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Abstract

Purpose – The purpose of this paper is to investigate the influence of cash holding, political connection and their interaction effect on earnings quality in the Malaysian environment, where political influence plays a vital role in many aspects of business dealings and resources allocation is seriously affected by politics.

Design/methodology/approach – This paper uses ordinary least square and seemingly unrelated regressions upon a sample of the Malaysian top 100 listed firms.

Findings – This paper finds that earnings of firms with excess cash reserves are of high quality. Consistent with previous research, the study finds that investors perceive earnings numbers of politically connected firms as being of low quality. However, this research fails to support an expectation that the adverse consequences of holding a large amount of cash to earnings quality would be more pronounced when political extraction is high. The findings of this study suggest that policy makers should encourage or mandate firms to disclose information in relation to their connections with government, political party, or politicians so that investors and all interested parties can use the information to better assess the firms' earnings quality.

Originality/value – This research is considered as the first attempt to examine the relationships between cash holdings, political connections, and earnings quality in a developing country such as Malaysia.

Keywords Malaysia, Earnings quality, Cash holdings, Political connections

Paper type Research paper

1. Introduction

In perfect capital markets, firms invest funds in all positive net present value (NPV) projects and return back the excess cash to shareholders as dividends (Pinkowitz *et al.*, 2006). This, however, is not the case in real life. Controlling managers of firms with more cash would prefer to stockpile the cash as reserves to remain in control of the firm's resources. Even though large accumulation of cash reserves enables a firm to fund all projects with positive NPV and avoid unanticipated events such as adverse economic shocks, it may lead to agency conflicts between controlling managers and outside shareholders. It is argued that leaving large amounts of cash reserves at controlling managers' disposal will exacerbate them to squander the cash in projects that provide them substantial private benefits at the expense of outside investors (Jensen, 1986; Stulz, 1990). These projects may not in the best interest of the firm and result in a reduction in the firm value. Prior works on cash holdings provide evidence that firms with high cash reserves experience low value, especially when corporate governance system is weak (e.g. Dittmar and Mahrt-Smith, 2007; Kalcheva and Lins, 2007;

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Kusnadi, 2011; Pinkowitz *et al.*, 2006). The reduction of firm value can draw the attention of capital markets and outside investors who jeopardize controlling managers' position. As a result, controlling managers tend to use opportunistic earnings management tools to inflate reported earnings for the purpose of obscuring the true picture of economic performance of the firm. Empirical evidence from Malaysia and elsewhere shows that earnings of firms with excess free cash flow are less reliable (Bukit and Iskandar, 2009; Chung *et al.*, 2005), and are of low quality (AL-Dhamari and Ku Ismail, 2012; Rahman and Saleh, 2008).

Firms usually have tendencies to closely link themselves to the government or politicians as such linkage provides benefits such as government subsidies, tax discounts, market power, and so on. These benefits ultimately may increase the firms' performance (e.g. Boubakri *et al.*, 2012a; Faccio *et al.*, 2006). However, having close ties with the governments may not always benefit the firms because governments seek different objectives that may go against value-maximizing objectives and shareholders' wealth maximization. Academic researchers argue that governments use firms' resources to benefit their cronies and supporters, who in return provide votes, political contributions, and bribes (e.g. Bushman *et al.*, 2004; Gul, 2006; La Porta *et al.*, 2002). A review of literature points to two important ways political involvement can affect earnings quality of politically connected firms (PCFs). First, since PCFs gain from their connections, managers of these firms may have incentives to obscure information in relation to benefits received with the purpose of increasing their wealth at the expense of outside investors (Chaney *et al.*, 2011). Second, governments may pressure PCFs to hide information regarding expropriation activities exercised by the governments or their cronies (Bushman *et al.*, 2004). It is suggested that the incentives of controlling managers to report account information with high quality is influenced by political factors (e.g. Ball *et al.*, 2000, 2003; Bushman *et al.*, 2004; Bushman and Piotroski, 2006). In this regard, ample evidence from extant research concludes that political influence deteriorates the quality of reported earnings (e.g. Ball *et al.*, 2000; Belkaoui, 2004; Bushman and Piotroski, 2006; Chaney *et al.*, 2011; Mohammed *et al.*, 2011).

From corporate governance perspective, it is evident that PCFs experience severe agency problems as argued by academic scholars that political influence is a reflection of a firm's agency problem (see Boubakri *et al.*, 2013; Chaney *et al.*, 2011). Moreover, the cash policy of these firms is typically shaped by corporate governance strength and political objectives the governments follow. Given that managers of PCFs adhere to political objectives, governments will enable PCFs to accumulate large cash reserves through raising cheap funds (Boubakri *et al.*, 2012b; Chaney *et al.*, 2011) and paying less tax (Boubakri *et al.*, 2013). Accumulation of cash along with weak corporate governance system would motivate controlling managers of PCFs to extract political benefits through wasting the firm's excess cash in activities with political agenda. Generally, PCFs are protected from market discipline by government bailout guarantees and easy access to credit and bank lending (Boubakri *et al.*, 2013). As such, managers of PCFs will be in a better position to obscure earnings information in relation to investing the firm's resources in political activities. Hence, it is plausible to expect PCFs with high cash holding to experience low quality earnings.

Our study contributes to a growing literature examining the effect of cash holdings on firm value. More specifically, prior research found that there is an association between cash holdings and firm value (e.g. Dittmar and Mahrt-Smith, 2007; Harford *et al.*, 2008; Kusnadi, 2011; Lee and Lee, 2009). A logical extension of this line of research would be to explore whether cash holdings influence earnings quality. The results of

this paper add to extant studies that found cash holdings increase firm value (e.g. Mikkelson and Partch, 2003; Opler *et al.*, 1999). Prior works in the Malaysian context employed free cash flow to reflect the agency conflict between controlling and minority shareholders with regard to firm resources. Evidence provided in these works shows that excess free cash flows have adverse consequences on earnings quality (AL-Dhamari and Ku Ismail, 2012; Bukit and Iskandar, 2009; Rahman and Saleh, 2008). We provide a new insight into these studies by using cash holdings as a measure to reflect the agency conflict and providing results that contradict the studies expectation[1]. The findings of this paper add to extant research on political influence, which is found to negatively affect earnings quality (e.g. Belkaoui, 2004; Bushman and Piotroski, 2006; Chaney *et al.*, 2011; Mohammed *et al.*, 2011). Finally, at the international level, a recent study finds firms with political connections to hold more cash reserves (Boubakri *et al.*, 2013). We extend the study by embarking on a hitherto unexplored area, that is, whether PCFs with high cash holdings are likely to disclose low quality earnings.

The remainder of this paper proceeds as follows. The next section reviews the literature and develops the hypotheses. Section 3 outlines the research design, and Section 4 presents and discusses the results of this study. Section 5 summarizes and concludes our paper.

2. Literature review and hypothesis development

2.1 Literature review

2.1.1 Cash holdings. Among other assets, cash is viewed as the most valuable assets that controlling managers can expropriate from firms under their control (Myers and Rajan, 1998). Even though the presence of excess cash reserves within a firm reduces the costs associated with external financing by increasing the flexibility of internal financing, it may have negative implications when controlling managers invest these liquid resources in value decreasing activities such as capital expenditures and acquisitions (Dittmar and Mahrt-Smith, 2007; Lee and Lee, 2009). The excess cash, as opposed to other firm resources, can be easily transformed into managers' private benefits at a lower cost (Pinkowitz *et al.*, 2006).

From the theoretical point of view, it is argued that leaving large amounts of cash reserves under managers' control will exacerbate them to squander the excess cash in projects that maximize the managers' wealth at the expense of outside investors, especially when the corporate governance system is poor (Jensen, 1986; Stulz, 1990). Moreover, managers of firms with high cash holdings generally are protected against market control as the firms can use the excess cash to finance their investment opportunities, all of which will play further role in encouraging the managers to use firm resources opportunistically.

In the context of Malaysia, normally firms are owned by individuals and family members who are involved in the management (Thillainathan, 1991). In the country, the quality of law enforcement to protect minority shareholders is relatively poor (La Porta *et al.*, 1998), the government intervention is high, and the external discipline is poor (Bhattacharyay, 2004). Moreover, Lee and Lee (2009) point out that cash is a substantial proportion of Asian firms' assets including Malaysia. This, combined with weak corporate governance, may lead controlling managers (i.e. controlling shareholders in Malaysia) to take advantage from retained cash reserves at the expense of minority shareholders. Thillainathan (1991) argues that because of the deviation between controlling rights and

cash flow rights of controlling shareholders in Malaysian firms, controlling shareholders are more likely to invest the free cash in destructive activities so as to have absolute power on resources of the firms. Furthermore, Claessens *et al.* (1998) contends that the extensive diversification by firms in Malaysia has led their management to misallocate capital investments in unprofitable and value destroying projects.

2.1.2 Political connections. Politicians try to establish relationships with firms in order to control and use them towards achieving their political goals. PCFs make political contributions for which the politicians award profitable contracts to them. Due to the improper way of awarding the contracts, based on this reciprocation, the PCFs become inefficient (Bliss and Gul, 2012). Malaysia is identified as a country where the corporate sector is dominated by firms associated with such political connections (Gul, 2006).

The political connection in the Malaysian firms can be traced back to the period of colonial rule. The colonial masters divided the three major ethnic groups (i.e. Malays, Chinese, and Indians) into distinct areas of employment to facilitate their administration. Later on, this resulted in an inequality that led to conflicts over control of economic resources and political power, among the ethnic groups, after independence. The government came up with two important policies, New Economic Policy and National Development Policy, which were seen to favour one ethnic group (Malays also known as Bumiputeras). The aim was to increase the Bumiputeras' ownership of firms to balance that of Chinese who were controlling the economy. For example, Bumiputera-owned firms were selectively financed by the United Malay National Organization to have capital shares in firms previously owned and controlled by Chinese. This has heavily affected the development of capital markets as foriegn investemens were minimal. The quest for foreign direct investments and the need for more transparency in the corporate governance following the economic crises of 2007 raised an issue on the PCFs in Malaysia. Ball *et al.* (2003) and Gul (2006) provide evidence that political connection reduces the quality of financial reporting.

The relationship between politics and business in Malaysia has received much attention from several studies (Gomez and Jomo, 1997; Faccio *et al.*, 2001; Johnson and Mitton, 2003; Faccio, 2006; Gul, 2006; Fraser *et al.*, 2006; Bliss and Gul, 2012). The PCFs in Malaysia receive favours from the government in the form of loans from the banking sector and investment resources at preferential prices to help them stabilize their capital base. The firms may have to contribute to political goals in exchange for favours received from the government. Informal ties between politicians and businessmen (Malays, Chinese, and Indians) may represent another form of political favouritism. Businessmen may use their personal linkage with leading politicians to impact the allocation of favours given by the government (Gomez and Jomo, 1997). Due to the improper allocation of resources, financial markets become inefficent and investors are less likely to invest in PCFs. Anecdotal examples of political extraction in Malaysia can be found in Bliss and Gul (2012), Gomez (2002), Gomez and Jomo (1997), Fraser *et al.* (2006), and Johnson and Mitton (2003). Moreover, Bushman *et al.* (2004) point out that financial reporting quality is adversely affected by politicians' misuse of power over banks and regulatory policies, by giving improper favours to their cronies in exchange for political support, bribes, and nepotism.

2.2 Hypothesis development

2.2.1 Cash holdings and earnings quality. Based on the existing literature, it is evident that when minority shareholders have less power to impose on managers' action,

managers with more cash at their disposal would be inclined to use the excess cash to expand their empire. This might result in an increase in agency conflict between the two parties (i.e. managers and minority shareholders) and a reduction of firm value. By using emerging market data, scholars document that investors perceive firms with weak corporate governance and high cash holding to have less value (Kusnadi, 2011; Lee and Lee, 2009). This is further confirmed by Harford *et al.* (2008) who find that the incremental value of excess cash is negative for US firms with weak governance structure as managers of the firms deploy the excess cash in value destroying activities such as acquisitions and capital expenditure. Moreover, international evidence shows that investors discount the value of cash reserves of firms in countries with poor shareholder protection (e.g. Dittmar and Mahrt-Smith, 2007; Kalcheva and Lins, 2007; Pinkowitz *et al.*, 2006).

While Malaysia is considered to have high quality of legal protection, the quality of law enforcement is still relatively poor (La Porta *et al.*, 1998). The poor quality of law enforcement might present remarkable obstacles for prompting good corporate governance practices (La Porta *et al.*, 1998; Thillainathan, 1991). As such, it is plausible to expect that in a country such as Malaysia controlling managers will invest cash reserves in suboptimal projects that may not be in the best interest of the firm they control but only increase the controlling managers' personal wealth and provide them with private benefits. The controlling managers are more likely to obscure accounting information in relation to the projects because doing so will avoid them from scrutiny and being controlled by minority shareholders and external investors. This eventually will increase the information asymmetry among interested parties concerned with the firm's activities and consequently impair earnings quality. In the context of Malaysia, studies show that firms with free cash flows experience more incidences of opportunistic earnings management (Bukit and Iskandar, 2009) and earnings numbers of low quality (AL-Dhamari and Ku Ismail, 2012; Rahman and Saleh, 2008). Since controlling managers of firms with high cash holdings are inclined to report less reliable earnings information, it is expected that investors will rely less on the information in making their investment decisions. Thus, the quality of earnings numbers would be deteriorated for firms with high cash holding. Therefore, we hypothesize that:

H1. Cash holding is negatively associated with earnings quality.

2.2.2 Political connections and earnings quality. Among the institutional factors, political factors influence the incentives of managers who are involved in preparing financial statements (e.g. Ball *et al.*, 2000, 2003; Bushman *et al.*, 2004; Bushman and Piotroski, 2006). The quality and quantity of accounting information contained in financial reports of a firm is seriously affected when political influences exist within a firm (Ball *et al.*, 2000; Ball *et al.*, 2003; Belkaoui, 2004; Bushman *et al.*, 2004; Bushman and Piotroski, 2006; Chaney *et al.*, 2011; Leuz and Oberholzer-Gee, 2006). Empirical evidence shows that firms with higher government shareholdings are less transparent (Bushman *et al.*, 2004; Leuz and Oberholzer-Gee, 2006). Ball *et al.* (2000) find the financial reports to be timelier and more conservative for firms in countries with low political influences than in countries with high political influences. Similarly, Bushman and Piotroski (2006) document that earnings of firms in countries with more state involvement in the economy are perceived by market participant to be less conservative.

In addition, Ball *et al.* (2003) find that adopting better accounting standards by East Asian counties *per se* does not guarantee high quality earnings numbers, and political

factors that influence managers' incentives are important in this regard. Cross-country data shows that PCFs experience lower accrual quality than non-PCFs (Chaney *et al.*, 2011). Belkaoui (2004) provides evidence that earning opacity increases with high political connections. In the context of auditing, Guedhami *et al.* (2009) find that state-owned firms are less inclined to appoint Big Four auditors, often known to issue high quality financial reports.

It is argued that PCFs in Malaysia are prevented by the government from disclosing earnings information that may put the activities of politicians under the microscope (Gul, 2006). This may create incentives for managers of PCFs to manage earnings with the purpose of intentionally misleading market participants with regard to profits received or losses incurred from their connections. By using Malaysian data, Gul (2006) provides evidence that since PCFs in Malaysia have a greater risk of misreporting of earnings numbers; audit fees for these firms are higher than non-PCFs. Consequently, we expect that earnings quality decreases in firms with political connections. This expectation is translated into the following hypothesis:

H2. Firm political connectedness is negatively associated with earnings quality.

2.2.3 Cash holdings, political connections, and earnings quality. PCFs are found to have poor corporate governance system (Chaney *et al.*, 2011) and hold more cash (Boubakri *et al.*, 2013). Moreover, these firms follow political goals that may not be in the best interest of shareholders and go against firm value maximization. This, along with the presence of weak corporate governance system, may encourage entrenched managers of PCFs to extract political benefits through squandering the firms' excess cash in activities associated with political agendas. The activities include financing election campaigns, using the firms' cash to build popular support for the government, paying bribes, or overinvesting in negative return regions to secure votes for connected politicians (Boubakri *et al.*, 2013). Since managers in PCFs are protected from market discipline through government bailout guarantees and easy access to credit and bank lending, the entrenched managers are more likely to hide earnings information regarding investing the firms' excess cash in political activities to receive benefits at shareholders' expense. As such, we expect that firms with high cash holding and at the same time are politically connected to experience earnings numbers of low quality, which leads to our final hypothesis:

H3. The negative influence of cash holding on earnings quality is more pronounced in PCFs than non-PCFs.

3. Research methods

3.1 Sample

The initial sample of this study consists of the Malaysian top 100 listed firms based on the 2011 market capitalization. We observe the companies over a five-year period, that is, from 2007 to 2011. These firms are selected because they are more likely to be affected by political influences (Roe, 2003) and would have financial and political connection data. Firms in the financial sector are excluded as they are subject to different financial reporting requirements. In addition, firms with missing financial and political connection data for the sample period are also eliminated. The sample selection process is summarized in Table I. We finally ended up with 295 firm years. Table II provides the industry breakdown of the sample firms.

3.2 Measurement of the dependent, experimental, and control variables

3.2.1 Dependent variable. Accrual quality (ACCQUAL), the dependent variable, is used in this study to assess earnings quality. Dechow and Dichev (2002) propose a measure of accrual quality that tests the extent to which total current accruals map into last-period, present-period, and next-period cash flow from operations. The gap between earnings and cash is viewed to be a result of accruals. As such, low variability of accruals corresponds to higher accruals quality and higher earnings quality. Following Francis *et al.* (2004), we run firm-specific regressions by using five-year rolling windows to measure accruals quality[2]. Accruals quality data are obtained from the Data Stream database. We require firms to have at least five years of data during each five-year window[3]. The following equation is used to estimate accrual quality:

$$TCA_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \varepsilon_{it}. \quad (1)$$

where TCA_{it} is the total current accruals in year t ($\Delta CA_{it} - \Delta CL_{it} - \Delta CASH_{it} + \Delta STDEBT_{it} - DEPN_{it}$); CFO_{it-1} the operating cash flows in year t–1, measured by net income before extraordinary items less total accruals; CFO_{it} the operating cash flows in year t; CFO_{it+1} the operating cash flows in year t+1. TCA and CFOs are deflated by firm's average total assets in year t and t–1; ΔCA_{it} the change in current assets between year t–1 and year t; ΔCL_{it} the change in current liabilities between year t–1 and year t; $\Delta CASH_{it}$, change in cash between year t–1 and year t; $\Delta STDEBT_{it}$ the change in debt in current liabilities between year t–1 and year t; and $DEPN_{it}$ the depreciation and amortization expense in year t.

ACCQUAL is the standard deviation of the five firm-specific residuals. Large (small) values of the standard deviation of residuals indicate lower (higher) accrual quality and lower (higher) earnings numbers quality. Since ACCQUAL is highly skewed, we use the natural logarithm of ACCQUAL to mitigate normality problem.

3.2.2 Experimental variables. One of the variables of interest in our study is cash holdings (CASH). CASH is measured by the logarithm of the proportion of cash and

Top 100 firms based on market capitalization year 2011	100
Financial firms	15
Firms with insufficient financial and political connection data	26
Final sample	59
Years	5
Final firm year observations used for analysis	295

Table I. Sample selection criteria (2007-2011)

Industry name	No. of firms	%
Consumer product	55	19
Industrial products	40	14
Construction	25	8
Trading/services	95	32
Properties	15	5
Plantation	45	15
IPC	20	7
Total	295	100

Table II. Sample breakdown by industry

cash equivalents to net assets. Net assets is calculated as total assets minus cash and cash equivalents (see e.g. Boubakri *et al.*, 2013; Dittmar and Mahrt-Smith, 2007; Kusnadi, 2011; Lee and Lee, 2009). As in Mohammed *et al.* (2011), we use the proportion of politically connected directors on the board to operationalize the presence of political influence (PCON). We consider a director to be politically connected if he/she is a member of parliament, a minister, a head of state, a state assemblyman, or a person who is or was working under a government bureaucrat (Chaney *et al.*, 2011; Faccio, 2006; Mohammed *et al.*, 2011). Data on CASH are extracted from Data Stream database, while PCON data are manually collected from the annual reports of the sample firms. The list of parliament members and senators is obtained by the official portal of parliament of Malaysia (www.parlimen.gov.my). On the other hand, the list of state assemblymen is taken from Report of General Election Malaysia. We review the director profiles and match their names against the two lists to identify whether a director has any political influence. To examine the third hypothesis as to whether the negative association between CASH and earnings quality is more prominent is PCFs, an interaction term CASH×PCON is computed.

3.2.3 Control variables. We include firm size (SIZE), profitability (ROA), leverage (LEV), growth opportunities (GROWTH), and audit quality (BIG4) in the regression models as control variables[4]. The inclusion of these variables is motivated by prior research that found them to be related to earnings quality (e.g. Becker *et al.*, 1998; Chaney *et al.*, 2011; Cheng and Warfield, 2005; Mashayekhi and Bazaz, 2010; Reynolds and Francis, 2000). Dechow and Dichev (2002) posit that large firms experience higher earnings quality. Therefore, we expect the estimated coefficient of SIZE to be negative. A negative coefficient estimate of SIZE implies that firm size is positively associated with earnings quality as smaller (more negative) values of ACCQUAL suggest desirable earnings numbers. SIZE is represented by the natural logarithm of total assets.

It is expected that firms with good operating performance report higher earnings quality (Jaggi *et al.*, 2009). This expectation leads us to predict the variability of ACCQUAL decreases and thus earnings quality is high as ROA increases. We measure ROA as net income before extraordinary items divided by average total assets. DeAngelo *et al.* (1994) argue that earnings quality is low as the likelihood of breaching debt covenants increases. As such, our study expects LEV to be positive for higher variability of ACCQUAL, indicating lower earnings quality for leveraged firm. LEV is operationlized by total liabilities divided by total assets. GROWTH is expected to be positively related to lower accruals quality as prior research found growth firms to have low earnings quality (Lee *et al.*, 2006). Our study measures GROWTH as the change in sales revenue from the previous year divided by sales revenue in the previous year.

Firms are perceived to disclose high earnings quality when their financial statements are audited by big audit firms (Gul *et al.*, 2002). Hence, we expect the estimated coefficient of BIG4 to be significantly negative as smaller values of ACCQUAL indicates higher accrual quality and higher earnings quality. BIG4 is represented by an indicator variable taking the value of 1 if a firm is audited by one of the Big Four auditing firms and zero if otherwise. Extreme values of ROA, LEV, and GROWTH are replaced with the variables mean to mitigate normality problem. Our study includes year (YR) and industry (INDUST) dummy variables into the regression models to control for their possible effects.

3.2.4 Regression models. We use the following regression model to test the hypotheses:

$$ACCQUAL_{it} = \delta 0 + \delta 1 CASH_{it} + \delta 2 PCON_{it} + \delta 3 CASH \times PCON_{it} + \delta 4 SIZE_{it} + \delta 5 ROA_{it} + \delta 6 LEV_{it} + \delta 7 GROWTH_{it} + \delta 8 BIG4_{it} + \delta year\, YR_{9-12} + \delta industry\, INDUST_{13-18} + \varepsilon_{it}. \quad (2)$$

where $ACCQUAL_{it}$ is the natural logarithm of standard deviation of residuals from the firm's regression of current accruals on lagged, current, and future cash flows from operations; $CASH_{it}$ the logarithm of ratio of cash and cash equivalents to net assets; $PCON_{it}$ the proportion of politically connected directors on the board; $SIZE_{it}$ the natural logarithm of total assets; ROA_{it} the net income before extraordinary items divided by average total assets; LEV_{it} the total liabilities divided by total assets; $GROWTH_{it}$ the sales revenues in current year minus sales revenue in previous year divided by sales revenue in previous year; and $BIG4_{it}$ the indicator variable, 1 if the firm's auditor is a Big Four, and 0 otherwise.

We employ panel ordinary least square regressions (OLS) to test our hypotheses[5]. We also run seemingly unrelated regressions (SUR) to ensure the robustness of our results[6]. However, since the findings are approximately similar in both methods, we only discuss the results of the OLS regressions.

4. Results

4.1 Descriptive statistics

Table III provides the descriptive statistics of key variables included in the regression models. The minimum (maximum) values of ACCQUAL of the sample firms are 0 (15.9 per cent) with an average value of 1.9 per cent. The mean value of CASH is 23 per cent. The mean of the proportion of politically connected directors on the board is 32.4 per cent. The size of the sample firms in terms of total assets ranges between RM 326.2 million and RM 74,600 million. ROA has an average of 10 per cent

Variables	*n*	Min	Max	Mean	SD
ACCQUAL	295	0.000	0.159	0.019	0.024
CASH	295	0.000	1.098	0.230	0.202
PCON	295	0.000	0.90	0.324	0.170
SIZE (RM'000)	295	326.2	74,600	8,899.5	13,400
ROA	295	−0.317	0.724	0.100	0.098
LEV	295	0.016	0.915	0.436	0.200
GROWTH	295	−1	1.816	0.154	0.296
		n (mean)			
		0	1		
BIG4	295	60(20.34)	235(79.66)		

Notes: Variable definitions: ACCQUAL is the standard deviation of residuals from the firm's regression of current accruals on lagged, current, and future cash flows from operations; CASH is the ratio of cash and cash equivalents to net assets; PCON is the proportion of politically connected directors on the board; SIZE is total assets; ROA is return on assets measured by net income before extraordinary items scaled by average total assets; LEV is total liabilities scaled by total assets; GROWTH is sales growth rate of a firm; BIG4 is the indicator variable that equals1 if the firm's auditor is Big Four and 0 otherwise

Table III.
Descriptive statistics

with a minimum (maximum) of 31.7 per cent (72.4 per cent). As for leverage, the mean value is 43.6 per cent with minimum and maximum values ranging from 1.6 to 91.5 per cent. The mean value of GROWTH is 15.4 per cent. Approximately 80 per cent of the sample firms are audited by one of the four big audit firms.

4.2 Correlations

Table IV presents the correlations among the key variables under investigation. PCFs are found to be larger in size, have more leverage in their capital structure, and experience lower profitability and quality of earnings numbers. On the other hand, firms with high cash holdings are found to utilize less leverage and report earnings of higher quality. The absolute values of correlation among the experimental and control variables are lower than 0.80, indicating that multicollinearity problem is not a major concern of this study (Hair *et al.*, 2006).

4.3 Regression results

Panel A of Table V reports the results of the four OLS regressions from examining the association between CASH, PCON, CASH×PCON, and accruals quality. As reported in the table, the variability of accruals surprisingly decreases as CASH increases, implying that firms with high cash holdings are inclined to report earnings numbers of high quality. Economically, this result suggests that earnings quality increases by approximately 0.174 for each point increase in cash. The unexpected finding might be due to the sample size. Our study chooses only the 100 top firms based on market capitalization in Malaysia. These firms are more likely to have a lot of potential investment opportunities and hence experience less serious free cash flow agency conflict. Previous research shows that large firms hold less cash as they are able to finance their investment projects externally (e.g. Boubakri *et al.*, 2013; Kusnadi, 2011). Our result is also consistent with prior studies that found holding large amounts of cash reserves does not necessarily represent conflicts of interests between managers and shareholders as it may enhance firm value (Mikkelson and Partch, 2003; Opler *et al.*, 1999).

The estimated coefficient on PCON is strongly significant at the expected direction in all regressions. This result shows that earnings of PCFs are of low quality as larger values of ACCQUAL indicate less desirable earnings numbers. The coefficient of 2.105 suggests that a 1 per cent increase in PCON corresponds to a 2.105 basis points reduction in earnings quality. The finding is in line with those of prior research which

Variables	1	2	3	4	5	6	7	8
1. ACCQUAL	1	*−0.121*	*0.144*	*−0.182*	−0.019	*0.122*	0.044	−0.021
2. CASH	−0.064	1	0.062	−0.018	0.084	*−0.139*	−0.063	−0.056
3. PCON	*0.126*	0.084	1	*0.247*	*−0.199*	*0.183*	−0.022	−0.024
4. SIZE	*−0.138*	−0.021	0.092	1	*−0.453*	*0.230*	0.087	−0.007
5. ROA	−0.004	0.051	*−0.129*	*−0.229*	1	*−0.311*	0.094	−0.014
6. LEV	*0.133*	*−0.187*	*0.139*	*0.280*	−0.110	1	0.022	−0.023
7. GROWTH	*0.124*	−0.098	−0.080	0.083	−0.004	0.031	1	−0.040
8. BIG4	0.077	−0.011	−0.018	0.012	0.004	−0.019	−0.027	1

Table IV.
Correlation matrix

Notes: The upper diagonal of the matrix presents Spearman correlations and the lower diagonal presents Pearson correlations. Please see Table III for variable definitions. Italics indicates statistical significance at the 5 per cent level or better

	Expected sign	Panel A: OLS regressions Dependent variable accruals quality (ACCQUAL) 1	2	3	4	Panel B: SUR regressions Dependent variable accruals quality (ACCQUAL) 1	2	3	4
Const	?	−2.891	−2.657	−3.419	−3.405	2.891	−2.657	−3.419	−3.405
		(−2.28)**	(−2.22)**	(−2.77)***	(−2.70)***	(−2.34)**	(−2.28)**	(−2.86)***	(−2.80)***
Experimental variables									
CASH	+	−0.174		−0.197	−0.187	−0.174		−0.197	−0.187
		(−2.01)**		(−2.34)**	(−1.06)	(−2.07)**		(−2.41)**	(−1.10)
PCON	+		2.105	2.171	2.124		2.105	2.171	2.124
			(4.37)***	(4.53)***	(2.33)**		(4.50)***	(4.68)***	(2.41)**
CASH×PCON	+				−0.028				−0.028
					(−0.06)				(−0.06)
Control variables									
SIZE	−	−0.238	−0.302	−0.271	−0.271	−0.238	−0.302	−0.271	−0.271
		(−3.10)***	(−4.08)***	(−3.64)***	(−3.63)***	(−3.19)***	(−4.21)***	(−3.75)***	(−3.75)***
ROA	−	1.582	1.558	2.124	2.127	1.582	1.558	2.124	2.127
		(1.21)	(1.24)	(1.68)*	(1.68)*	(1.25)	(1.28)	(1.73)*	(1.73)*
LEV	+	0.673	1.056	0.704	0.706	0.673	1.056	0.704	0.706
		(1.44)	(2.46)**	(1.56)	(1.55)	(1.48)	(2.53)**	(1.60)	(1.60)
GROWTH	+	−0.274	−0.136	−0.126	−0.127	−0.274	−0.136	−0.126	−0.127
		(−0.74)	(−0.37)	(−0.35)	(−0.35)	(−0.76)	(−0.39)	(−0.36)	(−0.36)
BIG4	−	0.017	0.058	0.046	0.049	0.017	0.058	0.046	0.049
		(0.08)	(0.30)	(0.24)	(0.25)	(0.09)	(0.31)	(0.25)	(0.26)
YR	?	controlled	controlled	controlled	controlled	controlled	controlled	controlled	controlled
INDUST	?	controlled	controlled	controlled	controlled	controlled	controlled	controlled	controlled
R^2		0.157	0.199	0.215	0.215	0.157	0.199	0.215	0.215
n		295	295	295	295	295	295	295	295

Notes: Standard betas are outside parentheses, while t-values (Z-values) for OLS regressions (SUR regressions) are in parentheses. Smaller values of ACCQUAL indicate higher earnings quality. Only six industry sectors (consumer product, industrial products, construction, trading, properties, and plantation) are included into regression analysis. We exclude IPC to avoid the dummy trap variable. Please see Table III for variable definitions. ***,**,*Indicates level of significance at the 1, 5, and 10 per cent level, respectively

Table V.
Regressions of accruals quality on CASH, PCON, CASH×PCON, and control variables

documented that political connectedness has a negative influence on earnings quality (e.g. Ball *et al.*, 2003; Belkaoui, 2004; Bushman and Piotroski, 2006; Chaney *et al.*, 2011; Leuz and Oberholzer-Gee, 2006). The interactive variable CASH×PCON is not statistically associated with accruals quality. A possible explanation for this result is that PCFs are less inclined to horde more cash as they usually benefit from a soft budget constraint, easy access to credit, and government bailout guarantees (Boubakri *et al.*, 2013). Besides, the firms are more likely to return back the excess cash to shareholders when they encounter with high likelihood of political extraction (Caprio *et al.*, 2013). Overall, given that PCFs are bailed out by the government to enhance the firms' performance and hold less cash, managers of these firms will not be pressured by politicians to hide earnings information in relation to squandering the firms' resources in government-oriented projects.

Out of the control variables, as expected, accruals quality is negatively and significantly associated with SIZE and is positively and significantly related to LEV. Since smaller (larger) values of ACCQUAL suggest higher (lower) accrual quality, these results indicate that large firms disclose high quality earnings while leveraged firms experience earnings numbers of low quality. Inconsistent with our expectation, ROA is positively associated with lower accruals quality, indicating that earnings of firms with good performance are of low quality. However, the coefficient of ROA is significant only at the 0.10 level of confidence. The R^2 of the regression analyses ranges from 15.7 to 21.5 per cent.

4.4 Robustness analysis

The previously discussed findings are based on ACCQUAL measured by Dechow and Dichev (2002) model. McNichols (2002) extends the Dechow and Dichev (2002) model by including the change in sales revenue and property, plant, and equipment (PPE) in the regression. It is argued that this modified accruals quality model overcomes the weaknesses of the absolute discretionary accrual model and increase the explanatory power of the Dechow and Dichev (2002) model (McNichols, 2002). The McNichols (2002) model is as follows:

$$TCA_{it} = \gamma 0 + \gamma 1 CFO_{it-1} + \gamma 2 CFO_{it} + \gamma 3 CFO_{it+1} + \gamma 4 \Delta REV_{it} + \gamma 5 PPE_{it} + \varepsilon_{it}. \quad (3)$$

where ΔREV_{it} is the change is sales revenues between year $t-1$ and year t; PPE the gross value of plant, property, and equipment in year t.

Both ΔREV and PPE are deflated by average total assets. Other variables are as previously defined.

We estimate Model 3 for each industry based on Bursa Malaysia classification. ACCQUAL is the standard deviation of the residuals from rolling five year window regressions of Model 3 in each industry[7]. We re-run the main model (Model 2) using the modified McNichols (2002) model to measure accruals quality. The unreported results for accruals quality measured by McNichols (2002) model do not differ much from those for the main analysis. We found PCFs to have low earnings quality, while those with high cash holdings report earnings numbers of high quality.

In the main analysis, our study measures cash holdings by the proportion of cash and cash equivalents to net assets. Boubakri *et al.* (2013) argue that using the ratio of cash holdings to net assets may distort the regression results due to the possible outliers. Therefore, following Boubakri *et al.* (2013), we scale cash holdings (i.e. cash and cash equivalent) by total assets and re-estimate Model 2 with the new variable CASH/TA.

The unreported findings for CASH/TA are approximately the same as those from using the ratio of cash holdings to net assets. The findings also are in conformity with our previous conclusion that earnings of PCF are of low quality.

5. Conclusions

This study is motivated by previous research that found high cash holding firms in East Asian counties to have low value and profitability (Kusnadi, 2011; Lee and Lee, 2009). It is also built on findings from previous papers that show PCFs in Malaysia experience lower earnings conservatism (Mohammed *et al.*, 2011) and greater likelihood of earnings manipulation, as reflected by high audit fees charged by auditors (Gul, 2006), than their counterparts. Our study opens the door to a hitherto unanswered question, that is, whether PCFs with high cash holdings in Malaysia are likely to report earnings numbers of low quality.

The results of this study show that Malaysian investors value more earnings numbers of high cash holding firms. Probably this is because managers of these firms are expected to hold cash for precautionary motives than self-interested motives. Since managers of high cash holding firms only accumulate cash to serve as a buffer to protect the firms against adverse shocks or to avoid underinvestment problems, investors perceive the performance and earnings quality of these firms to be higher than less cash holding firms. On the contrary, we find that investors perceive earnings numbers of PCFs to be of low quality. The evidence provided in this study fails to support our expectation that high cash holding firms are more likely to experience low earnings quality when the probability of political extraction is high. Governments usually bailout their favoured firms to increase their performance (Boubakri *et al.*, 2012a, b; Faccio *et al.*, 2006). Furthermore, these firms are less expected to hold more cash as they are provided with easy access to credit. The generous view of government as discussed earlier, may explain the insignificant result on CASH×PCON.

Several limitations of this study have uncovered the path for further investigations. First, our study collects data only on the Malaysian top 100 listed firms for five years time period (2007-2011). Since the majority of the sample firms are politically connected, the usage of a dichotomous variable to represent political influence was not possible. Second, the definition of political influence in this study was limited only to the presence of politically connected directors on the board. Future research could use a larger sample of data and different proxies and types of political connections to investigate the underlying relationships. Third, beyond the scope of our study, there may be other factors such as corporate governance mechanisms that influence earnings quality. Moreover, as the evidence provided in this study shows that political influence deteriorates earnings quality, we do not formally examine through which channels political connections reduce earnings quality. Prior research found political influence to be negatively associated with corporate governance (e.g. Agrawal and Knoeber, 2001; Fan *et al.*, 2007; Nee *et al.*, 2007). Future research could extend our study by exploring the effect of corporate governance in the relationship between political influence and earnings quality. Future research may also test these relations in deferent countries with different features.

Notes

1. Our study focuses on the proportion of cash to net assets to reflect the potential agency conflict between controlling and minority shareholders which is different from free cash flow studied by AL-Dhamari and Ku Ismail (2012), Bukit and Iskandar (2009), and Rahman and Saleh (2008).

2. Firm-specific approach (as opposed to industry approach) may reduce noise in accrual quality measurement, as argued by Francis *et al.* (2004). However, we employ firm-specific approach in the main analysis while our study uses industry approach in the additional analysis.
3. Francis *et al.* (2004) use five year and ten year rolling windows to measure accruals quality. However, we only use five year rolling window regressions to avoid losing too many observations due to the restriction imposed on ten year data.
4. We do not include loss in the regression as 98 per cent of sample firms experience profit.
5. We employ panel OLS regressions due to the presence of large number of dummy variables that may lower the statistical power of fixed effect panel data regression.
6. SUR regression can handle the problem of heteroskedasticity and contemporaneous correlations in the error terms for a given cross-section.
7. While we use time-serious regressions for each firm in the Model 1, in the Model 2, our study estimates accruals quality using five year data of firms in each industry following Chaney *et al.* (2011).

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