

The Relationship Between Audit Quality, Board Independence and Audit Committee Independence on Earnings Management Before and after Full Convergence of IFRS

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Abstract: This study examines the relationship between corporate governance mechanisms (audit committee, independent directors and audit quality) and earnings management. The study period examined was 2006/07 (pre-IFRS regime and 2012/13 (post-IFRS regime) and covered 176 and 175 firms, respectively. Unbalanced panel data analysis was used. The findings show that, pre-IFRS regime, corporate governance mechanism of independent directors mitigate earnings management but post-IFRS regime, auditor size (represented by Big 4 audit firms and non-Big 4 audit firms) mitigate earnings management and audit committee and independent directors do not mitigate earnings management

Key words: Earnings management, audit committee, audit quality, independent directors, Malaysia

INTRODUCTION

Dispersed ownership in modern corporations constrains shareholders from directly accessing to internal information and gives rise to agency costs. As a result, general purpose financial statements have become a major source of information to shareholders for decision-making. Shareholders rely on financial reporting to get useful information for their investment decisions, i.e., whether to buy, hold or dispose their securities investment. High quality financial information not only affects shareholders' investment decisions but it can also influence investment efficiency, debt contracting and cost of equity capital.

The production of financial information is an integrated process involving firm's economic events, selection and application of accounting policies, estimation and judgement and disclosure (Jonas and Blanchet, 2000). The quality of financial reporting is influenced by various stakeholders such as the preparers of financial statements, the accounting standard setting bodies, the internal and external governing parties, the regulators as well as other stakeholders (Francis *et al.*, 2008). Based on the arguments of agency theory, the managers who are the key party responsible for preparing the financial statements as a means to discharge their accountability may compromise with the quality of financial reporting due to conflict of interest between managers and shareholders. On the basis of literature 3 found that managers engaged in opportunistic earnings management practices that can decrease the quality of financial information and increase information asymmetry.

The literature suggested that managers manage earnings to increase their remuneration (Chaney and Lewis, 1995; Rahman and Ali, 2006; Palliam and Shalhoub, 2003), to decrease the probability of dismissal due to unfavourable financial results (Rahman and Ali, 2006; Palliam and Shalhoub, 2003; Leuz *et al.*, 2003), to meet analysts anticipations (Palliam and Shalhoub, 2003; Leuz *et al.*, 2003; Beneish, 2001) or to maintain management reputation (Becker *et al.*, 1998).

The Malaysian Code on Corporate Governance 2012 stipulates that the board should ensure that the financial statements provide credible information (Beneish, 2001). Further, Bursa Malaysia Main Market listing requirements requires the board to set up an audit committee to oversee the financial reporting process which includes external auditing. The listing rule specifically requires the audit committee to review activities such as auditor suitability for re-appointment as assurance of high audit quality.

Literature review and research objectives: Academic research has provided evidence that established links between weaknesses in governance and earnings management, lower financial reporting quality and financial fraud (Carcello and Neal, 2000). Following that attempts have been made to enhance corporate governance such measures include enhancing audit quality 12, 13 strengthening audit committees roles (Ernst *et al.*, 2012; Monks and Minow, 2004) full responsibility by the directors to disseminate reliable financial information (Monks and Minow, 2004).

The external auditor is assigned with the statutory duty to audit companies' accounts in accordance with the

requirements of the approved accounting standards and the Companies Act, inspecting the integrity of the financial reporting process and hence plays an important part in monitoring financial reporting quality. However, the external auditor task could not be discharged in isolation as the financial information is interrelated with other corporate governance mechanisms such as the board, the management and the audit committee.

The board of directors is selected by the shareholders to oversee managers' own-pursuits under the agency relationship (Monks and Minow, 2004). To ease the unaligned interest between managers and shareholders, agency theory proposed that the board of directors should make up by majority of non-executive directors (Ramdani and Witteloostuijn, 2010; Ismail and Rahman, 2011) and greater ratio of board independence can affect their efficiency in overseeing management activities (Hashim and Rahman, 2011). Evidence from prior studies suggested that higher level of independent directors is associated with lower earnings management (Peasnell *et al.*, 2005; Verschoor, 2008).

Furthermore, audit committee has been portrayed as the guard of a corporation's financial integrity (Xie *et al.*, 2003). Abbott, Parker and Peters (Abbott *et al.*, 2004) found that audit committee independence and its activity level have a significant and an inverse relationship with the incidence of restatement of financial information. Board and audit committee members with commercial and banking experience are likely to decrease earnings management practices (Xie *et al.*, 2003). A research based on UK's context documented that board independence support audit committee effectiveness in financial reporting (Song and Windram, 2004).

An Italian study noted that board independence and audit committee have greater effectiveness in limiting earnings management after the adoption of IFRS (Marra *et al.*, 2011). The improve in the effectiveness of the board and audit committee could be due to increase in reporting transparency following the application of IFRS which facilitate the monitoring activities by the board and audit committee.

On the basis of literature 24 and 25 found that companies that applied International Accounting Standards (IAS) reported less earnings management and earnings smoothing and increase the quality of accounting information as compared to companies that do not adopt IAS. Prior studies suggested that adoption of IFRS decreases the chance in managing earnings due to its underlying concepts which require extensive disclosure and promote transparent financial information (Nouri and Abaoub, 2014; Dimitropoulos *et al.*, 2013). An important development in the regulatory framework of

financial reporting in Malaysia is the convergence with IFRS effective from 2012. Following the worldwide shift towards the adoption of International Financial Reporting Standards (IFRS), Malaysia has made another major move to be fully converged with the implementation of IFRS in 2012. A major impact of this move is the greater extent of the usage of fair value as the measurement basis in the financial reporting process.

This present study intends to examine the influence of audit quality, independent board and audit committee on earnings management during the first wave of IFRS implementation and after the full convergence of IFRS. In particular, the research objectives are given as follows:

- To compare the influence of audit quality on earnings management before and after full convergence with IFRS
- To compare the influence of board independence on earnings management before and after full convergence with IFRS
- To compare the influence of audit committee independence on earnings management before and after full convergence with IFRS

MATERIALS AND METHODS

The sample of this study consists of non-financial companies listed in Bursa Malaysia over the period of 2006/07 (pre-IFRS regime) and 2012/13 (post-IFRS regime) and covered 176 and 175 firms, respectively. Unbalanced panel data analysis was used. The dependent variable is earnings management computed based on modified Jones model (Dechow *et al.*, 1995). The independent variables are audit committee, independent board and audit quality. Audit committee is measured by the number of audit committee members in the board whereas independent directors refer to the number of independent directors. Audit quality is a dummy variable, 1 if the audit firm is Big 4 and 0 otherwise. This study includes leverage and firm size as the control variables. Leverage is the ratio of total interest bearing debts to total assets. Firm size is measured as the natural logarithm of total assets. Regression analysis was conducted using panel data analysis.

RESULTS AND DISCUSSION

Financial reporting quality will increase when managers' manipulative action is monitored by corporate governance system (Dechow *et al.*, 1996). Corporations are under growing demand to oversee financial reporting quality following the growth in financial scandals around the world. This has encouraged certain corporate

Table 1: Descriptive statistics

Parameters	Obs.	Audit firm size	Earnings management*	Leverage	Directors No. of independent	No. of audit committee	Firm size
Panel 1 (2006/07)							
Mean	337	0.6825	0.0014	0.232400	3.2582	2.6410	13.33980
Median	337	1.0000	-0.0051	0.216000	3.0000	3.0000	13.12070
Maximum	337	1.0000	0.6351	0.761500	8.0000	4.0000	17.60060
Minimum	337	0.0000	-0.6380	1.31E-05	0.0000	0.0000	11.46620
Panel 2 (2012/2013)							
SD	337	0.4662	0.1474	0.164900	1.0445	0.6352	1.15754
Mean	342	0.6199	0.0058	0.208600	3.5058	2.8246	13.70990
Median	342	1.0000	-0.0013	0.182600	3.0000	3.0000	13.58780
Maximum	342	1.0000	0.5949	0.708800	7.0000	6.0000	18.08130
Minimum	342	0.0000	-0.4269	2.15E-05	1.0000	0.0000	11.01750
SD	342	0.4861	0.9418	0.158800	1.0445	0.6709	1.31950

Earnings management is measured using modified Jones and Blanchet (2000) Model

Table 2: Correlation matrix and Pearson correlation

Variables	1	2	3	4
Panel A (2006-2007)				
Leverage	1			
No. of independent directors	0.00136	1		
No. of audit committee members	-0.10091	0.55287	1	
Firm size	0.0946*	0.26037*	0.22155*	1
Panel B (2012-2013)				
Leverage	1			
No. of independent directors	0.0901*	1		
No. of audit committee members	0.05712*	0.05055*	1	
Firm size	0.3757*	0.2648*	0.0957*	1

Table 3: Regression results on corporate governance and earnings management

Variables	Model 1 2006/07	Model 2 2012/13
No. of audit committee members	0.0325 (0.3674)	0.0063** (0.0235)
No. of independent directors	-0.0343*** (0.0000)	0.0035*** (0.0054)
Leverage	-0.2272*** (0.0000)	-0.0276*** (0.0027)
Firm size	0.0945*** (0.7360)	-0.0009 (0.7189)
Audit quality	0.0812*** (0.0000)	-0.0121** (0.0108)
Constant	-0.4517*** (0.0000)	-0.0104 (0.3619)
Firm random effect	Yes	Yes
Observations	337	342
R ²	0.0421	0.0100

***Significant at 1% level; **significant at 5% level and *significant at 10% level

governance mechanisms to put in place to reduce some of financial fraud risks (Wild, 1996). From Table 1, Panel 1 (pre-IFRS regime), 68.3% of the sample firms were audited by the Big-4 audit firms, in terms of leverage, the mean leverage (as measured by interest bearing debts to total assets) is low at 0.23 and the maximum leverage is 0.76. The number of independent directors range from none to a maximum of 8. The number of audit committee members range from none to a maximum of 4 persons. In Panel 2 (post-IFRS regime), on average, 62% of the sample firms were audited by the Big 4 audit firms. Leverage ranged from 0 to as high as 0.71. The number of independent directors ranged from 1-7 persons. The number of audit committee members ranged from none to a maximum of 4

persons. Table 2, showing the correlation matrix for the independent variables indicate that the magnitude of the correlation coefficients do not indicate any multicollinearity problems. The maximum correlation coefficient is only 0.55, well below the threshold that indicate multicollinearity problems (one of the diagnostics for regression analysis).

In Table 3 Panel 1 presents the role of corporate governance mechanism on the relationship with earnings management pre-IFRS regime. Independent directors and leverage have a significant negative relationship with earnings management. Hence, this study supports literature 20 and 19 findings. The negative relationship between leverage and earnings management supports the

Table 4: Major events affecting financial reporting in Malaysia

Years	Major events
2006-2011	Use of Malaysian Financial Reporting Standards (FRS Framework). These are in line with standards issued by International Accounting Standards Board (IASB) except for some minor modifications
2010	Audit Oversight Board to promote and develop an effective audit oversight framework and to promote confidence in quality and reliability of audited financial statements
2012	Full International Financial Reporting Standards (IFRS) convergence by 1.1.2012. All approved accounting standards applicable to entities other than private entities will converge with all IFRS issued by the IASB. Approved accounting standards are named Malaysian Financial Reporting Standards (MFRS) are word for word the same as IFRS
2012	Release of Malaysian Code on Corporate Governance (MCCG) 2012

agency theory in that debt is used as a tool to monitor management. On the other hand, firm size and auditor firm size have a positive significant relationship with earnings management. Audit committee independence has no significant relationship with earnings management. In Table 2, the results indicated that the number of audit committee members and number of independent directors have a significant positive relationship with earnings management. On the other hand, leverage, firm size and audit quality have a significant negative relationship with earnings management. The results of this study contrasts with the findings of literature 33 who found that IFRS adoption had no significant impact on either real or accrual-based earnings management based on their sample of 22 countries from 2000-2010. On the basis of literature 34 on the other hand found that earnings management using loan loss provisions is significantly reduced after IFRS adoption and that earnings management is more pronounced for riskier banks for 18 European Union countries from 1999-2008.

Table 4, provides the major events that affect financial reporting and the quality of financial reports for Malaysian listed firms. The application of approved accounting standards is mandatory for all listed firms. However, the application of MCCG 2012 is not mandatory but is an indication of best practices.

CONCLUSION

In Malaysia, pre-IFRS regime, corporate governance mechanism of independent directors mitigate earnings management but post-IFRS regime, audit quality/audit firm size (represented by Big 4 audit firms and non-Big 4 audit firms) mitigate earnings management and audit committee and independent directors do not mitigate earnings management. With the establishment of the Malaysian Audit Oversight Board which monitors auditors on compliance with International Standards of Auditing has resulted in ensuring audit firm size had an effect on earnings management.

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