EARNING QUALITY IN MESDAQ COMPANY

SITI NOR JUNITA BINTI MOHD RADZI

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EARNING QUALITY IN MESDAQ COMPANY

A thesis submitted to the Graduate School in partial Fulfillment of the requirement for the degree Master in Science (International Accounting)
By
Siti Nor Junita Binti Mohd Radzi

KOLEJ PERNIAGAAN
(College of Business)
Universiti Utara Malaysia

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I certify that any help received in preparing this thesis and all sources used has been acknowledged in this thesis.

Siti Nor Junita Binti Mohd Radzi

87022

College of Business

Universiti Utara Malaysia

06010 Sintok

Kedah

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ABSTRACT

Earning Management can be viewed from financial reporting perspective. From a financial reporting perspective, managers may use earning management to meet analysts' earning forecast, thereby avoiding the strong negative share price reaction that quickly follow a failure to meet investor expectations. Also, they may record excessive write off or emphasize earning construct such as net income. Management may use it to create a stream of smooth and growing earning over time. Give securities market efficiency, this requires management to draw on its inside information. Thus, earning management can be a vehicle for the communication of management's inside information to investors. Too much earning management, however, reduces the earning quality and the ability investor to interpret current net income as well, particularly if the earning management is buried in core earning or otherwise not fully disclosed. The reported net income is useful to investor in evaluating future firm performance but excessive earning management may reduce this usefulness. Thus this study is very important because from the research findings shows that the size of audit firm, internal audit establishment and former senior auditor as company director have no significantly effect on earning management which being proxy by total discretionary accruals. An understanding of the earning management is also important to accountants because it enables an improved understanding of the usefulness of the net income, especially for reporting to investor. It also may assist them to avoid some of the serious legal and reputation consequences that arise when firms become financially distress where such distress is often preceded by serious abuse of earnings management.

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SITI NOR JUNITA BINTI MOHD RADZI

COLLEGE OF BUSINESS

UNIVERSITI UTARA MALAYSIA

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ABBREVIATIONS

aud_signal	Audit delays
audit_partner	Senior and junior auditor
big4	Big four audit firm (KPMG, PwC, Deloitte and EY)
bodxsenaudit	Existence of former senior auditor as company director
caudpartner	Company audit partner
CLERP	Corporate Law Economic Reform Program
COGS	Cost of Good Sold
CPA	Chartered Public Accounting
EPS	Earning Per Share
EY	Earns & Young
GAAP	General Accepted Accounting Principles
IIAM	Institute of Internal Auditor of Malaysia
int_audit	Existence of independent internal audit function
IV	Independent Variables
lgasset	Total asset
lgaudfee	Audit fees
MESDAQ	Malaysia Exchange for Securities Dealing and Automated Quotation
MIA	Malaysia Institute of Accountants
MSC	Multimedia Super Corridor
NYSE	New York Stock Exchange
OLS	Ordinary Least Square
SAC	Statements of Accounting Concepts
SEC	Securities Commission
SFAC	Statement of Financial Accounting Concepts
SMI	Small Medium Industries
SOX	Sarbanes Oxley
SPSS	Statistical Package for Social Science
sqrtsubs	Number of all subsidiaries

CHAPTER ONE

INTRODUCTION

1.0 Introduction

Firm value is derived from the market's expectations of firm performance. Accounting provides the necessary information for the market to form these expectations. Books value of equity represents past performance and current earnings are indicative of future performance. Thus these measures are commonly used as the basis for firm valuation (Easton and Harris 1991; Wild 1992; Ohlson 1995; Penman 1998; Ou and Sepe 2002).

This study is conducted for the purposes that the reliability of accounting information may affect its relevance to the market in determining firm value and reducing the quality of reported earning as well. The earning figure is susceptible to manipulation that may also reduce its reliability and thus its usefulness in the valuation process. This is due to the accrual components of earnings which is in part subject to managerial discretion. This is because according to the GAAP (General Accepted Accounting Principles) allow a degree of freedom; this pliancy may be exploited by management (Levitt 19998). The prospect of exploitation increases when incentives exist for management to manipulate the accruals components of earnings targets (Beaver and Angel 1996; Dechow et al 1996; Wu 1997; Teoh et al 1998b; Erickson and Wang 1999; Holland and Ramsay 2003).

The rationale for the use of accrual accounting is that it allows management to adjust cash flows to better reflect the performance and position of the firms. In this context, accruals are used as a signal to the market. However when the managers use accruals to opportunistically manage earnings, the earning measure is not a reliable indicator of the firm's financial performance. Accordingly, such opportunistic behavior will reduce the usefulness of the information contained earnings. The difficulty for the market participants is to identify when accruals are used as a credible signal and when

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