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Accounting conservatism, corporate governance and political connections

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Abstract

Purpose – The purpose of this paper is to examine the relationship between accounting conservatism, corporate governance and political connection in listed firms in Malaysia where political influence plays a significant role in the capital market and in many business dealings.

Design/methodology/approach – By utilizing 824 firm-year observations comprising large listed companies over a period of four years from 2004, this study uses ordinary least squares regression models to investigate the relationship between accounting conservatism, corporate governance and political connections in Malaysia. Multiple measures of conservatism developed by Basu (1997) and Khan and Watts (2009) are employed.

Findings – The results show evidence of accounting conservatism (bad news being recognized earlier than good news) in Malaysia. Further, the results reveal that better corporate governance structure in terms of board independence is positively associated with accounting conservatism while management ownership is negatively associated with it. However, political connection has a negative moderating effect on the positive relationship between accounting conservatism and board independence. The results also suggest political connections have a positive association with firm's future performance.

Originality/value – This study is the first in investigating the effect of political connections on accounting conservatism in Malaysian context and how political connections negatively affect the monitoring role of the corporate boards. By directly measuring political connection and controlling for various corporate governance mechanisms and firm-specific attributes, this study contributes to enhance the authors' understanding of the political influence in financial reporting quality and firm performance in an emerging market setting.

Keywords Corporate governance, Malaysia, Accounting conservatism, Political connection

Paper type Research paper

1. Introduction

Accounting conservatism is an important feature of quality financial information because it enhances the reliability of financial statements by facilitating effective monitoring of managers and contracts as part of corporate governance mechanisms (Ball *et al.*, 2000; Ball, 2001; Watts, 2003; Ball and Shivakumar, 2005; Basu, 2005). Evidence has shown a direct association between strong corporate governance mechanisms and the implementation of conservative accounting policies (Beekes *et al.*, 2004; Ahmed and Duellman, 2007; García Lara *et al.*, 2007, 2009; LaFond and Roychowdhury, 2008; Ahmed and Henry, 2011). However, recent studies have also indicated that politically connected firms and boards with politically connected directors affect the effectiveness of corporate governance adversely due to more agency problems thus negatively affect accounting conservatism (Johnson and Mitton, 2003; Faccio, 2006; Gul, 2006).

Political connections are still an important factor, particularly in emerging economies[1] such as in Malaysia where resource allocation is heavily influenced by politics (La Porta

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et al., 2002). Political connections can be perceived as a weak form of corporate governance because agency costs will increase at the expense of public merit (Goldman *et al.*, 2009) since politically connected firms enjoy substantial economic benefits. Therefore, on average, they gain from political ties and subsequently simply care less about corporate governance issues and the quality of the information they disclose. This will, however, result in lower earnings quality (as measured by accruals) (Chaney *et al.*, 2011). Although prior studies suggest a positive relationship between accounting conservatism and the effectiveness of corporate governance, the issue of how politically connected directors on the corporate boards affect accounting conservatism is worth exploring.

We investigate the relationship between accounting conservatism, corporate governance and political connections by employing a large sample of publicly listed companies in Malaysia where political influence is embedded in corporate operations and is institutionalized through government policies. For example, the New Economic Policy (NEP) of 1971, implemented in Malaysia to redistribute economic wealth, resulted in a policy of favoritism for Bumiputera-Malays[2] over other ethnic groups. With the NEP, Bumiputeras are given preferential treatment by government through privileges, benefits and subsidies in getting involved in politics and business activities which facilitated political connections between government officials, business people and political parties, specifically the United Malays National Organization (UMNO). UMNO has been in power since independence (Gomez and Jomo, 1997; Johnson and Mitton, 2003).

The motivation for us in choosing Malaysia as the research subject is because the institutional setting of Malaysia wields substantial political influence and clear divisional ethnic lines. Rapid globalization in the capital market demands high-quality financial information even in emerging economies. Examining the issue of accounting conservatism in Malaysia is important because high-quality financial statements are essential to boost investors' confidence and facilitate the country's fast-growing capital market and economy. This paper explores corporate governance characteristics in a relationship-based[3] economy where dependence on resource providers such as government or politicians is a common practice. The practice of using political influence in firms is the norm in many emerging countries as prior literature has demonstrated that political influence is a tool that can enhance firms' performance (Goldman *et al.*, 2009, 2013). Consequently, having a close connection with politicians alleviates any difficulties in accessing resources, but reduces the demand for good quality reporting (Chaney *et al.*, 2011). Hence, the unique context of Malaysia motivates this paper to examine whether there is a strong association between western corporate governance systems and accounting conservatism side-by-side with the reality of substantial political influence. In this study, accounting conservatism is proxied by asymmetric timeliness measure (also known as conditional conservatism) (Basu, 1997), modified by Roychowdhury and Watts (2007) as the primary measure of accounting conservatism[4]. Basu (1997) defines accounting conservatism as a concept where accountants tend to require a higher degree of verification for recognizing good news relative to bad news in earnings. Utilizing 824 firm-year observations drawn from listed firms on the Bursa Malaysia (Malaysian Stock Exchange) over 2004-2007, we find evidence of accounting conservatism in Malaysia. We find a strong association between accounting conservatism and the dimensions of independence and management ownership. However, no such association has been found to exist with the board and audit committee size dimension, audit quality dimension and government ownership. Political dimension as an aggregate measure is not associated with accounting conservatism but further analysis of the associations between accounting conservatism and the specific measures of political influence dimension demonstrates some meaningful results. When dividing political influence into two different measures, a negative association is found between the proportion of politically connected directors on the board and accounting conservatism.

However, the proportion of Bumiputera-Malay directors on the board is unrelated to accounting conservatism.

The finding of this study is important as it shows the effect of political influence in shaping financial reporting in an environment in which political influence is institutionalized. Additionally, using agency theory and resource dependency theory to examine an emerging economy, this study contributes to our understanding of the roles of corporate governance and political connections in accounting conservatism. The remainder of this study is organized as follows: a discussion of Malaysia's institutional background is presented in Section 2; Section 3 discusses the theoretical framework and hypothesis development that form the basis for developing the empirical model; Section 4 presents the research methods; Section 5 discusses the descriptive statistics and correlation analysis; Section 6 analyzes and discusses the results; and Section 7 concludes the study.

2. Institutional background

Malaysian politics are heavily dominated by one main ethnic group (the Malays) while socio-economic activities are dominated by another ethnicity (the Chinese) (Jomo and Hui, 2003; Tamam, 2009). The ethnic divisions in Malaysia led the government to launch the NEP in 1971 with the intention of enhancing economic stabilization, addressing the income disparities that existed between the people of various races, and bringing about social harmony[5]. The policy resulted in close relationships between politicians and corporations in Malaysia, and this had an impact on economic and accounting outcomes (Gomez and Jomo, 1997; Johnson and Mitton, 2003; Gul, 2006). Firms that are subject to greater political influence are perceived to have poorer corporate governance practices and suffer from severe agency problems (Gomez and Jomo, 1997; Johnson and Mitton, 2003). The government policy of protecting one ethnicity against other ethnicities in business and economic dealings is also believed to result in different accounting practices (Ball *et al.*, 2003), thereby impacting on accounting quality in financial statements.

Despite the institutional differences between Asian markets and markets with more dispersed shareholdings such as in the USA or the UK, the Asian financial crisis of 1997-1998 proves this region also suffered from agency conflicts, which demonstrated the need for monitoring mechanisms even in a high ownership concentration environment. Examples of high profile cases of misconduct in Malaysia during the crisis are Renong, Perwaja Steel, Technology Resources Industry and Malaysian Airlines. As a response to the Asian financial crisis, the Malaysian Government introduced governance reforms in order to regain investors' confidence. In 2001, the Malaysian Code on Corporate Governance was included in the revised Bursa Malaysia Listing Requirements[6]. The Malaysian Code on Corporate Governance was based on the Cadbury (1992) Report and Hampel (1998) Report in the UK (FCCG, 2000). Despite mimicking the western corporate governance system, Zhang (2009) contends that the Malaysian capital markets have not converged with the Anglo-American model and have instead diverged significantly due to political influence. In addition, Ball *et al.* (2003) suggest that the extent of political influence may be a factor contributing to the poor quality of financial reporting in Malaysia, despite complying with International Accounting Standards (IASs) (later, the International Financial Reporting Standards (IFRS)). Based on the above arguments, examining the issue of accounting conservatism as a feature of quality financial statements in the Malaysian context is potentially useful.

3. Theoretical framework and hypothesis development

Managerial opportunistic behavior due to agency conflicts, arises as a result of the separation of management and ownership (Jensen and Meckling, 1976). While the ownership structure in Malaysia and many other emerging countries is concentrated, Berle and Means' (1932) and Jensen and Meckling's (1976) notions of agency conflicts as a result of separation of ownership and management are still applicable (Liew, 2007). However, agency conflicts occur more between the principal-controlling shareholders and minority shareholders, which is known as a type 2 agency problem (Morck *et al.*, 2005).

Agency conflicts manifest in numerous ways, including manipulating financial information, conducting accounting frauds and expropriating shareholders' wealth. As such, strong corporate governance mechanisms are needed to mitigate the consequences of these conflicts. Since corporate governance mechanisms require accounting numbers to be used as a tool by boards of directors to monitor and control the system (Fama and Jensen, 1983), Basu's (1997) asymmetric timeliness measure of conservatism, has been argued to facilitate the contracting and monitoring roles of accounting (Ball and Shivakumar, 2005; Beaver and Ryan, 2005)[7]. For example, by requiring a more timely recognition of bad news, conservatism helps to identify negative net present value projects or poorly performing investments (Ball, 2001) and avoid inappropriate distribution, thus guaranteeing that minimum resources are retained inside the company (Gotti, 2008). Those arguments suggest that conservatism is a potentially useful tool for directors in fulfilling their role of ratifying and monitoring key decisions. These potential benefits of conservatism for corporate governance suggest a positive relationship between conditional conservatism and strong corporate governance characteristics. Since corporate governance is a mechanism for contract monitoring, consistent with previous research, Basu's (1997) asymmetric timeliness measure of conditional conservatism is utilized in this research as the primary measure of conservatism. Mora and Walker (2015) conclude that the empirical evidence from prior research has shown that conditional conservatism has a variety of benefits including constraining upwards accruals earnings management.

Since corporate governance standards in different countries vary due to their respective cultural values, and political, social and historical circumstances, political influence is another dimension of corporate governance worth exploring. Some prior research employs resource dependency theory in conjunction with agency theory to explain corporate governance structure beyond the monitoring roles (Hillman *et al.*, 2000; Udayasankar and Das, 2007). The integration of the agency and resource dependency theories is appropriate for helping us understand what contributes to the provision of resources and effective monitoring because in practice, boards of directors have two roles: first, to monitor firms' performance; and second, provide resources for them (Korn and Ferry, 1999). The agency theory suggests that accounting conservatism should be positively correlated with better corporate governance characteristics because firms with strong corporate governance characteristics will demand higher conservatism, thus mitigating the agency problem (Watts, 2003). In contrast, firms with more management and government ownership have less demand for accounting conservatism since manager and government interests are more aligned in firms (Beekes *et al.*, 2004; Bushman and Piotroski, 2006; LaFond and Roychowdhury, 2008).

With regard to corporate governance, resource dependency theory focuses on the role that directors play in providing or securing essential resources for an organization through their connections with the external environment (such as resource providers), which place the firm in a competitive advantage position (Hillman *et al.*, 2000). Resource dependency theory also explains how reliance on resource providers (e.g. in this case, politically connected directors, government-owned firms and Bumiputera-Malay-owned firms) results in government or politicians exerting influence on firms' decision making (Pfeffer and Salancik, 1978), including the outcomes in financial reporting. One example of such influence, suggested by Ball *et al.* (2003), is that the government of Malaysia prohibited the reporting of losses during recessions. The delay in reporting losses is one such less conservative approach as defined by the asymmetric timeliness of earnings. Differential in the level of accounting conservatism may emerge due to the existence of two forms of political favoritism in Malaysia: the official status awarded to firms that are run by Bumiputeras; and the close relationship between firms and politicians and the fact these firms are run by both Bumiputeras and Chinese business people (Gomez and Jomo, 1997; Johnson and Mitton, 2003). Accordingly, the political influence dimension in this study is proxied by two attributes: the proportion of politically connected directors on the board (a direct measure); and the proportion of Bumiputera-Malays on the board of directors (an indirect measure).

Prior studies on accounting conservatism and corporate governance such as Beekes *et al.* (2004), Ahmed and Duellman (2007) and García Lara *et al.* (2007) emphasize the importance of the board of directors in the role of corporate governance monitoring. In studying the US market, García Lara *et al.* (2009) incorporate several internal and external characteristics of corporate governance, where some characteristics might not be relevant in the emerging market of Malaysia. Ahmed and Henry (2011) examine the role of board composition, board size and voluntary formation of a board audit committee as important agency and governance attributes in accounting conservatism of listed firms in Australia. Beekes *et al.* (2004) and LaFond and Roychowdhury (2008) document the negative impact of management ownership on accounting conservatism. While most prior studies focus on the role of board of directors and ownership structure in more dispersed shareholdings markets, we select variables for governance structure, governance composition, external auditors and ownership in addition to variables from the political influence dimension above. Previous studies found that the components of governance mechanisms have the most profound effect on the quality of financial reporting (Cohen *et al.*, 2004). The variables are board size, board independence, the chief executive officer (CEO) duality, audit committee size, audit committee expertise, audit committee independence, the presence or absence of the "Big auditors", and provision of non-audit fees (Cohen *et al.*, 2004; Beekes *et al.*, 2004; Ahmed and Duellman, 2007; García Lara *et al.*, 2007, 2009; Ahmed and Henry, 2011).

The use of Basu's (1997) model of asymmetric timeliness involves interactions with bad news and good news and this restricts the inclusion of too many variables in the model specification. Therefore, following Larcker *et al.* (2007), principal component analysis (PCA) has been undertaken to reduce these ten governance variables down to four dimensions, consisting of board and audit committee size, independence, audit quality and the extent of political influence. Another important institutional factor in Malaysia that differs from the developed countries is the high ownership concentration in the hands of managers and government (Tam and Tan, 2007). Since ownership structure affects agency conflicts, it is another important factor to be examined with reference to accounting conservatism (Beekes *et al.*, 2004; LaFond and Roychowdhury, 2008). Hence, management ownership and government ownership are controlled when estimating the models in order to obtain more reliable estimations. The following sections explain the hypotheses, presented in accordance with the PCA classification of internal governance variables, then followed by ownership structure.

3.1 Board and audit committee size

Size is an important dimension of governance that captures the board and audit committee's resource potential. The results from PCA demonstrate that board size and audit committee size fall under the same size dimension. Since more resources are devoted to large board and audit committee, these increase their knowledge base allowing directors to specialize more and provide better monitoring and control financial statements (Anderson *et al.*, 2004; Ahmed and Duellman, 2007). Furthermore, Kalbers and Fogarty (1998) suggest that larger audit committees have greater authority and receive more meaningful support from the board of directors, and their activities are thus more likely to be recognized by external auditors and internal auditors. The studies by Malaysian researchers document a significant positive relationship between board size and corporate performance (Haniffa and Hudaib, 2006) and corporate governance statements (Amran *et al.*, 2010). However, some prior studies have also shown that small boards are more effective. For example, Ahmed *et al.* (2006) demonstrate a significant negative relationship exists between board size and earnings quality. Smaller boards and audit committees are more effective monitors because they have a higher degree of membership coordination which could reduce the following: communication difficulties, information costs and incidence of severe free-rider problems (Jensen, 1993; Hermalin and Weisbach, 2003; Karamanou and Vafeas, 2005). Some Malaysian studies even reveal insignificant results in relation to audit committee size and reporting quality (Rahman and Ali, 2006; Saleh *et al.*, 2007).

Indeed, there are two competing views of size and the evidence from prior literature is inconclusive. However, due to difficulties in coordinating large boards, evidence from prior literature seems to support the contention that small boards are more effective than large boards. Accordingly:

H1a. Accounting conservatism is negatively associated with the board and audit committee size dimension of corporate governance.

3.2 Independence

Independence is another important dimension in corporate governance which is strongly supported by agency theory. Results from PCA demonstrate that variables of board independence composition, audit committee independence and CEO duality fall under this category. The agency theory postulates that independent directors are needed on companies' boards to monitor and control the actions of managers (Fama and Jensen, 1983). The importance of an independent audit committee is emphasized by the High Level Finance Committee on Corporate Governance (HLFC) (2000) in Malaysia. The independent audit committee provides a means of reviewing a company's procedures in preparing financial statements, its internal controls and the independence of the company's external auditors and a forum for dialogue with the company's external and internal auditors (Liew, 2007). Similarly, it is recommended that the role of the chairman be separated from that of CEO to make the board more independent, and reduce the potential for management having too much power over daily business operations (Jensen, 1993).

The importance of board independence is documented by Beekes *et al.* (2004) and Ahmed and Duellman (2007), who find that having more independent directors on a board is linked to a higher level of accounting conservatism. A significant negative relationship is found between audit committee independence and abnormal working capital accruals when using data from Singapore and Malaysia (Bradbury *et al.*, 2006), suggesting that monitoring effectiveness is affected by the extent of the independence of the audit committee members. Prior studies have shown that separating CEO and chairman is an effective tool for board monitoring (Beasley, 1996); evidence from Malaysia shows that the separation of CEO and chairman does improve earnings quality (Saleh *et al.*, 2005). In contrast, Haniffa and Cooke (2002), Haniffa and Hudaib (2006) and Rahman and Ali (2006) find results contradictory to prediction in agency theory. Rahman and Ali (2006) contend that the insignificant role of independent directors on boards in Malaysia could be due to a lack of knowledge about company affairs which has led to management dominance over board matters.

Overall, the independence dimension plays an important role in terms of helping to uphold the integrity and credibility of published financial statements which is expected to result in higher accounting conservatism in financial reporting. The hypothesis is written as follows:

H1b. Accounting conservatism is positively associated with the independence dimension of corporate governance.

3.3 Effectiveness of auditing functions (audit quality)

The quality of auditing might be another possible explanation for accounting conservatism in Malaysia. Results from PCA reveal that audit committee expertise, the Big Four auditors and the provision of non-audit fees fall under this dimension. The Malaysian Code on Corporate Governance requires at least one member of the audit committee to be a member of the Malaysian Institute of Accountants or to have not less than three years' accounting experience and to have passed the professional examination. Krishnan and Visvanathan (2008) find that the degree of accounting expertise on audit committees is positively related to unconditional accounting conservatism. Other studies document a negative correlation between accounting financial expertise and various internal control problems (Krishnan, 2005; Hoitash *et al.*, 2009). In Malaysia, the financial expertise of audit committee members is found to be associated with high quality of financial reporting (Rahman and Ali, 2006; Saleh *et al.*, 2007).

Big Four[8] auditors have been used as the proxy for audit quality in many studies. Prior analyses have shown that the use of high-quality external auditors, proxied by the "Big Five or Four", are negatively correlated with the levels of abnormal accruals (Francis *et al.*, 1999) and with the incidence of accounting errors (DeFond and Jiambalvo, 1991). Basu (2001) suggests that the globalization of auditing has resulted in the extension of auditing practices internationally. "Big Four" accounting firms audit most large firms in Malaysia, and they are more likely to enforce a greater level of asymmetric conservatism in these firms because of their reputation. In Malaysia, it is common practice that reputable (then Big Six) auditors also provide non-audit services and this trend is likely to increase (Teoh and Lim, 1996). Empirical evidence seems to be mixed on whether non-audit fees affect audit quality. Gul *et al.* (2006) have documented there is a negative association between the provision of non-audit services and value relevance of earnings, suggesting that providing non-audit services compromises an auditor's independence. However, other studies (Simunic, 1984; DeFond *et al.*, 2002; Ashbaugh *et al.*, 2003) have found little evidence that the receipt of non-audit fees jeopardizes an auditor's independence. Ruddock *et al.* (2006) also found that a higher provision of non-audit services has no impact on accounting conservatism.

In general, the arguments above seem to support the contention that better audit quality will demand higher accounting conservatism. Therefore, the hypothesis is stated as follows:

H1c. Accounting conservatism is positively associated with the audit quality dimension of corporate governance.

3.4 Political influence

As previously explained in the theoretical framework, political influence is proxied by the proportion of politically connected directors and the proportion of Bumiputera-Malay directors. The proxies are consistent with the results derived from PCA. Resource dependency explains how connections with political leaders affect firms' decision making (Pfeffer and Salancik, 1978). Politically connected firms are more likely to manipulate reported financial performance statistics in order to minimize the political costs due to adverse or damaging news (Shleifer and Vishny, 1994). The negative influence of political connection on auditing and reporting quality is further evidenced, respectively, by Gul's (2006) Malaysian study and Chaney *et al.*'s (2011) cross-country study. Gul (2006) documents higher audit fees for firms with political connections due to the greater likelihood of business failure, misreporting, overstatement of earnings. Further, Chaney *et al.* (2011) find that firms with political connections do not only have poor quality of reporting but also suffer less negative consequences as a result of it. Additionally, How *et al.* (2014) contend that managers of politically connected firms tend to practice greater discretion in disclosing financial information, and thereby contributing to the manipulation of media releases. Since accounting conservatism relates to the release of good or bad news, consistent with the arguments above, political connections lead to less accounting conservatism. The proportion of politically connected directors on a company or corporation board is used as the first proxy for political influence.

The government's efforts to increase the participation by Malays and other indigenous groups in the national economy have brought these politically favored ethnic groups, i.e. the Bumiputeras, into the capital markets (Ahmad *et al.*, 2006). Firms with more Bumiputera-Malay directors are mostly either Bumiputera conglomerates or government owned. Bumiputera-Malay firms are able to obtain easy credit facilities from banks and Bumiputera trust agencies under the direction of the UMNO, which was created to acquire shares for Bumiputera-Malays (Mehmet, 1988).

Bumiputera-controlled firms (i.e. politically favored firms) and politically connected firms are perceived as having poor corporate governance practices and greater agency problems because these businesses rely heavily on the government; there is less difficulty in obtaining resources should they run into financial trouble (Johnson and Mitton, 2003; Gomez and Jomo, 1997; Chen *et al.*, 2010) and thereby demanding less accounting conservatism in their financial statements. Less incentive to report losses in a timely fashion is also motivated by the fact that this ethnic group suffers less political fall-out from reporting large profits because they are protected by the government (Ball *et al.*, 2003).

The arguments outlined above suggest that political influence would be negatively associated with accounting conservatism. Accordingly, the hypothesis is stated as follows:

H2a. Accounting conservatism is negatively associated with the political influence dimension.

H2b. Accounting conservatism is negatively associated with the proportion of politically connected directors on board.

H2c. Accounting conservatism is negatively associated with the proportion of Bumiputera-Malay directors on the board.

3.5 Ownership structure

Government and the management dominance in corporate ownership structure are typical of Malaysian businesses. Ownership structure has a significant influence on the quality of reporting. According to Jensen (1993), managers have strong incentives to perform if they have significant equity stakes in the firm (known as the alignment effect). However, it has been claimed that a high level of concentrated ownership leads to poorer performance and equally poor reporting quality due to the dominance of insiders (known as the entrenchment effect) (Morck *et al.*, 1988; Jiang and Kim, 2000).

Beekes *et al.* (2004) find no evidence of an increase in accounting quality in firms with greater managerial share ownership. This finding is supported by recent evidence in LaFond and Roychowdhury (2008), which documents a negative association between asymmetric timeliness and management ownership. They argue that since accounting conservatism is a tool to address agency problems, greater accounting conservatism is demanded when the interests of managers and shareholders are less aligned. Since these firms are less subject to governance by their boards of directors and discipline by market for corporate control (Fan and Wong, 2002), businesses with higher management ownership are more likely to adopt less conservative accounting practices. Accordingly, the hypothesis is stated as follows:

H3a. Accounting conservatism is negatively associated with the proportion of management ownership.

The resource dependency theory explains how ownership by government allows it to exert control over management appointments, incentives and major economic decision making (Pfeffer and Salancik, 1978). It will affect what is reported in financial statements (Ball *et al.*, 2003). This is evidenced by prior studies which have shown that firms with a higher degree of government share ownership are associated with a lower level of financial transparency and that they push for the early recognition of good news (Bushman *et al.*, 2004; Bushman and Piotroski, 2006). Further, Fan and Wong (2002) find firms with high ownership concentration which include those with substantial government ownership manipulate earnings; in fact their earnings are less informative. Based on the arguments above, the hypothesis is stated as follows:

H3b. Accounting conservatism is negatively associated with the percentage of government ownership.

In summary, we test three hypotheses in this paper. *H1* looks at the effect of internal governance on accounting conservatism, *H2* examines the effect of political influence on conservatism and *H3* explores the effect of government ownership on conservatism. We test these hypotheses in the Malaysian setting because it is significantly different to developed economies, e.g. the USA. In Malaysia there is blatant favoritism for Bumiputera-Malays over the other ethnic groups, strong political connections between directors of listed firms and politicians, and significant government ownership. We will investigate whether western-style corporate governance can still be effective and efficient in such a unique institutional setting. Prior studies have established a link between governance and conservatism (Beekes *et al.*, 2004; Ahmed and Duellman, 2007; García Lara *et al.*, 2007). The main issue in our paper is the role played by political connections. We view this new variable as a form of weak governance and expect it has a negative impact on accounting conservatism.

4. Research methods

The sample for this study consists of 206 firms, with the fiscal years 2004-2007 being selected. These firms were chosen based on the firms having the top market capitalization in 2007. Large firms have been chosen because according to Roe (2003), these firms are more likely to be affected by political factors. The years 2004-2007[9] have been chosen in order to examine the impact of the code a few years after the incorporation of the code of corporate governance into the Bursa Malaysia Listing Requirements (2001). The selection period is consistent with Ahmed and Duellman (2007), who examine the period after a formal corporate governance framework was introduced. Further, training and education about, and general exposure to corporate governance since it was first implemented, may result in some variations concerning the effectiveness of corporate governance within firms. The impact of convergence with IASs in Malaysia in 2005 is minimal as the previously known MASB[10] were mostly borrowed from IASs and renamed IFRS (Lazar *et al.*, 2005).

The revised Basu (1997) model accumulates the profits backwards for three years, thus going back to the year 2002, being the year immediately after the code of corporate governance was introduced. The period from 2004 to 2007 also represents a period of economic and political stability for Malaysia. The corporate governance and political influence data from 2004 to 2007 were hand-collected from the annual reports of the firms concerned. The financial data and the annual reports were extracted from the OSIRIS database. Table I Panel A presents a summary of how the final sample was obtained. In order to generate the complete set of data for about 200 firms each year, a list of 350 firms was initially obtained from the OSIRIS database, which comprises the top 500 firms in 2007 based on market capitalization. Totally, 24 firms in the financial services and insurance sector were eliminated from the list due to differences in the requirements relating to their financial statements. Furthermore, 15 firms were eliminated due to changes in their

Panel A: sample selection	
List of 350 firms in OSIRIS top 500, 2007	
Market capitalization	350
Financial services and insurance	24
Change of accounting year	15
Missing data or annual reports	105
Final sample	206
Panel B: sample breakdown based on industry	
Bursa Malaysia industry classification	No. of firms
Consumer products	42
Industrial products	56
Construction	17
Trading/Services	41
IPC	5
Technology	3
Hotels	3
Properties	16
Plantations	23
Total sample	206
Years[a]	4
Total firm-year observations	824

Table I.
Sample in the analysis

accounting years. Additionally, 105 firms were eliminated due to missing data or annual reports in the OSIRIS database. This left a final sample of 206 firms for the years 2004-2007 including 824 firm-year observations. Table I Panel B presents the industry breakdown of the sample firms. These industry classifications are based on the Bursa Malaysia (Malaysian Stock Exchange) guideline. The industry distribution in our sample is similar to that of the population of listed firms on the Bursa Malaysia.

4.1 Measures of accounting conservatism and independent variables

In measuring the asymmetric timeliness of earnings, Basu (1997) uses a reverse regression of returns and earnings, whereby the dependent variable, namely, earnings per share, is regressed on a dummy variable indicator scheme using 1, if the return is negative, and 0 otherwise, a return variable and an interacting variable between the dummy and the return[11]. The stock price return is used as a proxy for good or bad news incorporated in earnings. The coefficient on stock returns ($\beta 2$) measures the sensitivity of earnings to positive stock returns (a proxy for economic gains). A positive coefficient ($\beta 3$) on the return interacting with the dummy variable indicates accounting conservatism. This coefficient measures the incremental sensitivity of earnings to the incorporation of bad news relative to good news.

According to Roychowdhury and Watts (2007), if the reverse regression of the returns model uses a single period returns and earnings, the coefficient ($\beta 3$) reflects asymmetric timeliness of earnings with respect to news arrival within that one period only, which implies only the asymmetric verification standards. Roychowdhury and Watts (2007) suggest that for the coefficient ($\beta 3$) to be better at measuring aggregate conservatism, this will entail accumulating the effect of asymmetric timeliness across all prior periods. Following the approach suggested by them and used by Ahmed and Duellman (2007), returns and earnings are accumulated over the three years in our study. Earnings are deflated by the market value of equity at the beginning of the period to control for heteroscedasticity. The basic model used in this study is stated below. The following equation is then interacted with other independent variables to examine the relationship between those factors and accounting conservatism. Accordingly, this relationship is modeled as:

$$\frac{E_{t,t-j}}{P_{t,t-j-1}} = \alpha_0 + \beta_1 D_{t,t-j} + \beta_2 R_{t,t-j} + \beta_3 D_{t,t-j} \times R_{t,t-j} + \varepsilon, \tag{1}$$

where $E_{t,t-j}$ is income before extraordinary items cumulative from year $t-j$ to year t, and j is equal to 2, $P_{t,t-1}$ is the market value of equity at the beginning of the year t_j, $R_{t,t-j}$ is the accumulated annual returns of year $t-j$ to year t (calculated annually from the price starting four months after the end of the fiscal year $t-j-1$ and ending four months after the end of year t), $D_{t,t-j}$ is a dummy variable indicator equal to 1, if the return is negative, and 0 otherwise, $D_{t,t-j} \times R_{t,t-j}$ is an interaction variable consisting of the firm's stock return and return dummy variable. This coefficient captures the response of bad news compared to good news. A positive coefficient represents conservative financial reporting.

The corporate governance, political influence and ownership structure variables are measured as follows. Board size denoted as BSIZE is measured as the total number of board members. ACSIZE represents audit committee size measured by the total number of audit committee members. Board independence denoted as BIND is measured as the proportion of independent directors to the total number of directors on the board. ACIND represents audit committee independence measured by the proportion of independent audit committee members to the total number of audit committee members. CEO/chair separation is referred to as CEODUALITY and coded as 1 if the positions of CEO and chairman are occupied by different persons and 0 otherwise. ACEXPERT which refers to audit committee financial expertise, is measured as the ratio of an audit committee of financial expertise to total audit committee members (ACSIZE). The definition of an audit committee expertise follows the Bursa Malaysia Listing Requirements (2001). Firms' financial reports audited by the "Big Four" audit firms are coded 1, and those audited by "non-Big Four" firms are coded 0, and this variable is called BIG4. We also include the ratio of non-audit fees to total audit fees as NAF in the model.

POLCON is the ratio of politically connected directors to the total number of directors on the company board. A politically connected director may be a member of parliament, a minister, a head of state or a state assemblyman (Chaney *et al.*, 2011) or a person who is either currently or was formerly a government bureaucrat (Agrawal and Knoeber, 2001; Fan *et al.*, 2007). Following Fan *et al.* (2007), data about politically connected directors were obtained by reviewing the profiles of relevant directors in the company's annual report, based on the definition mentioned before. In addition, the list of cabinet members and parliamentarians and state legislators were also reviewed (www.pilihanraya.com.my/melayu/parliamentlist.asp). MALDIR represents the proportion of Bumiputera-Malay directors to total number of directors. The proportion of management ownership (MAGTOWN) is measured as the number of ordinary shares held by non-independent directors divided by the total number of ordinary shares. The government ownership percentage (GOVOWN) is the proportion of government shareholdings in the number of ordinary shares held by 30 largest shareholders. The government shareholdings are proxied as the number of ordinary shares held by Khazanah Nasional, Employee Provident Funds, Lembaga Tabung Haji, Lembaga Tabung Angkatan Tentera, Permodalan Nasional Berhad, State Economic Corporation Development, Ministry of Finance Incorporated, Felda, Felcra, Pertubuhan Keselamatan Sosial (PERKESO) and other government agencies[12].

While Beekes *et al.* (2004), Ahmed and Duellman (2007) and Ahmed and Henry (2011) assume the nature of corporate governance characteristics exogenously, García Lara *et al.* (2007, 2009) build an aggregate index that combines several characteristics of corporate governance. A methodology in this study which differs from the abovementioned studies is the application of PCA to reduce the number of independent variables into a few coherent and uncorrelated factors (Dey, 2008; Larcker *et al.*, 2007). This technique accounts for most of the variance in the observed variables in determining which of them are associated with each of the reduced factors. Following prior studies, this study uses a mixture of metric and non-metric measurements in performing the factor analysis.

4.2 PCA and the empirical model

In our PCA, all factors with an eigenvalue greater than unity are retained for subsequent analysis. This procedure results in four factors that retain about 57 percent of the total variance of the original data (Table II: Panel A). Panel B depicts an unrotated component analysis factor matrix. This reduced solution is then rotated by using an orthogonal rotation

Panel A: results from the extraction of components factors

	Initial eigenvalues		
Component	Total	Proportion of variance	Cumulative proportion
1.000	1.843	0.184	0.184
2.000	1.521	0.152	0.336
3.000	1.261	0.126	0.463
4.000	1.095	0.110	0.572

Panel B: unrotated component analysis factor matrix

	Components			
Variables	1	2	3	4
BSIZE	−0.097	0.630	0.178	−0.091
CEODUALITY	0.138	0.125	0.226	0.603
BIND	0.467	−0.151	−0.266	0.196
ACSIZE	0.054	0.586	−0.165	−0.121
ACIND	0.237	0.179	0.121	0.627
ACEXPERT	0.119	−0.401	0.381	−0.035
BIG4	0.196	−0.022	0.536	−0.236
NAF	0.172	0.139	0.571	−0.156
POLCON	0.539	0.090	−0.191	−0.219
MALDIR	0.568	0.035	−0.098	−0.230

Panel C: rotated (orthogonal varimax) component analysis factor matrix

	AUDQ	INDEP	POLINF	BACSIZE
BSIZE	0.149	−0.032	−0.025	0.693
CEODUALITY	0.170	0.432	−0.101	0.068
BIND	−0.236	0.532	0.271	−0.268
ACSIZE	−0.235	0.114	0.123	0.553
ACIND	0.074	0.716	−0.112	0.092
ACEXPERT	0.433	−0.012	−0.005	−0.324
BIG4	0.550	0.039	0.067	0.006
NAF	0.575	0.030	0.064	0.147
POLCON	−0.030	−0.031	0.656	0.049
MALDIR	0.104	−0.029	0.670	−0.006

Notes: BIND is the proportion of independent directors divided by the total number of directors on the board; BSIZE is the total number of directors; CEODUALITY is a dummy variable whereby 1 signifies that the positions of CEO and chairman of the board are occupied by different directors and 0 signifies otherwise; ACIND is the number of independent audit committee members divided by the total number of audit committee members; ACSIZE is the total number of audit committee members; ACEXPERT is the number of audit committee members who possess financial expertise divided by the total number of audit committee members; BIG4 is a dummy variable whereby 1 signifies "Big Four" auditors and 0 signifies otherwise; NAF is the ratio of the amount of non-audit fees to total fees; POLCON is the proportion of politically connected directors on the board; and MALDIR is the proportion of Bumiputera-Malay directors on the board

Table II.
Principal component analysis

in order to enhance the interpretability of the PCA solution. The rotated matrix solution is depicted in Panel C. Each of the retained components of the rotated solution is interpreted by identifying the variables with high loadings in each given component, and by determining what these in common variables have. Each factor (or index) named is based on the characteristics of the indicators. It is considered to be high if its absolute loading exceeds 0.40 (Larcker *et al.*, 2007). Factor (1) is called AUDQ and this captures the audit quality dimension, with ACEXPERT, BIG4 and NAF having a positive loading on this dimension. Factor (2) is known as INDEP and this represents an independence dimension, with BIND, ACIND and CEODUALITY having a positive loading on this dimension. Factor (3) is called POLINF and this represents the political influence dimension, with POLCON, and MALDIR having a positive loading on this dimension. Finally, factor (4) is referred to as BACSIZE and this represents the size of the board and audit committee, with BSIZE and ACSIZE having a positive loading on this dimension.

Following Larcker *et al.* (2007), the factor-based scores are computed as the average equal-weighted sum of the standardized variables associated within each factor. The factor-based scores derived from these four dimensions are used in the ordinary least square (OLS) regression so that the relationship between accounting conservatism and corporate governance can be ascertained. These four new dimensional variables and the ownership structure variables are employed in the subsequent empirical model. The regression is then repeated to observe the effect of each political influence measure. The model based on Basu (1997), and modified by (Roychowdhury and Watts, 2007) and (Ahmed and Duellman, 2007)[13] is presented below:

$$\begin{aligned}\frac{E_{i,t-j}}{P_{t,t-j-1}} = {} & \alpha_0 + \beta_1 D_{t,t-j} + \beta_2 R_{t,t-j} + \beta_3 D_{t,t-j} \times R_{t,t-j} + \sum_{i=1}^{3} \beta(\mathrm{CG})_{i,t} \times D_{t,t-j} \\ & + \sum_{i=1}^{3} \beta(\mathrm{CG})_{i,t} \times R_{t,t-j} + \sum_{i=1}^{3} \beta(\mathrm{CG})_{i,t} \times D_{t,t-j} \times R_{t,t-j} + \beta_{0,\mathrm{pol}} \mathrm{POL}_{i,t} \\ & + \beta_{1,\mathrm{pol}} \mathrm{POL}_{i,t} \times D_{t,t-j} + \beta_{2,\mathrm{pol}} \mathrm{POL}_{i,t} \times R_{t,t-j} + \beta_{3,\mathrm{pol}} \mathrm{POL}_{i,t} \times D_{t,t-1} \times R_{t,t-j} \\ & + \sum_{i=1}^{2} \beta(\mathrm{OWN})_{i,t} + \sum_{i=1}^{2} \beta(\mathrm{OWN})_{i,t} \times D_{t,t-j} + \sum_{i=1}^{2} \beta(\mathrm{OWN})_{i,t} \times R_{t,t-j} \\ & + \sum_{i=1}^{2} \beta(\mathrm{OWN})_{i,t} \times D_{t,t-j} \times R_{t,t-j} + (\text{other control variables}) + \varepsilon, \end{aligned} \tag{2}$$

where corporate governance (CG) variables are BACSIZE, AUDQ and INDEP. BACSIZE is the average equal-weighted sum of the standardized BSIZE and ACSIZE, AUDQ is the average equal-weighted sum of the standardized BIG4, ACEXPERT and NAF, INDEP is the average equal-weighted sum of the standardized BIND, ACIND and CEODUALITY. Political (POL) variables are POLINF, POLCON and MALDIR where POLINF is the average equal-weighted sum of the standardized POLCON and MALDIR, POLCON is the proportion of politically connected directors on the board, MALDIR is the proportion of Bumiputera-Malay directors on the board. Ownership (OWN) variables are MAGTOWN and GOVOWN where MAGTOWN is the number of ordinary shares held by non-independent directors divided by the total number of ordinary shares, and GOVOWN is the percentage of number of ordinary shares held by government over the total number of ordinary shares. All other variables are as previously defined.

Following Khan and Watts (2009), the control variables are the ratio of growth, firm size, leverage industry and year. The variables growth, firm size and leverage are also interacted with $D_{t,t-j} \times R_{t,t-j}$ following the approach taken in previous studies (Ahmed and Duellman, 2007; LaFond and Roychowdhury, 2008; Chen *et al.*, 2010). Following Roychowdhury and Watts (2007), differences in firm growth opportunities have also been controlled. This is measured by market-to-book (MTB) ratio. A positive relationship is expected between MTB and accounting conservatism. Firm size (FSIZE) is measured as the natural log of the market value of equity at the end of the financial year (Khan and Watts, 2009). Khan and Watts (2009) argue that large firms have lower information asymmetry, and therefore less demand for conservatism. This has also been noted by Givoly *et al.* (2007) and LaFond and Watts (2008), who found that the asymmetric timeliness of earnings for large firms is significantly smaller for large firms. Therefore it is expected that firm size is negatively associated with accounting conservatism. Leverage (LEV) is measured as the amount of total long-term debt divided by average total assets. Highly leveraged firms experienced more conflicts between bondholders and shareholders (Ahmed *et al.*, 2002), and higher agency costs (Dey, 2008). Litigation risk is not directly controlled because there is minimal risk of litigation in Malaysia (Favere-Marchesi, 2000).

5. Descriptive statistics and correlation analysis

5.1 Descriptive statistics

Panel A of Table III presents descriptive statistics of the accounting and market variables. Panel B presents descriptive statistics of the corporate governance variables, while Panel C presents descriptive statistics of the four principal component factors. The mean (median) of earnings is 0.340 (0.312) with the range being from −2.144 to 2.635. The mean (median) of returns is 0.306 (0.368), and not skewed significantly. Panel A shows that the MTB ratio is between 0.139 and 7.884, with the mean being 1.341, indicating the presence growth opportunities. The natural log of market value of equity (a measure of firm size) is between 9.908 (RM20,093) and 17.262 (RM43,100,505), with the mean being 13.143 (RM1,732,328), indicating that the sample firms are fairly large. The leverage ratio is 12.4 percent, with the range being between 0 and 66.6 percent.

The descriptive statistics of the corporate governance variables show that the average board size is 8.141 members, and 42.5 percent of the directors being independent. About 72.4 percent of audit committee members are independent directors, while the average audit committee size is 3.65 members. The proportion of audit committee members with accounting expertise is between 16.7 and 100 percent, with the average being 37.8 percent. On average, 19.4 percent of the total fees are non-audit fees, ranging between 0 and 85.1 percent. The average percentage of politically connected directors is 22.3 percent, with the range being 0-67 percent. Bumiputera-Malay directors comprise 43.8 percent of the total number of directors, and this ranges between 0 and 100 percent. The mean of the percentage of management ownership is 28.1 percent with the range between 24.1 and 87.4 percent. The average government ownership is 11.32 percent, with the range being 0-66.99 percent, suggesting some firms are subject to strong government influence.

On average, 88.68 percent of firms are privately owned, being either Bumiputera conglomerates or Chinese business people. The firms with more Bumiputera-Malay directors are those with higher government ownership and Bumiputera conglomerates. The existence of Bumiputera-Malays on a board and in the ownership structure is a result of the government's political decisions. Despite the politics of favoritism, non-Bumiputera directors (mostly Chinese) still comprise a larger proportion of the total number of directors in the listed firms on Bursa Malaysia. Since the sample is derived from firms with large market capitalization, most of the firms have a separate chairman and CEO (91.6 percent) and are audited by the Big Four auditors (71.6 percent). The descriptive statistics for

Panel A: descriptive statistics for financial statement variables					
Variables	Mean	Median	SD	Minimum	Maximum
E/P	0.34	0.312	0.585	−2.144	2.635
R	0.306	0.268	0.617	−1.488	2.092
MTB	1.341	0.977	1.219	0.139	7.884
FSIZE	13.143	12.979	1.376	9.908	17.262
LEV	0.124	0.074	0.141	0	0.666
Panel B: descriptive statistics for corporate governance and political influence variables					
Continuous variables	Mean	Median	SD	Minimum	Maximum
BSIZE	8.141	8	1.85	4	13
BIND	0.425	0.4	0.106	0.167	0.8
ACIND	0.724	0.75	0.097	0.5	1
ACSIZE	3.647	4	0.678	3	5
ACEXPERT	0.378	0.333	0.16	0.167	1
NAF	0.194	0.111	0.216	0	0.851
POLCON	0.223	0.222	0.162	0	0.857
MALDIR	0.436	0.375	0.258	0	1
MAGTOWN	0.281	0.296	0.241	0	0.874
GOVOWN	0.113	0.579	0.169	0	0.67
Dichotomous measure					
	No. = 1	No. = 0	Percent = 1	Percent = 0	
CEODUALITY	756	68	0.916	0.084	
Big Four	590	234	0.716	0.284	
Panel C: descriptive statistics for principal component factors					
	Mean	Median	SD	Minimum	Maximum
BACSIZE	0.002	−0.051	0.816	−1.597	2.036
AUDQ	−0.001	−0.05	0.648	−1.26	1.999
INDEP	0.003	−0.035	0.643	−2.029	2.229
POLINF	0	−0.137	0.865	−1.533	3.05

Notes: *E/P* is income before extraordinary items cumulative from year *t–j* to year *t*, and *j* is equal to 2 divided by the market value of equity at the end of the year *t–j*. *R* is the buy and hold return starting four months after the end of the fiscal year *t–j*–1 and ending four months after the end of year *t*. MTB is market-to-book ratio. FSIZE is the natural log of market equity. LEV is the amount of total long-term debt divided by average total assets. BSIZE is the total number of directors; BIND is the proportion of independent directors divided by the total number of directors on the board; ACIND is the number of independent audit committee members divided by the total number of audit committee members; ACSIZE is the total number of audit committee members; ACEXPERT is the number of audit committee members who possess financial expertise divided by the total number of audit committee members; NAF is the ratio of the amount of non-audit fees to total fees; POLCON is the proportion of politically connected directors on the board; MALDIR is the proportion of Bumiputera-Malay directors on the board; MAGTOWN is the proportion of total ordinary shares held by non-independent directors over total shares and GOVOWN is the percentage of total number of ordinary shares held by the government divided by the total number of ordinary shares. CEODUALITY is a dummy variable whereby 1 signifies that the positions of CEO and chairman of the board are occupied by different directors and 0 signifies otherwise; BIG4 is a dummy variable whereby 1 signifies "Big Four" auditors and 0 signifies otherwise. BACSIZE is the average equal-weighted sum of standardized BSIZE and ACSIZE. AUDQ is the average equal-weighted sum of standardized ACEXPERT, BIG4 and NAF. INDEP is the average equal-weighted sum of standardized BIND, CEODUALITY and ACIND. POLINF is the average equal-weighted sum of standardized POLCON, and MALDIR. BIND is the proportion of independent directors divided by the total number of directors on the board; BSIZE is the total number of directors; CEODUALITY is a dummy variable whereby 1 signifies that the positions of CEO and chairman of the board are occupied by different directors and 0 signifies otherwise; ACIND is the number of independent audit committee members divided by the total number of audit committee members; ACSIZE is the total number of audit committee members; ACEXPERT is the number of audit committee members who possess financial expertise divided by the total number of audit committee members; BIG4 is a dummy variable whereby 1 signifies "Big Four" auditors and 0 signifies otherwise; NAF is the ratio of the amount of non-audit fees to total fees; POLCON is the proportion of politically connected directors on the board; and MALDIR is the proportion of Bumiputera-Malay directors on the board

Table III.
Descriptive statistics

principal component factors are presented in Panel C. These factors consist of the aggregate of the standardized variables loaded into each principal component factor.

The Pearson correlation (r) (not reported) shows none of the variables are not highly correlated with each other. Despite this, there are still concerns about collinearity when interaction variables are involved. Therefore regression results in Table IV are based on the centering approach for interaction variables in models (2)-(5) to reduce the variance inflation factor (VIF). The centering approach refers to the mean (a constant) subtracted from each variable, yielding a centered variable (Robinson and Schumacker, 2009). VIF is inspected less than 10 for all regressions[14].

The proportion of Bumiputera-Malay directors on a board (MALDIR) is significantly negatively correlated with earnings (E/P) (−0.076, $p \leqslant 0.05$), suggesting firms run by more Bumiputera-Malay directors perform poorly. The positive r (0.106, $p \leqslant 0.05$) between E/P and management ownership (MAGTOWN) and a negative r (−0.062, $p \leqslant 0.10$) between E/P and government ownership (GOVOWN) indicate firms with more management ownership and less government ownership perform better. As expected, all specific political influence variables are positively and significantly correlated with POLINF. Nevertheless, these specific political influence variables are not tested in the same regression with the aggregate measure of political influence (POLINF). POLCON is positively correlated with GOVOWN and MALDIR. GOVOWN is positively correlated with MALDIR. This is not surprising since most government-owned firms are run by Bumiputera-Malays, who also dominate Malaysia's political system. It is interesting to note that there are significant positive correlations between INDEP and AUDQ, and also between INDEP and POLINF (POLCON and MALDIR). The $r = 0.075$ between INDEP and AUDQ suggests that independent directors are significantly associated ($p < 0.05$) with audit quality in Malaysia. Additionally, the findings indicate that the composition of independent directors is significantly associated with POLINF ($r = 0.237$) in Malaysian companies. The BACSIZE dimension is significantly correlated with GOVOWN ($r = 0.084$) and with AUDQ dimension ($r = 0.287$). The highest r of 0.454 is between GOVOWN and POLINF. However, both variables' presence in the models does not indicate a serious multicollinearity problem since the absolute correlation magnitude is less than 0.8 (Gujarati, 1995). To address this concern a separate regression is estimated by grouping the sample into above median and below median groups.

6. Empirical results and discussions

6.1 Accounting conservatism, corporate governance and political influence

The result achieved by using the basic Basu (1997) model, modified by Roychowdhury and Watts (2007) is reported in regression (1) in Table IV. It is consistent with the finding of Vichitsarawong *et al.* (2010) in the post-Asian economic crisis period, in which the coefficient on $D_{t,t-j} \times R_{t,t-j}$ (accounting conservatism) is positive and significant. This outcome suggests that conditional conservatism exists in Malaysia. Regressions (2)-(5) in Table IV present the results using Equation (2). Regressions (2), (3) and (4) include one political influence measure in each regression since they proxy for the same construct. Regression (5) includes both political influence measures into the regression model. Due to the concerns of multicollinearity, regressions (2)-(5) and regressions in subsequent analyses report the results based on the centering approach for interaction variables. The existence of conditional conservatism, indicated by the coefficient ($\beta 3$), which captures or documents the timelier recognition of bad news over good news, is consistently repeated to be significantly positive in regressions (2)-(5). We also test the models by using un-centered interaction variables and the results are materially similar to those reported in Table IV.

The results from regressions (2) and (3) reveal that the independence (INDEP) dimension of corporate governance is significantly associated with accounting conservatism, but the

Table IV.
Results of relationship between asymmetric timeliness, corporate governance and political connection characteristics

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

Variable	(1) Coefficient	(1) *t*-statistic	(2) Coefficient	(2) *t*-statistic	(3) Coefficient	(3) *t*-statistic	(4) Coefficient	(4) *t*-statistic	(5) Coefficient	(5) *t*-statistic
Intercept	0.230***	6.674	0.147	0.374	0.150	0.377	0.029	0.073	0.068	0.165
D	0.152*	1.879	0.028	0.415	0.030	0.443	0.036	0.541	0.032	0.475
R	0.364***	7.753	0.488***	9.672	0.489***	9.694	0.489***	9.643	0.487	9.605
$D \times R$	0.247**	2.245	5.363***	3.306	4.988***	3.092	4.995***	3.005	4.537***	2.704
BACSIZE			−0.006	−0.156	−0.006	−0.149	−0.007	−0.175	−0.006	−0.156
BACSIZE × D			−0.022	−0.273	−0.026	−0.321	−0.019	−0.239	−0.032	−0.396
BACSIZE × R			−0.031	−0.580	−0.032	−0.586	−0.030	−0.559	−0.030	−0.548
BACSIZE × $D \times R$			−0.242	−1.533	−0.259	−1.636	−0.220	−1.400	−0.269*	−1.701
INDEP			−0.049	−0.942	−0.039	−0.767	−0.050	−0.956	−0.052	−0.993
INDEP × D			−0.050	−0.454	−0.067	−0.620	−0.068	−0.623	−0.059	−0.539
INDEP × R			0.038	0.476	0.033	0.404	0.039	0.491	0.045	0.549
INDEP × $D \times R$			0.578**	2.324	0.559**	2.356	0.398	1.571	0.447*	1.757
AUDQ			0.008	0.150	0.005	0.096	0.007	0.130	0.009	0.171
AUDQ × D			−0.110	−1.009	−0.107	−0.978	−0.105	−0.967	−0.114	−1.040
AUDQ × R			0.091	1.234	0.094	1.271	0.092	1.247	0.089	1.196
AUDQ × $D \times R$			−0.287	−1.036	−0.292	−1.055	−0.251	−0.905	−0.275	−0.992
POLINF			0.052	1.110						
POLINF × D			−0.118	−1.398						
POLINF × R			−0.036	−0.563						
POLINF × $D \times R$			−0.256	−1.593						
POLCON					0.141	0.613			0.074	0.305
POLCON × D					−0.435	−1.007			−0.312	−0.653
POLCON × R					−0.121	−0.375			−0.103	−0.298
POLCON × $D \times R$					−1.585**	−2.056			−1.774**	−2.082
MALDIR							0.183	1.205	0.163	1.027
MALDIR × D							−0.311	−1.113	−0.197	−0.641
MALDIR × R							−0.102	−0.488	−0.078	−0.351
MALDIR × $D \times R$							−0.127	−0.215	0.540	0.831
MAGTOWN			−0.084	−0.517	−0.098	−0.607	−0.093	−0.573	−0.078	−0.482
MAGTOWN × D			−0.228	−0.795	−0.170	−0.606	−0.226	−0.780	−0.204	−0.707
MAGTOWN × R			0.598	2.604	0.607	2.670	0.612	2.664	0.602	2.622

(*continued*)

Table IV.

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

Variable	(1) Coefficient	(1) t-statistic	(2) Coefficient	(2) t-statistic	(3) Coefficient	(3) t-statistic	(4) Coefficient	(4) t-statistic	(5) Coefficient	(5) t-statistic
MAGTOWN $\times D \times R$			−2.038***	−3.390	−1.953***	−3.282	−2.042***	−3.368	−1.922***	−3.177
GOVOWN			−0.004	−1.479	−0.003	−1.294	−0.004	−1.526	−0.004	−1.538
GOVOWN $\times D$			0.006	1.026	0.004	0.715	0.005	0.971	0.004	0.795
GOVOWN $\times R$			0.005	1.377	0.005	1.319	0.005	1.391	0.005	1.390
GOVOWN $\times D \times R$			0.008	0.822	0.005	0.496	0.002	0.190	−0.001	−0.067
Control variables		No		Yes		Yes		Yes		Yes
n		824		824		824		824		824
Adjusted R^2		0.171		0.305		0.308		0.301		0.307
VIF		2.359		6.640		6.833		6.730		6.981
F-statistic		57.669		8.847		8.952		8.716		8.290
Significance		0.000		0.000		0.000		0.000		0.000

Notes: All variables are defined in Table III. *,**,***Represent statistical significance at the 10, 5 and 1 percent levels, respectively (using two-tailed tests) board and audit committee size (BACSIZE) and audit quality (AUDQ) dimensions are not significantly related to accounting conservatism. However, the coefficient on the board and audit committee size dimension (BACSIZE) is negatively significant at 10 percent with accounting conservatism in regression (5) and the coefficient on independence ceases to be significant in regression (4). Consistent with LaFond and Roychowdhury (2008), the proportion of management ownership (MAGTOWN) is negatively and significantly associated with conditional conservatism in all regressions. The dimension of political influence, as an aggregate measure, is not related to accounting conservatism. This outcome leads to further tests using each of the political influence variables. As expected, Table IV demonstrates the presence of more politically connected directors on the board (POLCON) is significantly and negatively related to accounting conservatism but the proportion of Bumiputera-Malays on company boards (MALDIR) is unrelated to conditional conservatism. Regarding the relationship between accounting conservatism and ownership structure, conditional conservatism has been found to be negatively and significantly associated with the proportion of management ownership (MAGTOWN) in all regressions which are consistent with the findings reported in LaFond and Roychowdhury (2008). However, the percentage of government ownership (GOVOWN) is unrelated to accounting conservatism.

Even though the aggregate measure of the political influence variables does not demonstrate a significant result, the specific measures show more clear relationships. Our finding supports the argument of resource dependency theory that having influential leaders or resource providers on boards could influence firms' decision making and financial reporting. The results support the explanation of the "political view" that its influence can be negative as evidenced by the significant negative coefficient for the proportion of politically connected directors on a company board. Aggarwal (1999) and Chen *et al.* (2010) argue that politically connected directors on a board enables a firm to gain access to assistance, resources and contracts that have their origins in government directions and political connections. Such easy access to resources provides less incentive for the preparers to produce good quality reporting (Ball *et al.*, 2003). Political influence proxied by the proportion of Bumiputera-Malay directors on boards is unrelated to accounting conservatism, suggesting government policies that favor some ethnicities do not influence financial reports. Our result is consistent with the result in Johnson and Mitton (2003).

It has been shown there is no evidence that government-owned firms are more conservative. A plausible reason for this is that the insignificant association between government ownership and accounting conservatism is due to competing incentives existing for government-owned firms in financial reporting. Some studies have argued that government-owned firms play a key role in promoting the growth of a country, especially in an emerging market (La Porta *et al.*, 2002). As these firms are subject to greater public pressure (La Porta *et al.*, 2002), it is vital for these firms not to report aggressively. The findings from Bushman and Piotroski (2006) reveal significant different directions of influence of government ownership on accounting conservatism in Common Law countries and Code Law countries. Further analysis is done by separating the sample into two portfolios according to the median of government ownership, in order to examine the role of politically connected directors on accounting conservatism (or in financial reporting).

Unlike the coefficient on government ownership, that on the interaction between management ownership and accounting conservatism is negative and significant. It is consistent with the findings reported in LaFond and Roychowdhury (2008) regarding the US market. Even though agency conflicts in Malaysian listed firms are different to those experienced by firms in developed countries (Liew, 2007), our results demonstrate that when management and shareholders' interests are more closely aligned, there is less demand for conditional conservatism (LaFond and Roychowdhury, 2008) to mitigate agency conflicts.

Our results support independence of board of directors and audit committee as the most important governance mechanisms that ensure accounting conservatism. Independence is essential in protecting stakeholders' interests and ensuring financial integrity. The findings from this research suggest that the steps taken by the Malaysian Government to adopt Anglo-American corporate governance systems is generating some fruitful results on accounting quality.

In general, the results do not show size and audit quality dimensions enhance the quality of financial statements. The insignificant finding on size dimension is consistent with Ahmed and Duellman's (2007) study on accounting conservatism and a more recent one by Dimitropoulos and Asteriou (2010) on earnings informativeness. Nevertheless, a smaller board and audit committee size being potentially effective for accounting conservatism has been found in regression (5), though the significance level is not strong. The results for the audit quality dimension confirm the doubts raised by Favere-Marchesi (2000) and Ali *et al.* (2006), who questioned the effectiveness and quality of audits conducted in Malaysia[15].

For brevity, the results on control variables are untabulated but are explained in texts. With regard to control variables, the coefficient on MTB ratio is found to be negative but is not significant in all regressions. Consistent with Givoly *et al.* (2007), our results show a negative relationship between firm size and accounting conservatism in regression models (2)-(5). A positive relationship between leverage and accounting conservatism is found in regression models (2) and (3) due to more monitoring efforts being made by external debt-holders as the debt-equity ratio increases.

6.2 Additional analysis: the moderating effect of political influence on the relationship between corporate governance and conservatism

Further analysis is done by testing the moderating effect of political influence on the relationship between corporate governance and conservatism. Since the previous analyses reveal independent directors play an important role in accounting conservatism and the ratio of politically connected directors has the negative effect on accounting conservatism, we further investigate whether the interacting of these two factors also has an impact on accounting conservatism. The other control variables in model (3) remain the same as in previous models (defined in Section 4.2), including: board size, management ownership, firm size, MTB ratio and leverage. The model (3) is as follows:

$$\begin{aligned}\frac{E_{i,t-j}}{P_{t,t-j-1}} = {} & \alpha_0 + \beta_1 D_{t,t-j} + \beta_2 R_{t,t-j} + \beta_3 D_{t,t-j} \times R_{t,t-j} + \beta_4 \mathrm{INDEP}_{i,t} + \beta_5 \mathrm{INDEP}_{i,t} \times D_{t,t-j} \\ & + \beta_6 \mathrm{INDEP}_{i,t} \times R_{t,t-j} + \beta_7 \mathrm{INDEP}_{i,t} \times D_{t,t-j} \times R_{t,t-j} + \beta_8 \mathrm{POLCON}_{i,t} \\ & + \beta_9 \mathrm{POLCON}_{i,t} \times D_{t,t-j} + \beta_{10} \mathrm{POLCON}_{i,t} \times R_{t,t-j} \\ & + \beta_{11} \mathrm{POLCON}_{i,t} \times D_{t,t-1} \times R_{t,t-j} + \beta_9 \mathrm{INDEP}_{i,t} \times \mathrm{POLCON}_{i,t} \\ & + \beta_{10} \mathrm{INDEP}_{i,t} \times \mathrm{POLCON}_{i,t} \times D_{t,t-j} + \beta_{11} \mathrm{INDEP}_{i,t} \times \mathrm{POLCON}_{i,t} \times R_{t,t-j} \\ & + \beta_{12} \mathrm{INDEP}_{i,t} \times \mathrm{POLCON}_{i,t} \times D_{t,t-1} \times R_{t,t-j} + (\text{other control variables}) + \varepsilon,\end{aligned} \tag{3}$$

The results in Table V further confirm the effect on asymmetric timeliness as reported in the main analysis. The results in Table V reveal consistent results that bad news are recognized earlier than good news with the coefficient of $D \times R$, 3.772 (t-statistic = 2.2.090). The results indicate firms with better corporate governance are more conservative. The coefficient of $\mathrm{INDEP} \times D \times R$ is 6.856 (t-statistic = 5.172) and firms with more politically connected directors are rather less conservative and tend to delay the recognition of bad news with the coefficient of $\mathrm{POLICON} \times D \times R$ is −0.899 (t-statistic = −0.761).

Table V.
Results of the relationship between asymmetric timeliness, corporate governance, political influence and the moderating effect

Variables	Coefficient	t-statistic
	Dependent variable: income before extraordinary items divided by the market value equity at the beginning of the period (6)	
Intercept	0.324	0.595
D	−1.243	−1.218
R	−0.592	−0.613
$D \times R$	3.772**	2.090
INDEP	0.009	0.025
INDEP × D	−0.151	−0.257
INDEP × R	−0.044	−0.065
INDEP × $D \times R$	6.856***	5.172
POLCON	−0.041	−0.104
POLCON × D	−0.979	−1.571
POLCON × R	−0.090	−0.139
POLCON × $D \times R$	−0.899**	−0.761
INDEP × POLCON	0.276	0.450
INDEP × POLCON × D	0.791	0.809
INDEP × POLCON × R	−0.161	−0.161
INDEP × POLCON × $D \times R$	−3.533**	−2.154
Control variables		Yes
n		824
Adjusted R^2		0.204
F-statistic		7.301
Significance		0.000

Notes: All variables are defined in Table III. **,***Represent statistical significance at the 5 and 1 percent levels, respectively (using two-tailed tests)

We also test the moderating roles played by political influence on the association between corporate governance and conservatism by interacting the proportion of independent directors on board (INDEP) and the proportion of politically connected directors on the board (POLCON) and results are presented in Table V. It appears that political connection has a negatively moderating effect as evidenced by the negative and significant coefficient at the 5 percent level (coefficient INDEP × POLCON × $D \times R = -3.533$, t-statistic $= -2.154$). It shows that politically connected directors on board have weaken the effective role played by independence directors. All other control variables are found significantly related to the asymmetric timeliness recognition of gain and loss except for the management ownership. In general, the results from additional analysis in Table V support the contention that politically connected directors have a negative influence on the quality of financial reporting, and affect the effectiveness of corporate governance mechanism as well.

6.3 Sensitivity analyses

We conducted sensitivity tests for the models estimated in Tables IV and V. The results of these tests do not change the overall conclusions associated with corporate governance and political influence. First, we re-estimated regressions (2), (3), (4) and (5) using panel estimated generalized least squares (EGLS) fixed-effect models with t-statistics adjusted for panel corrected standard errors to control for heteroscedasticity and serial correlation. The results are quite similar to those in the main analysis as reported in Tables IV and V. The independence dimension is strongly associated with accounting conservatism while firms with politically connected directors are less conservative. Second, we added more control variables such as cash flows and firms' tax rates, which do not affect the overall results. Third, we partitioned the firms with the proportion of politically connected directors above or below the median. The evidence indicates firms with more politically connected directors are more conservative than firms with less politically connected directors. We also test models for endogenous problems following the approach suggested in Wooldridge (2002). This process involves estimating traditional fixed-effect models augmented with leading values of the potentially endogenous variables. Overall, the strict exogeneity test reveals no evidence of an endogenous relationship between corporate governance and political influence attributes with the firm-year accounting conservatism measure (detailed results are not tabulated but are available on request).

6.4 The consequences of negative accounting conservatism due to political connections

In this paper, we have found that firms with more politically connected directors have inferior earnings quality as measured by accounting conservatism. Studies have shown that businesses with poor reporting standards suffer from a number of negative consequences such as higher cost of capital, loss of reputation and a higher probability of litigation. However, politically connected firms with poor quality financial information may not actually suffer from these negative consequences. According to Chaney *et al.* (2011), politically connected firms have strong ties with financing organizations and get preferential treatment such as cheap loans. If these firms perform better the negative consequence associated with poor financial reporting are ignored by market participants (Johnson and Mitton, 2003). We regress firm performance on the proportion of politically connected directors while controlling for accounting conservatism[16] and other governance and control variables to investigate the relationship between firm performance and political connection and conservatism. Since the likelihood ratio test shows OLS is unsatisfactory, the following model is tested using panel EGLS fixed-effect specification:

$$\begin{aligned}\mathrm{ROA}_{i,t+1} = {} & \beta_0+\beta_1\mathrm{POLCON}_{it}+\beta_2\mathrm{BACSIZE}_{it}+\beta_3\mathrm{INDEP}_{it}+\beta_4\mathrm{AUDQ}_{it}\\ & +\beta_5 C\_\mathrm{Score}_{it}+\beta_6\mathrm{MALDIR}_{it}+\beta_7\mathrm{MAGTOWN}_{it}+\beta_8\mathrm{GOVOWN}_{it}\\ & +\beta_9\mathrm{CFO}_{it}+\beta_{10}\mathrm{MTB}_{it}+\beta_{11}\mathrm{FSIZE}_{it}+\beta_{12}\mathrm{LEV}_{it}\\ & +\sum(\text{other control variables})+\varepsilon_{it}\end{aligned} \tag{4}$$

where $\mathrm{ROA}_{i,t+1}$ is one year ahead earnings after tax divided by total assets. $\mathrm{C\_Score}_{it}$ is firm-year measure of conservatism following Khan and Watts (2009). CFO_{it} is cash flow from operations divided by beginning total assets. All other variables have been defined. Since the explanatory variables are one year lag to the dependent variable of the future performance (ROA), only the data for the period 2005-2008 can be utilized. The regression model is based on Haniffa and Hudaib (2006), where future performance is treated as a function of previous year governance and control variables. Firms' previous year profitability and growth are controlled and the coefficients are expected to be positive (Haniffa and Hudaib, 2006; Fan *et al.*, 2007). The regression also controls for leverage and a negative relationship is expected between leverage and performance (Haniffa and Hudaib, 2006; Tam and Tan, 2007).

Based on 820 firm-year observations reported in Table VI, politically connected directors bring more resources and competitive advantage to the firms through their linkages which result in better future performance. The coefficient on politically connected directors is found to be positive and significant, and consistent with Johnson and Mitton (2003). They seem to perform better, despite the firms with more politically connected directors having less conservative financial statements in earlier analyses using Basu's (1997) model, modified by Roychowdhury and Watts (2007), and indicating less good quality financial statements. The finding provides some new evidence supporting Chaney *et al.*'s (2011) argument that politically connected firms do not seem to suffer problems due to the poor

Table VI. Results of relationship between performance, conservatism, corporate governance and political connections

Variable	Dependent variable: ROA_{t+1} Coefficient	t-statistic
C	−3.721	−1.176
CSORE	1.140**	2.459
BACSIZE	0.690**	2.151
AUDQ	−0.269	−0.643
INDEP	−0.513	−1.264
POLCONR	4.129**	2.281
MALDIR	−3.832***	−3.055
MAGTOWN	1.226	0.988
GOVOWN	−0.038**	−1.965
CFO	19.849***	7.311
MTB	2.974***	10.170
FSIZE	0.554**	2.273
LEV	−9.671***	−5.182
Adjusted R^2		0.362
F-statistic		25.407
n		824

Notes: Where ROA_{t+1} one year ahead return on asset, a proxy for performance. C_Score is the firm-year measure of conservatism developed by Khan and Watts (2009). Other variables are defined in Table III. **,***Represent statistical significance at the 5 and 1 percent levels, respectively (using two-tailed tests)

quality of reporting. The percentages of Bumiputera-Malay directors and government ownership are negatively associated with firms' performance. It has been suggested that Bumiputera-Malay directors still lag behind the other ethnic communities, and consequently the inferior performance of Bumiputera-Malay directors is not surprising (Amran and Susela, 2008; Zainol and Ayadurai, 2010). There is no evidence that management ownership is related to firm performance, which is consistent with the finding in Wahab *et al.* (2007).

The results show conservatism scores are positively and significantly related to future performance, which suggest that conservatism has predictive ability but the coefficient of political connection is about four times larger which means that political connections continue to dominate firm performance in Malaysia's economy. Having politically connected directors on company boards gives benefits to their firms such as allocation of subsidies and other forms of government funding (Johnson and Mitton, 2003). Political connections also give firms more opportunities to access government controlled information, participate in government projects which there will be fewer business uncertainties, for example, in terms of payments and less likelihood of contract cancellation. Furthermore they will enjoy the reduced transaction costs through government tax and fee exemptions (Hillman *et al.*, 1999; Faccio *et al.*, 2006). The findings in this study indicate that good connections with politicians outweigh the importance of the quality of financial information in relationship-based economies. Consistent with Haniffa and Hudaib (2006), the coefficient on firm size is positive but the coefficient on the independence dimension is not significant. All the control variables are significant and in the direction as expected.

7. Conclusion

This paper investigates the impact of corporate governance, political connection and ownership structure on accounting conservatism in Malaysia. Our findings are consistent with prior studies showing that accounting conservatism is linked to stronger corporate governance mechanisms (Beekes *et al.*, 2004; Ahmed and Duellman, 2007; García Lara *et al.*, 2007, 2009; Ahmed and Henry, 2011) and that political influence adversely affects the quality of financial reporting, as measured by accounting conservatism (Chaney *et al.*, 2011).

We also find that while political connections lead to poorer quality financial reporting as shown by less accounting conservatism despite strong corporate governance mechanisms in place by firms, the negative consequences may not be severe. This is because politically connected directors can bring more resources to their firms and thus do business better and generally perform well. The findings in this study open avenues for further research to clarify why political connection pays different roles in terms of enhancing accounting quality and in terms of enhancing firm performance in Malaysia. Our results add to a flourishing stream of empirical research on the topic of accounting conservatism, showing that conditional conservatism is correlated with the strength of corporate governance. However, the principal contribution of this analysis is to provide more direct evidence on the effect of political influence on accounting conservatism. This paper provides support for the view that corporate governance and political influence do influence the credibility of financial reporting.

The practical implications of our study are twofold. First, a good corporate governance and financial reporting environment stimulates capital market performance and greater investor confidence, particularly for international investors. Our findings in this paper offer insights and additional guidance for regulators and policy makers in emerging economies like Malaysia who are devising the relevant corporate governance and financial reporting frameworks. The negative relationship between management ownership and accounting conservatism found in this paper implies a reduced monitoring role of directors in firms owned by insiders in Malaysia. Perhaps increasing the number of independent directors in closely owned firms could help the board perform more effectively in monitoring the quality of financial statements.

Second, our finding of this paper does not support the appointment of politically connected directors on a company's board because it may compromise the quality of financial statements from the perspective of accounting conservatism. However, opposing the appointment of politically connected directors to a board cannot be easily done because such an appointment is theoretically supported by resource dependency theory. The appointment of influential community members on the board, such as politicians, may provide benefits in terms of firm links and competitive advantage (Pfeffer and Salancik, 1978). There is evidence for this not only in the emerging economies but also within the confines of strong legal systems such as that in the USA (Goldman *et al.*, 2009). If this practice is pervasive, the information provided in this paper will alert regulators to be cautious when appointing politically connected directors, particularly to audit committees because an audit committee is more directly responsible for financial reporting tasks.

Notes

1. This term generally refers to both developing and transitional economies where institutional underdevelopment (Ramamurti, 2003) and significant governmental or political involvement in business affairs are hallmarks (Child and Tsai, 2005). China, Taiwan, Malaysia, India, Brazil and Mexico are examples of emerging economies (Yamakawa *et al.*, 2008).

2. Bumiputera literally means "son of the soil." According to Rahman and Ali (2006), those with cultural affinities indigenous to the region are classified as Malays or Bumiputeras, and those whose cultural affinities lie outside the region are classified as non-Bumiputera (consisting primarily of Chinese, Indians and others). This paper uses the term "Bumiputera-Malays" to refer to people having Malay ethnicity, while acknowledging that about 5 percent of the population are classified as Bumiputera even though they are non-Malays (such as the indigenous communities in Sabah and Sarawak).

3. Rajan and Zingales (1998) describe East Asian financial institutions as relationship-based systems. According to Li (2003), most transactions in this system are based on personal, implicit agreements, local information and partial contracts enforceable by the state. These are the norms of most economies during the catching-up stage (Li, 2003).

4. This approach is consistent with LaFond and Roychowdhury (2008) who use only Basu's (1997) conditional conservatism as a primary measure of accounting conservatism. The terms "accounting conservatism" and "conditional conservatism" are used interchangeably in this paper, and they refer to the asymmetric timeliness of earnings (Basu, 1997).
5. With the launch of the National Economic Policy (NEP) in 1971, and later the National Development Policy (NDP) in 1991, the government enforced positive discrimination among the Bumiputeras. At that time, 40 percent of Malaysia's population (made up of Chinese and Indians) controlled over 80 percent of the country's wealth (Jesudason, 1989). This policy indeed enhances the level of ownership by Bumiputera-Malays in the capital markets.
6. Bursa Malaysia was previously known as the Kuala Lumpur Stock Exchange (KLSE).
7. Ball and Shivakumar (2005) explain that unconditional conservatism gives rise to a poor match between economic costs and benefits, and creates a fixed bias in accounting. It is therefore unlikely to facilitate either the valuation or contracting roles of accounting.
8. The "Big Four" auditors consist of a group of leading international accounting firms. Before the collapse of Arthur Andersen in 2002, this group was known as the Big Five or Big Six. The "Big Four" auditing firms are Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers.
9. We did not include 2008 because of the Global Financial Crisis which saw government interventions in corporate affairs and monitoring of what was happening in the country. Also the Malaysian Code on Corporate Governance was revised on October 1, 2007 (see www.bursamalaysia.com), which is not expected to affect the sample.
10. In 1997, the Malaysian Accounting Standards Board (MASB) was established to issue legally binding accounting standards known as MASBs.
11. Dietrich *et al.* (2007) discuss the limitations of Basu's (1997) approach to estimating asymmetric timeliness as yielding bias when earnings information affects returns. However, Ryan (2006) contends that the measurement error of this model is likely to be small.
12. The firms under direct government control and Government-Linked Investment Companies (GLICs), some of which are as mentioned before, are termed Government Linked Companies (GLCs) (see www.pcg.gov.my).
13. This approach, sample size and number of variables are comparable with 747 firm-year observations in Ahmed and Duellman (2007). The sample size in this study is 824 firm-year observations.
14. VIF of more than 10 indicates harmful collinearity (Neter *et al.*, 1983).
15. The lack of incentives for statutory auditors to provide quality audit services is perhaps one of the factors affecting audit quality (Favere-Marchesi, 2000). Ali *et al.* (2006) contend that auditing in Malaysia is done merely to fulfill the legal requirements and provide an "image" of a modern economy in order to attract investment from overseas investors, rather than to address the needs of its own social environment. They also contend that the existence of a strong relationship between corporate elites and political leaders has weakened if not compromised the modern auditing infrastructure.
16. In this case, a firm-year measure of conservatism is needed as an independent variable, therefore C_Score (Khan and Watts, 2009) is used in the regression model.

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