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The Impact of Company and Board Characteristics on Earnings Management: Evidence from Malaysia

Fatimah Hanim Abdul Rauf*, Nor Hasimah Johari**, Sharifah Buniamin*** and Noor Raida Abd Rahman****

This study examines the impact of company and board characteristics on earnings management practices among Malaysian public listed companies. In particular, firm size and cash flow from operations represent the company characteristics; whereas board size and board race represent the board characteristics. Data are obtained using content analysis on the annual report of 214 companies for the year 2008. The earnings management practice is measured by discretionary current accruals based on modified Jones (1991) model. The study reveals that firm size has a positive significant relationship with earnings management. This indicates that as the total assets increase, the company may have higher incentive to engage in earnings management activities. Additionally cash flows from operating activities are found to have a significant negative relationship with earnings management which shows that companies with poor performance tend to use accruals to increase earnings. The results, however, indicate that board size and board race do not influence the practice of earnings management.

JEL Codes: M41, G34

1. Introduction

Earnings management is defined as "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Healy & Wahlen 1999). Earnings management practices with the intention to manage users' perceptions in firms are considered unethical even though no accounting standards are violated. Rafik (2002) in his study indicated that the majority of the respondents do not believe that earnings manipulation is ethical. Hence, this practice has to be monitored.

Executives are motivated to manipulate earnings due to maximizing firm's value (Beneish 2001), increasing corporate managers' compensation and job security (Healy & Wahlen 1999), avoiding negative earnings surprises (Matsumoto 2002)

*Fatimah Hanim Abdul Rauf, College of Business Management & Accounting, Universiti Tenaga Nasional, Malaysia. Email: fatimahhanim@uniten.edu.my
**Nor Hasimah Johari, College of Business Management & Accounting, Universiti Tenaga Nasional, Malaysia. Email: hashimah@uniten.edu.my
***Sharifah Buniamin, College of Business Management & Accounting, Universiti Tenaga Nasional, Malaysia. Email: sharifah@uniten.edu.my
****Noor Raida Abd Rahman, College of Business Management & Accounting, Universiti Tenaga Nasional, Malaysia. E-mail: norraida@uniten.edu.my

and avoiding reporting losses and earnings declines (Park & Shin 2004). Incentives to engage in earnings management could be mitigated through effective corporate governance mechanisms.

Board of directors play an important role to ensure the interest of shareholders and managers are aligned. It has been shown by previous studies that board size (Jensen 1993; Yermack 1996; Denis & Sarin 1999; Abdul Rahman & Mohamed Ali 2006), board independence (Beasley 1996; Klein 2002; Xie Davidson & Dadalt 2003; Peasnell, Pope & Young 2005, 2006), competency of the board (Chtourou, Bėdard & Courteau 2001; Xie et al. 2003; Agrawal & Chadha 2005) and separation of roles between CEO and chairman (Chaganti, Mahajan & Sharma 1985; Bowen, Rajgopal & Venkatachalam 2002) are effective mechanisms in monitoring the management.

In this study, we examine whether company and board characteristics have an impact on earnings management practices among Malaysian public listed companies, specifically focusing on size of firm, cash flow from operating activities, board size and board race. As a developing country with a multi-racial society and diverse backgrounds and languages, Malaysia becomes a unique country and place of interest. The three major ethnic groups in Malaysia are Malays, Chinese and Indians with various indigenous groups in Sabah and Sarawak. Malays and the indigenous groups in Sabah and Sarawak such as Kadazan, Bajau and Iban are classified as Bumiputras. In this multi-racial society, Malaysia has various cultures which play a significant role in determining the culture of an organization since culture has a strong influence on the way people behave (Abdullah 1992). Since every corporation has its own unique history, culture and business goals (Haniffa & Hudaib 2006), race or ethnicity becomes one of the essential demographic factors that can be considered in disclosure practices by Malaysian corporations. Consequently, this motivates our study to examine board race as one of the board characteristics that may have an influence on the earnings management activities of the companies.

This study contributes to the literature by providing evidence on the impact of company and board characteristics on earnings management practices in Malaysia. In this study, we not only examine the impact of company characteristics on earnings management, we do this examination along with an assessment of the influence of board characteristics, particularly board race on earnings management. Although some prior studies examine the influence of board characteristic on earnings management, most of them were focusing on board size (Gulzar & Wang 2011; Kouki et al. 2011; Yang, Xhun & Mohamad Ramadili 2009; Mohd Saleh et al. 2005; Kao & Chen 2004) and board independence (Jaggi, Leung & Gul 2009; Nui 2006). Accordingly, this study contributes to the literature exploring additional factors of board diversity and earnings management.

The remainder of this paper is organized as follows. The next section reviews the literature on company characteristics and earnings management, as well as board characteristics and earnings management which lead to the development of hypotheses. The third section outlines the research design, followed by findings and discussion in section 4. The final section concludes the paper.

2. Literature Review and Theoretical Framework

2.1 Company Characteristics and Earnings Management

There are several variables that may explain variations in earnings management. These include firm’s size and cash flow. Managers of large firms are politically sensitive and are more likely to exploit accounting discretion to reduce political cost (Watt & Zimmerman 1978). The larger a firm, the more pressure is placed on management to report more predictable earnings (Pincus & Rajgopal 2002). Bushman, Chen, Engel and Smith (2004) found that firm size is a variable that could influence a firm's tendency to manage earnings and might affect the magnitude of earnings surprise or earnings informativeness. Lobo and Zhou (2006) and Shen and Chih (2007) note that large firms may have higher incentives and more opportunities to engage in earnings smoothing and overstate earnings due to the complexity of their operations and the difficulty for users to detect overstatement. Thus, our hypothesis, on the basis of agency theory is stated as follows:

H1: Size of firm has a significant relationship with earnings management in Malaysian companies

Cash flows from operations have a significant relationship with discretionary accruals (DeFond & Jiambalvo 1994; Dechow et al. 1995; Peasnell et al. 2000). Becker et al. (1998) and Lobo and Zhou (2006) argued that firms with strong operating cash flow performance are less likely to employ income increasing discretionary accruals to boost earnings because they are performing well. Whereas, firms with poor operating cash flows are more likely to employ income increasing discretionary accruals to send a positive signal to investors. To be consistent with agency theory, our hypothesis is as follows:

H2: Cash flows from operations has a significant relationship with earnings management in Malaysian companies

2.2 Board Characteristics and Earnings Management

Malaysian Code on Corporate Governance lays out the major component of the principles and best practices of good governance including some benchmarks of board of directors’ characteristic. The monitoring role of the board of directors is an important component of corporate governance. One of the important corporate governance characteristics that may have an impact on earnings management is size of the board. However, there is not yet any consensus about the optimal size composing board structure (Kouki et al. 2011). Jensen (1993) argued that smaller boards are more effective in monitoring the CEO’s action. Yermack (1996) in his empirical investigation found a clear inverse relation between firms' market valuation and the size of boards of directors, indicating that smaller boards are associated with better performance. Similarly, Denis and Sarin (1999), Abdul Rahman and Mohamed Ali (2006), Ishak et al. (2011) and Gulzar and Wang (2011) provide evidence whereby earnings management is positively related to the board size showing that larger boards are less effective in their oversight duties. However, Zahra and Pearce (1989) argued that larger boards are capable of monitoring the actions of top management. Their results are in line with John and Senbet (1998), which signify that the board's capacity for monitoring increases as more directors are added. Meanwhile, a study by Cornett, Marcus and Tehranian (2008) fail to find evidence that board size has a significant impact on accruals policy. Thus, the hypothesis with respect to board size and earnings management is:

H3: Board size has a significant relationship with earnings management in Malaysian companies

Proportion of Bumiputra directors also may influence the disclosures made by directors. Different societies may have strong impact on accounting practices (Askari 2006). A study by Haniffa and Cooke (2000) concluded that there is a significant association between the proportion of bumiputra directors on the board and the extent of voluntary disclosure of information. Their findings support the Islamic values that encourage transparency in doing business, which may lead yo a lower tendency of managing earnings. Yatim, Kent and Clarkson (2006) indicated that Bumiputra corporations practice better corporate governance compared to the non-bumiputra and thus may have fewer tendency to manage earnings. Compared to other professions, accounting is a difficult professional sector for the Bumiputras to invade (Che Ahmad, Houghton & Mohamad Yusof 2006), thus, the involvement of bumiputras in accounting practices may be likely to mitigate earnings management activities. However, a problem with prior studies in earnings management (for example Abdul Rahman & Mohamed Ali 2006) is that it has been unable to demonstrate that board race (which measured as the ratio of Bumiputra directors to the total number of directors on board) has an effect in mitigating earnings management. Therefore, it is reasonable to come out with the following hypothesis:

H4: Board race has a significant relationship with earnings management in Malaysian companies

2.3 Agency Theory

The study is based on agency theory, the theoretical framework most often used by researchers to understand the relationship between board characteristics and firm value (Carter, Simkins & Simpson 2003). It involves a contract under which the principal engages another party, called agent, to perform some services on their behalf, where some powers of decision making are delegated to the agent (Jensen & Meckling 1976). In the corporate world, the principal is the shareholders, the owners of the company, whereas the management of the company represents the agent.

According to Brennan (1995), the agency problem may arise as the agent fails to act in the best interest of the principal and the effect may be reflected in the company's share price. It specifically exists in the companies when the management has incentives to achieve their own interests at the expense of the shareholders (Agrawal & Knoeber 1996) and will act in an opportunistic manner to maximize their rewards. As parties internal to the organization, management tends to have an information advantage over the principal due to the day-to-day information and the insider knowledge.

When considering the earnings management practice, agency theory elucidates the existence of the incentive for management to use earnings management. The agency problem will cause managers who are able to give a misrepresentation of the earnings figure without the opportunity for shareholders and others to see through it (Salah 2010). Furthermore, management could use earnings management to mislead shareholders by showing a different image of the company's earnings (Salah 2010).

Because of the opportunistic behaviour of agents, organizations will try to put in place mechanisms to align the interests of the agents and principals. One of the important mechanisms is through the establishment of the board of directors. In addition, to safeguard the interests of shareholders, the board of directors is appointed through the election in the annual general meeting. The board of directors is the agent to the shareholders in ensuring the transparent financial reporting that reflect the real financial position of the companies. Thus, the role of the board of directors is imperative to counter 'managerial opportunistic' behaviour, which includes taking action for their own personal interests at the expense of the shareholders interests (Donaldson & Davis 1991). In this sense, the corporate governance framework of which the board of directors is a part, serves as an effective tool in meeting the expectations and needs of the shareholders. Board of directors may provide better monitoring of management leading to transparent and reliable reporting.

Figure 1: Research Model

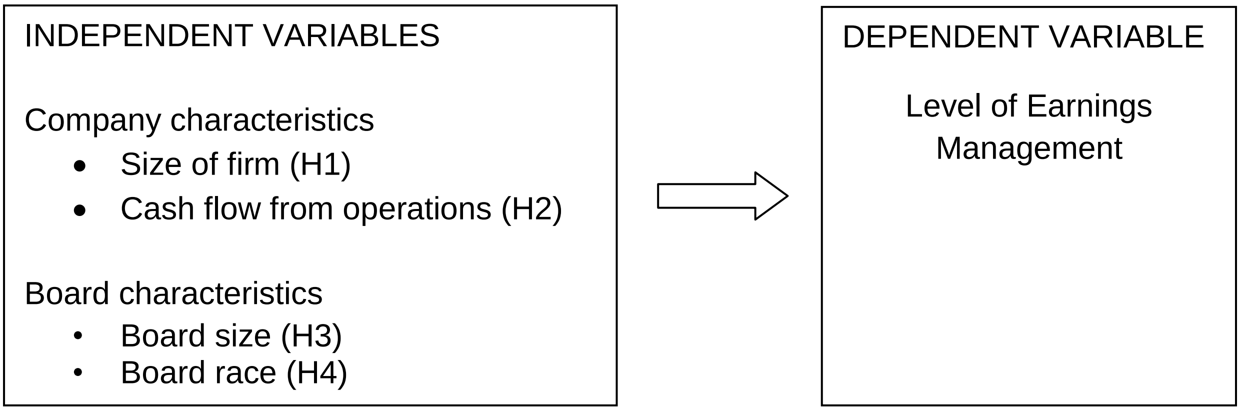

Figure 1 shows the research model of the study. The objective of the study is to examine whether company characteristics and board characteristics have an impact on the earnings management in Malaysian public listed companies. Size of firm, cash flow from operations, board size and board race represent the independent variables. While level of earnings management is the dependent variable.

3. Methodology

3.1 Sample and Data Collection

Companies were randomly selected using the random number generator available in Excel to ensure a representative sample from all industrial sectors. Due to different statutory requirements and different accrual procedures, companies from finance industries were excluded. Annual reports of 2008 were chosen because these annual reports were the latest and available at the time the data were collected. After excluding companies from finance industries and companies in which information was insufficient, the final sample has a total of 428 firm-year observations which represent 214 public listed companies.

Even though in Malaysia many studies have investigated the issue of earnings management and board characteristics (Mohd Salleh et al. 2005; Johari et al. 2008; Alzoubi 2012), only Abdul Rahman and Mohamed Ali (2006) explored the issue of other elements of board characteristics, that is, race or ethnicity. We extend the study on the same issue but we combine them with the firm characteristics using more recent data. For this purpose, Thompson's Data Stream was employed to collect the data on earnings management and the data on firm characteristics (size of firm and cash flow) of public companies listed on the main board of Bursa Malaysia covering financial periods of 2007 and 2008. Any missing data from the datastream were collected manually from the respective annual reports, while data on board characteristics (board size and board race) were gathered by examining the disclosures in the annual reports that were down-loaded from the Bursa Malaysia website.

3.2 Measurement of Variables

3.2.1 Measurement of Dependent Variable - Earnings Management

Modified Jones (1991) model is employed as it was found to be superior to other extant methods at the time in detecting abnormal accruals, i.e., discretionary accruals (Dechow & Skinner 2000). This is consistent with Teoh, Welch and Wong (1998), Chtourou et al. (2001) and Xie et al. (2003) who used discretionary current accruals to measure earnings management. In addition, a cross-sectional study is used instead of time series due to increased observation which eliminates the survivorship-bias problem (Bartov, Gul & Tsui 2001). We used current accruals since current accruals are easier for managers to manipulate (Xie et al. 2003). Current accruals (TAC) are defined as the changes in non-cash current assets less the changes in operating current liabilities. Total current accruals (TAC) are decomposed into non-discretionary accruals (NDA) and discretionary accruals (DAC). Thus,

$$TAC = NDA + DAC$$

Non-discretionary accruals are considered as changes in companies' underlying performance (Rashidah & Afidah 2002). In contrast, discretionary accruals are the managerial interventions into the reporting process. In order to estimate NDA, regression analysis is performed for current accruals on the change in sales. Specifically, the parameters of the following modified Jones model were estimated:

The model is described as follows:-

$$\frac{TAC_{ijt}}{TA_{ijt}} = \alpha_j \left(\frac{1}{TA_{ijt-1}} \right) + \beta_{1j} \left(\frac{\Delta Sales_{ijt}}{TA_{ijt-1}} \right) + \varepsilon_{ijt} \qquad (1)$$

Where,

TAC_{ijt} = Total accruals, i.e., changes in non-cash currents assets minus changes in operating current liabilities for firm i, industry j and year t,

TA_{ijt-1} = Total assets for firm i and year t-1,

Δ $Sales_{ijt}$ = Changes in revenue for firm i from year t-1 to year t,

αj β_{1j} = Specific parameters for industry j, and

ε_{ijt} = errors for firm i, industry j and year t.

All variables are deflated by prior year's total assets to reduce the problem of heteroscedasticity. Consistent with prior studies (for example, Rashidah & Afidah 2002), non-discretionary accruals (*NDA*) are defined as the fitted value of regressions using the parameter of estimates obtained in equation (1) for each industry and year portfolio:-

$$NDA_{ijt} = \alpha_j \left(\frac{1}{TA_{ijt-1}} \right) + \beta_{1j} \left(\frac{\Delta Sales_{ijt} - \Delta \mathrm{Re}\, c}{TA_{ijt-1}} \right) \qquad (2)$$

Since the discretionary accruals (*DAC*) can be obtained as $TAC_{ijt} - NDA_{ijt}$, the discretionary accruals are estimated as follows:-

$$DAC_{ijt} = \frac{TAC_{ijt}}{A_{ijt}} - \left[\alpha_j \left(\frac{1}{A_{ijt-1}} \right) + \beta_{1j} \left(\frac{\Delta Sales_{ijt} - \Delta \mathrm{Re}\, c}{TA_{ijt-1}} \right) \right] \qquad (3)$$

3.2.2 Measurement of Independent Variables

The independent variables are size of firm, cash flow from operations, board size and board race. Table 1 presents the summary of measurements of each independent variable.

Table1: Measurement of independent variables

No	Independent variables	Measurement
1	Size of firm (Size)	Natural logarithm of total assets
2	Cash Flows from operation (CFO)	Net cash (used in)/from operating activities
3	Board size (BSize)	Number of board members (*n*)
4	Board race (BRace)	Number of Bumiputra BOD

4. Findings and Discussion

4.1 Descriptive Analyses

Table 2 presents the distribution of companies according to Bursa Malaysia's industrial classification. These companies are representatives of various sectors, with the majority of the sample companies coming from industrial products (33.2%), followed by trading and services (20.5%) and consumer products (15%). The majority of the companies (91.6%) meets the Bursa Malaysia Listing Requirement of having at least one-third of the board directors as independent directors.

Table 2: Distribution of Companies According to Industrial Sector

	No. of Companies	Percentage (%)
Consumer products	32	15
Industrial products	71	33.2
Constructions	18	8.4
Technology	7	3.3
Infrastructure project companies	2	0.9
Properties	18	8.4
Trading and services	44	20.5
Plantations	22	10.3
Total	**214**	**100.0**

As shown in Table 3, the magnitude of the absolute accruals of the companies in the sample has a mean value of 0.066581 with the minimum value of 0.0003 and maximum value of 0.4993. Based on the one sample T-test, it shows that the p-value for absolute DAC is significantly different from 0 at p = 0.000. Thus, it provides evidence that, on average, Malaysian companies do manage their reported earnings.

Normality test based on Kolmogrov-Smirnov (K-S) test is conducted. As shown in Table 3, all variables show significance levels of less than 0.05 which indicates that the distribution of the data is not normal (De Vaus 2002).Variables that are not normally distributed are transformed to normal scores (Young 1998) before conducting regression analysis since one of the requirements of linear analysis is for the data to be normally distributed (Field 2000). The advantage of using normal scores is that the result from the test would have exact statistical properties as the significance level can be determined. Besides, both F and t-test and also the regression coefficients from the transformation are more meaningful for interpretation.

Table 3: Descriptive Statistics for Dependent and Independent Variables

	Min	Max	Mean	Standard Deviation	Skewness	Kurtosis	K-S test
DAC	-.4993	.3806	-.008858	.1020036	-.396	5.006	.006
ABDAC	.0003	.4993	.066581	.0776511	2.463	7.777	.000
Size	10.92	18.06	13.4469	1.35890	.986	0.891	.000
CFO	-1646.24	973.25	65.6602	167.28402	-3.840	57.150	.000
BSize	2	14	7.92	1.989	.598	.848	.000
BRace	.00	11.00	3.0935	2.46680	1.113	0.622	.000

** Significance at 0.01; K-S with significance <.05, hence data not normally distributed

4.2 Correlation Analysis

Since the data are not normally distributed, the appropriate correlation test is Spearman's rho (De Vaus 2002). This test is important to determine the existence of any multi-co-linearity problems among the independent variables before the regression analysis could be performed. According to Field (2000) and Cooper and Schindler (2003), serious multi-co-linearity problems exist when the bivariate correlation score is 0.80 or greater.

The result from the correlation analysis indicates that size of the firm *(Size)* is positively significant with *earnings management (DAC)*.It also shows that cash flows from operation *(CFO),* has a significant negative relationship with *earnings management (DAC)*. However, none of the associations have coefficient correlation of greater than 0.80, a situation which indicates no serious multi-co-linearity problem exists (Field 2000; Cooper & Schindler 2003).

Table 4: Spearman Correlations

	DAC	ABDAC	SIZE	CFO	Bsize	BRace
DAC	1.000	-.114	.157*	-.462**	.027	.007
ABDAC		1.000	-.022	.001	-.003	.095
Size			1.000	-.079		
CFO				1.000		
BSize			.267**	.037	1.000	.410**
BRace			.329**	-.106		1.000

** Significance at 0.01 level
* Significance at 0.05 level

4.3 Regression Analysis

The empirical models used to test the hypotheses are as follows:-

$$DAC_{it} = \beta_0 + \beta_1 \, Size_{it} + \beta_2 \, CFO_{it} + \beta_3 BSize_{it} + \beta_4 \, BRace_{it} + \varepsilon_{it}$$

Where,

DAC_{it}	=	Discretionary accruals
$Size_{it}$	=	Size of the firm
CFO_{it}	=	Cash flows from operation
$BSize_{it}$	=	Board size
$BRace_{it}$	=	Number of Bumiputra directors
ε_{it}	=	Error term

Sensitivity analysis is conducted to assess the stability of the results. Initially, the linear regression is run using dependent variables of absolute discretionary accruals which is transformed using natural log. These findings, however, are not reliable as the value of ANOVA is not significant. As for the alternative, we transform the dependent variables and the other independent variables which are not normally distributed using normal rank scores. Prior studies that used rank scores include Wallace, Kamal and Mora (1994) and Wallace and Naser (1995). As shown in Table 5, the value of R^2 is 0.122 which is considered low and indicates there are other factors that influence the variation of earnings management. More importantly, the model is significant with p value at 0.000 and F ratio of 4.778.

Table 5: Multiple Regression Result

Variables	Coefficients value	t-statistics	Sig. t
Constant		-2.222	.027
Size	.155	2.173	.031
CFO	-.304	-4.642	.000
BSize	.039	.486	.628
Brace	-.009	-.072	.942

R^2 = 0.122., F-statistic = 4.778, p = 0.000

The results of the multiple regressions on the relationship between company characteristics (size of firm and cash flow from operations) and board characteristics (board size and board race) with the *earnings management (DAC)* are presented in Table 5.

This study also found that there is a significant positive relationship between firm size and earnings management. This is consistent with previous studies by Pincus and Rajgopal (2002), Lobo and Zhou (2006), Shen and Chih (2007), Ishak et al. (2011) and Roodposhti and Chashmi (2011). Past research found that firm size is a variable that could influence a firm's tendency to manage earnings and might affect the magnitude of earnings surprise or earnings informativeness.

The result also shows that the CFO coefficient is negative, but it is statistically significant. This finding indicates that firms with high levels of cash flows are less likely to manage the accrual. Consistent with Dechow (1994), Peasnell et al. (2000), Jiang, Lee and Anandarajan (2008) and Gulzar and Wang (2011), the companies with poor performance tend to manage their earnings using discretionary accrual.

However, no such relationship is observed for board size and board race. Our results support studies by Cornett et al. (2008), Bello (2011) and Kouki et al. (2011) who fail to find evidence that board size has significant impact on accruals policy. The result of board race is consistent with Abdul Rahman and Mohamed Ali (2006) whereby they found that the race of the board has no effect in reducing earnings management.

5. Conclusion

This study attempts to investigate whether company and board characteristics have an impact on the magnitude of earnings management among Malaysian companies. In particular, the study focuses on size of firm and cash flow from operations as the company characteristics, while board size and board race represent the board characteristics and attempts to assess whether these factors affect the earnings management practices. The study reveals that size of firm (total assets) has a positive significant relationship with earnings management which indicates that as the total assets increase, the company may have higher incentive to engage in earnings management activities. In addition, cash flow from operating activities is found to have a significant negative relationship with earnings management which shows that companies with poor performance tend to use accruals to increase earnings. The results, however, indicate that board size and board race do not influence the practice of earnings management.

One of the primary limitations of this study is that the findings demonstrate relationships instead of causal effects between company and board characteristics and earnings management. Second, the earnings management is measured using the popular Jones model which estimates discretionary accruals and does not examine the quality of accruals. Therefore, accruals measurement by other researchers might be used. Third, this study merely includes the board size and board race as the board characteristics. Future research could incorporate other board characteristics such as number of board meetings, competency and committees.

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