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Earnings Manipulation among Malaysian Firms: Have Boards Sufficiently Lent Their Governance Skills in Monitoring These Activities?

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Abstract: The primary objective of this study is to examine the relationship between board of director attributes (board independence, board meeting, board size and duality role) and the tendency of earnings manipulation. This study employed a sample of 334 Public Listed Companies in Malaysia from the year 2010-2012. The finding of this study shows that the board independence is positively related to earnings manipulation. This implies the higher the proportion of independent directors, the higher the propensity of earnings manipulation. The result also indicates that the board size is positively related to earnings manipulation. This suggests that the larger board size will increase earnings manipulation occurrences. However, the board meetings and duality role fail to show any significant relationship with earnings manipulation. The result of this study is robust after controlling the other firm-specific effects.

Key words: Earnings manipulation, governance monitoring, board attributes, positively, Malaysia

INTRODUCTION

Earnings manipulation is a legitimate practice done by managers in order to show practical and predictable financial information (Fakhfakh and Nasfi, 2012). Or more explicitly Healy and Wahlen (1999) stated that earnings manipulation occurs when managers use their professional judgments in financial statements to modify financial information with the intention to mislead some stakeholder about the progress and the financial performance of the company or to influence predetermined outcomes that depend on the reported accounting figures. The flexibility and the wide range of choices offered by the accounting system open space for the managers to select accounting methods that are acceptable by Generally Accepted Accounting Principles (GAAP) and thus, give an opportunity for the managers to manage earnings (Brown, 1994; Jiraporn *et al*., 2008).

According to Dechow and Skinner (2000), the most common tool in earnings manipulation practices is discretionary accruals. The nature of accrual accounting allows managers to estimate the earnings and decide the time of recognition (Xie *et al*., 2003). Other than accruals, the company can also manipulate earnings by delaying the production and alter the earnings towards the targeted income (Hashemi and Rabiee, 2011).

Earnings manipulation is not a new issue. In fact, many researchers have made a study of earnings manipulation, in terms of the causes, consequences, motives, factors and others. Yet, earnings manipulation problem still exists and deepened. Gonzalez and Garcia-Meca (2013) stated that poor corporate governance may provide an opportunity for the managers to get involved in earnings manipulation practices and directly, downgrade the quality of reported earnings. Tangjitprom (2013) also highlighted an issue regarding corporate governance towards earnings manipulation. According to the researchers, companies with weak corporate governance structure are more susceptible to earnings manipulation activities as compared to companies with strong governance structure. Thus, corporate governance is one of the leading causes of earnings manipulation.

Corporate governance has a wide scope and it is supported by a number of major spinal which is known as a corporate governance mechanism. As stated by Man and Wong (2013), corporate governance has two types of mechanisms, namely internal and external. Internal mechanisms are determined by internal factors such as ownership structures, shareholding and board of directors. Meanwhile, external mechanisms are influenced by outside factors, consisting of legal protection and interests of stakeholders. Whether internal or external, both are essentials in ensuring that the company is well-administered (Agrawal and Knoeber, 1996). This current study will focus on the most vital internal mechanisms of corporate governance which is the board

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attributes. Board of directors in each company is supported by a number of attributes, consisting of board composition, board size, board meeting, director backgrounds and leadership structure (Man and Wong, 2013). Hence, this study aims to investigate and evaluate whether these board attributes have any association with the existence of earnings manipulation practices in Malaysia.

Earnings manipulation problem is leaving many direct implications to the company and the most feared implication is when earnings manipulation turns into fraud. According to Brown (1994), earnings manipulation and fraud are only separated by a thin line. The only difference between the two events was, earnings manipulation is still within GAAP while fraud is outside GAAP. However, earnings manipulation and fraud are still said to share the same objective. Thus, if this practice is left without rigorous control, it is not impossible for the earnings manipulation to become aggressive and will end with fraud. As evidenced by Perols and Lougee (2011) in their study, the tendency of a company to commit fraud is very high if the company has previously involved with earnings manipulation.

Based on Malaysian public listed companies, this study aims to investigate the association of board of director with earnings manipulation by narrowing down the scope of the board into their attributes. The board attributes were carefully chosen and these would imply the board independence, meeting frequency, size and duality role.

Literature review: In general, earnings manipulation gives a negative impact to the company. However not all earnings manipulation can be detrimental to the company. Tangjitprom (2013) stated that the effects of earnings manipulation can be both, either beneficial or harmful to the company, depending on the strength of a company's corporate governance. This means, companies with weak corporate governance structures will face a severe negative consequence of earnings manipulation, otherwise companies with strong corporate governance structures, will enjoy a positive consequence of earnings manipulation. Earnings manipulation can still be informative and trusted if the practice is governed by a good governance structure (Gulzar and Wang, 2011). Thus, it is clear that corporate governance plays a crucial role in mitigating earnings manipulation. However, corporate governance is supported by a number of mechanisms. Hence, the effective mechanism in mitigating earnings manipulation should be identified.

Board independence can be reinforced by the availability of independent directors. Independent director is an outsider of caliber with a necessary experience and expertise who is able to bring about independent judgments in carrying out their duties. The presence of independent directors is important, to monitor and limit the opportunistic behavior among managers and directors (Rahman and Ali, 2006). In other words, it is to ensure that the management act in the best interest of the shareholders and stakeholders and thus mitigate earnings manipulation.

The effectiveness of monitoring mechanism that offered by non-executive directors help to reduce earnings manipulation (Jaggi *et al*., 2009). As an outsider who does not know anyone in the company, non-executive director is not easy to be influenced and influence. Thus, they will perform their duties diligently and this indirectly will fear the managers to commit any financial offenses such as earnings manipulation. A study done by Peasnell *et al*. (2005) found a significant negative relationship between independent directors and earnings manipulation. This implied that company with higher outside directors tend to have lower earnings manipulation. Board which is dominated by non-executive directors will be more powerful in ensuring the reliability of financial reporting and thus can limit earnings manipulation activity. In addition, a survey by Man and Wong (2013) also gave the same findings which is the highest proportion of independent directors will help a lot in reducing earnings manipulation. The independent directors will perform their duty in the best way possible, due to the pressure from shareholders. Since, the shareholders have the authority to remove and replace the independent directors, this will pressure them to monitor the management well. Therefore, this type of quality monitoring will prevent earnings manipulation.

However, when it comes to family controlled company, the existence of independent directors is not able to prevent earnings manipulation from occurring, even higher occurrence of the case (Mansor *et al*., 2013). Family intervention in business affairs makes the role of independent directors becomes less effective and thus, earnings manipulation activity occurs without borders. This is supported by Gonzalez and Garcia-Meca (2013) with evidence that contended that the level of earnings manipulation and the proportion of outside directors are weak. It happens because there is lack of rotation and makes the directors permanently external. This long tenure will create an unhealthy relationship between directors and management, which lead the directors to be not transparent and not diligent in performing their duties.

Surprisingly, Rahman and Ali (2006) and Abed *et al*. (2012) discovered insignificant relationships between independent directors and earnings manipulation. This is

also supported by Gulzar and Wang (2011) where the statistical results evidenced that no relationship was found between the existence of independent directors and earnings manipulation.

Mansor *et al.* (2013) found that, board meeting has a negative relationship with earnings manipulation for family owned company. That statistical result implied that the higher the number of meetings held by the board, the lower the earnings manipulation. This occurs because board meetings promote communication between directors and managers as well as giving more attention on the company's issues. Therefore, when more frequent meetings are held, interactions between directors and management will be enhanced many problems can be solved and thus earnings manipulation symptom can be hampered. This is consistent with Gulzar and Wang (2011) which stated that the board meeting will improve board monitoring. Thus, the more frequent meetings are conducted, the more robust board monitoring process and directly, will lessen the earnings manipulation activity.

However, Lorca *et al.* (2011) posited that sometimes board meetings are not useful. In general, a board meeting needs a proper preparation and usually, it will take too much time. Directors are already busy with their daily tasks and getting busy with the meeting preparation. This will definitely make the directors tired. Since, board meeting is time consuming, the directors will be exhausted and not able to give a thoughtful idea. Therefore, if a board meeting is frequently conducted, it will not produce a quality outcome and cannot achieve what is expected.

In addition, research conducted by Ahmed (2013) also revealed no relation between the number of board meetings and earnings manipulation. The researcher believes that this is due to the director's attitude, who does not want to appeal for extra seating, intending only to meet the minimum number of holding meetings.

According to Xie *et al.* (2003), larger board has a great ability to limit earnings manipulation, due to various expertise and synergetic monitoring. Dalton *et al.* (1999) found that experiences among directors can serve as a weapon to disable earnings manipulation. Larger board consisted of many directors with various experiences, able to share their experience with each other and definitely will give them more advantage to easily detect the existence of earnings manipulation in the company.

In addition, board size of the company in Iran is also significantly and negatively correlated with earnings manipulation (Hashemi and Rabiee, 2011). This means that companies in Iran are making a number of directors as one of the important factors in limiting earnings manipulation. Based on the statistical results, it shows that, the larger the board size, the more effective it is in curbing earnings manipulation. Hashemi and Rabiee (2011) added that board of directors plays an essential role in monitoring management activities and company's affair. Thus by having a larger board, monitoring process will be more extensive and comprehensive and so, inhibit the growth of earnings manipulation.

A study done by Rahman and Ali (2006), who took Malaysia as evidence found that board size significantly influence earnings manipulation in a positive direction. This means, the larger the board size, the higher the earnings manipulation. A larger board is more likely to have internal problems among the directors and probably difficult to control. This problem to some extent undermines the monitoring process of the management and thus, earnings manipulation activity was rampant.

However, an empirical study conducted by Gulzar and Wang (2011) found that there is no relationship between board size and earnings manipulation. It shows that the number of directors does not relate to the existence of earnings manipulation. Furthermore, Al-Abbas (2009) who conducted an empirical study of the Saudi market also found similar results. This result suggests that Saudi companies only use corporate governance rules just for obedience to the regulations and not for governance purposes.

Klein found that the duality role has a positive relationship with earnings manipulation. It suggests that firm with a duality role is more likely to manage earnings due to excessive power of CEO. Gulzar and Wang (2011) who have conducted a study on Chinese public listed firms also revealed that duality position will give more opportunity for management to manipulate earnings. This is because when a CEO is also powerful as a chairman, it will weaken the board monitoring system over management and thus, earnings manipulation definitely would be the toy of managers.

Interestingly, Rahman and Ali (2006) found an insignificant relationship between duality role and earnings manipulation. This means whether the company practices duality or non-duality role, it has no effect on earnings manipulation. Hahemi and Rabiee (2011) also failed to find any relationship between duality role and earnings manipulation. The presence of duality or non-duality role does not matter to earnings manipulation because of the managers' dominance over the board affairs.

MATERIALS AND METHODS

Research design: This study is looking forward to observe the correlation of board attributes and earnings manipulation in the Malaysian Public Listed companies

for 3 consecutive years from the year of 2010-2012. This study has taken seven industries listed on Bursa Malaysia to be used as samples. Those seven industries are construction, consumer product, industrial product, trading and services, property, mining and plantation and technology. However, the banking and finance industry has been excluded from this study due to requirement and regulatory differences. After eliminating for the incomplete observations, 334 companies were selected. The data were obtained from data stream, Thompson reuters as at 30 March 2014. The variables include board of directors attributes and some financial variables such as firm size, performance, industry and leverage. Then, the multiple regression was estimated on the following regression:

$$DACC_{it} = \beta_0+\beta_1 (BIND)_{it}+\beta_2 (BM)_{it}+\beta_3 (BS)_{it}+ \beta_4 (DUAL)_{it}+\beta_5 (SIZE)_{it}+\beta_6 (ROA)_{it}+ [\beta_7 (CONSTR)_{it}+\beta_8 (CONSPROD)_{it}+ \beta_9 (INDSPROD)_{it}+\beta_{10} (TRDGSER)_{it}+ \beta_{11} (PROPERTY)_{it}+ \beta_{12} (PLANT)_{it}+ \beta_{13} (TECH)_{it}+\beta_{14} (LEV)_{it}+\varepsilon_{it}$$

Where:

DACC = A proxy for earnings manipulation and it is measured using Modified Jones and Kothari Model

BIND = Percentage of independent non-executive directors to the total number of board members

BM = A number of meeting held annually

BS = A number of directors on the board

DUAL = A dummy variable that takes value 1 if duality role presence I company and 0 if otherwise

ε_{it} = An error term

RESULTS AND DISCUSSION

Table 1 represents the regression results of the relationship between the discretionary accruals with the board attributes. Discretionary accruals determined by modified Jones and Kothari was used to be a proxy of dependent variable in this study which is earnings manipulation. Meanwhile, board attributes that consist of board independence, board meeting, board size and duality role are the independent variables. The independent variables have contributed for 18.7% to the variance of dependent variable for Kothari and only 8.5% for modified Jones. Even though the adjusted R^2 for Modified Jones is not as high as Kothari but the figure of 8.5% is still acceptable, since 1% of adjusted R^2 found by Becker *et al*. (1998) is also acceptable.

In addition, the model that has been used is found to be well specified as the F value for both modified Jones and Kothari are significant at 0.000. This study

Table 1: Regression coefficient table

	Modified jones			Kothari		
Models	Coeff	t-stats	Sig.	Coeff	t-stats	Sig.
(Constant)		-0.768	0.442		-0.560	0.576
BIND	0.072	2.146**	0.032	-0.030	-0.944	0.345
BM	-0.035	-1.090	0.276	0.017	0.553	0.580
BS	-0.026	-0.749	0.454	0.117	3.506***	0.000
DUAL	-0.031	-0.990	0.323	-0.035	-1.204	0.229
SIZE	-0.059	-1.572	0.116	-0.035	-0.989	0.323
ROA	0.308	8.653***	0.000	0.254	7.557***	0.000
CONSTR	0.073	2.225**	0.026	0.184	5.952***	0.000
CONSPROD	0.009	0.244	0.807	-0.039	-1.145	0.253
INDSPROD	-0.456	-1.110	0.267	-0.974	-2.233**	0.026
TRDGSER	0.037	1.015	0.310	-0.065	-1.882*	0.060
PROPERTY	0.041	1.266	0.206	0.085	2.753***	0.006
PLANT	0.062	1.769*	0.077	-0.227	-6.919***	0.000
TECH	-0.050	-1.527	0.127	-0.119	-3.861***	0.000
LEV	0.134	4.119***	0.000	-0.032	-1.049	0.295
R^2	9.7%			19.8%		
Adj. R^2	8.5%			18.7%		
F-value	8.158			18.731		
N	1002			1002		

*, ** and *** characterizes statistical significance at 0.10, 0.05 and 0.01 levels, respectively (two-tailed test). DACC is the normal score of DACC computed using Van der Waerden's formula. DACC is the firm discretionary accruals measured using Kothari Model as suggested by Kothari *et al*. (1995). BIND is the board independence obtained from the percentage of independent non-executive directors to the total number of board members. BM is the board meeting obtained from number of board meetings per annum. BS is the board size obtained from the total number of directors on board. SIZE is referring to firm size obtained from the natural logarithm of market value. ROA is return on assets obtained from operating income divide by total assets. LEV is the leverage obtained from total debt over total asset. CONSTR captures the value of 1 if the firm is construction firm; 0 otherwise. CONSPROD captures the value of 1 if the firm is consumer product firm; 0 otherwise. INDSPROD captures the value of 1 if the firm is industrial product firm; 0 otherwise. TRDGSER captures the value of 1 if the firm is trading and services firm; 0 otherwise. PROPERTY captures the value of 1 if the firm is property firm; 0 otherwise. PLANT captures the value of 1 if the firm is plantation firm; 0 otherwise. If the firm is classified other than constr, consprod, indspprod, trdgser, property and plant, it will categorized as tech

hypothesized that there is a relationship between board independence and earnings manipulation. The modified Jones Model shows a significant positive relationship between board independence and discretionary accruals at 95% confidence level. On the other hand, Kothari failed to find any significant relationship between board independence and earnings manipulation. Thus, it can be concluded that this first hypothesis is accepted for Modified Jones Model but rejected for Kothari Model.

This study has also hypothesized that there is a relationship between frequency of board meetings and earnings manipulation. Surprisingly, both modified Jones and Kothari failed to show any significant relationship between board meetings and discretionary accruals. Therefore, this second hypothesis is fully rejected.

This study expected that there is a relationship between board size and earnings manipulation. This expectation appears to fumble when Modified Jones could not show any relationship between board size and discretionary accruals and this finding is consistent with Al-Abbas (2009) together with Gulzar and Wang (2011). However, the expectation turns out to be right when Kothari managed to show a significant positive relationship between board size and discretionary accruals at 99% confidence level. Thus, this third hypothesis is accepted but only under Kothari and not modified Jones.

This study has also designated that duality role may have a relationship with earnings manipulation. Unfortunately, both models; modified Jones and Kothari failed to indicate a significant relationship between duality role and discretionary accruals. This means whether the company practices duality or non-duality role, it has no effect on earnings manipulation. Thus, the fourth hypothesis is rejected.

For the control variables, ROA indicate a significant result in relation to discretionary accruals at 99% confidence level for both model, modified Jones and Kothari. When it comes to the industries, modified Jones is able to show that only two industries are significant with discretionary accruals. Meanwhile, Kothari managed to prove almost all industries involved, significant with discretionary accruals.

For leverage, only modified Jones succeeds to show a significant relationship between leverage and discretionary accruals. Overall, discretionary accruals measured by modified Jones model discovered different findings with discretionary accruals determined by Kothari Model. There are some findings which support the hypotheses in this study and some others justified to be the other way around. The findings have been summarized and shown in Table 1.

CONCLUSION

Earnings manipulation issue is believed to have close relationship with poor corporate governance system. By looking at the role and the responsibilities, the board is believed to help controlling earnings manipulation among managers. Hence, this study aims to examine the board of director's attributes and propensity of earnings manipulation. The findings suggest that the board independence and board size have a significant positive relationship with earnings manipulation. Both results are supported by Gonzalez and Garcia-Meca (2013). Meanwhile, the study has discovered that board meetings and duality role are insignificant with earnings manipulation. These findings are consistent with a study done by Ahmed (2013) and Gulzar and Wang (2011) respectively. However, this study is subjected to several limitations such as insufficient sample data and limited application of accrual model. Thus, in order to get more robust results, future research is hoped to increase the number of sample data and employ more accruals models in measuring discretionary accruals.

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