Corporate Governance and Malaysian Politics: Theoretical Framework for Accounting Quality

Nor Farizal Mohammed¹*, Zuraidah Mohd Sanusi², Fahdah Sultan Alsudairi³

¹Faculty of Accountancy, Universiti Teknologi MARA, Selangor, Malaysia, ²Accounting Research Institute, Universiti Teknologi MARA, Selangor, Malaysia, ³Faculty of Economics and Administration, King Abdul Aziz University, Jeddah, Arab Saudi.

Email: norfa783@salam.uitm.edu.my

ABSTRACT

This paper reviews various theories of corporate governance in the attempt to explain the variation in the level of accounting quality in a setting with the adoption of Anglo-American corporate governance system, yet many aspects of business dealings of the setting are heavily influenced by politics. Although many prior studies examining accounting quality and corporate governance from the point of view of agency theory, the review from this paper suggests that accounting quality may also be attributed due to the presence of political influence in corporate governance structural mechanisms in firms which can be explained from resource dependency theory. The integration of the agency and resource dependency theories is appropriate in understanding what contributes to the provision of resources and effective monitoring. The theoretical contribution from this paper can be extended to future research examining quality of reporting in markets where resources allocation is highly political, particularly, in the developing countries.

Keywords: Corporate Governance, Political Influence, Accounting Quality

JEL Classifications: M4, O16

1. INTRODUCTION

In this review piece, we survey literature on accounting and politics and corporate governance with the principle objective of providing insights into the theoretical explanation of phenomena in relation to accounting quality and governance structure in Malaysia. Malaysia is a unique country in that politics are heavily influenced by one main ethnicity (the Malays) while socio-economic activities are dominated by another ethnicity (the Chinese) (Jomo and Hui, 2003). In Malaysia, the Finance Committee on corporate governance defines corporate governance as the process and structure used to direct and manage the business and affairs of a company towards enhancing business prosperity and corporate accountability (High Level Finance Committee [HLFC], 2000). A system that enhances the firm’s value in the best interests of its various stakeholders has been analysed in many studies, but the contentious issue is pertaining to what characteristics of corporate governance are strong and effective, particularly in an emerging economy, remains unresolved. In this country, despite mimicking the Western corporate governance system and complying with IFRS, the Malaysian capital market does not perform effectively and has shown to diverge significantly from the Anglo-American capitalism and capital market liberalization (Zhang, 2009). Political influence is identified as the intervening factor that undermines the operation of the system in Malaysia (Ball et al., 2003; Zhang, 2009). In that case, by reviewing prior literature, this paper is to search for a theoretical explanation on how the politics in Malaysia shape the economy of the country thereby influencing the behavior of the firms including the accounting quality and corporate governance.

A review of prior literature in finance, accounting and management demonstrates alternative views of corporate governance, the most notable being the views from agency theory (Jensen and Meckling, 1976), stewardship theory (Donaldson and Davis, 1991), resource dependency theory (Pfeffer and Salancik, 1978), stakeholder theory (Freeman and Reed, 1983) and managerial hegemony theory (Galbraith, 1967). Although agency theory overwhelmingly dominates corporate governance research, other theories do complement the recognition that many mechanisms
and structures can reasonably enhance organizational functioning. This paper contributes in the literature by explaining the unique context of Malaysia with heavily influenced by politics in many transactions, thereby impacting the behavior of accounting and corporate governance using the integration views from the agency and resource dependency theories. The next section reviews on corporate governance and political influence in Malaysia, while section three discusses on prior studies on the relationship between accounting and politics. Section four searches for a theoretical explanation and section five concludes the review.

2. CORPORATE GOVERNANCE AND POLITICAL INFLUENCE IN MALAYSIA

This section reviews the literature on corporate governance and political influence in Malaysia in order to gain understanding on the background of the setting which differ from the dispersed shareholding market and search for theoretical explanation of the phenomena. Ownership concentration is quoted as one of the remedies for agency conflicts in western market (Shleifer and Vishny, 1994), since the goals between the owners and managers are more aligned as ownership becomes more concentrated. However, the situation differs in Malaysia, where despite ownership is concentrated, the agency conflicts exist due to the risk of diverting wealth to controlling shareholders when they become too powerful such as paying themselves special dividends and sweetheart deals with their own companies (Liew, 2007; Maury, 2006). Ownership concentration and the efforts to strengthen corporate governance practice before the Asian financial crisis, apparently did not prevent the crisis from adversely affecting the Malaysian capital market. Examples of high profile cases of misconduct during the crisis such as Renong, Perwaja Steel, Technology Resources Industry and Malaysia Airlines System provide some evidence on problematic agency conflicts in the market. Indeed, the wake of Asian financial crisis in 1997 has provided an impetus for more rigorous reforms in the corporate governance system in the East Asian countries, particularly in Malaysia.

As a consequence, the Malaysian government took the initiative to promote good corporate governance practice in an effort to stimulate the development of the local equity market as well as to boost foreign investors’ confidence in the capital market (Rahman and Ali, 2006). However, the implementation of a strong corporate governance system in developing countries is not without challenges because the factors such as excessive government intervention, highly concentrated ownership structure, weak external market control, weak legal system, low reporting quality, lack of investor protection and lack of a developed capital market (Bhattacharya, 2004). Since Malaysia adopts a more government interventionist approach, these factors are likely to affect the implementation process, thereby impacting financial reporting quality (Ball et al., 2003; Gul, 2006). The government involvement and political influence in businesses started with the launch of New Economic Policy (NEP) in 1971, aiming at redistributing wealth inequalities among ethnicities. With that policy, government has openly announced policies and incentives in favour of the ethnic of Bumiputeras in terms of enhancing Bumiputera participation in corporate equity, creating a pool of Bumiputera entrepreneurs, contracts and vendors are given to Bumiputeras, and absorbing Bumiputeras employment into services and manufacturing (Rasiah and Shari, 2001). In turn, this policy has created the opportunity for more political involvement in business and for business people to have more personal connections with politicians (Johnson and Mitton, 2003; Gul, 2006). Nonetheless, political agenda is not necessarily detrimental to the country. Even though the policy is arguably contributing to the rise ofcronyism, bribes and corruption, the blending system of government intervention and markets has indeed heralded to rapid growth, reduced poverty and inequality in the country and thereby contributing to the social harmony of the country (Rasiah and Shari, 2001).

This has led to the question of whether the government involvement in business is not really efficient as suggested from the western literature or whether this is the suitable system for the economy in transition. The different situation in Malaysia from the West also raises questions of effectiveness with regards to the adoption of western corporate governance in emerging countries such as Malaysia. Ideally, every country should consider the country factor in setting an effective corporate governance framework due to different legal, regulatory and market standards (Cornelius, 2005). Nevertheless, given the historical connection between Malaysia and the UK, the Malaysian Code of Corporate Governance was basically derived from the Cadbury Report (1992) and the Hampel Report (1998) in the UK. Reform after the crisis started with the Malaysian government forming the HLFC in March 1998. The committee later issued guidelines on the issue of corporate governance for Malaysian companies which were made available in the Report on Corporate Governance 1999 (Abdullah, 2004). With the establishment of the Malaysian Institute of Corporate Governance in 1999, the report was later subsumed in the Malaysian Code on Corporate Governance in the year 2001. Malaysia enhances the corporate governance regime by providing greater obligation with the incorporation of the Malaysian Code of Corporate Governance into the revised Bursa Malaysia Listing Requirements in 2001 (Yatim et al., 2006). The approved accounting standards (Financial Reporting Standards) become mandatory through the Bursa Malaysia Listing requirements, Companies Act 1965, Companies Commission Malaysia and the Securities Commission. This paper does not intend to describe the details of Malaysian Code of Corporate Governance as they are basically similar to the codes adopted in western countries and the issues have been discussed comprehensively in Haniffa and Hudaib (2006), Liew (2007), Tam and Tan (2007) and Germain et al. (2014).

It is undeniable that the Malaysian government has put all efforts in raising the standard of corporate governance in the country to avoid further corporate collapses and for sustainable and strong growth of the country (Shim, 2007). However, some prior studies (Cheung and Chan, 2004; Haniffa and Hudaib, 2006) argue that the adoption of the Malaysian Code of Corporate Governance that merely mimics the recommendations from developed countries might not be suitable to an emerging capital market and developing country like Malaysia. The effective enforcement of the reform
in corporate governance in Malaysia is halted with the presence of close ties between government or politicians and business (Liew, 2007; Wahab et al., 2011). For example, in the situation of Malaysia where there is significant government ownership in some firms, the directors may be elected by the controlling owners and some firms appoint politically-connected directors to the board, knowing the benefits that stem from this relationship. This raises doubts as to whether the independent directors are truly independent and provide an adequate degree of monitoring of the majority shareholders. Haniffa and Hudaib (2006) suggest that independent directors in Malaysia may not able to monitor efficiently because they are selected more for political motives rather than based on their expertise and experience.

From the above, it can be seen that Malaysia offers a powerful laboratory to examine the effectiveness of corporate governance system as there are other unique factors at the outset. It is very important to examine the effectiveness of corporate governance from the view of quality reporting because theoretically, financial statements are used in contract monitoring as explained by the agency theory. However, the outcome of financial reporting can be influenced by resource providers, as argued by resource dependency theory. It is therefore undeniable that knowledge of corporate governance and the institutional factors are of great importance for understanding the financial reporting environment. The move to market economy which often requires quality reporting, together with serious government attempts to improve corporate governance and political intervention, offer a venue where these issues can be examined. The following section reviews prior studies on the relationship between accounting and politics.

3. ACCOUNTING AND POLITICS

The impact of politics on accounting has been investigated by several cross-country studies. For example Picur (2004) and Riahi-Belkaoui (2004) examine the elements of politics and earnings opacity. Picur (2004) show significant relationships between the level of corruption and the level of earnings opacity using a sample of 34 countries, suggesting a lack of good accounting information may be exploited by both politicians and firms to pursue their own agenda, or to appropriate part of the wealth of citizens and stakeholders. The results from Picur (2004) also identify accounting quality as a tool to create a good climate for accountability and the curtailment of corruption. While the findings between the level of disclosure, the number of auditors per 100,000 inhabitants and the adoption of International Accounting Standards (as elements of the accounting order) and earnings opacity are not significantly related internationally, Riahi-Belkaoui (2004) reveals earnings opacity is positively related to the percentage of politically-connected listed firms (criteria based on Faccio [2002]) in 32 countries. Both studies suggest the importance of exploring the political element.

Political influence in terms of state ownership is documented to be related to financial transparency in a cross-country study by Bushman et al. (2004). Financial transparency is shown to be higher in countries with low state ownership of enterprises, low state ownership of banks, and low risk of state expropriation of firms’ wealth. A more recent cross-country study examining political influence on reporting quality is undertaken by Chaney et al. (2011). The firms are classified as politically connected firms if at least one of its large shareholders (at least 10% of votes) or top directors (CEO, chairman of the board, president, vice-president or secretary) is a member of parliament, a minister or a head of state, or is tightly related to a politician or party (Chaney et al., 2011). They include close relationship to ministers in only well-known cases of relationship from the media. In general, they show that political connections are associated with poor reporting quality. Moreover, they also document the negative association between the quality of reported earnings and the cost of debt only for non-politically connected firms in the sample. The results suggest politically-connected firm typically derive gains from their connections and these connections mitigate the negative consequences of poor reporting quality.

In addition to cross-country studies, prior studies also focus on the setting in one country such as Leuz and Oberholzer-Gee (2006) who examine the issue in the Indonesian setting. Their analysis shows that political connections, in terms of a firm’s closeness to Soeharto1, are negatively related to proxies for disclosure during the Asian financial crisis. This result is consistent with and complements recent evidence by Johnson and Mitton (2003), who show that politically-connected firms in Malaysia benefited from the imposition of capital controls during the Asian crisis. In China, defining politically-connected CEOs as current or ex-government bureaucrats, Fan et al. (2007) demonstrate a poor relationship between the accounting and stock return performance of the firms run by politically-connected CEOs, relative to their less political counterparts.

As a result of NEP and later being replaced with the National Vision Policy for the period 2001-2010, aiming to restructure the socio-economic imbalance among ethnic groups, there have been close ties between businessmen and politicians or politically-connected people. According to Gomez and Jomo (1997), there are two types of politically favoured firms in Malaysia; the first type is those firms run by ethnic Malays and they are given the Bumiputra status by the government; and the second type is those firms run by ethnic Malays, Chinese or Indian but they have close connection with politicians or higher officers in government. Many prior studies in Malaysia look at political influence from the perspective of politically-connected firms (Johnson and Mitton, 2003; Gul, 2006). One early study in Malaysia to examine politics and the economic outcomes is Johnson and Mitton (2003), who base the list of politically-connected firms from Gomez and Jomo (1997). Even though stock returns of politically-connected firms are found lower relative to other Malaysian firms in the early phase of the Asian crisis, Johnson and Mitton (2003) find the returns of these favoured firms are higher on average once the capital controls are imposed. This is consistent with their argument that capital controls are introduced primarily to benefit politically-connected firms. In their study, they also consider the element of ethnically favoured (Bumiputra), the ethnic group which received more help after the imposition of capital controls (Johnson and Mitton, 2003). The findings reveal the Bumiputra coefficient is

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1 Soeharto is a former President of Indonesia.
insignificant, which suggest that “political favouritism” is a more important relationship than simply ethnicity in determining the fortunes of Malaysian firms.

Following the above study, Gul (2006) examines the effect of dynamic changes from the social contract from the perspective of auditors’ assessments of audit risk for firms. More specifically, this study examines the response of auditors, in terms of audit effort and audit fees of politically-connected firms to the 1997 Asian financial crisis and the subsequent implementation of capital controls. These components are likely to influence the property of accounting numbers, thereby affecting auditors’ assessment of audit risk. Using the list of politically connected firms from Gomez and Jomo (1997), the results show that there is a greater increase in audit fees for firms (indicating less reporting quality) with political connections than for non-politically connected firms as a result of the Asian financial crisis. Contrary to Johnson and Mitton (2003), ethnicity is found significant and positive in Gul (2006), thus suggesting that firms with Bumiputera ownership are associated with higher audit risks and thus higher audit fees. Gul (2006) also document that politically-connected firms have a higher audit risk during the financial crisis relative to other firms due to a greater likelihood of business failure and a greater likelihood of misreporting and overstatement of earnings in order to avoid debt default. These results are consistent with a stream of recent cross-country findings that the political economy does matter in financial reporting (Picur, 2004; Riahi-Belkaoui, 2004). The significant result on the ethnic Bumiputera variable and consistent result with politically connected firms in Gul (2006) suggests this variable to be considered in future analysis of political influence study, in Malaysia.

Prior studies in Malaysia found that institutional investors do play a monitoring role in order to reduce agency costs, thereby mitigating the negative effect of politically-connected firms in accounting (Wahab et al., 2007; Wahab and Rahman, 2009; Wahab et al., 2009, Wahab et al., 2011). For example, Wahab et al. (2007) found that the negative association between political connection and corporate governance is mitigated by institutional ownership. Similar results were found in Wahab et al. (2009) where two-way interaction between institutional investors and politically-connected firms and audit fees suggest that politically-connected firms pay higher audit fees than non-politically-connected firms when institutional investors are present in their firms. This exploration suggests institutional investors play a role in monitoring by demanding higher quality audits for politically-connected firms. On the other hand, political influence is also a possible factor that mitigates institutional monitoring in relation-based economies such as Malaysia. For example, Wahab and Rahman (2009) find a negative relationship between institutional ownership and remuneration reduces in politically-connected firms. Politically connected firms are also found to pay higher audit fees, while firms with better governance demand a higher audit quality, leading to higher audit fees (Wahab et al., 2011). Further, political connections are demonstrated to be a threat to auditor independence, thus affecting the confidence of public in the profession (Wahab et al., 2015). The above findings of prior studies in Malaysia contribute to the notion that the political economy matters in financial reporting.

Therefore, the concerns regarding the quality of reported earnings in politically-connected firms are justifiable.

4. THEORETICAL EXPLANATIONS

Many studies employed agency theory to explain the monitoring role of corporate governance. According to Jensen and Meckling (1976), this notion of problem in agency theory is due to potentially different goals and aspirations between the principal and the agents as a result of separation between ownership and control. The agents may succumb to pursuing their own utility instead of the firm’s value resulting in agency costs such as lower operational performance, higher rents for managers and excess resource distribution to shareholders at the expense of debt-holders (Jensen and Meckling, 1976). These are also consistent with the existence of inefficient contracts among the relevant parties, which raises the alarm for corporate governance mechanisms.

Corporate governance mechanisms are implemented to mitigate conflicts in the agency relationship. For example, the board of directors plays a central role in monitoring and controlling the behaviour of senior managers, thereby improving contracting efficiency (Fama, 1980; Fama and Jensen, 1983). In addition, the board of directors also delegates certain duties, such as those in relation to financial reporting tasks, to other committees, in particular audit committees and external auditors. Indeed, financial reporting plays a critical role in contracting as accounting information is often used in the contract terms and in monitoring the contract terms (Watts and Zimmerman, 1986). As has been noted by Watts (2003a), contracting induces accounting quality. The same explanation of contracting induces accounting quality is arguably applicable in Malaysia as the enforcement of agency contracts in emerging countries is more costly and problematic (Wright et al., 2005). Therefore, this study posits that quality financial statements reduces agency conflicts and facilitates contract efficiency even in emerging countries. Accordingly, agency theory is relevant in that it explains the phenomena in exploring the complementary monitoring role of corporate governance and financial reporting in emerging market economies.

A contrasting perspective is presented in stewardship theory which believes in the structures that empower the steward based on trust to act more autonomously so that shareholders’ returns are maximised (Donaldson and Davis, 1991). Stewardship theory emphasizes a consistent goal for managers and shareholders since the managers are fully motivated to manage the assets effectively and to gain intrinsic satisfaction by performing their job well (Muth and Donaldson, 1998; Hendry and Kiel, 2004). This view suggests there is no need for monitoring and controlling behaviours as managers are willing to prepare quality financial statements since the financial statements can assist them in the firm’s decision-making, thereby maximising shareholders’ returns. However, scandals such as Enron and Worldcom and the Asian financial crisis of 1997 show that manipulations do occur and therefore, there is still a need for a corporate governance monitoring role. As there is still room for accounting choice and manipulations in accounting, this theory seems to be less relevant in explaining...
resulting in strong political influence in the monitoring role of corporate governance in financial reporting. In that case, this paper finds that agency theory and hegemony theory complement each other in explaining the situation with western corporate governance mechanisms adoption and heavily politicised resource allocation. The integration of both theories view corporate governance as a mechanism for providing competitive advantage, resources to firms and effective monitoring because in practice, boards of directors have two roles: Firstly, to monitor firms’ performance; and secondly, provide resources for them (Korn and Ferry, 1999; Udayasankar and Das, 2007).

As agency conflicts persist in the Asian region, agency theory is relevant for discussing issues pertaining to the monitoring and quality of reporting. To agency theorist, corporate governance mechanisms are designed to be involved in the preparation of financial statements. In that case, the presence of political influence in corporate governance mechanisms may also influence the decision in the process of preparing financial statements. Political influence may exist in firms with the appointment of politicians or government representatives on board. The firms tend to follow political influence rather than the board’s decisions. This passive view of directors arguably explains the phenomenon in developing countries where the application of Anglo-American corporate governance is implemented merely to legitimise the process. The effectiveness of the system is still questionable and its empirical support is still limited (Hendry and Kiel, 2004). As shown in Figure 1, multiple relevant theories have been applied to explain the problem which include agency theory, stewardship theory, resource dependency theory, stakeholders theory and hegemony theory.

Recent study shows contradict results with most findings in the US market that uses agency theory where Germain et al. (2014) find no evidence that the measures under the monitoring hypothesis are related to board independence, which requires further investigation on the monitoring role played by Malaysian boards. In that case, notwithstanding the strength of agency theory in explaining the monitoring role of corporate governance in financial reporting, this paper proposes resource dependency theory is prevalent in supporting the explanation of specific corporate governance phenomena in emerging countries. Dalton and Dalton (2005) explain that agency theory has limited explanatory power for corporate governance research. Further, Daily et al. (2003) also suggest adopting other theories such as resource dependency theory in order to provide more productive results beyond the focus of a board’s monitoring role. Reviewing the institutional background of Malaysia suggests high political influence in the allocation of resources. Therefore, merely discussing corporate governance with the element of political influence under the agency theory contributes to the incomplete explanation. In that case, this paper finds that agency and resource dependency theories complement each other in explaining the situation with western corporate governance mechanisms adoption and heavily politicised resource allocation. The integration of both theories view corporate governance as a mechanism for providing competitive advantage, resources to firms and effective monitoring because in practice, boards of directors have two roles: Firstly, to monitor firms’ performance; and secondly, provide resources for them (Korn and Ferry, 1999; Udayasankar and Das, 2007).

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firm. In dealing with the pressures of uncertainty and scarcity of the environment, the resource dependence theorists contend that in order for the organizations to survive, they therefore comply with the requirements of strategic resource providers (Verbruggen et al., 2014) According to Carpenter and Feroz (2001), many prior research generally ignores the fact that how institutional and governmental pressure constrain accounting choice in the firm under their control. Financial resources are critical for the firms to survive and this acquisition of financial resources can be problematic and uncertain at certain times. Since the outcome of financial reporting can affect the distribution of future resources, the resource providers can exert influence on accounting choice and this pressure can be a dominant factor in influencing choice of accounting practices (Carpenter and Feroz, 2001). With agency theory background, the influence to financial reporting can be disseminated through corporate governance mechanisms. In that case, from the review, agency theory and resource dependency theory are found capable to explain the role of board in monitoring as well as providing resources to the firms, thereby influencing the outcome of financial reporting.

5. CONCLUSION

Accounting as one of the regulator control mechanism in the capital market is not left out from being influenced by the political factors. The review of the financial reporting framework above demonstrates Malaysia has a sophisticated accounting system that is consistent with international developments. In spite of all the improvements in the accounting system in moving towards a global liberal market economy, the quality of reporting and auditing is still questionable. Similarly, corporate governance system as a tool to regulate the performance of companies in Malaysia has also been inherited from the West. Nevertheless, the issue is whether the western system of corporate governance is effective in the environment of Malaysia with different shareholding structure and political influence. This review of literature prompts further investigations on the issues of corporate governance and financial reporting quality such as earning manipulation in the environment such in Malaysia where there is substantial political influence in the market. This paper proposes, due to differences in governance structures from the developed countries, the resource dependency theory is used collectively with the agency theory to explain the phenomena of monitoring and providing resources in Malaysia. Agency theory is relevant to explain the monitoring role of corporate governance where the agency conflicts exist despite the difference in institutional factors from the developed countries. Although this country adopts the Anglo-American corporate governance system, the political economy of Malaysia differs from the general Anglo-American experience by diversities in ethnic, political and economic relationships. Hence, resource dependency theory enables to explain the phenomena of resource providing in this transition economy, thereby allowing to the expectation of relationship with quality of financial statement. Indeed, this paper contributes to the theoretical perspective of corporate governance and accounting quality by integrating the agency and resource dependency theories. This is appropriate in understanding what contributes to the provision of resources and effective monitoring because in practice, board of directors play two roles: Firstly, to monitor firms’ performance; and secondly, provide resources for them.

The reviewed studies indicate the existence of a rich field of potential research topics in relation to proposed framework. The frameworks using agency and resource dependency theory can be extended to other emerging markets for example countries in Africa or Middle East, where resources allocation is highly political and political connection become valuable resources in businesses. The question remains is whether firms in emerging economies need quality financial statements to enhance performance or instead, the appointment of politically connected directors on board. Future extensive examination using various accounting quality proxies, corporate governance, political influence and performance can help to clarify the matters. The agency theory and resource dependency theory suggest the role of directors to monitor as well as provide resources to firms. Examination from the perspective of politically connected directors would allow the discovery of their true role that they play, whether they do play the role in ensuring quality financial statement or the role is mainly on enhancing performance of the firms. Indeed, the issues of accounting quality and corporate governance in emerging
economies remain relevant and important. The analysis using the proposed framework partially contributes in searching for the appropriate governance in the emerging economies. Though the issues with regards to emerging economies are not easily solved, the discussions above raise alarms to the improvement to the current system. Conclusively, the literature review in this paper and the proposed framework using agency theory and resource dependency theory raise several implications for future research in contributing to the enhancement of knowledge.

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