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Firm Characteristics and Financial Reporting Quality: The Moderating Role of Malaysian Corporate Governance Index

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Abstract

The principle role of financial reporting is to provide investors with useful information for investment decision makings. In this study, we examine whether corporate governance moderates the relationship between firm characteristics and financial reporting quality. We use earnings management as measure for financial reporting quality. This study uses secondary data obtained from Thompson Database. The sample of this study is firms listed on the Main Market of Bursa Malaysia from 2012 to 2015. The results of our study reveal that there is a positive value of abnormal cash flow which indicates that companies do practice earnings management through manipulation of cash flow from operations. Large firms are practicing earnings management. Factors such as many business segments and business complexity have encouraged large firms to manage their earnings by manipulating their cash flow from operation. In contrast, firms with high leverage and firms audited by Big 4 are less likely to involve with earnings management. Interestingly, when corporate governance index is used as moderating variable, our result shows that only firms audited by Big 4 are related to earnings management. In terms of the contribution of the study, this study is important for the development of Malaysian capital market and it help investors to better understand how the impact of corporate governance mechanisms on financial reporting quality varies across firms.

Keywords: Corporate governance index; Real earnings managements; Firm characteristics.

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1. Introduction

The topic of earnings quality has always been an issue of interest among stakeholders such as shareholders, employees, potential investors, researchers and accounting profession itself (Parte-Estaben and Garcia, 2014). (Dechow *et al.*, 1996) view earnings quality as the ability of earnings to provide more information about the attribute of a firm financial performance that are relevant to a specific decision made by a specific decision maker. However, there have been many efforts to manipulate earnings with the intention to change the true picture of firm's economic performance (Ahmed A. *et al.*, 2014). Earnings manipulation can be described as the decision that made by some corporate managers by employing some accounting methods or by directing operational activities in order to affect earnings with intention to meet firm's specific objectives. Enomoto *et al.* (2014) summarize that earnings manipulation can affect the process of accrual-based accounting or operational activities. Earnings management is a strategy used by the managers to manipulate earnings. It entails the use of selective judgment in the choice of accounting policies and in structuring transactions to alter financial report and account so as to either mislead users or to influence contractual outcome that depends on the accounting figures being reported. It is a process of taking deliberate steps within the constraints of Generally Accepted Accounting Principles to bring about a desired level of reported income.

Previous studies investigate whether earnings management exists in firm financial statement such as Burstangler and Dichev (1997). They attempt to find out the types of the earnings management motive and conclude that factors that relate with compensation of management incentive of contract and incentive of external contract are among criteria that lead managers to manage the earnings. Earnings management is categorized in three ways; a) the use of certain revenue structuring and/or transaction of expense; b) the use of accounting procedures change; and c) the use of accrual management (McNichols and Wilson, 1998; Shipper, 1989). Among these techniques of earnings management, accrual management is the most harmful to the accounting report value, because the investors are unconscious of the amount of accrual. Accrual can be perceived as the difference between the earnings and cash flow from operating activities, indeed, accruals can be classified into discretionary and non-discretionary. Discretionary accruals are adjustment to cash flows selected by the managers whereas non-discretionary accruals are accounting adjustment to the firms cash flows mandated by the accounting standard-setting body. Therefore, many scholars observe that high quality of accounting standards deter or minimize earnings management and information asymmetry among managers, owners and other users of financial reports (Onalo and Lizam, 2014).

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As business activities become more complex and diversified, the detection of earnings management using accrual based accounting become less effective. Thus, to overcome the shortcoming of accrual based accounting, Roychowdhury (2006) explains that real earnings management (REM) can be a complementary to accrual based accounting to detect manager illegal practice. REM is a process of managers who manipulate earnings and cash flow to be reported through manipulating real activities with cash flow consequences. Roychowdhury (2006) classifies REM into three elements namely cash flow from operation (CFO), production cost (PC) and discretionary expenses (DE). The principle of CFO method is to rise the volume of sales for the present period through the use of favorable credit terms and discounts. For discretionary expenses, corporate managers may utilize expense at discretion such as selling, administrative and general expense; advertising expense; research and development expense for the purpose to attend short-term reported earnings.

With the objective to provide more transparency, meaningful and high quality of accounting figures, the Malaysian government introduce its first corporate governance code in 2000 as a guideline for company to enhance their best governance practice. Whether corporate governance mechanisms influence the quality of financial reporting is an important question that need to be addressed. In this paper, we examine whether corporate governance mechanisms moderate the relationship between firm characteristics and financial reporting quality. We measure financial reporting quality as the extent of the firm engages in earnings management. Existing literature indicates that financial reporting quality is influenced by various factors such as firm characteristics (Abdul-Manaf *et al.*, 2014; Cullinan *et al.*, 2012; La and Roychowdhury, 2008). As financial reporting quality differs among firms, we expect that the impact of corporate governance on financial reporting quality would vary with firm characteristics. Our study is relevant as it is in line with the government agenda to stimulate the development of Malaysian capital market. Our results would help firms to understand corporate governance mechanisms that have impact on their financial reporting quality and to focus more on these corporate governance mechanisms. Furthermore, our results would contribute to literature by providing evidence on whether the impact of corporate governance mechanisms on financial reporting quality varies with firm characteristics.

This study is organized as follows. Section 2 reviews prior studies and develop the hypotheses. Section 3 discusses the research method and Section 4 presents findings and discussions. Section 5 provides the conclusion.

2. Literature Revie and Hypotheses Development

2.1. Malaysian Code on Corporate Governance (The Code)

The Malaysian Code on Corporate Governance (The Code), first issued in March 2000, marked a significant milestone in corporate governance reform in Malaysia. The Code was later revised in 2007 to strengthen the roles and responsibilities of the board of directors, audit committee and the internal audit function. Later, the MCCG 2012 was issued that focused on strengthening board structure and composition and contains two components, which are the principles and the best practices. Recently, a new Malaysian Code on Corporate Governance 2017 was released by the Securities Commission Malaysia and takes effect on the 26 April 2017, replacing the 2012 code. The new MCCG introduces substantial changes and recommendations with a view of raising the standards of corporate governance of companies in Malaysia. The MCCG now employs the CARE approach which are Comprehend, Apply and Report by shifting from the 'comply or explain' method in the 2012 code to a 'apply or explain an alternative' method. This is believed to allow greater flexibility in the application of the best practices. The new MCCG also adopts a proportionate application to companies depending on size, complexity and suitability. In addition, the new Code requires board that at least half of the board must comprise of independent directors and, for large companies with market capitalization of RM2 billion and above, there must be a majority of independent directors. The board of large companies is also need to comprise at least 30% women directors (Malaysian Code of Corporate Governance, 2017).

2.2. Board Independence

Board independence refers to a corporate board with majority of outside directors. Based on the Code, it is suggested that at least two (2) members or one-third of board are Independent Non-Executive Directors. It is believed that independence directors are more vigilant in monitoring behaviours and decision making of the company (Fama and Jensen, 1993). The reason is that shareholders` interest could be well protected by outside directors than the inside directors. The fact that independent directors are on board does not guarantee good governance control. It may be possible some independent directors are appointed to just fulfill the minimum regulatory requirements. Some of them may not be truly independent from the firm's executives who hire them or they might have developed strong friendship with the top management over the period they have served on the board.

A number of studies examine the association of board independence with the quality of financial reporting. For example, finds that the percentage of outside directors is negatively related to the likelihood of fraud, whereas Klein (2002) and Xie *et al.* (2003) document a negative relationship between the percentage of outside directors and earnings management. Report a positive relationship between the percentage of outside directors and analyst ratings of financial reporting quality. Furthermore, studies in Malaysia provide mixed results with regard to the monitoring function of non-executive directors. Haniffa and Cooke (2002) report that board independence enhances the monitoring function of the board. They find that the quality of firm disclosure improves as the number of non-executive directors increase. On the other hand, Report that there is no relationship between non-executive directors and earnings management. The result indicates that non-executive directors are not able to mitigate earnings

management. Abdul Rahman and Mohamed Ali (2006) work on similar vein and they obtain similar result. These results suggest that non-executive directors in Malaysian firms are not effective in preventing earnings management activities. Perhaps, non-executive directors in Malaysia are lacking sophisticated skills that enable them to detect earnings management activities.

2.3. Board Meeting

The important role of the board is to have appropriate and sufficient time to its members for the achievement of board effectiveness; the board serves as an avenue where management collectively deliberates on issues that are of significant impact to the company. The effectiveness of the board is seen in the level of activities which is measured by the frequency meeting. The frequency of board meeting is among governance practices and the Code requires companies to disclose the numbers of their board meeting to the public while the Companies Act 2016 requires company to have a minimum of four meeting conducted in a year. The important role of the board is to have appropriate and sufficient time to its members for the achievement of board effectiveness; the board serves as an avenue where management collectively deliberates on issues that are of significant impact to the company. The effectiveness of the board is seen in the level of activities which is measured by the frequency meeting.

Ahmed S. (2013) investigates the association between the board of directors' structures and earnings management in Malaysia. The sample of the study is 71 listed companies in Bursa Malaysia Stock Exchange from 2001 to 2005. Board meeting frequency is among the variables of corporate governance that examined earnings management. The study utilizes multiple linear regression as a technique of data analysis. The result reveals that there is a negative correlation between board meeting frequency and earnings management. In essence, a company with frequent board meeting will restrain myopic behavior of corporate managers to alter earnings.

Zgarni *et al.* (2014) examine the correlation between board structure and earnings management in 29 non-financial firms listed on the Tunis Stock Exchange. Using Roychowdhury's model of earnings management, the study establishes that relationship between board meeting frequency and earnings management is negative. Therefore, the more the frequent board meetings, the less the manipulation of sales and over production. Similarly, Bala and Gugong (2015) examine the board structure and earnings management of listed food and beverage firms in Nigeria. The study utilizes the sample of 71 quoted firms in NSE for the year 2009 to 2014. Multiple regression is employed for the purpose of analysis. The result shows that there is a negative and significant correlation between board meeting frequency and earnings management in Nigerian food and beverage industry. The study concludes that firms can restrain earnings management by frequent board meeting.

Gonzalez and Garcia (2014) investigate the relationship between internal mechanism of corporate governance and earnings management proxy by discretionary accrual. The study uses the sample of 435 firms in the Latin American economy for the period 2006 to 2009. Linear regression was employed as techniques of analysis the finding reveals that there is a negative and significant relationship between board meeting frequency and earnings management. It also indicates that corporate board meeting frequency will reduce earnings manipulation practices by managers.

2.4. Board Leadership Structure

The leadership structure of a company can be either separate or dual. Separate leadership exists when the positions of the Chairman and the CEO are held by two different individuals. Duality exists when the Chairman and the CEO is the same individual. To date, there is still no conclusive evidence to suggest which leadership structure is best to govern firms. Abdul and Mohd (2005) find that firms with separate leadership structure perform better than firms with duality leadership structure. Dechow P. M. *et al.* (1995) find that financial reporting quality is higher in firms that separate leadership structure. Similarly, Klein (2002) report that earnings manipulation is less likely to happen when the roles of the Chairman and the CEO are separated.

Previous studies find that firms with CEO duality do not perform as well as their competitor and incline to do earnings management (Abdul and Mohd, 2005). In the same vein find that duality is positively related to earnings management. Claims that CEO duality reduces the check and balances on top management which leads to fraudulent behaviors of managers and increase intensity to manage earnings. A study in Indonesia by Murhadi (2009) reveals a positive association between earnings management and CEO duality. Similarly using 81 Malaysian firms listed in Bursa Malaysia, Hamad (2010) discovers a positive relationship between CEO duality and earnings management. Similarly, study by Ishak *et al.* (2016) find a positive relationship between duality and REM which indicates that duality will increase possibility of REM as the position of CEO and Chairman is held by a single person, it gives more room to the CEO and Chairman to involve with firm operation. In order to increase their salary or remuneration, they may use their position as CEO cum Chairman to manipulate the earnings figure.

A study in Kuwait by evidences that CEO duality has a negative relationship with reporting quality. He argues that concentration of power in one hand can exacerbate potential conflicts of interest and reduce the monitoring effectiveness. However, a study by Mahad *et al.* (2015) using 334 samples for three consecutive years of 2010 to 2012 of Malaysian PLCs fails to accept that duality increase earnings manipulation. Their result shows that using both earnings management model, modified Jones and Kothari, the coefficient of duality exhibit insignificant relationship with discretionary accruals. They explain that duality or non-duality role has no effect on earnings manipulation.

2.5. Audit Committee Independence

States that audit committee performance is of high quality when the members are independent. This will lead to the effectiveness in protecting the credibility of financial reporting. It shows that an independent audit committee is more effective in controlling earnings management (Bedard *et al.*, 2004). According to Persons (2005), fraud is less likely to happen when audit committee is independent. Klein (2002) discovers that there is a negative relationship between independent audit committee with earnings management practices. Furthermore, studies find that there is a negative association between audit committee independence and financial reporting fraud and misstatement (Abbott, 2002). However, a contradicting result has been reported by Bronson *et al.* (2006). They indicate that audit committee independence has no significant relationship with higher levels of audit committee effectiveness.

2.6. Expertise of Audit Committee Members

Malaysian Code of Corporate Governance (2012) requires at least one member of the audit committee to have professional affiliations in accounting or financial expertise. Persons (2005) finds that audit committee expertise is not associated with the fraud occurrence. According to Defond *et al.* (2005), companies would improve their corporate governance if the audit committee members have financial expertise in discharging their duties. McMullen and Raghunanthan (1996) state in their study that financial problems are unlikely to happen to companies that have audit committee members with financial expertise. According to Bedard *et al.* (2004) earnings management is negatively associated with audit committee member's expertise. Similarly, Xie *et al.* (2003) and Felo *et al.* (2003) also find that there are smaller discretionary accruals when audit committee members have financial expertise. Persons (2005) mentions that independent members of an audit committee with financial or accounting expertise are more likely to detect any financial misstatements or improper business transactions because they have to comply with professional codes of ethics in order to maintain their reputation. However, Hussain (2012) highlights that accounting expert's role is not significantly related in mitigating earnings management practice. The next subsection discusses the impact of corporate governance mechanisms on financial reporting quality based on different characteristics of the firms.

2.7. Firm Characteristics, Corporate Governance Compliance and Financial Reporting Quality

Many studies have examined the relationship between firms' characteristics and financial reporting quality and the results of these studies are mixed. For example, Owusu-Ansah (1998) finds a positive and significant association between profitability and financial reporting quality, whereas it is a contrary position for Meek *et al.* (1995). These studies indicate that agency problem varies with firm characteristics, and therefore, the quality of financial reporting varies with firm characteristics.

2.7.1. Firm Size

It has been argued that large firms are more likely to experience higher agency problem. It would be more difficult to manage the operations of large firm especially when it diversifies their line of businesses. Farrel and Herch (2005) assume that the larger the firm, the more visible it to the public which leads high disclosure and compliance to the standard. Similarly, Galani *et al.* (2011) suggest that large Greek companies tend to disclose more information than small companies. Study by Ishak *et al.* (2016) find that firm size exhibits positive relationship with real earnings manipulation. This result indicates that earnings manipulation does exist in large firm. This is may be due to a large volume of transactions together with some complexities handle by large firms, give a room for managers to manipulate the transaction for their own benefits. From the above arguments, we hypothesize that:

H1 The impact of corporate governance mechanisms on financial reporting quality varies with firm size.

2.7.2. Firm Leverage

Highly geared firms that rely more on debt to finance new investments are categorized as riskier and they are more concerned with debt covenant. A high debt rate would frighten shareholders from bankruptcy risk. Studies find that highly geared firms are more likely to engage in earnings management to meet debt covenant. Due to high an increase in bankruptcy risk, the debt situation will warn leader of feeling threatened by the likelihood of losing remuneration and other benefits which in turn will lead leader to adopt more effective management strategies including compliance with good governance practice.

Shows leverage is positively associated to earnings management. Similarly, the findings in the study conducted by Wallace *et al.* (1994) concur to the earlier findings of other which found positive relationship between leverage and earnings management. Renneboog (2010) finds that higher leverage increases board restructuring which suggests that creditors would intervene as the risk of financial distress increases. Due to creditors' intervention in high leveraged firms, firms tend to produce a high quality of earnings. In addition, highly geared firms are more likely to disclose more information to meet the requirements of the lenders. It is expected that corporate governance would benefit highly geared firms more as compared to low leverage firms. Therefore, we hypothesize that:

H2 The impact of corporate governance mechanisms on financial reporting quality varies with firm leverage.

2.7.3. Auditor Type

Previous studies find that auditor type which refers to Big 4[1] and non-Big 4 do have significant influence on the quality of financial statement. Due to their credibility, financial figures disclosed by firms that are audited by Big 4 are viewed as having a high quality. This statement is supported by Ishak and Md. Yusof (2013) as they find that firms audited by Big 4 are less likely involved with financial restatement. In other words, the quality of earnings for firms that audited by Big 4 are more reliable and value relevant. Therefore, it is expected that corporate governance mechanism would be more beneficial to firms audited by non-Big 4. A recent evidence by Abdul-Manaf *et al.* (2016) reveals that based on 4,127 firm-year observations over the period 2003-2012, earnings of firms audited by Big 4 audit firms are more value relevant that earnings of firms audited by non-Big 4 audit firms. Mahad *et al.* (2015) investigate the association between Big 4, auditors switch and earnings management by utilizing 334 quoted firms in Bursa Malaysia for the period of 2010 to 2012. Their result shows that likelihood of earnings managements is lower for firms that are audited by Big 4. In contrast, Ishak *et al.* (2016) reveal that the existence of Big 4 as an audit companies do not limit the practice of REM. However, the relationship between Big 4 and REM is very marginal as the coefficient of auditor type is positive and significant at 10 percent level. Thus, we hypothesize that:H3The impact of corporate governance mechanisms on financial reporting quality varies with auditor type.

3. Research Methodology

This study uses secondary data obtained from Bursa Malaysia. For the purpose of this study, data is collected from the annual report of Malaysian Main Market. All the required information on board independence, board size, leadership structure, audit committee characteristics including independence, expertise frequency of meeting and tenure are collected from corporate governance and directors' profile. Data on financial items is gathered from Thompson Datastream. The sample of this study is all firms listed on the Main Market of Bursa Malaysia from 2012 to 2015. We focus on the relationship between earnings management level, corporate governance score and firm characteristics. Also, we will include interaction terms between corporate governance and firm characteristics.

We measure corporate governance mechanisms as corporate governance score, whereby, a score of one is given for each corporate governance standard that is met by the firms. Table 1 explain the main element focus by Malaysian Code of Corporate Governance (2012) and our focus is on corporate governance mechanisms for board composition (item1-4), leadership structure (item 5-7) and audit committee (item 8-10). The score uses unweighted index which is calculated as the ratio of compliance with MCCG 2012 requirement and the index should be less than one (1) and more than 0.

Table-1. Corporate Governance Compliance Index

No.	Corporate Governance Requirement
1.	At least 2 members or one-third of board are Independent Non-Executive Directors.
2.	Board diversity – experience, skills, competence, race, gender, culture and nationality
3.	Directors possess range of skills, competence, knowledge and experience.
4.	Disclose number of board meetings held in a year with a minimum of four meeting in a year.
5.	The positions of Chairman and CEO should be held by different individuals
6.	The chairman must be a non-executive member of the board.
7.	The board must comprise a majority of independent directors where the Chairman of the board is not an independent director.
8.	At least 3 members of audit committee are Non- Executive Directors
9.	Majority of audit committee are independent
10.	Financially literate and at least 1 of audit committee should be a member of an accounting association/body.

To examine the moderating effect of corporate governance mechanisms on the relationship between financial reporting quality and firm characteristics, this study regresses earnings management level on corporate governance score and firm characteristics. Also, we include interaction terms between corporate governance score and firm characteristics and our regression model is as follows:

$$EM_{it} = \alpha + \beta_1 CGINDEX_{it} + \beta_2 FSIZE_{it} + \beta_3 LEVERAGE_{it} + \beta_4 AUDITOR_{it} + \beta_5 FSIZE*CGINDEX_{it} + \beta_6 LEVERAGE*CGINDEX_{it} + \beta_7 AUDITOR*CGINDEX_{it} + \varepsilon_{it}$$

[1] Big 4 is referred to auditor companies that audited firms financial statement, namely Ernst & Young (EY), PricewaterhouseCoopers (PwC), KPMG and Deloitte

Table-2. The variables and their operation measures

Variables	Operational measures
Earnings Management (EM) Corporate governance index (CG INDEX)	Real Earnings Management Unweighted dichotomous model
Firm size (FSIZE)	Natural log of total assets
Firm leverage (LEVERAGE)	Total debt divides by total assets
Auditor type (AUDITOR)	1- The Big 4 audit firms, 0- otherwise

We measure financial reporting quality as the level of earnings management. Low level of earnings management indicates high quality financial reporting. This study employs real earning manipulation as a proxy for earnings management following suggestion made by Roychowdhury (2006) that classifies REM into three elements namely cash flow from operation (CFO), production cost (PC) and discretionary expenses (DE). As sample of this study includes service industry, REM is determined based on combination of abnormal CFO and DE. Due the unavailability of data on research and development cost, this study only applies cash flow operation model as a proxy for earnings management. The abnormal CFO is calculated as a different between actual figures minus the estimated cash flow from operation. Actual CFO from operation is figure provided in Statement of Cash Flows while the estimated CFO is calculated based on formula provided.

Estimated CFO = $CFO_t/A_{t-1} = \alpha_0 + \alpha_1(1/A_{t-1}) + \beta_1 (S_t/ A_{t-1}) + \beta_2 (\Delta S/ A_{t-1}) + \varepsilon_t$ (Eq.1)

Where:

CFO = Cash flow from operation

A_{t-1} = total assets for the previous year

S_t = sales for a current year

ΔS = changes in sales which calculated as sales in current year minus sales in a previous year

Therefore, abnormal cash flow is:

ABNCFO = Actual CFO from operation – Estimated CFO

4. Findings and Discussions

Part 1 of Table 3 explains the descriptive results for corporate governance requirement. Ninety five percent of companies follow the Code requirement as they practice one third of their members consist of independent non-executive directors. However, only 30% of their directors possess range of skills, competence, knowledge or expert in their area. Six hundred and five companies have women as their board members and 74% of companies conducted their board meeting for more than 4 times a year. For leadership structure, 757 companies practice CEO/ Chairman duality and the Chairman are acting as non-executive directors but less likely being independent directors. For audit committee, majority members are independent with at least three members are non-executive directors. Ninety six percent of the audit committees have at least one member that has membership in the accounting association body.

Based on Part 1 descriptive of corporate governance requirement, the overall corporate governance compliance score is 66% as displays in Part 2 of Table 3. There is a positive abnormal cash flow from operation with a minimum of RM8,720 with a maximum number of RM71,224,800 and the average of RM2,451,696. The positive value of abnormal cash flow indicates that the sample companies do practice earnings management through manipulation of their cash flow from operations. Mean of firm size is 13.309 with a leverage of 0.40. Sixty four percent of sample firms are classified as R&D and capital-intensive companies which enjoy a healthy ROA performance. Less than half of the companies are audited by Big 4 audit firms.

Table-3. Descriptive Statistics

	Min	Max	Mean	SD
Part 1: Corporate Governance Requirement				
1. One-third of board are INED				
2. Board diversity gender	0 (64)	1(1117)	0.95	0.226
3. Directors possess range of skills,	0 (576)	1(605)	0.61	0.500
competence, knowledge	0 (641)	1(540)	0.31	0.138
4. A minimum of four meeting in a year.	0 (310)	1(871)	0.74	0.440
5. Chairman and CEO should be held by different individual	0 (424)	1(757)	0.64	0.480
6. Chairman must be a non-executive	0 (437)	1 (739)	0.63	0.483
7. Chairman of the board is not an independent director	0 (891)	1 (285)	0.24	0.429
8. Majority AC members are independent				
9. Three members of AC are NED	0 (398)	1(783)	0.66	0.473
10. At least 1 AC member should be a member of an accounting association/body	0 (263) 0 (51)	1(918) 1(918)	0.78 0.96	0.416 0.230
Part 2: Descriptive for independent variables				
Abnormal CFO (EM)	8720	71224800	2451696	6942569
Corporate governance index	0.200	1.000	0.657	0.164
Ln Firm Size (FSIZE)	9.070	18.080	13.309	1.548
Firm Leverage (LEVERAGE)	0.000	1.000	0.400	0.187
Auditor type (AUDITOR)	0.000	1.000	0.480	0.500
CGINDEX*FSIZE	2.890	15.820	8.371	2.120
CGINDEX*LEVERAGE	0.000	0.700	0.253	0.131
CGINDEX*AUDITOR	0	0.900	0.303	0.329

( ) parentheses- actual number of cases of corporate governance requirement

The correlation analysis as displayed in Table 4 reveals that REM do have positive association with corporate governance index and significant at 10% level. This result implies that even though firms comply with the recommendations made by the Code, they still marginally involve with earnings management. REM is also having a positive correlation with firm size, leverage and Big 4 which are significant at 5% level. These results indicate that firms that are large, have high leverage and audited by Big 4 are practicing earnings management.

Table-4. Correlation Analysis

	1	2	3	4	5
1. REM	1				
2.CGINDEX	0.063*				
3.FSIZE	0.645**	0.141**	1		
4.LEVERAGE	0.161**	0.054	0.300**	1	
5.AUDITOR	0.203**	0.064*	0.419*	0.0043	1

*significant at 10%, ** significant at 5% (two-tailed)

The result of regression on the effect of corporate governance index, firm characteristics and earnings management is presented in Table 5. It is explained that large firms do involve with earnings management as it coefficient is positive and significant at 1% level. Due to many business segments and complexity of managing its operation, large firms tend to manage their earnings by manipulating its cash flow from operation. This activity is done by rising the volume of sales for the present period through the use of favorable credit terms and discounts. Result of this study also finds that firms that are audited by Big 4 are less likely to involve with earnings management. This finding is similar with Ishak and Md. Yusof (2013) and (Abdul-Manaf *et al.* (2016)) as they find that firms audited by Big 4 are less likely involved with financial restatement and earnings of Big 4 audited firms are more value relevant that earnings of firms audited by non-Big 4 audit firms. Firm leverage does not have a significant influence on earnings management activity. Similarly, the coefficient of corporate governance index also does not exhibit a significant relationship with earnings management. This indicates that the compliance of the Code requirement does not influence earnings management practices.

Table 5 also explains the effect of moderating role of corporate governance index on the relationship between REM and firm characteristics. Results reveal that the introduction of corporate governance index as moderating variable do improve the coefficient of firm size as the coefficient change from positive to negative sign. However, the coefficient is not significant. This result explains that the compliance of corporate governance index limit large firms in practicing earnings manipulation activity. Interestingly, the compliance of corporate governance index changes the direction of Big 4 coefficient from negative to positive significant relationship. It indicates that by using

the loophole is corporate governance mechanisms leave a room for firms audited by Big 4 to practice earnings management.

Table-5. The Moderating Role of CG Index on REM and Firm Characteristics

Variables	Coefficient	t-Statistic	p-value
GINDEX	0.002	0.026	0.979
FSIZE	0.132	3.944	0.000***
LEVERAGE	-0.043	-1.834	0.067*
AUDITOR	-0.086	-3.522	0.000***
CGINDEXFSIZE	-0.152	-0.614	0.539
CGINDEXLEV	0.069	0.018	0.888
CGINDEXAUDITOR	0.477	3.663	0.000***
Constant		-5.679	0.000***
R^2	0.431		
Adj. R^2	0.427		

5. Conclusion

Our study is in line with the government agenda to stimulate the development of Malaysian capital market, whereby this study contributes to the understanding of firms on corporate governance mechanisms and the impact on financial reporting quality. Furthermore, our findings contribute to literatures by providing evidence on the impact of corporate governance mechanisms on financial reporting quality varies with firm characteristics.

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