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THE EFFECTS OF MANAGERIAL OVERCONFIDENCE, FINANCIAL DISTRESS, AND CORPORATE GOVERNANCE PRACTICES ON MATERIAL ACCOUNTING MISSTATEMENTS: EVIDENCE FROM MALAYSIA

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ABSTRACT

As evinced by prior accounting scandals, misrepresentations in financial statements have caused their users to suffer irrecoverable losses. In an effort to mitigate this issue, this study investigated the factors that contribute to the occurrence of material accounting misstatements. Specifically, this study examined the motivations and opportunities associated with the occurrence of material accounting misstatements in Malaysian public listed companies (PLCs). The motivation factors are represented by managerial overconfidence and financial distress, while opportunities are represented by internal and external corporate governance practices. The internal corporate governance practices are proxied by board independence, multiple directorships, audit committee independence, audit committee expertise and CEO duality; while the external corporate governance practices are proxied by non-audit services, big 4 audit firms and size of borrowings. To examine their relationship, 206 firms listed in Bursa Malaysia's main market over the period of 2010 to 2018 are selected. This study also identified the characteristics of misstatement and non-misstatement firms using univariate analyses. Binary logistic regression model is used to analyse the relationship between these factors and the occurrence of material accounting misstatements. The result is then validated via the reduced model approach and analysis of the top 5 industrial sectors involved in material accounting misstatements. From the analysis conducted, the study finds financial distress leads to material accounting misstatements. The presence of CEO duality is found to be significantly associated with the occurrence of material accounting misstatements. Interestingly, a higher proportion of board independent members increased the likelihood of material accounting misstatements. There is also a strong and significantly positive relationship between size of borrowings and the occurrence of material accounting misstatements. Although found to be insignificant, it is noteworthy that, to the best of the researcher's knowledge, this study is the first in Malaysia that examined the relationship between managerial overconfidence and material accounting misstatements. Overall, this study contributes to the literature on corporate governance and accounting misstatements by including internal and external corporate governance practices. Finally, it is hoped that this study helps the regulators to improve the rules and regulations so firms can implement effective corporate governance practices to ensure financial reporting quality.

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CHAPTER ONE
INTRODUCTION

1.1 Chapter Description

The first chapter describes the background and problem statement for this study. This chapter also includes the research questions, research objectives, the scope and significance of study.

1.2 Background of The Study

The general purpose of financial statements, according to the Malaysian Accounting Standards Board (MASB), is to provide information about a firm's financial position, performance, and cash flow to its users, who do not have the right to demand statements tailored to their specific needs in making economic decisions (MASB, 1999). Financial statement is the most important research tool available especially to the external users as they have limited access to the information of a firm. Due to its importance, firms and regulators must ensure that the report contains information that is relevant, accurate, sufficient and timely.

Nowadays, even with the establishment of accounting frameworks, regulations and standards, doubts are still being raised on the credibility of financial reporting as accounting scandals by Enron, Lehman Brothers, Satyam, Toshiba, Tesco and Patisserie Valerie, have misstated their financial reports either by overstating earnings or omitting debt from million to billion dollars emerged. These misstatements-related scandals have caused people to lose their jobs and losses to investors, and in the context of financial reporting, have led users to make economic decisions based on misstated information.

The General Accounting Office (GAO) in the United States (US) has recorded 2,705 restatements in the year of 1997 to 2006 (GAO, 2002, 2006) and 6,436 restatements for the reporting years of 2005 to 2011 (GAO, 2013). Throughout the period of 1997 to 2011, the number of material accounting misstatements have fluctuated inconsistently. Nonetheless, it is a matter of grave concern because in addition to significant economic consequences, it raises public scrutiny to the accounting profession, particularly to the auditors’ role in ensuring the quality of