

Relationship between Earning Multiples, Corporate Governance and Earnings Management Practices: An Empirical View with a Mediation Analysis

Syeda Faiza Urooj Assistant Professor, Department of Commerce, Federal Urdu University of Arts Science & Technology, Islamabad, Pakistan.
Email: urooj53@yahoo.com

Muhammad Anees Khan Assistant Professor, Department of Management Studies, Bahria University Islamabad Campus, Pakistan.

Muzammal Ilyas Sindhu Lecturer, Department of commerce, Federal Urdu University of Science and Technology, Islamabad, Pakistan

Abstract

This paper investigated the effect of corporate governance in improving the earnings multiple and reducing the discretionary accruals. This study developed four econometrics models. Random effect model employed for examining the first three econometric models, while for the fourth econometric model study used Andrew F. Hayes mediation process. Results suggest that BOD size, BOD meetings and audit committee size has a significant positive impact on earnings multiples, while earnings multiples have a negative impact on dictionary accrual. Moreover, BOD size and audit committee size has a significant negative impact on dictionary accrual, whereas BOD meetings and employee ownership has a significant positive impact on dictionary accrual. The results further revealed the novel link that earnings multiples partially mediate the relationship between corporate governance variables and dictionary accrual. The new findings provide important insights for all the stakeholders like government, practitioners, academia, researchers, banks, Bursa Malaysia, security commission and public listed companies.

Key Words:

Corporate Governance Variables,
Earnings Multiples (Firm's
Financial Performance),
Discretionary Accruals (Earnings
Management), Mediation

Introduction

The system through, companies are being monitored is known as corporate governance. It defines the association between business management, a board of directors (size, composition), audit committee shareholders, stakeholders, and other investors. In other words, corporate governance is defined as, "The balancing the interest of different stakeholders". Moreover, Corporate governance multiples resolve the problems between company stakeholders and shareholders, employees, clients, and the public.

During the last two years, the Sarbanes-Oxley Act was imposed with new sanctions on the corporate sector and multinational companies to enhance the level of transparency of their financial statements for better records. Due to this new act, we can say that it will improve the level of corporate governance of the companies and it will boost all financial and non-financial efficiencies of the companies which are operating in Pakistan. The company's governance should be implemented in a way that provides such interest for stakeholders and investors. (Ehikiyoa, 2009) argued that management and ownership of the companies should be separated from each other and handled by different persons. These circumstances create a lot of agency problems which are widely faced by companies like shareholder and company executive issues (Jensen & Meckling, 1976).

Frauds in accounting mainly occur due to a lack of information and lack of understanding between owners and managers. The agent does not exchange details (Placeholder1)(Esty, 2014) on the basis of the actual situation, but only communicates the status of the organization. Strong corporate governance is required to avoid these unnecessary situations and to handle these issues.

Corporate governance has many objectives, but one of its main objectives is to make sure the protection of stakeholders from the corporate sector's behaviors. In which all kind of frauds, misrepresentation, and manipulation is on the top of the list (Agrawal & Cooper, 2017; Awolowo, Garrow, Clark, & Chan, 2018), (Garrow & Awolowo, 2018). By taking these steps or taking precautionary measures the organizational image is built and which leads to gain the trust of the majority of the stakeholders related to the organization, for example, banks and financial experts which in one way or another way leads to organizational profitability.

When the organization has a weak and unmaintained corporate governance, it leads to having losses, frauds, and other discrepancies. The organizations which have strong corporate governance

practices who don't have (Bushee & Goodman, 2007), (Leuz, 2007) all financial experts are keen and also referred to invest in the organization who have strong corporate governance practice which leads to profitability, and it is a good thing for all stakeholders. (Jensen & Meckling, 1976), have a point of view that corporate governance is a good tool to ensure that the managerial and administrative staff is working for the profitability of the organizations and all stakeholders. Board structure and owner structure also have a strong effect on the performance of the organization and employees and also releases the stress, which can degrees the productivity of the organization. Effective and efficient decision-making by managers who have a sense of ownership and ownership immersion can improve organizational performance. Wealth maximization also depends on the effective decision making of all the stakeholders involved in the organization. The underpinning theory for this study is agency theory because it can be used and applied in the area of both CG and EM (San Martin-Reyna & Duran-Encalada, 2012). All the above reasons provide a motive to investigate and carry out the study by giving the answer to the following research questions.

RQ 1: Do the CG mechanism has any impact on earnings multiples (firm financial performance)?

RQ 2: What is the impact of earnings multiples on discretionary accruals (earning management)?

RQ 1: What is the impact of the CG mechanism on discretionary accruals (earning management)?

RQ 3: Is there any mediating impact of earnings multiples in the relationship between CG variables and earning management?

Literature Review

Corporate Governance

Corporate governance is defined as a system by which companies are directed and controlled (O'Sullivan, 1999). So, Corporate governance has many objectives, but one of its main objectives is to make sure the protection of stakeholders from the corporate sector's behaviors. In which all kind of frauds, misrepresentation, and manipulation is on the top of the list (Agrawal & Cooper, 2017), (Awolowo et al., 2018), (Garrow & Awolowo, 2018). By taking these steps or taking precautionary measures the organizational image is built and which leads to gain the trust of the majority of the stakeholders related to the organization, for example, banks and financial experts which in one way or another way leads to organizational profitability.

When the organization has a weak and unmaintained corporate governance, it leads to having losses, frauds, and other discrepancies. The organizations which have strong corporate governance practices have more trust in the market and competitors than those who don't have (Bushee & Goodman, 2007), (Leuz, 2007) all financial experts are keen and also referred to invest in the organization who have strong corporate governance practice which leads to profitability, and it is a good thing for all stakeholders. (Jensen & Meckling, 1976), have a point of view that corporate governance is a good tool to ensure that the managerial and administrative staff is working for the profitability of the organizations and all stakeholders. Board structure and owner structure also have a strong effect on the performance of the organization and employees and also releases the stress, which can degrees the productivity of the organization. Effective and efficient decision-making by managers who have a sense of ownership and ownership immersion can improve organizational performance. Wealth maximization also depends on the effective decision making of all the stakeholders involved in the organization.

Earnings Multiples (Firm Financial Performance)

Return on assets (ROA) and return on equity (ROE) are the indicators of firm financial performance. In this regard, although many ways exist to measure FFP like accounting performance, market performance or economic performance, this study introduced the earnings multiple as a novel measurement for the FFP, which was developed by Principal Component Analysis (PCA) technique through STATA 15.0. The Principal component is a data reduction technique that creates components by summaries a large number of data series into a small number of components. (Shittu, Che Ahmad, & Ishak, 2015). PCA created uncorrelated variables through correlated variables. This method is useful in social, human, and management science research. One of the main functions of the PCA method, there is no Multicollinearity, and the result is more accurate.

Different research uses the PCA method in different countries to reduce the number of factors thereby defensible over study. (Bird & Casavecchia, 2007) they use a large number of data and multiples variables of EPS (earning per share), then combine these factors to forecast the exact stock. (Larcker, Richardson, & Tuna, 2007) used PCA techniques for condensing 39 variables to 14 variables of corporate governance multiples to observe the impact on firm performance. (Dey, 2008) applied PCA method on corporate governance multiples. He used 22 different CG multiples on firm performance and got 7 separate CG variables. (Raheja, 2007) identified that by using the PCA method, CG multiples reduce the number of structures that have the same principles. PCA convert 9 CG multiples into 3 variable that define the whole company statically, data, and material (Habib & Azim, 2008). To sum up, the

principal component method has been applied in several fields of knowledge, such as to deduct the number of correlated factors into new factors that are uncorrelated. (Ittner & Larcker, 2001).

Earning Management

According to Healy and Whalen (1999), "earning management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Ali Shah, Butt, & Hassan, 2009).

According to (Di Donato & Tiscini, 2005) Accounting fraudulence is definite as thoughtful false reporting or revelations in accounts statements, to betray account statement users, such as stakeholder, borrower, and lenders. Accounting frauds is also known as financial indiscretions. (Young & Nusbaum, 2006) described two different types of accounting misreports. The first is erroneous and the second is indiscretions. If the statement is reported incorrectly by chance then is called erroneous, and indiscretions are defined to be inaccuracies that are intentional. When a company fined an unintentional financial mistake, it does its best to fix it. Meanwhile, financial indiscretion is not an unintentional fault that implies that somebody is lying. (Hemraj, 2004) distribute frauds into two different terms first is administration deceptions, and the second is worker deceptions. It is very hard to find administration faults as compare to worker deceptions because many persons are involved in it. If a minor mistake is not fixed on revealed, then it will convert to deceptions. There are many previous studies on accounting frauds. (Pamungkas, Ghozali, & Achmad, 2018) in this research, they use 12 fraud enterprises and 32 non-fraud enterprises located in the Indonesia stock exchange, to analyze the relationship between corporate governance multiples and Accounting Frauds. Company governance work on this research as a moderator. The result indicates there is a weak relationship between corporate governance mechanisms and accounting frauds. Further, they reveal the significant relationship while a change in directing to accounting frauds. One of the most important points raised in this research is that enterprise which brings the urge change in direction, then investor have to be more careful while participating in their funds because that type of companies is more likely to have accounting frauds. Moreover, if the CG mechanism improves then the accounting frauds will reduce.

The objective of the Study

To develop a model that identifies the impact of CG mechanism (board of director size, the board of director meeting, audit committee size, employee ownership) on EM practices, with a mediation impact of earnings multiples on the relationship of CG mechanism and EM.

Hypothesis Development

In view of the above we, therefore, state our direct and mediating hypothesis as;

- H1 (a):** BOD size has a significant positive impact on firm financial performance.
- H1 (b):** Firm financial performance has a negative impact on discretionary accruals (earning management).
- H1 (c):** BOD size has a significant negative impact on earning management.
- H1 (d):** Firm financial performance (earnings multiples) mediates the relationship between BOD size and discretionary accruals (earning management0).
- H2 (a):** meeting of BOD has a significant positive impact on a firm's financial performance (earnings multiples).
- H2 (b):** Firm financial performance (earnings multiples) has a negative impact on discretionary accruals (earning management).
- H2 (c):** BOD meeting has a significant negative impact on earning management.
- H2 (d):** Firm financial performance (earnings multiples) mediates the relationship between BOD meeting and discretionary accruals (earning management)
- H3 (a):** Audit committee size has a significant positive impact on firm financial performance (earnings multiples).
- H3 (b):** Firm financial performance (earnings multiples) has a negative impact on discretionary accruals (earning management).
- H3 (c):** Audit committee size has a significant negative impact on earning management.
- H3 (d):** Firm financial performance (earnings multiples) mediates the relationship between audit committee size and discretionary accruals (earning management0)
- H3:** Audit committee size has no impact on earning management.
- H4 (a):** Employee ownership has a significant positive impact on firm financial performance (earnings multiples).

H4 (b): Firm financial performance (earnings multiples) has a negative impact on discretionary accruals (earning management).

H4 (c): Employee ownership has a significant negative impact on earning management.

H4 (d): Firm financial performance (earnings multiples) mediates the relationship between employee ownership and discretionary accruals (earning management)

Model Specification and Tests

$$EM = \alpha_0 + a_1 (\text{BOD Size}) + a_2 (\text{BOD meeting}) + a_3 (\text{AC size}) + a_4 (\text{EMP Own}) + a_5 (\text{Levg}) + a_6 (\text{SP}) + a_7 (\text{Mkt to BV}) + a_8 (\text{FirmSize}) + e$$

$$FFP = \alpha_0 + a_1 (\text{BOD Size}) + a_2 (\text{BOD meeting}) + a_3 (\text{AC size}) + a_4 (\text{EMP Own}) + a_5 (\text{Levg}) + a_6 (\text{SP}) + a_7 (\text{Mkt to BV}) + a_8 (\text{FirmSize}) + e$$

$$EM = \alpha_0 + a_1 (\text{FFP}) + a_2 (\text{Levg}) + a_3 (\text{SP}) + a_4 (\text{Mkt to BV}) + a_5 (\text{FirmSize}) + e$$

$$EM = \alpha_0 + a_1 (\text{FFP}) + a_2 (\text{BOD Size}) + a_3 (\text{BOD meeting}) + a_4 (\text{AC size}) + a_5 (\text{EMP Own}) + a_6 (\text{Levg}) + a_7 (\text{SP}) + a_8 (\text{Mkt to BV}) + a_9 (\text{FirmSize}) + e$$

Where:

EM: Earning Management

α_0 : Constant

BOD Size: Board of director size

BOD: BOD meeting

AC size: Audit committee size.

EMP own: Employee Ownership

Levg: Leverage

SP: Share Price

Mkt to BV: Market to book value

ROA: Return on Assets

FFP: firm financial performance

e = allowed error.

Research Design

This study uses balanced panel data because it is a more sensitive measurement of the changes that could take place between points in time (Cavana, Delahaye, & Sekaran, 2001). Data is collected from 320 firms listed on the Bursa Malaysia stock exchange during the period 2010–2014. Financial institutions, insurance companies and mining firms are excluded because of their peculiar type of accounting practices (González & García-Meca, 2014). The accounting data on earning management (Kothari model data) and firm financial performance (earnings multiple) are secondary in nature and obtained from DataStream database, while BOD size, BOD meeting, audit committee size and employee ownership data collected from annual reports of companies.

Results are interpreted through Descriptive statistics, correlation, multiple regression and mediation. SPSS, Version 21.0 and (STATA), Version 15.0 are used for data analysis (Bickel, 2007; Hayes, 2013). For making the result more robust, constant and stable, we run some initial steps for cleaning and screening the data like outliers removal, normality, heteroscedasticity, multicollinearity, autocorrelation and endogeneity, which will imply that the samples are more representative and the results are meaningful (Habib, Uddin Bhuiyan, & Islam, 2013; Sekaran & Bougie, 2003).

Empirical Results

Table I shows the descriptive statistics for all the variables. The descriptive statistics of discretionary accruals (DAC) in the model, as presented in Table I, show that the absolute value of DAC for the companies in this study sample has a mean value of 0.409, whereas the minimum value is -1.77 and the maximum value is 0.636. The mean value of discretionary accruals for EM is greater than one shows that Malaysian Public listed Companies are involved in earning management practices during the years 2010-2014. These findings don't match the studies of developing countries results like with Klein conducted a study in 2012 obtains a minimum value of absolute DAC among large US firms of 0.00002. Moreover, the average of BOD size is 7.23 with a minimum of 3, and a maximum of 14 which is according to the minimum requirement in Malaysia (Coles, McWilliams, & Sen, 2001; Haniffa & Cooke, 2000). Similarly, Table I, shows that on average, BOD conducted meeting 5.36 time per year, while the Table also showed the average audit committee size for the sample of this study is 3.21. About 12.27 percent of the sample company's

shares are held by employees of the firms. Further, on average, the company have taken 0.199% debts in the form of leverage. Therefore, the following Table I shows mean, standard deviation, minimum and maximum, for dependent, independent and control variables.

Table 1. Descriptive Statistics

Variable	Obs	Min	Max	Mean	SD
EM	1600	-1.77	0.636	0.409	0.86
BODsize	1600	3	14	7.23	1.72
BODmeeting	1600	2	18	5.36	1.68
Auditcomsize	1600	2	7	3.21	0.497
Employee own	1600	0	74	12.27	17.01
sLeverage	1600	0	2.83	0.199	0.145
Shareprice	1600	-3.11	3.23	0.0001	0.996
Markttobval	1600	-193.26	1077065.59	1862.4047	31935.722
Firm size	1600	4.07	7.35	5.59	0.5866
IFRS	1600	0	1	0.6	0.49

Pearson product-moment correlation (r) is computed in order to observe the correlation between the variables. As can be seen from Table II earnings management (EM) is found to be positively correlated to the BOD size, BOD meetings and audit committee size, while negative correlated to the employee ownership. Table II of correlation matrix also indicates that there is no serious multicollinearity among the variables. Moreover, when we employed the Breusch-Pagan/Cook-Weisberg test for heteroscedasticity, we found the problem of heteroscedasticity by revealing the results as; $\text{Chi}^2(1) = 4.64$; $\text{Prob.} > \text{chi}^2 = 0.000$. However, heteroscedasticity issue was removed by random effect robust model. Panel data is used for hypothesis testing for all four econometric models. Random effect regression model method is used based on the Hausman test for results and interpretation. However, before running the regression analysis, we also meet the basic assumption of the regression equation, i.e. normality, linearity, hertoscedastisity, multicollinearity and endogeneity. For normality, we run the skewness and kurtosis test, for minimizing the linearity issues in the data we transform the data into \log_{10} , for hertoscedastisity we run Breusch Pagan test and for multicollinearity we run variance inflation factor (VIF) in STATA software. Moreover, for the assumption of endogeneity, we used the Ramsey test and found no endogeneity in the models. Similarly, in order to bring the most robust result of the model, a natural log of some of the control and dependent variables was calculated so as to scale the data.

Table 2. Correlation Matrix

	EM	sBDS	BDM	ASZE	EMP	LEV	SP	MBV	FimSize
EM	1								
BODsize	.052*	1							
BODmeeting	0.18**	-0.013	1						
AudtSize	0.16**	0.131**	.056*	1					
EmplOwnr	-0.15**	-0.048	0.011	-.122**	1				
Leverage	0.0883	0.0866	0.0142	0.0494	-0.0083	1			
Share price	0.263**	-0.01	-0.006	0.170**	.238**	-0.044	1		
MktBokValu	0.411**	.0760**	0.004	0.261**	.205**	0.192**	-0.18**	1	
Firm size	0.548**	0.047	-0.049	0.355**	.211**	0.130**	-0.28**	0.12**	1

Table III shows the results for three regression models (CG>FFP), (FFP>EM), (CG>EM). The random effect (GLS) regression model is selected based on the Hausman specification test. For model one (1), Table III reports that there is a significant positive impact of BOD size on FFP by showing, i.e. (0.072411) at ($p < 0.001$), which means that BOD size increases FFP performance in Malaysian Public Listed Companies hence, support H1 of the study. Above results are in compliance with the results of prior research (De Miguel, Pindado, & De la Torre, 2004; Hahn & Lasfer, 2007; Vafeas, 1999). Moreover, for model one (1), Table III also shows that BOD meeting and audit committee size have a significant positive relationship with FFP, while employee ownership has no impact on FFP. Moving to our second model table III shows that firm financial performance has a negative and significant impact on EM practices by showing the results as -0.5865 at ($p < 0.000$), which means that FFP helps in minimizing EM practices, opposite to the results provided by prior researcher (Moeller, Schlingemann, & Stulz, 2004). In order

ascertain out third model in table III, study found that BOD size ($b = -0.084^{***}$, $p = 0.001$) and audit committee size ($b = -0.863^{***}$, $p = 0.000$) has a statistical negative significant relationship with EM, while BOD meeting ($b = 0.0332^{***}$, $p = 0.002$) and employee-owner ($b = 0.0668^{***}$, $p = 0.0041$) has a statistical positive relationship with EM. Which means that only two out of four, i.e. (BOD size and audit committee size) are helping in minimizing the EM practices in Malaysian public listed companies for the years 2010-2014. Control variables produced a mixed and inconclusive finding in all three regression models. The R^2 values of Model (CG>FFP), (FFP>EM), (CG>EM) are 0.7258, 0.4281, 0.3440 respectively which suggests that all the variables together contribute 72.58%, 42.81%, 34.40%. Industry and years are taken as a dummy variable for controlling its impact. The regression model once again has mix and inconclusive results for some very important corporate governance variable (BOD size, BOD meeting and employee Ownership) in improving firm financial performance (FFP) and constraining EM practices in Malaysian listed Companies.

Table 3. Regression Results

	Model 1 (CG>FFP)	Model 2 FFP>EM	Model 3 CG>EM
BODSize	0.072411*** (0.0079)		-0.084*** (0.0123)
BODMeeting	0.028*** (0.0088)		0.0332*** (0.0134)
AudtSize	0.064*** (0.0182)		-0.0863*** (0.0278)
Employee Owner	0.0319 (0.0218)		0.0668*** (0.0337)
Earnings Multiple (FFP)		-0.5868*** (0.0357)	
Leverage	0.00307*** (0.007)	0.007 (0.00086)	0.00247*** (0.0092)
Shareprice	0.021*** (0.024)	-0.0162 (0.03)	-0.0674 (0.0338)
Markttobval	0.021*** (0.016)	0.0298 (0.02348)	-0.034 (0.0257)
Firm size	0.0933*** (0.025)	0.076617 (0.0485)	0.599 (0.0384)
IFRS	0.0013 (0.03)	-0.1450*** (0.0386)	-0.1373*** (0.0423)
Year Dummies	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes
Sample	320	320	320
Observations	1600	1600	1600
GLS Model	Random effect	Random effect	Random effect
R-squared	0.7258	0.4281	0.3440
F-value	68.08	57.66	67.91
Prob >F	0	0	0

Standard errors are shown in parentheses *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

The result of the path (a), (b), (c) and (c') about the hypothesis H1 (d), H2 (d), H3 (d), and H4 (d) are shown in Table IV, which assumed that firm financial performance (earnings multiple) mediates the relationship between corporate governance variables (BOD size, BOD meeting, audit size, employee ownership) and earning management of Malaysian public listed companies for the year 2010-2014. We used Andrew F. Hayes process for analysis.

For testing of mediation, the authors [49], [50] recommend the following conditions to be satisfied.

1. IV on MV, known as a path (a);
2. MV on DV, as a path (b);
3. IV on DV, path (c); and
4. IV on DV may change after the effect of the mediator is controlled, which is known as the path (c') (Baron and Kenny, 1986).

Table IV indicates that there is partial mediation (PM) between the relationship of BOD size>FFP>EM as well as between the relationship of audit size>FFP>EM respectively. While there is Full Mediation (FM) between the relationship of BOD meeting>FFP>EM and employee ownership>FFP>EM respectively.

Table 4. Summary of Mediation Analysis

A-B (a)		B-C (b)		A-C (c)		Path (c')	
β	R ²	β	R ²	β	R ²	β	R ²
0.0133 (0.305)	0.007	0.0907*** (0.000)	0.013	0.025*** (0.027)	0.022	0.0240*** (0.069)	P.M
0.047***		0.073***		0.076		0.079***	F.M
0.002	0.006	0.000	0.0374	0.001	0.0374	0.000	0.0308
0.047***		0.072***		0.0756		0.079***	P.M
0.002	0.0086	0.000	0.0378	0.001	0.0374	0.000	0.0308
0.0037***		0.0792***		0.0070***		0.0073***	F.M
0.0035	0.0025	0.003	0.0332	0.000	0.0337	0.000	0.0254
BODSIZE>FFP>EM		BODMeet>FFP>EM		AudtSize>FFP>EM		Empleeown>FFP>EM	

Table 5. Summary of Hypotheses Results

Variable	Main Model	Hypothesis	Results
BODsize>FFP	Positive (***)	H1a	Supported
FFP>EM	Negative (***)	H1b	Supported
BODsize>EM	Negative (***)	H1c	Supported
BODmeet>FFP	Positive (***)	H2a	Supported
FFP>EM	Negative (***)	H2b	Supported
BODmeet>EM	Positive (***)	H2c	Not Supported
AudtSize>FFP	Positive (***)	H3a	Supported
FFP>EM	Negative (***)	H3b	Supported
AudtSize>EM	Negative (***)	H3c	Supported
EmpOwn>FFP	No Impact	H4a	Not-Supported
FFP>EM	Negative (***)	H4b	Supported
EmpOwn>EM	Positive (***)	H4c	Not Supported

Contributions and Conclusion

This study provides evidence that the effective use of corporate governance mechanism has a differential effect on firm financial performance and earning management, which, clarify the important contribution of corporate governance attributes towards the maximization of the financial performance of the firm and reducing malpractices in Malaysian Public Listed Companies among the years 2010-2014. This research provides key insights for market participants, including investors, analysts, accounting and auditing professionals. The result also improves general awareness of the extent of corporate governance effectiveness in improving the shareholder value.

The empirical results also contribute to the latest knowledge of the study by investigating the mediating role of a firm's financial performance in the impact of corporate governance on earnings management.

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