Pertanika J. Soc. Sci. & Hum. 25 (S): 255 - 264 (2017)

PERTANIKA JOURNALS

SOCIAL SCIENCES & HUMANITIES

Journal homepage: http://www.pertanika.upm.edu.my/

Effects of Board Characteristics on Financial Restatement in Malaysia

Suhaily Hasnan[1]*, Hafizah Marzuki[2] and Shuhaida Mohamed Shuhidan[3]

[1]*Faculty of Accountancy, Universiti Teknologi MARA, 40000 Shah Alam, Selangor, Malaysia*
[2]*Internal Audit Department, Islamic Science University of Malaysia, 71800 Nilai, N. Sembilan, Malaysia*
[3]*Accounting Research Institute, Universiti Teknologi MARA, 40000 Shah Alam, Selangor, Malaysia*

ABSTRACT

This study examines the character of a board (i.e., its size, independence, director's tenure, gender diversity, competence, ethnicity, status, age and position of its founder) on the financial restatement of Malaysian Public Listed Companies (PLCs). The study found board size, multiple directorship, political connections and position of the founder has a significant relationship with financial restatement. The results support the findings of the Resource Dependence Theory and the Agency Theory.

Keywords: Accounting misstatement, board composition, board diversity, board of directors' characteristics, corporate governance, financial restatement

INTRODUCTION

Companies experience massive losses such as deterioration of company reputation (Albring, Huang, Pereira, & Xu, 2013), loss of investor confidence (Kim, Roden, and Cox, 2013), high turnover of management (Nasr & Mohammadi, 2015); fall of share prices and reduction in market capitalization (GAO, 2006) as a result of financial restatements. The focus of this study is how the character of a board's composition can influence restatements.

In Malaysia, Abdullah, Yusof and Noor (2010) state that the scale of restatement incidents is relatively low compared to some developed countries. From the regulatory perspective, the roles of board of directors has received great concern with regards to financial reporting. In Malaysia the newly revised Malaysian Code on Corporate Governance (MCCG 2012) emphasizes the principle of board composition and

ARTICLE INFO

Article history:
Received: 15 September 2016
Accepted: 30 December 2016

E-mail addresses:
suhailyhasnan@salam.uitm.edu.my (Suhaily Hasnan),
mutiarawakafan@gmail.com (Hafizah Marzuki),
shuhaida6704@salam.uitm.edu.my (Shuhaida Mohamed Shuhidan)
* Corresponding author

ISSN: 0128-7702

boardroom diversity for Malaysian PLCs. Previous studies suggest the presence of independent directors as "form over substance" (Abdullah et al., 2010; Hasnan and Hussain, 2015). Further, Mahadeo and Soobaroyen (2012) state that the notion of independence is deemed unworkable and seems to be a symbol of "showing off".

Some scholars have drawn a number of theories in attempt to explain the relationship between board characteristics and financial restatements. This study focuses on the Agency Theory and the Resource Dependence Theory. Based on the Agency theory, board of directors should act on behalf of shareholders to oversee management's activities (Hillman & Dalziel, 2003), thus preventing the likelihood of restatement (Wang, Lin, and Chao, 2013). In the Resource Dependence Theory, board of directors are viewed as a resource provider of knowledge, experience and business expertise (Hillman, Canella & Paetzold, 2000). This study constructs 12 hypotheses related to financial restatements to investigate the effect of a board's character on financial restatement in Malaysia.

H_1: There is a significantly negative association between board size and the incidence of financial restatement.

H_2: There is a significantly negative association between board independence and the incidence of financial restatement.

H_3: There is a significantly negative association between board tenure and the incidence of financial restatement.

H_4: There is a significantly negative association between female board presence and the incidence of financial restatement.

H_5: There is a significantly negative association between board competence and the incidence of financial restatement.

H_6: There is a significantly negative association between the proportion of Bumiputera members on the board and the incidence of financial restatement.

H_7: There is a significantly positive association between foreign board and the incidence of financial restatement.

H_8: There is a significantly positive association between duality role and the incidence of financial restatement.

H_9: There is a significantly negative association between multiple directorships and the incidence of financial restatement.

H_{10}: There is a significantly positive association between political connections and the incidence of financial restatement.

H_{11}: There is a significantly negative association between senior board members and the incidence of financial restatement.

H_{12}: There is a significantly positive association between founder on board and the incidence of financial restatement.

METHODS

The initial dataset consists of 814 companies from 11 sectors. 61 firms in the financial services sector were excluded from the list because they are subject to different requirements of corporate governance. Based on the list, companies reporting restatements from 2006 to 2013 were identified. The sample of restatement firms was compiled by searching few primary keywords relating to restatements, such as “restate”, “restatement”, “restated”, “prior adjustment”, “reclassified” and “comparative”. Consistent with prior research, such restatement firms are selected based on: cost/expense recognition; revenue recognition; securities-related issues; restructuring of assets/inventory; reclassification; acquisitions and mergers; related-party transactions; in-process research and development; and others. This yielded with a final restatement sample of 76 firms. For comparison purposes, each sample of restatement firms is matched with a control firm according to its size and industry. The control sample, thus, consist of 152 non-restatement firms. Consistent with past studies by Hasnan, Rahman, and Mahenthiran, (2013); and Ettredge, Scholz, Smith and Sun (2010), the timeline of restatement incidence is illustrated in Figure 1, where “t” signifies the year of restatement incidents; and “t – 1” denotes the year of data collection which includes all variables. For example, a company announcing in 2013 that it was restating its financial statements for the year 2011 would be matched with a control company based on information for 2010.

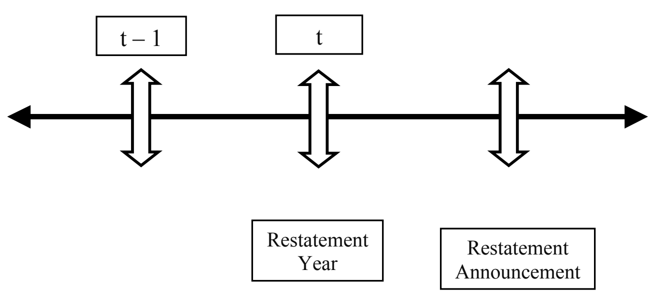

Figure 1. Timeline of financial restatement

Consistent with prior studies this study used a logistic regression technique to test the impact of board characteristics on the financial restatement (Hasnan and Hussain, 2015; Abbott, Parker, & Presley, 2012). The logistic regression technique is most appropriate for this study because it allows us to test model with a dichotomous dependent variable and a match pair sampling. The regression model is as follows:

$$\text{RESTATEMENT} = \alpha + \beta 1\ \text{BDSIZE} + \beta 2\ \text{BDIND} + \beta 3\ \text{INDTENURE} + \beta 4\ \text{GENDER} + \beta 5\ \text{ACQLFD} + \beta 6\ \text{ECBD} + \beta 7\ \text{FORBD} + \beta 8\ \text{DUALITY}$$

+ β9 CROSSDIR + β10 POLITIC + β11 AGE + β12 FOUNDER + β13 LEVERAGE + Ɛ,

Where the dependent, independent and control variables are explained below and summarized in Table 1. RESTATEMENT dependent variable is coded '1' for restating companies and '0' for non-restating companies. Consistent with Abbott et al. (2012), this study include a control variable in the model and expect a positive impact of LEVERAGE on restatement. Information on the financials and board characteristics were hand collected from annual reports.

Table 1
Description of variables

Variables	Operationalisation	Past Studies
RESTATEMENT (The incidence of financial restatement)	Indicator variable with a value of 1 for firms that restated their annual financial statements, 0 for control firms that did not.	(Hasnan & Hussain, 2015)
BDSIZE (Size of the board)	Likert scale of one to five: 1 = < 3 members, 2 = at least 3 members, 3 = 4 to 6 members, 4 = 7 to 9 members and 5 = 10 and more members on board.	(Hussin et al., 2014)
BDIND (Percentage of independent directors)	No of independent non-executive directors/total no of board members	(Zhizhong et al., 2011)
INDTENURE (Average years of service of independent directors on the board)	Average no of years of board service of independent non-executive directors	(Rahman & Ali, 2006)
GENDER (At least one female director on the board)	Indicator variable with the value of 1 if there is at least one woman director on the board, 0 else.	(Abbott et al., 2012)
ACQLFD (At least one member of the board is a qualified accountant)	Indicator variable with the value of "1" if at least one member is a qualified accountant and "0" otherwise	(Rahman & Ali, 2006)
ECBD (The ratio of Bumiputera directors)	Ratio of Bumiputera directors to total number of directors on board	(Rahman and Ali, 2006)
FORBD (The ratio of foreign directors)	Ratio Foreign directors / Total no. of Board of Directors	(Randøy, Thomsen, & Oxelheim, 2006)
DUALITY (The dual position of CEO/ Chairman)	Indicator variable with the value of "1" if the roles of chairman and CEO are combined and "0" otherwise	(Abdullah et al., 2010)
CROSSDIR (The percentage of directors having cross-directorships)	Percentage of directors having cross-directorship	(Hasnan & Hussain, 2015)

Table 1 *(continue)*

POLITIC (Directors/firms having political connections)	Indicator variable with the value of "1" if the firm is considered political connections and "0" otherwise	(Hussin et al., 2014)
AGE (The average age of directors on the board)	Average Age Board of Directors	(Bonn, 2004)
FOUNDER (Founder serves on the board)	Indicator variable with the value of "1" if there is founder on board and "0" otherwise	(Donoher, 2009)
LEVERAGE (Total debt/total assets)	Total debt/total assets	(Abbott et al., 2012)

RESULTS AND DISCUSSION

Table 2 presents the descriptive statistics that provide univariate support for this study. Panel A of Table 2 shows that the mean difference of the proportion of independent directors on restatement firms and control firms is 1%. Meanwhile, other variables, such as BDSIZE, INDTENURE,

Table 2
Univariate results

Panel A: Continuous Variables						
	Restatement Firms (N=76)		Control Firms (N=152)			
Variable	Mean	Std. Dev.	Mean	Std. Dev.	Mean Diff.	t-value
BDSIZE	3.610	0.655	3.770	0.635	0.164	1.824**
BDIND	0.450	0.143	0.437	0.113	-0.013	-0.684
INDTENURE	5.728	3.627	5.660	3.302	-0.068	-0.142
ECBD	0.396	0.277	0.344	0.271	-0.052	-1.348
FORBD	0.052	0.110	0.072	0.157	0.021	1.158
CROSSDIR	0.527	0.279	0.603	0.283	0.077	1.934**
AGE	55.12	5.900	55.07	4.967	-0.048	-0.061
LEVERAGE	0.402	0.234	0.408	0.197	0.006	0.205
Panel B: Dichotomous Variables						
Variable	Frequency of "0"	Frequency of "1"	Mean (restated)	Mean (non-restated)	Mean Diff.	t-value
GENDER	134 (58.8%)	94 (41.2%)	0.360	0.440	0.086	1.249
ACQLFD	8 (3.5%)	220 (96.5%)	0.950	0.970	0.026	0.911
DUALITY	159 (69.7%)	69 (30.3%)	0.390	0.260	-0.138	-2.071*
POLITIC	179 (78.5%)	49 (21.5%)	0.320	0.160	-0.151	-2.458*
FOUNDER	130 (57%)	98 (43%)	0.550	0.370	-0.184	-2.679*

Notes: N=228
* Denote significant at the 0.01 level. ** Denote significant at the 0.10 level.

ECBD, FORBD, CROSSDIR, AGE and LEVERAGE have small mean differences ranging between 0.006 and 0.16. Consistent with Yunos, Ismail and Smith (2012), the mean proportion of Bumiputera directors is lower than 40%, which signify that more than half of the directors on the board comprise other races, while the mean ratios of foreign directors on the board for restatement and non-restatement firms are 5% and 7%, respectively. In Panel B of Table 2, the average number of GENDER is moderate ranging between 36% and 44%. The mean of ACLFD of restatement firms and control firms is slightly similar at 0.95 and 0.97, respectively. Further, the mean of DUALITY in restatement firms is greater than control firms and the difference of scores is statistically significant ($t = -2.071$, $p<0.05$). This result is similar to Abbott et al. (2012), who suggest that restating firms support the dual position whereas control firms favour a separate leadership role. Also, the mean difference of POLITIC is statistically significant ($t = -2.458$, $p < 0.05$). As in Hussin et al. (2014), FOUNDER of restatement firms is significantly higher ($t = -2.679$. $p < 0.05$) than its counterparts.

Table 3 shows logistic regression results which provides multivariate support for research hypotheses. As expected, BDSIZE is negatively associated with financial restatements. This result is consistent with the Resource Dependence Theory, which indicates that a number of directors on board can provide extra sources of knowledge and business expertise to improve the quality of managerial oversight (Saleh, Iskandar, & Rahman, 2005). Also, there is a significant negative association between CROSSDIR and financial restatements suggesting that directors who practice multiple directorships can reduce restatement incidence to coincide with the principle of Resource Dependence

Table 3
Multivariate results

	Exp. Sign	B	Sig.			
BDSIZE	-	-0.674	0.015*			
BDIND	-	0.513	0.705	Nagelkerke R^2	0.211	
INDTENURE	-	0.029	0.602	Observation	228	
GENDER	-	-0.333	0.315	Classification	71.9%	
ACQLFD	-	-0.174	0.837	performance		
ECBD	-	1.165	0.082	-	Restatement	39.5%
FORBD	+	-1.161	0.325	firms		
DUALITY	+	0.505	0.133	-	Control firms	88.2%
CROSSDIR	-	-1.326	0.035*			
POLITIC	+	1.352	0.001*			
AGE	-	0.001	0.968			
FOUNDER	+	0.992	0.003*			
LEVERAGE	+	-1.052	0.171			
Constant		1.497	0.511			

Theory (Pritchard, Ferris, & Jagannathan, 2003; Sarkar & Sarkar, 2009). In addition, POLITIC is positively associated with restatement incidence. Specifically, firms with political connections are found to engage in financial misstatement (Chaney, Faccio, & Parsley, 2011). Such adverse exposures may lead to agency costs (Rahman & Salim, 2010). Moreover, a positive and significant effect of FOUNDER on financial restatement signifies that founder as member of the board fails to monitor management activities. The study failed to identify a statistically significant association for BDIND, INDTENURE, GENDER, ACQLFD, ECBD, FORBD, DUALITY and AGE.

As per Kilic (2015), the study used LOGBOARDSIZE (the effect of natural log of the size of board) as an alternative measurement for board size. Results show similar directions with the earlier observations where LOGBOARDSIZE, CROSSDIR, POLITIC and FOUNDER are statistically associated with financial restatement. Second, this study examined the percentage of founder on the board (represented as FOUND) as an alternative proxy for FOUNDER as suggested by Hussin et al. (2014). The findings present a significant impact of BDSIZE, DUALITY, CROSSDIR, POLITIC and FOUND on financial restatement. However, DUALITY and FOUND are now statistically significant at 10%. Thus, the findings produce similar observations thus imply that the results are fairly robust. The robustness test results are shown in Table 4.

Table 4
Robustness test results

	Exp. Sign	B	Sig.		Exp. Sign	B	Sig.
	Alternative 1				Alternative 2		
LOGBOARDSIZE	-	-3.710	0.022*	BDSIZE	-	-0.559	0.042*
BDIND	-	0.330	0.814	BDIND	-	0.329	0.806
INDTENURE	-	0.028	0.606	INDTENURE	-	0.026	0.634
GENDER	-	-0.313	0.342	GENDER	-	-0.360	0.274
ACQLFD	-	-0.354	0.675	ACQLFD	-	-0.153	0.856
ECBD	-	1.058	0.115	ECBD	-	0.940	0.149
FORBD	+	1.111	0.345	FORBD	+	-0.956	0.404
DUALITY	+	0.456	0.174	DUALITY	+	0.591	0.075**
CROSSDIR	-	-1.355	0.031*	CROSSDIR	-	-1.268	0.042*
POLITIC	+	1.347	0.001*	POLITIC	+	1.278	0.001*
AGE	-	0.006	0.868	AGE	-	0.003	0.925
FOUNDER	+	1.028	0.002*	FOUND	+	2.649	0.056**
LEVERAGE	+	-1.058	0.167	LEVERAGE	+	-0.845	0.265
Constant		2.183	0.374			1.233	0.589

Notes: *p < 0.05, **p < 0.1, two-tailed tests

CONCLUSION

This paper investigated the relationship between the character of a board's composition and financial restatements using a matched-pair sample of restatement and control firms. Logistic regression analysis was conducted to provide multivariate support for the research hypotheses. The findings reveal that the likelihood of restatement is significantly influenced by board size, multiple directorships, political connections and founder on board. In short, the extent of board size and the presence of directors holding directorships could improve monitoring efficacy, thus supporting the Resource Dependent Theory. Firms with political connections and the presence of a founder member in the board may create incentives for managers to misstate financial statements, leading to agency problems. Despite of reporting insignificant results, the criteria of board independence, directors' tenure, gender diversity, board competence, board ethnicity, foreign board, duality role and board age should be of greater concern when addressing more credible and reliable financial disclosures.

ACKNOWLEDGEMENTS

The authors would like to thank the Accounting Research Institute (ARI) and Faculty of Accountancy, Universiti Teknologi MARA for awarding the ARI HICoE Grant that provided the financial support for the preparation of this research paper.

REFERENCES

Abbott, L. J., Parker, S., & Presley, T. J. (2012). Female Board Presence And The Likelihood Of Financial Restatement. *Accounting Horizons Of American Accounting Association, 26*(4), 607–629.

Abdullah, S. N., Yusof, N. Z. M.& Nor, M. N. M. (2010). Financial Restatements And Corporate Governance Among Malaysian Listed Companies. *Managerial Auditing Journal, 25*(6), 526–552.

Albring, S. M., Huang, S. X., Pereira, R., & Xu, X. (2013). The Effects Of Accounting Restatements On Firm Growth. *Journal Of Accounting And Public Policy, 32*(5), 357–376.

Bonn, I. (2004). Board structure and firm performance: Evidence from Australia. *Journal of Management and Organization, 10*(01), 14-24.

Chaney, P. K., Faccio, M., & Parsley, D. (2011). The Quality Of Accounting Information In Politically Connected Firms. *Journal Of Accounting And Economics, 51*(1-2), 58–76.

Donoher, W. J. (2009). Firm Founders , Boards , And Misleading Disclosures : An Examination Of Relative Power And Control. *Journal Of Managerial Issues, 21*(3), 309–326.

Ettredge, M., Scholz, S., Smith, K. R., & Sun, L. (2010). How Do Restatements Begin? Evidence Of Earnings Management Preceding Restated Financial Reports. *Journal Of Business Finance And Accounting, 37*(3-4), 332–355.

Hasnan, S., & Hussain, A. R. (2015). Factors Associated With Financial Restatements: Evidence From Malaysia. *Jurnal Pengurusan (Scopus-Q4), 44*(September), Forthcoming.

Hasnan, S., Rahman, R. A., & Mahenthiran, S. (2013). Management Motive, Weak Governance, Earnings Management, And Fraudulent Financial Reporting: Malaysian Evidence. *Journal Of International Accounting Research, 12*(1), 1–27.

Hillman, A. J., Cannella, A. A., & Paetroid, R. L. (2000). The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change. *Journal of Management Studies, 37*(2), 235-256.

Hillman, A. I., & Dalziel, T. (2003). Boards Of Directors And Firm-Performance: Integrating Agency And Resource Dependence Perspectives. *Academy Of Management Review, 28*(3), 383–396.

Hussin, A. R., Hasnan, S., & Sanusi, Z. M. (2014). Accounting Mistatements And Monitoring Mechanisms. *Asia Pacific Journal Of Accounting And Finance, 3*(1), 95 – 118.

Kilic, M. (2015). The Effect of Board Diversity on the Performance of Banks : Evidence from Turkey. *International Journal of Business and Management, 10*(9), 182–193.

Kim, J. Y., Roden, D. M., & Cox, S. R. (2013). The Composition And Compensation Of The Board Of Directors As Predictors Of Corporate Fraud. *Accounting And Finance Research, 2*(3), 142–154.

Mahadeo, J. D., & Soobaroyen, T. (2012). Board Composition And Financial Performance : Uncovering The Effects Of Diversity In An Emerging Economy. *Journal Of Business Ethics,* (105), 375–388.

Nasr, M. D., & Mohammadi, B. (2015). Evaluation Of The Impact Of Financial Restatements On Corporate Governance And Management Turnover. *Indian Journal Of Fundamental And Applied Life Sciences, 5*(3), 1109–1119.

Pritchard, A. C., Ferris, S. P., & Jagannathan, M. (2003). Too Busy To Mind The Business? Monitoring By Directors With Multiple Board Appointments. *The Journal Of Finance, 58*(3), 1087–1112.

Rahman, R. A., & Ali, F. H. M. (2006). Board, Audit Committee, Culture And Earnings Management: Malaysian Evidence. *Managerial Auditing Journal, 21*(7), 783–804.

Rahman, R. A., & Salim, M. R. (2010). Corporate Governance In Malaysia. In *Sweet and Maxwell Asia*.

Randøy, T., Thomsen, S., & Oxelheim, L. (2006). *A Nordic Perspective On Corporate Board Diversity. Nordic Innovation Centre*.

Saleh, N. M., Iskandar, T. M., & Rahmat, M. M. (2005). Earnings Management And Board Characteristics : Evidence From Malaysia. *Jurnal Pengurusan, 24*, 77–103.

Sarkar, J., & Sarkar, S. (2009). Multiple Board Appointments And Firm Performance In Emerging Economies: Evidence From India. *Pacific Basin Finance Journal, 17*(2), 271–293.

Wang, T., Lin, Y.M., & Chao, C.-F. (2013). Board Independence, Executive Compensation And Restatement. *Applied Financial Economics, 23*(11), 963–975.

Yunos, R. M., Ismail, Z., & Smith, M. (2012). Ethnicity And Accounting Conservatism: Malaysian Evidence. *Asian Review Of Accounting, 20*(1), 34–57.

Zhizhong, H., Juan, Z., Yanzhi, S., & Wenli, X. (2011). Does Corporate Governance Affect Restatement Of Financial Reporting ? Evidence From China. *Nankai Business Review International, 2*(3), 289–302.