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Profitability, Market Incentive and Audit Quality of Financial Misstatements: Evidence from Malaysian Public Listed Companies (PLCs)

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Abstract: The purpose of this study is to examine whether there is mean difference in profitability (Profit), market incentive (EPrice) and audit quality (AudQ) variables between restatement and non-restatement firms in Malaysia. The sample comprises of 285 public listed companies on the Main Board of Bursa Malaysia for the years between 2005 and 2013. A descriptive statistics analysis is performed to differentiate the characteristics of restatement and non- restatement firms. The study finds significant difference between restatement and non-restatement firms in the profitability and market incentive variables. The results show that restatement firms reported higher profit than non- restatement firms in the year prior to the restatement year. And, restatement firms have higher earnings-to-price ratio (proxy for market incentive) relative to the non-restatement firms that are matched by total assets, but lower than non-restatement firms which not matched by total assets. This indicates that restatement firms are able to maintain high growth expectations embedded in the firm's share price. The study finds no significant difference in audit quality between misstatement and non-misstatement firms. The comparable audit fees between restatement and non-restatement firms indicate that the external auditors of restatement firms failed to appropriately assess the audit risk of these firms.

Keywords: Profitability; Market Incentives; Audit Quality; Financial Misstatements; Financial Restatements

I. INTRODUCTION

The International Federation of Accountants (IFAC) provides a formal definition for "misstatement", which refer as "*A difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework"* (IFAC, December 2009: 370). Ettredge, Scholz, Smith, & Sun (2010) and Dechow, Ge, Larson, & Sloan (2011) viewed misstatement as the manipulation or falsification of financial statements disclosure, which have been conducted beyond the established accounting framework.

The terms "misstatement" and "restatement" are used interchangeably in the research of accounting issues (i.e. Palmrose, Richardson, & Scholz, 2004; Abdullah, Yusof, & Nor, 2010; Rotenstein, 2011). This is because, subsequent to the detection of financial misstatements, firms need to prepare financial restatements in order to revise the misstated financial statements. This is consistent with the statement by Richardson, Tuna & Wu (2003), who emphasize that *"…it is reasonable to assume that earnings restatement firms can be characterized as firms who knowingly and intentionally engage in earnings manipulation"*. Generally, scholars view financial restatement as the process of altering the misstatements, both error and irregularity, in the previously issued financial statement (Palmrose et al., 2004; Abdullah et al., 2010).

The issue of financial misstatement has been debated for decades, but still remains as a global concern to date. In the United States (U.S.), the cumulative totals of financial restatement in year 2011 increased to 6,436 cases compared to 1,390 cases in the year 2005. Further, the 6,436 restatement cases were reported by only 4,536 firms (GAO, 2013), which indicates that there are firms who restate their financial statement more than once. Thus, financial misstatement is seen as imminent threat in the financial reporting process. And, this issue has raised questions about the credibility of accounting practices and the quality of corporate financial disclosure and oversight, in protecting the reliability of financial statements from misstatements (Abdullah et al., 2010).

In Malaysia, although the scale is small compared to other global cases, the corporate landscape is scattered with several bad accounting scandals (i.e. Transmile Group Berhad, Megan Media Holdings Berhad, MEMS Technology Bhd.). According to Rotenstein (2011), although fraudulent activity could lead to the need for restatement, financial restatements do not necessarily involve fraud and thus represent a broader scope of firms. However, non-fraud misstatement is often an indicator for a more severe type of financial misstatements, called as fraudulent financial reporting. This is further supported by Hasnan, Rahman, & Mahenthiran (2013), who found that prior violations that are not necessarily involved fraud, is indeed, a strong predictor of fraudulent financial reporting in Malaysia. Thus, it is important to investigate the root cause for such failure to occur.

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This motivates current study to look on the issue of financial misstatements, proxy by the occurrence of financial restatement, in Malaysia.

Although there are cases of understatement of financial statement, such as tax-related restatements, prior studies reveal that most financial restatement involved overstatement, which intended to maintain investors' expectation and analysts' prediction, and to maintain or increase firm's share price (Abdul Hamid, Shafie, Othman, Wan Hussin, & Fadzil, 2013). In order to meet such objectives, firms overstate income by overstating revenues, assets and profits, or, understating expenses, liabilities and losses (Dechow et al., 2011; Dalnial, Kamaluddin, Sanusi, & Khairuddin, 2014). And, poor monitoring from the external force provide greater opportunity for financial misstatement to take place (Abdullah et al., 2010; Hasnan et al., 2013; Shanmugam et al. 2019a, 2019b). Thus, this study attempts to examine whether there is a significant difference in mean for profitability, market incentive and audit quality variables between restatement and non-restatement firms.

The organization of the paper is as follows. Section 2 describes hypotheses development, followed by Section 3 which discusses the research methodology in the study. The subsequent section discusses the results of the study, and the paper is concluded in Section 5.

II. HYPOTHESES DEVELOPMENT

A. Firm Profitability and Financial Statement Restatements

Kinney & McDaniel (1989) found that less profitable firms with slower growth are more likely to misstate their financial statements. Such argument is further supported by Desai, Hogan, & Wilkins (2006), who found poor financial performance as the main cause for corporate offences in the U.S. The rationale behind this argument is that, higher pressure has forced the poorly perform firms to misstate financial statement in order to improve the appearance of the firm's financial condition (Spathis, 2002). However, Richardson et al. (2003) and Dechow et al. (2011) posit that misstatements are commonly engaged by large and high growth firms which motivated to conceal their actual downturn. As profitability normally referred to make economic decision, firms tend to manipulate their financial statement so as to achieve particular earnings targets, which lead to higher financial misstatements.

Although there is conflicting argument on the profitability level of restatement firms, generally, scholars agree that firm profitability is an indicator of erroneous financial statements. Highly focus on firm profitability can create pressure that lead firms to manipulate financial statements in order to achieve the targeted profits or to conceal the downturn financial performance. Thus, the study hypothesized that:

H_1: There is significant difference in mean value of profit between restatement and non-restatement firms.

B. Market Incentive and Financial Statement Restatements

Besides the profitability, focusing on maintaining or increasing firm's share price is also found to be an indicator of financial misstatements. Trueman & Titman (1988), Chi & Gupta (2009) and Weske (2013) provide evidence that higher share price is associated with financial misstatements and fraudulent financial reporting.

Further, Chi & Gupta (2009) found that abnormally higher share price is induced by income increasing earnings management. This indicates that financial statement is inflated for the purpose of increasing firm's share price.

And, Dechow et al. (2011) added that misstating firms are in the need for financing in the year prior to misstatement and tend to make equity issuance in the manipulation year. This strengthens the view that firms misstate financial statements for the purpose of obtaining external financing at the favorable price. Thus, firms are under greatest pressure to misstate financial statements. It is hypothesized that:

H_2: There is significant difference in mean value of market incentive, proxy by earnings-to-price ratio, between restatement and non-restatement firms.

C. Audit Quality and Financial Statement Restatements

The agency theory recognizes auditing as one of the main governance to regulate conflict of interest and as a means of reducing agency costs (Adeyemi & Fagbemi, 2010). Only high audit quality can discover misstatements in financial reporting.

Che Haat, Rahman, & Mahenthiran (2008) and Hasnan et al. (2013) stated that, amongst others, the use of audit fees provide more robust result compared to the use of a dummy variable to measure audit quality. It is argued that audit fees reflect the magnitude of audit effort, and higher audit fees are expected to indicate more audit work, which contributes to higher audit quality. Keune & Johnstone (2012) put forward that auditors are less likely to let managers waive qualitative and quantitative material misstatements as audit fees increase.

However, merely expecting lower audit fees for restatement firms is inappropriate since these firms may also incur higher audit fees as a result of greater audit efforts and audit works due to high audit risks. Hence, current study hypothesized that:

H_3: There is significant difference in mean value of audit quality, measured using ratio of audit fees to total assets, between restatement and non-restatement firms.

III. RESEARCH METHODOLOGY

The sample comprises of the public listed companies on the Main Board of Bursa Malaysia for the years between 2005 and 2013. The objective of sample formation is to

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construct a comprehensive database of financial misstatements in Malaysia. In this study, financial restatement is used as a proxy for the financial misstatement.

Following prior research that studied financial restatement (i.e. Abdullah et al., 2010), the sample in this study was selected based on the GAO financial restatement category description. A total of 97 restatement firms that meet the selection criteria included in the study. The selection criteria is based on the step introduced by Abdullah et al. (2010), in which the keywords of "restate", "restated", "restatements" and "prior adjustment" are searched in each of the annual reports to find the incidents of financial restatements. The final sample for this study is 285 companies that consist of 97 restatement firms 97 non-restatement firms which matched by total assets and 91 non-restatement firms which not matched by total assets. **Figure 1** depicts the procedures taken in the sample formation and data collection.

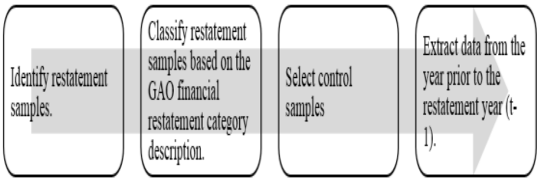

Figure 1: Flow Chart of Sample Formation and Data Collection

According to Abdullah et al. (2010), "Companies from a certain industry may be more prone to restate their accounts.", and in their study, they found that almost half of the Malaysian PLCs restatements were classified under trading and services. Hence, industry effects are controlled for, by matching the control firms with the experimental firms based on the type of industry. Table 1 provides the classification of sample firms. The categorization of firms is based on Bursa Malaysia industrial sector classification which includes industrial product, consumer product, plantation, property, construction, trading and services, hotel and technology. Consistent with Abdullah et al. (2010), trading and services is found to be the highest contributor for financial restatements, followed by industrial products and consumer products.

Table 1: The Breakdown Classification

Table 1: The Breakdown Classification	of 285 Sample Firms	According to Bursa	Malaysia's	Industrial Sector
Sector	Restatement	Non-Restatement	Total	Percentage
Industrial Products	20	40	60	21.05
Consumer Products	18	32	50	17.54
Plantation	5	10	15	5.26
Property	12	24	36	12.63
Construction	10	21	31	10.88
Trading & Services	30	57	87	30.53
Hotel	1	2	3	1.05
Technology	1	2	3	1.05
Total	97	188	285	100

A. Variable Measurement

With regard to the profitability variable, consistent with Kinney & McDaniel (1989), the study uses the firm's net income for the year prior to the restatement year.

Following Dechow et al. (2011), current study measure market incentive variable using earnings-to-price ratio which represent managers optimistic expectations that embedded in their stock price. The equation for earnings-to-price ratio is as follows:

$$\text{Earnings-to-Price} = \frac{\text{Earnings}}{(\text{OSC x MP})}$$

Where:

OSC : Ordinary Share Capital Outstanding

MP : Market Price per Share

Since current study predict that stock price of restatement firms are higher as compared to the non- restatement firms, lower earnings-to-price ratio is expected for restatement firms than non-restatement firms.

With respect of the audit quality variable, , consistent with Che Haat et al. (2008) and Hasnan et al. (2013), the study measure audit quality by the ratio of audit fees to total assets. Che Haat et al. (2008) and Hasnan et al. (2013) state that the use of audit fees provides more robust result compared to the use of dummy variable for audit firm size and Big4 vs non-Big4 firms. It is argued that audit fees reflect the magnitude of audit effort, and higher audit fees are expected to indicate more audit work, which contributes to higher audit quality.

IV. Empirical Evidence and Discussions

Table 2 illustrates the descriptive statistics analysis of restatement and non-restatement firms (both matched and not matched by total assets) for profitability, market incentive and audit quality variables in the year prior to the restatement year. Since the variables are all continuous data, the study provides t-test of differences between restatement and non-restatement firms.

As reported in Table 2, it appears that on average, the profit of restatement firms is significantly higher than non-restatement firms, both matched and not matched by total assets, thus, supporting hypothesis H1. The significant level of t-test is much higher between restatement and non-restatement that are matched by total assets,Profitability, Market Incentive and Audit Quality of Financial Misstatements which is significant at five per cent level of significance compared to 10 per cent level of significance between restatement and non-restatement firms not matched by total assets. The results is consistent with Richardson et al. (2003) and Dechow et al. (2011), who posit that restatement firms have higher profit than non-restatement firms, probably due to the aggressive earnings management, which aim to report higher than expectations.

Table 2 also depicts significant difference in terms of market incentive, measured using earnings-to-price ratio, between restatement and non-restatement firms matched by total assets as well as between restatement and non-restatement not matched by total assets. Thus, hypothesis **H2** is supported.

Interestingly, the mean variance is not consistent between non-restatement firms matched by total assets and non-restatement firms not matched by total assets. Restatement firms reported significantly higher and positive earnings-to-price as compared to the non-restatement firms matched by total assets (at 10 per cent level of significance), but, statistically significant lower earnings-to-price than non-restatement firms not matched by total assets (at 10 per cent level of significance).

As earnings-to-price is calculated by dividing earnings to the market price of ordinary share outstanding, the positive and higher earnings-to-price reported by restatement firms indicate that earnings of restatement firms is higher relative to the market price, particularly within the similar size firms. This is further supported by the mean difference for profit variable between restatement and non-restatement firms matched by total assets, which is significant at five per cent level. However, significantly lower earnings-to-price ratio reported by restatement firms seems not to support such argument. The contradict findings is however, consistent with Dechow et al. (2011), which found that restatement firms have extremely lower earnings-to-price ratio as compared to the non-restatement firms. And, the inconsistent results between non-restatement firms matched by total assets and non-restatement firms not matched by total assets could be due the circumstances that earnings of restatement firms are inflated by aggressive earnings management in the year prior to the restatement year and embedded in the firm's share price (Dechow et al., 2011). Thus, results higher (lower) earnings-to-price ratio as compared to non-restatement firms within the similar (different) size.

With regards to the audit quality variable, measured by ratio of audit fees to total assets, no statistical difference is found between restatement and non-restatement firms, both matched and not matched by total assets. This suggests that the audit fee for restatement firms is almost equivalent to that incurred by the non-restatement firms. Thus, there is no support for hypothesis **H3**. As depicted in **Table 2**, the mean value of audit fees of restatement firms is comparable to the non-restatement firms, suggesting that the external auditor of restatement firms failed to properly assess the audit risk associated with these firms, which could be one of the reasons for the financial restatement to occur.

Table 2: Descriptive Statistics Comparing Mean Value of Restatement and Non-Restatement Firms

	Restatement	Non-Restatement matched by Total Assets		Non-Restatement not matched by Total Assets	
	Mean	Mean	T-test	Mean	T-test
Profit	2.285b	38.508m	1.000**	47.430m	0.997*
EPrice	0.0021	-0.0026	0.023*	0.0581	-0.273*
AudQ	0.000482	0.000482	0.000	0.000436	0.730

* and ** denote significance at 10 percent and 5 percent levels respectively.

V. CONCLUSIONS

The study identify the significant difference between restatement and non-restatement firms of Malaysian PLCs between 2005 and 2013 on profitability, market incentive and audit quality. With regards to the objective of the study, independent t-test analysis found that there is statistical significant difference in mean for profitability variable between restatement and non-restatement firms, both matched and not matched by total assets.

In addition, the study also find significant difference in mean for market incentive variable, measured by earnings-to-price ratio, between restatement and non-restatement firms matched by total assets as well as non- restatement firms not matched by total assets. However, there is no statistically significant difference in mean for audit quality variable, measured by ratio of audit fees to total assets, between restatement and both non-restatement firms matched by total assets and not matched by total assets. Thus, hypotheses **H1** and **H2** are accepted and hypothesis **H3** is rejected.

Overall, the findings of the study help to establish a starting point to empirically explore the issue of financial misstatements in Malaysia. This study provides a useful insight that may be beneficial to the users of financial statements, particularly investors, to assess financial misstatements through available information. In addition, the findings may be used to explain the possible manipulation activities of financial statement (i.e. market incentive). The findings also offer opportunities for future studies to explore other potential factors that can add value to the financial restatements research. Indeed, the findings could be useful for the external auditor to objectively perform audit procedures and appropriately assess audit risk of each firm in order to mitigate the occurrence of financial misstatements.

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