

Environmental, Social and Governance (ESG), Earnings Management and High-Quality Auditors: A Conceptual Framework in the Malaysian Context

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Abstract

This paper develops a conceptual framework that explains the effect of Environmental, Social and Governance (ESG) disclosure on accrual earnings management in Malaysian public-listed companies, and how high-quality auditors may strengthen or weaken this relationship. This paper develops a detailed conceptual framework by combining existing studies on ESG, earnings management, agency theory and audit quality. The framework suggests that the relationship between ESG and earnings management is affected by two proxies of high-quality auditors which are the competence of industry-specialist auditors and the independence shown based on audit fees. Based on the analysis from the results of previous evidence, both variables show inconsistent results between ESG and earnings management, especially in the context of Malaysia. This paper argues that high-quality auditors can strengthen the trustworthiness of a company's ESG disclosures and reduce managerial discretion, thus moderating the effect of ESG disclosure on earnings management. This paper is constrained by the lack of readings from multidisciplinary literature to obtain a more comprehensive theoretical understanding. This paper represents a review from another publication and the data is currently being collected but not yet been regressed. Furthermore, because of the time restrictions, the literature related to the topic is not thoroughly explored.

Keywords: Environmental, Social, Governance, Earnings Management, High-Quality Auditors

Introduction

In the literature, the idea of earnings management has drawn interest and been addressed by analysts, investors, regulators and the financial press (Dechow and Dichev, 2002; Elkalla, 2017; Velte, 2020; Gadhoum, 2021). Current debates in the social sciences increasingly examine the tension between managerial stewardship and opportunistic behavior through the lens of institutional trust. Within the Malaysian capital market, this tension is exacerbated by information symmetry where managers may utilize their discretionary power to achieve preset objectives under the guise of generally accepted accounting principles (GAAP) (Pereira and Alves, 2017). According to Gaio (2010), the early 2000s global stock market meltdown was caused by a lack of availability of financial reporting and the calibre of financial accounting data. Managers can behave as “good” stewards of the company by enhancing the company’s reputation and acting in an ethical manner (Donaldson, 1990; Donaldson and Davis, 1991). On the other hand, managers can have “bad” opportunistic motives that result in information asymmetry between stakeholders and managers (Kabir *et al.*, 2022).

This study specifically examines the intersection of Environmental, Social and Governance (ESG) disclosure and accrual earnings management within the top 100 non-financial Malaysian public-listed companies. The scope is limited to these entities to ensure comparability as financial institutions operate under distinct regulatory frameworks that may mask typical earnings management patterns. By exploring how high-quality auditing moderates this relationship, the research aims to establish whether ESG reporting serves as a genuine ethical commitment or a strategic tool for greenwashing to mislead stakeholders.

Environmental, Social and Governance (ESG) practices have been adopted as a result of the company’s efforts to improve its financial reporting. According to Velte (2020), ESG practices reduce managers’ motivation to falsify results since lower-quality earnings do not reflect stakeholders’ interests. In addition, according to Velayutham (2018), stakeholders’ demand also makes managers less involved in earnings management since the high implementation of ESG represents a positive image and reputation of a company. According to Atan *et al.* (2016), previous studies demonstrate that stakeholders now have different perspectives as the ESG concerns have intervention from many sides. ESG has been shown to significantly impact companies’ performance by helping a number of companies improve their public image while continuing to conduct their operations (Dalal and Thaker, 2019). This illustrates how ESG has the ability to increase the quality of a company’s financial reporting and avoid opportunistic behaviour of managers from using earnings management.

According to Han (2022), investors rely on audited financial statements due to the information asymmetry between managers and stakeholders. This is due to the fact that stakeholders rely on the available audited financial statements to make investment decisions, and the only ones that have access to the original accounting records are auditors. According to Basiruddin (2011), stakeholder interest can be boosted by audited financial reports which is why few companies have the capacity to pay high-quality auditors.

Based on agency theory, Jensen and Meckling (1976) mentioned that conflict of interest between the principal (stakeholders) and agent (managers) exists when the agent has different intentions from the principal perspective. Therefore, this theory shows that most researchers concluded that earnings management has a bad impact as it would lead to a

conflict of interest between two parties (El Diri, 2016; Elkalla, 2017). However, the opportunistic behaviour of managers can be explained by prospect theory which in terms of wealth, losses seem to matter more than gains. The pain of losing a certain amount of money is higher than the joy of acquiring the same amount (Kahneman and Tversky, 1979) because reported losses or lower earnings would be detrimental to the value of the company. The prospect theory's knowledge may be able to provide light on managers' usage of earnings management. Managers are motivated to guide earnings and unintentionally misuse them in a way that will be most advantageous or least destructive for themselves and the company.

In this conceptual paper, the top 100 non-financial Malaysian public listed companies from FTSE Bursa Malaysia 100 Index are selected based on total population sampling. The reason to exclude financial companies is because financial services companies are frequently having different nature of their business which are more sensitive to financial hazards compare to regular companies (Foerster and Sapp, 2005) and it is also has many regulatory requirements that they must adhere to (Liu *et al.*, 2016; Martinez-Ferrero *et al.*, 2017). The reason to select the top 100 non-financial public-listed companies in Bursa Malaysia is because it serves as a measurement for the Malaysian stock market and has been often utilised in past literature (Esa and Ghazali, 2012; Yusoff *et al.*, 2019). Moreover, according to KPMG's International Survey of Sustainability Reporting 2020, 99% of the top 100 Malaysia's companies publishing sustainability reports (KPMG, 2020). In addition, 97% of the top 100 public listed companies in Malaysia include corporate responsibility information in their annual reports.

Problem Statement

Managers have often abused earnings management as one of the frauds (Healy, 1999; Beneish, 2001; Nelson *et al.*, 2002; Rosner, 2003; Razaur Rahman, 2006; Chia *et al.*, 2007; Perols and Lougee, 2011; Rahman *et al.*, 2016; Wang *et al.*, 2022) which widen the gap of information asymmetry between them and stakeholders and cause the conflict of interest to exist (Bergh *et al.*, 2019). Because of that, ESG practice is acknowledged as a tool that can affect the quality of financial reports and reduce managers' opportunistic behaviours (Boffo and Patalano, 2020). ESG is also recognized as a tool that may enhance a company's public perception (Dalal and Thaker, 2019). Recent empirical evidence highlights that this issue is particularly acute in developing markets like Malaysia where the efficacy of ESG practices as mitigant for managerial opportunism remains inconclusive.

To examine how ESG affects earnings management in the context of Malaysia, the literature was limited. Seker and Sengür (2021) studied the impact of ESG on earnings management around the world which includes Malaysia and it proved ESG mitigate earnings management. Furthermore, Nurrahman *et al.* (2019) examine the relationship between ESG and earnings management in the context of Islamic and non-Islamic companies in Malaysia. The study proved that companies that have better ESG sustainability performance, tend to reduce their opportunistic and unethical behaviour as they have better earnings quality. Therefore, how ESG practice affects the managers' behaviour on earnings management in Malaysia needs further investigation.

Due to the inconclusive result of the direct relationship between ESG and earnings management, a moderator is taken into account to strengthen or mitigate the relationship. Auditing is a crucial strategy for minimizing information asymmetry, preventing opportunistic

behaviour and improving ESG performance (Agyei-Mensah, 2018). At the best of the author's knowledge, no study has taken into account the moderating role of high-quality auditors on the relationship between ESG and earnings management especially in Malaysia. Therefore, the interaction effect of high-quality auditors on the relationship between ESG and earnings management deserves further investigation.

Significance of the Research

The conceptual paper is significant as it will provide a theoretical extension to Agency Theory by identifying the specific conditions under which ESG disclosure effectively reduces agency costs in Malaysia. Apart from that, the present study identifies high-quality auditors that moderate the relationship between ESG and earnings management. Krishnan (2003) suggested that auditors with high-quality skills are able to mitigate a company's earnings management as they are skilful in terms of knowledge, resources and incentives to reduce a manager's opportunistic behaviour. Last but not least, for the aspect of practical use, the study will contribute valuable information to the main stakeholders of Malaysian non-financial public-listed companies, which includes potential investors, shareholders, employees and customers. Because Malaysian companies may adhere to various ESG practice standards, it may result in a different impact on earnings management. ESG practice may cause managers less motivated to implement earnings management as it requires managers to disclose company information.

Literature Review

Agency Theory

Agency theory represents the relationship between the principal (shareholders) and the agent (manager). According to Jensen and Meckling (1976), this relationship is a contract that is formed when the principal gives permission to the agent to make a decision that is in the best interest of the principal. The goal of the contract is to reduce the conflict of interest. A conflict of interest arises when managers attempt to maximize their efficiency at the expense of shareholders' interests. Companies suffer from agency conflict as a result of this disagreement. According to Bhundia (2012), managers are keen to provide shareholders with a detailed image of the company's financial status in order to maximize their position and interests.

Offering stakeholders more information about the companies can boost their trust and lessen information asymmetry which in turn reduces the conflict of interest (Healy and Palepu, 2001). Managers provide stakeholders with complete financial reporting which prevents them practicing earnings management by altering the financial statement to deceive the stakeholders. This agency theory perspective is the basis for understanding the issue between earnings management and ESG practice.

Besides that, stakeholders want reassurance that managers act in their best interests. One of the strategies to lessen conflict is to employ agency costs. For this present study, the auditor monitoring role is proposed as a variable that can strengthen the direct relationship between earnings management and ESG practice. According to Solomon (2007), an external audit is an essential part of a company's internal control system, and check and balance mechanism that allows shareholders to monitor managers' activities. Based on a previous study, a company with a high-quality auditor performs noticeably in the community (Agyei-Mensah, 2018). This

is due to the fact that stakeholders believe that excellent corporate responsibility raises the company's worth and reputation as it is feasible to ensure the voluntary disclosure of higher ESG by developing a high-quality audit (Ali and Lesage, 2013). This perspective is the basis to understand that high-quality audits may enhance ESG performance by discouraging the opportunistic behavior of managers to use earnings management and reduce the conflict of interest by disclosing a complete financial report.

Earnings Management

Earnings management has no single universal definition in the literature. This study adheres to Healy and Wahlen (1999) definitions of earnings management which is one of the most widely used. Healy and Wahlen (1999) stated that earnings management occurs when managers use judgment in financial reporting and in structuring transactions in order to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that rely on reported accounting numbers.

To decide the measurement of earnings management, both accrual and real earnings management are analyzed as these two often get attention from researchers. For accrual earnings management, it involves altering accruals under GAAP such as the calculation of bad debt and depreciation rates, changing how the firm's economics are presented in the accounting system rather than its underlying economics and it also affects how much money is distributed among the stakeholders. (El Diri, 2016). Although accrual earnings management may have an effect on cash flows but the value of a firm is unaffected (Walker, 2013).

There are many models that explain accrual earnings management which are Ronen and Sadan Model (Ronen and Sadan, 1981), Healy Model (Healy, 1985), De Angelo Model (DeAngelo, 1986), Jones Model (Jones, 1991), The Modified Jones Model (Dechow et al., 1995), The Forward-Looking Model (Dechow et al., 2003), The Cash-Flows Model (Dechow and Dichev, 2002), Performance-Matching Model (Kothari *et al.*, 2005), Stubben's model (Stubben, 2010) and others.

In this study, accrual earnings management will be prioritized which is in line with the statement from Ibrahim *et al.* (2015) that accrual proved to be the most crucial tool that managers employ to control or change earnings, by increasing or decreasing reported income. This study also will be using the Modified Jones Model as it explains total accruals in detail and minimizes the error of discretionary measurement (Dechow *et al.*, 1995).

Environmental, Social, and Governance (ESG)

ESG is a voluntary component of CSR or corporate sustainability reporting (Baron, 2014). There is an increasing need for more systematic ESG, which has prompted the creation of various international programs including GRI and the United Nations Global Impact (Lydenberg, 2014). Regarding ESG disclosure requirements, different countries have different rules. Government and regulatory agencies play significant roles in establishing the requirements for market participants' required compliance. According to Atan *et al.* (2016), the establishment of national standards and the inclusion of national instruments in national policy are two examples of the strategies employed by regulatory agencies to encourage corporate enterprises to embrace ESG practices. Baron (2014) stated that the countries'

securities exchanges may provide guidelines that are either mandated or voluntary that specify the necessary disclosure of ESG through CSR or sustainability reporting.

ESG variable in this study is measured by ESG score as it is recognized as the key financial instrument to create green portfolios and assess a company's ESG performance. ESG score helps companies to enhance their performance (Arouri *et al.*, 2019), mitigate regulatory restrictions on their operations (Christensen *et al.*, 2019), lower financial hazard (Chollet and Sandwidi, 2018) and engage with additional capital (Cheng *et al.*, 2014). ESG scores is used to quantify sustainability, Corporate Social Responsibility and the disclosure of ESG. According to Clement *et al.* (2023), the disclosure definition is largely recognized by the community and is compatible with the methodologies and supporting information supplied by ESG scores agencies. Hence, this present study adopts ESG disclosure scores as a proxy for ESG.

High-Quality Auditors

The auditors are in charge of enhancing the accuracy of a company's financial statement in order for the company's information to remain reliable to provide the foundation of decision-making. Hence, the auditors need to possess both competence and independence the quality of the audit is directly impacted by these two characteristics (Al-Hadrami *et al.*, 2020). According to Lee and Stone (1995), competence can be defined as the ability to use sufficient information to carry out an audit in an impartial manner. For auditors to be considered competent, they must undergo adequate technical training and auditing skills. However, auditors' ability to perform tasks independently may be impacted by their degree of professional scepticism. This is why auditors should possess independence characteristics as well. Independence is when auditors hold on to the principles of integrity and objectivity personal interest while avoid personal interest in the work they do (Al-Hadrami *et al.*, 2020). This present study focuses on two proxies to measure audit quality that based on auditor competency and independence, namely industry specialist auditors and audit fees.

Industry Specialist Auditors

The reputation capital concept in relation to major auditors serves as the foundation for the use of industry specialist auditors. Beatty (1993) believes that companies may lessen the knowledge gap between management and shareholders by highlighting and marketing their attributes through a reputable auditor. The company employs auditors with industry expertise to fulfill the requirement for improved supervision because of increase agency costs. Chang *et al.* (2008) performed a study that suggests a company examined by specialist auditors my offer higher audit quality due to numerous types of theoretical and practical findings.

According to Audousset-Coulier *et al.* (2016), industry specialist auditors are auditors who have gained knowledge and experience in the industry which enabling them to provide their customer with high-quality audits and better services. Auditors can establish their reputation to become industry experts through resource and technology investment of specific industries (Mohd Khairuddin, 2015). In addition, in order to improve their reputation and audit quality, industry specialist auditors are more inclined to invest in personnel and control systems of the companies that operate beyond of their broad area of competence (Simunic and Stein, 1987; Craswell *et al.*, 1995). Experts and experienced auditors in a certain industry can recognise problems faster (Krishan, 2005) because they have better skills (Simunic and

Stein, 1987), make better decisions and discover errors and risks more accurately (Owhoso *et al.*, 2002; Moroney, 2007). Current scholars have paid little attention to the emergence of industry specialist auditor. The lack of recent references for this variable is justified.

Audit Fees

According to Deangelo (1981), high audit fees encourage auditors to provide the highest calibre of audit services as they have greater resources available to conduct audits. It can be said that auditors who are paid more are better fortunate than those who are paid less. The abilities and efforts of the auditors determine audit fees, demonstrating that high audit fees lead to improved audit quality (Wolinsky, 1983). This is because the client's fees can have a range of effects on audit quality. The audit fees are highly influenced by the amount of work required and the experience of the auditor (Knechel *et al.*, 2012). According to Almasria (2018), a high-quality audit comprises not only a guarantee of excellent financial reporting quality but also a financial statement free of biases, inaccuracies and omissions. Audited financial statements are used as monitoring tools and give users assurance (Nikkinen and Sahlstrom, 2004; Watkins *et al.*, 2004).

Previous studies mentioned that higher audit fees are often associated to higher-quality audits as a result of they necessitate more audit effort (Deis and Giroux, 1996; Hoitash *et al.*, 2007). Given that auditors are specialized and have the necessary expertise, as well as the desire to recuperate the high cost of reputation capital (Ferguson and Stokes, 2002; Defond and Zhang, 2014). The specialist auditors of brand name industry are often being paid supplemental fees for their services compared to non-specialist brand name auditors (Craswell *et al.*, 1995; Ferguson and Stokes, 2002).

On the other hand, high audit fees might be negatively impacted (Al-Ajmi, 2009). This is corroborated by an earlier study that stated high audit fees diminished the independence of the auditor by making them financially reliant on the client, which in turn affected the auditor's judgement (Magee and Tseng, 1990; Becker *et al.*, 1998). According to Almasria (2018), auditor independence has a direct impact on auditor opinion and audit quality. This is because auditors' fear of losing highly profitable fees leads them hesitant to take the necessary monitoring measures or inquiries during the auditing process.

Hypotheses Development

Relationship between ESG and Earnings Management

According to Mahoney *et al.* (2013), information overload and greenwashing reduced the validity of ESG reporting. Hence, ESG disclosure should ample to complement financial accounting and thus increase ESG and financial performance (Murphy and Mcgrath, 2013).

The majority of the studies on ESG and earnings management relationship originated from developed countries and no less either from developing countries. Overall, empirical studies show a negative relationship between ESG and earning management (e.g. Alswalmeh *et al.*, 2019; Grimaldi *et al.*, 2020; Ibrahim *et al.*, 2015; Ji *et al.*, 2019; Kim *et al.*, 2019b; Kim and Lee, 2019; Kumala and Siregar, 2021; Seker and Sengür, 2021; Sial *et al.*, 2019; Velte, 2019; Yuan *et al.*, 2022). A possible reason of the negative relationship between ESG and earnings management is due to CSR or ESG is an act of accountable manner and ethics, so managers

tend to avoid any misbehaving attitude such as implementing earnings management which will reduce the transparency of the organization (Sial *et al.*, 2019).

Very limited previous studies show a positive relationship between ESG and earnings management (e.g. Rusydi, 2021) and no relationship (e.g. Mohamed *et al.*, 2019). The CEO or managers' deceptive actions may be the source of the positive correlation between ESG and earnings management. They frequently use their authority and flexibility as top policymakers to apply earnings management in order to satisfy personal interests (Rusydi, 2021). Table 1 shows the summary of the analysis of previous studies on the relationship between ESG and earnings management which has been classified into developed and developing countries.

Table 1

Summary of Empirical Studies between ESG and Earnings Management Relationship

ESG and Earnings Management Relationship	Studies conducted in Developed Countries	Developed Country	Studies conducted in Developing Countries	Developing Country
Positive	Nil		Rusydi (2021)	Indonesia
Negative	Seker and Sengür (2021)	US, Canada Italy, Korea, Russia, France, Singapore	Yuan <i>et al.</i> (2022)	China
	Grimaldi <i>et al.</i> (2020)	Italy	Kumala and Siregar (2021)	Indonesia
	Ji <i>et al.</i> (2019)	Korea	Seker and Sengür (2021)	Malaysia, Philippines, Indonesia, China,
	Kim and Lee (2019)	Korea	Nurrahman <i>et al.</i> (2019)	Malaysia, Indonesia, Philippines,
	Velte (2019)	UK	Kim <i>et al.</i> (2019)	China
	Nurrahman <i>et al.</i> , (2019)	Singapore	Sial <i>et al.</i> (2019)	China
			Ibrahim <i>et al.</i> (2015)	Malaysia
No relationship	Mohamed <i>et al.</i> (2019)	United Arab Emirates	Mohamed <i>et al.</i> (2019)	Egypt

Source: Authors own work

Hypothesis 1: There is a significant negative relationship between ESG and earnings management in Malaysia

Moderating Effect of High-Quality Auditors (Industry Specialist Auditors) on the Relationship between ESG and Earning Management

Reputable auditors may preserve their independence from clients and reputational capital by conducting high-quality audits (Bacha *et al.*, 2020). Industry specialist auditors are known to provide superior audit quality because they know they need to bear a bigger loss in the case of a misreporting issue compared to a profitable case (Donelson *et al.*, 2020). Based on empirical evidence, companies audited by industry specialist auditors provide more information (Dunn and Mayhew, 2004), document less accounting restatement (Romanus *et*

et al., 2008) and engage in less accrual earnings management (Balsam *et al.*, 2003; Krishnan, 2003). In addition, Habib (2011) concluded that company that employs industry specialist auditors are less likely to engage in earnings management activities. Thus, ESG information may be more believable as the audit made by specialist auditors.

Hypothesis 2: High-quality auditors proxied by industry specialist auditors moderate the negative relationship between ESG score and earnings management.

Moderating Effect of High-Quality Auditors (Audit Fees) on the Relationship between ESG and Earning Management

Zahid *et al.* (2022) mentioned that by establishing high-quality and cost-effective audits, it is possible to guarantee the voluntary disclosure of ESG information is more trustworthy and precise. This is supported by previous studies that demonstrate that audit fees consider customer characteristics and all perspectives of agency controversies (Ali and Lesage, 2013). In addition, Krishnan (2003) suggested that auditors with high-quality skills are able to mitigate a company's earnings management as they are skilful in terms of knowledge, resources and incentives to reduce manager's opportunistic behaviour. Chen *et al.* (2016) reported that the accuracy and legitimacy of corporate responsibility information disclosure can be boosted by high auditors' quality as they are the ones who responsible for doing so. Companies that disclose their corporate responsible information willing to bear a higher cost of audit by hiring high-quality auditors to maintain a high standard of reporting as they are more concerned with ethical matters and integrity (Trpeska *et al.*, 2017).

Hypothesis 3: High-quality auditors proxied by audit fees moderate the negative relationship between ESG score and earnings management.

Conceptual Framework

This conceptual paper attempts to investigate the relationship between ESG score and earnings management moderated by high-quality auditors. Based on Figure 1, the study proposed:

Hypothesis 1: There is a negative relationship between ESG score and earnings management in Malaysia.

Hypothesis 2: High-quality auditors proxied by industry specialist auditors moderate the negative relationship between ESG score and earnings management.

Hypothesis 3: High-quality auditors proxied by audit fees moderate the negative relationship between ESG score and earnings management.

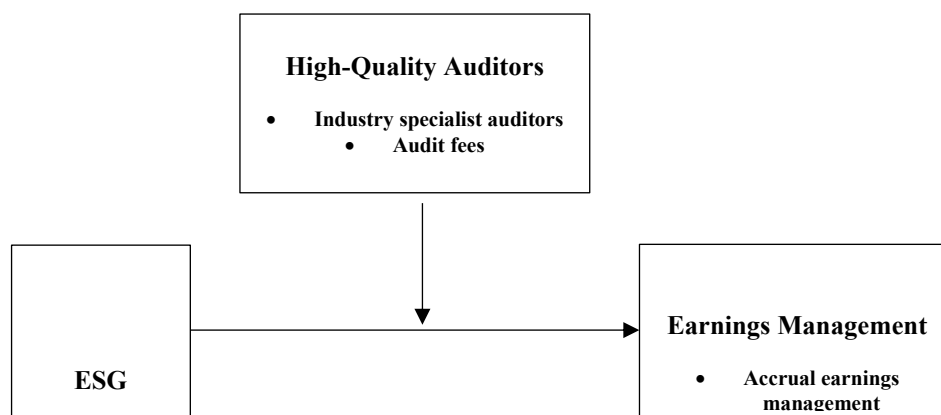


Figure 1: Proposed Research Model

Conclusion

The results provide a starting point for investigating the relationship between ESG and earnings management moderated by high-quality auditors. A broader range of literature must be examined in order to gain insight understanding before moving on with the empirical research. In alignment with current social science debates, this research moves beyond simple direct relationships to examine the critical "validation role" of high-quality auditors. The proposed framework suggests that the competence of industry specialists and the independence signalled by audit fees act as essential institutional safeguards. These mechanisms serve to distinguish between substantive ESG stewardship and symbolic "greenwashing," thereby reducing the conflict of interest between managers and stakeholders. The study's focus on the top 100 non-financial companies on the FTSE Bursa Malaysia 100 Index ensures that the findings are directly relevant to the core of the Malaysian stock market. Ultimately, this research offers significant practical implications for regulators, investors, and practitioners by highlighting that the credibility of ESG as a signal of financial integrity is fundamentally dependent on the quality of external oversight. It is hoped that this effort provides a timely extension to the literature, encouraging a more nuanced, multidisciplinary understanding of corporate accountability in emerging economies

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