; Norwani et al., 2011; Zaimee, 2007). As the highest authority in a firm, the board of director is the key to the establishment and implementation of good corporate governance practice. The director's behaviour and decision, either individually or collectively, is crucial in motivating firm's strategic direction.

In Malaysia, a number of mini-Enron cases also pressured the key participants in the local corporate governance, among others the board of directors, to play a strong role in preventing accounting scandals from recurring and restoring the public confidence. Several Malaysian firms such as Transmile Group Berhad, Megan Media Holdings Berhad, Nasioncom Holdings Berhad and Wimems Corporation Berhad blamed due to the falsification of their revenue, receivables, and tangible assets (Mahmud, Ibrahim, & Pok, 2009).

Although extensive studies on board of director’s role have been carried out associated with firm’s financial reporting quality , the effect of board of director’s networks on firm’s financial reporting quality is still unclear (Larcker et al., 2013). Therefore, this study intends to increase understanding the effect of the board of director’s networks towards firm’s financial reporting quality. This study also provides empirical evidence on the consequence of board of director’s networks on the financial reporting quality in order to assist corporate governance regulators as well other policy makers in considering the following board of director’s networks.

This study, therefore, offers an attempt to identify the board of director’s networks structural pattern at a macro-level associated with firm financial reporting quality. The innovation of this study is the construct of the board of director’s professional network and measure its relative position in the network. This study, then assesses the board of director’s networks centrality and establish its association with firm’s financial reporting quality.

1.4 Research Questions

This study investigates whether there is a relationship between the board of director’s network and earnings quality of Malaysian publicly listed firms in the post-AFC period. As the 5th fastest growing capital market in Asia, Bursa Malaysia plays a major role in increasing the market capitalisation growth to reach RM 2.4 trillion (US$ 800 billion) in 2020 (Securities Commission Malaysia, 2011c).

The first research question is to ascertain the existing board of director's network structures. In pursuing this question, this study explores the existing structural pattern of the board of director's network of publicly listed firms. If there are structural patterns exist, so, this study would seek to establish whether the relationship between the board of director's network structures and earnings quality significantly differs. Therefore, the first research question of this study is:

What are the existing characteristics of board of director's networks among publicly listed firms in Malaysia?

The second research question, assuming that there is significant characteristics between the publicly listed firm's board of director's networks, is to ascertain whether the impact of board of director's social networks on earnings quality is the same or different for all firms. Thus, the second research question of this study is:

What are the effects between the board of director's networks and firm's financial reporting quality in Malaysia?

This question is important because it helps to understand the board of director's network's role in representing the shareholders' interests and influencing firm's earnings quality, as well as the influences that give rise to formation of board of director's networks.

This study final question is to ascertain the effects of other corporate governance mechanisms to the firm's financial reporting quality in the presence of the board of director's networks. Thus, the third research question is:

What are the effects of other corporate governance mechanisms on the relationship between the board of director's networks and firm's financial reporting quality in Malaysia?

The lack of consensus of prior studies leads to the emergence of more social and relational perspectives on the board of directors' roles (Dicko & Breton, 2010). The roles of individual director as well as the way they are selected will differ (Pesämaa *et al.*, 2011). Larger director's social network are likely empowers the directors and enable them to influence the firm's board of directors (Brown *et al.*, 2012). It also could create value through non-information based channel. No matter at what reasons, board of director networks must represent something for which firms willing to pay for (Engelberg et al., 2013). One way directors gain experiences and knowledge is by serving on a firm's board of directors (Larcker *et al.*, 2005).

Furthermore, board of director's networks does have significant impacts on a firm's economic performance (Larcker & Tayan, 2010). By exploring further on the board of directors' network, it could bring understand the complexity in which board members make decisions (Barnea & Guedj, 2006). Specifically, a less connected firms tend to have better financial reporting quality (Dey & Liu, 2011). Therefore, this study intends to provide evidence of a causal relationship between the board of director's social networks and the firm's earnings quality.

Pesämaa et al. (2011) showed that the combination of board of directors' characteristics, including networks, proper administration, and firm's age does affect the firm's performance. This shows that the model receives strong support, which indicates that the theory has a significant effect on further verification. The social network is important in increasing the director's monitoring role effectiveness (Dey & Liu, 2011). Board of directors with insufficient professional or social connections are less likely to exert control over firm's strategic decisions on behalf of shareholders (Carpenter & Westphal, 2001).

The board of directors' network has an impact on the firm's performance (Pesämaa et al., 2011). It is the board of director's personal networks that enable them to access firm's resources (Smith, 2009). The needs of the board of director's networks may be manipulated to enhance firm's strategic issues through the valuable information flow within the network. However, there is also evidence that information flows through networking could be irrelevant to the firms; thus, the directors appointed will not able to perform effectively (Carpenter & Westphal, 2001).

Commonly, possible reasons for the increasing of studies in this area are that the board of directors is in a position to exercise at least a minimum control over the firm's strategic directions. Secondly, board members are overlapping where a firm shares at least one director on the board. Thus, the board of directors has been the apex for research focus in management sciences (Durbach & Parker, 2009). The board of directors' network with other directors allegedly has an impact on the director's independence and thus may have influence over board decisions (Larcker *et al.*, 2005).

1.5 Research Objectives

In achieving the goal of this study, the objectives of this study are:

1. To examine the current patterns of board of director's networks by mapping the board of director's networks structural networks patterns within and outside the firm. The first objective is to fill gaps in the literature; specifically, to examine the existing director's structural network patterns established using social network analysis (SNA).
2. To examine the association between the board of director's networks and the quality of firm's financial reporting. The second objective provides an explanation of the director's network phenomenon and the effect on the firm's earnings quality, supported by theoretical arguments offered by the SNA approach. Regardless of the relationship, a better understanding of board of director's networks and its association to firm's financial reporting is required. Eventually, it is expected to be of interest not only academicians, but also to practitioners as well as regulators.
3. To determine the effects of other corporate governance mechanism to firm's financial reporting quality in the presence of the board of director's networks effects. This third objective is to provide additional support on whether there any differences in firm's earnings quality affected by corporate governance mechanisms in the presence of the board of director's networks.

1.6 Contribution of the Study

This study is significant from several aspects of the contribution to methodological, theoretical, policy maker, practitioner, as well as literature factors. The contributions are as follows:

1. Methodological

   This study employs social network analysis (SNA) incorporated existing tools to examine the association between the board of director's networks and firm's financial reporting quality. The use of SNA enable capturing and mapping the structural pattern of entire networks, both at the director's and the firm's levels. The differences between networks signify that there are different effects on financial reporting quality. Further, SNA application is able to derive network centrality measures, which are important to identify and explain network patterns at both director's and firm's level.

2. Policy makers

   The study addresses the issue of the effectiveness role of the board of directors. Malaysia provides an interesting platform for examining this issue, as from MCCG 2000 until 2012 includes the establishment of a well-balanced and effective board of director. It also highlighted the separation of power between the chairmen and the Chief Executive Officer (CEO) to ensure higher quality financial reports are conveyed to the users of the financial statement.

While most prior studies on board of director's characteristics focus mainly on the role of board independence and CEO duality, this study also examines their professional and social networks to effectively acquire access and resources in assisting a higher quality financial reporting process. Although the Revised MCCG 2007 does not state specifically the criteria for networks, this study attempts to gather evidence through various network proxies, such as academic background, past and present employment or directorships, or other social club memberships and events.

Additionally, the code also requires non-executive directors to have the necessary skills, experience, and be a person of calibre and credibility in order to bring independent judgment to the board. Further, recent changes in the revised MCCG 2012 show greater clarity on the nominating committee role, which consists exclusively of non-executive directors, to recommend candidates for directorship. They are required to consider, among other factors, skills, knowledge, expertise, and experience of candidates so that the appointed directors will be able to discharge their functions more effectively.

3. Practitioners

Most Malaysian firms have appointed their directors from various ethnic, religious, gender or academic works, or social backgrounds. The examination of their influence over the quality of financial reporting quality will provide a new direction for the sociological aspects of corporate governance research. This would be an interesting issue that has a significant impact on business ethics, corporate practices, and the behaviour of board members in Malaysian corporations in terms of ethnicities characteristics (Ow-Yong & Kooi Guan, 2000).

This study considers Malaysia as an appealing case because it has identified important relationships between politicians and firms before capital controls are imposed (Jomo, 1998). Politically connected firms may generally differ in unobservable ways relative to unconnected firms, but in the Malaysian data it is possible also to examine variation in earnings quality within the set of politically connected firms (Johnson & Mitton, 2003).

4. Theoretical

To date, a relatively small number of studies has been conducted comparing the board of directors' networks of publicly listed firms in Malaysia. Thus, this study would ascertain the significant differences between the board of director's structure networks for publicly listed firms and through the empirical results, whether the differences are reflected in firm earnings quality. Thus, the study contributes by providing insight into the association between the board of director's network variables and earnings quality in Malaysian publicly listed firms and further explores whether this relationship depends on the type of directors' networks.

This study is also an evaluation of applicable main theory sought to elucidate the trend and pattern of the board of director's networks and its association with the firm's financial reporting quality. This study mainly attempts to reduce the knowledge gap by introducing the effect of board of director's networks on financial reporting quality using the analysis of accruals quality in Malaysia. It adds to recent literature showing the links between the board of director's network and earnings quality, but in a different institutional setting.

Despite legislative reforms in corporate governance structure, the relationship between the board of director's networks and earnings quality remains a relatively unexplored research issue. Thus, investigation of the association between the board of director's structures and the quality of reported earnings in different institutional settings, specifically for a developing country such as Malaysia, provides interesting evidence of this aspect of corporate governance research. Most prior studies linking institutional features and earnings quality in the East Asian market are cross country studies of a relatively young market (Ball, Kothari, & Robin, 2000; Foo & Mat Zain, 2010).

Further, relatively few similar studies look into the same approach in an emerging market such as Malaysia. Prior studies more focusing on developed countries such as U.S., U.K. and Australia. As mentioned in the previous section, this study would determine whether there are any significant differences on the board of director's structural network pattern. This study also attempts to determine, through the empirical, whether these differences mirrored in firm financial reporting quality. Thus, this study contributes by providing insights into the association between the board of director's networks and financial reporting quality of Malaysian firms and further explores if this relationship depends the uniqueness of director's networks characteristics.