Board of Director Characteristics and Earnings Management in Malaysia

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***Abstract*- This paper seeks to study the relation between board of director characteristics as a corporate governance mechanism and earnings management in the Malaysian scenario. Earnings management is measured by discretionary accruals and for estimating discretionary accruals, Modified Jones Model is used. Board of directors' characteristics includes number of meetings, existence of outside directors, financial expertise and separation of the roles of chair and chief executive officer. In this study, the multiple linear regressions have been used. To test the hypothesis, cross-sectional and pooled data of 71 companies listed in Bursa Malaysia from 2001 to 2005 were used. The results demonstrate that financial expertise are positively related to earnings management in the Malaysian scenario.**

Introduction

No doubt the advent of joint-stock companies in the industrial world is one of the biggest economic developments and probably the most important factor of industrial development. Separation of ownership from administration, existence of natural difference in the function of their desirability resulting into the contrariety of benefits and thus forming owner-agent relationship and agency theory are the outcome of this phenomenon. Since the very day the problem of the interference of rights in general and the risk of rights of minority shareholders to be lapsed by high level influential shareholders specifically has been an important owner agent difficulty in most of the countries. Scandals of accounting and the downfall of companies like Enron, World Com of America and Tel Van Company in Australia has brought forth serious anxieties about earnings management, making use of the reported profit and moral problems of those who audit and prepare these reports. Legislative organizations in Australia and America reacted against bankrupt companies and disclosed embezzlement by improving the principle of corporate governance. For the same purpose U.S.A in July 2002 to respond to the above mentioned bankruptcy levied the law of Sarbanes-Oxley. Regarding these reactions it is expected that earnings management and corporate governance mechanisms are highly interrelated. This research is focused on achieving the effectiveness of some of these mechanisms and methods on the decline of earnings management. Identifying the ways and means having an impact on the decline of earnings management is very important. It is so that the investors being doubtful about the impartiality of the given information will behave more conservatively and consequently affect the efficiency of capital market.

Literature Review

In case of the relationship between earnings management and infrastructure of corporate governance, research work in Malaysia is an ongoing basis. Mashaikh and Ismaili (2006) did not find any significant relation between quality of the earnings along with the ownership percentage of the board of directors and number of the outside directors. As compared to the research work in Malaysia and expanded work has been done externally about the relation between corporate governance and earnings management. Here the paper briefly take a look at these studies: Beasley (1996) showed that as outside director ownership in the corporation and outside director tenure on the board augment and as the number of outside directorships in other firms held by outside directors decreases, the probability of financial statement fraud decreases. Vafeas (1999) found that board meeting frequency has a relationship with corporate governance and ownership characteristics in a way that is consistent with contracting agency theory. Chtourou et al. (2001) concluded that income decreasing earnings management has a negative relationship with the presence of at least a member with financial expertise and a clear mandate for overseeing both the financial statements and the external audit. For the board of directors, they found that less income increasing earnings management in firms whose outside board members have experience as board members with the firm and with other firms. Klein (2002) examined whether audit committee and board characteristics

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are related to earnings management by the firm. He found a negative relation between board independence and abnormal accruals. Reductions in board or audit committee independence were accompanied by great increases in abnormal accrual. Xie et al. (2003) show that board and audit committee members with corporate or financial backgrounds are related with firms that have smaller discretionary current accruals. Board and audit committee meeting frequency is also related with reduced levels of discretionary current accruals. They also found that board and audit committee activity and their members' financial sophistication may be pivotal factors in constraining the propensity of managers to be involved in earnings management. Park and Shin (2004) found that earnings are managed upward to prevent reporting losses and earnings declines. While outside directors, as a whole, do not decreases abnormal accruals, directors from financial intermediaries decreases earnings management, and the board representation of active institutional shareholders decreases it further. Agrawal and Chadha's (2005) findings are consistent with the idea that independent directors with financial expertise are important in providing oversight of a firm's financial reporting practices. Peasnell et al. (2005) stated that in the U.K. outside directors are effective in constraining earnings management only after the issuance of the Cadbury Committee Report. Chen et al. (2007) examined whether corporate governance characteristics, mandated by the Corporate Governance Best- Practice Principles (CGBPP) for companies which were listed in Taiwan, are associated with earnings management. They examined, particularly whether the independence, financial expertise, and voluntary formation of independent directorship are associated with the absolute value of discretionary accruals. Their findings conveyed that the independence of supervisors, financial expertise of independent directors, and voluntary formation of independent directorship are associated with lower probability of earnings management. These findings are stronger after the CGBPP was enacted, suggesting that the implementation of CGBPP has decreased the probability of earnings management. Cornett et al. (2008) found that Earnings management reduces when there is more monitoring of management discretion from sources like institutional ownership of shares, institutional representation on the board, and independent outside directors on the board.

Research hypotheses:

H1: There is a significant relation between discretionary accrual and the number of meetings held by the board of directors in the company.

H2: There is a significant relation between discretionary accrual and existence of outside directors in the combination of the board.

H3: There is a significant relation between discretionary accrual and the level of financial expertise.

H4: There is a significant relation between thediscretionary accrual and presence or absence of the managing director as a chief or vice chief executive of the board.

Research methodology

The present research is descriptive and a type of multiple variable correlation. Data has been analyzed in the pooled manner and composed data form while cross-sectional analysis (yearly study) has also been performed. Multiple linear regression model have been used to test the research hypothesis. Statistical community of the research was whole sum of the companies recognized by Bursa Malaysia during 2001 to 2005. It is also required that the fiscal information especially the notes along with account statements must be accessible to extract the required data including accounts of discretionary accrual. According to the above mentioned conditions, 131companies were selected as the statistical community. The sample size was also selected from 71 companies by using the sampling formulae of limited Random methodology. Data and the financial information were used in the analytical studies. Information relevant to earnings management of companies was obtained by Bursa Malaysia and internet site of the organization. Information concerned with the characteristics of the board of directors up to accessibility was extracted from reports of the summary of the decisions made by the common general assembly issued by stock exchange annual report of the board of directors presented to the common general assembly of the shareholders. Remaining information has been obtained directly from the companies under study. Modified Jones model (Dechow and others 1995) has been used to estimate discretionary accrual. Jones has recognized the difference between the income and cash flow operation as discretionary accrual:

$TA_{it} = E_{it} – CFO_{it}$

In this formula the variables are:

TA_{it}: total accrual of firm i in period t
E_{it}: net income prior to extraordinary items of firm i in period t
CFO_{it}: cash flow operation of firm i in period t

On the other side, to estimate α1, α2 and α3 which are the specific estimated parameters of the company, the following formula is used:

$$TA_{it} = \alpha 1\ (1/A_{it-1}) + \alpha 2\ (\Delta REV/A_{it-1}) + \alpha 3(PPE_{it}/A_{it-1}) + \varepsilon_{i,t}$$

Ultimately, for the appraisal of discretionary accrual, non- discretionary accrual must be Estimated\ through the following formulae:

$$NDA_{it} = \alpha 1\ (1/A_{it-1}) + \alpha 2\ [(\Delta REV-\Delta REC)/A_{it-1}] + \alpha 3\ (PPE_{it}/A_{it-1}) + \varepsilon_{i,t}$$

In the two formulas above:
ΔREC: changes in receivables accounts of firm i in period t and t-1
A_{it-1}: total assets of firm i in period t-1
ΔREV: changes in revenue of firm i in period t and t-1
NDA_{it}: non-discretionary accrual of firm i in periodt
PPE_{it}: net property, plant and equipment of firm i in period t
$\varepsilon_{i,t}$ = residual for company i in year t.

For the appraisal of parameters α1, α2, and α3 to estimate discretionary accrual, the Excel and SPSS software had been used. By deducting non-discretionary accrual from total accrual we get discretionary accrual. So discretionary accrual is estimated by using modified Jones model as follows:

DA=TA-NDA

Independent variables of research are defined and estimated as following:
The meetings held by the board of directors: The number of meetings held by the members of the board of directors. Percentage of the outside directors: Proportion of outside directors to board member Level of the financial expertise of board members: Number of the managers who have university degree in any major of accounting or management or at least two years expertise of financial affairs. Presence or absence of the managing director as chief or vice chief executive of the board: In case the managing director in a company is the chief or vice chief executive of the board we use artificial variable No1 and if he is not possessing this post, artificial variable zero will be used. Ultimately to test the hypothesis multiple linear regression has been used. Four tests of the hypothesis have been performed respectively by 1st, 2nd, 3rd and 4th model:

1) DAit = s0 + s3 MEET+ ε

2) DAit = c0 + c1 OUTDIR+ ε

3) DAit = f0 + f2 FINEXPER + ε

4) DAit = β0 + β1 CEOCHAIR + ε

Findings

In the present research discretionary accrual of modified Jones model has been used. First for appointing the discretionary accrual data of 71 companies from 2001 to 2005 was gathered around and then coefficients of the model; α1, α2, a3 have been assigned by SPSS software. Table1 shows the descriptive statistics of data to be studied to estimate parameters of modified Jones model and usage of linear regression. Tables 4 and 5 indicate the descriptive statistic of discretionary accrual.

Table 1: Descriptive statistics related with the estimation of the parameters of modified Jones model

	Mean	Max	Min	Std. Deviatio
TA_{it} / A_{it-1}	0.0459	0.750	-0.655	0.164
$1/A_{it-1}$	0.000	0.000	0.000	0.000
$\Delta REV_{it} / A_{it-1}$	0.143	1.320	-0.501	0.226
PPE_{it} / A_{it-1}	0.329	1.269	0.000	0.227

According to Tables 2 and 3, results of statistical analysis of above model may be summarized as following:

Table2 : Result of Regression

Model	R square	Adj. R-square	F statistic	Durbin-Watson	Sig.
Regression	0.129	0.122	17.017	2.049	0.000

It is observed in Table 2 that F statistic, 17.017 and related significant level is zero and its comparison with 0.05 error level indicates the regression model is significant which indicates the significance of goodness fit index of regression model is verified at 95% assurance level. R square shows that independent variables explain about 0.129 variations in dependent variable. Durbin Watson statistic indicates that no correlation among the error particles of regression model is found. Likewise, regarding the rate of tolerance and VIF in Table 3, it is observed that no correlation exists among independent variables. The number related to VIF should be near to 1 but being more than 30 means that a high level correlation exists among independent variable.

Table3: Result of Regression

	Corfficient	t. statistic	Tolerance	VIF	Sig.
α1	1465.975	3.736	0.874	1.144	0.000
α 2	0.209	5.853	0.764	1.308	0.000
α 3	-0.052	-2.035	0.682	1.467	0,043

Table 4: Descriptive statistic of dependent variable in pooled form

	N	Max	Min	Mean	Std. Deviation
DA	347	0.671	-0.50	0.025	0.164

Table 5:Descriptive Statistics of Dependent Variable as Cross Sectional

2001	N	Max	Min	Mean	Std Deviation
Discretionary Accrual	68	0.32	-0.507	-0.013	0.149
2002	N	Max	Min	Mean	Std Deviation
Discretionary Accrual	71	0.418	-0.35	-0.008	0.145
2003	N	Max	Min	Mean	Std Deviation
Discretionary Accrual	70	0.41	-0.276	-0.014	0.144
2004	N	Max	Min	Mean	Std Deviation
Dicretionary Accrual	70	0.671	-0.423	0.08	0.215
2005	N	Max	Min	Mean	Std Deviation
Discretionary Accrual	68	0.613	-0.401	0.024	0.141

Table 6: Result of SPSS Test

Year	2001	2002	2003	2004	2005	Pooled
Sig	0.371	0.969	0.785	0.761	0.256	0.217

Table 7: Result of H1 Test 1

Year	Number of Meeting	R Squared	Adjusted R Squared	Coefficient	F Stat	Sig	Durbin Watson	Result
2001	920	0.000	0.017	0.000	0.017	0.896	2.362	Reject
2002	985	0.011	0.004	0.002	0.720	0.399	1.778	Reject
2003	971	0.013	0.004	0.002	0.799	0.381	2.010	Reject
2004	973	0.006	0.016	0.002	0.366	0.547	1.978	Reject
2005	940	0.001	0.016	0.001	0.039	0.843	2.001	Reject
Pooled	4789	0.001	0.002	0.001	0.229	0.633	1.985	Reject

Findings of tests of hypothesis

One of the conditions of using regression model is that the dependent variable be normal. The normality of data was studied by using the SPSS software.The results of this test have been given in Table 6.As the obtained significant level in every year is more than the considerate significant level (0.05), therefore we an say that dependence variable of the research i.e.,discretionary accrual,is normal.

Discussion and conclusion

Based upon the above data, results of the research display no relation between the number of meetings held by the board of directors and discretionary accrual. Thus my results do not coincide with the results of Xie and others (2003) because they found when members of the board have frequent meetings, discretionary accrual decreases. In this research, no relation was found between the number of meetings and discretionary accrual. I believe that this may result from the fact that members of the board, having no appeal for extra sittings, intend only to reach at the fixed least limit of holding meeting. As given in the constitution of most of the companies, the least level of meetings to be held is once a month and most of the firm desire to fulfill the very least .And other argument may be lack of an organized system to hold the meetings of board and thus enhancing this disconnection.Second hypothesis was nullified. Presence of outside directors in the combination of executive board is important because their benefits are not contrary to the interests of the company. So they can play an effective role of supervisor by judging and solving the decisions of directors quite professionally and impartially. Whether outside directors in Malaysia perform their role of supervision or not, is an important point to be considered. If they just participate in decision making and ignore from their guardianship their effectiveness can decrease significantly. On the other way, simultaneous membership of most of the outside members of the board of directors in some other companies can also decrease their effectiveness. Based upon the principle of corporate governance regulation draft, in big companies at least 2 persons and in all others at least 1 person from the members of the board of directors must be from independent manager. In this research, the managers who have no executive post are defined as outside directors and it is supposed that they are independent from firm while it may be possible that they have ties with the company. For example, in practice many of them might be appointed as managing director or chief executive of the board by the big companies. It is also possible that they have a kind of association with the company due to long term membership in the board of directors. Therefore the traditional differences in defining the terminology of 'executive managers' and 'outside directors' may be unable to identify the potential oppositeness of interests between outside managers and the company where they are present as a member of the board. Third hypothesis was confirmed. I expect a relationship between financial expertise level and discretionary accrual but important debate is; why this relation is positive. From my point of view this may result from the fact that most of the members with financial expertise were of employed cadre while a number of companies did not have even a single outside manager possessing financial expertise. In most of the literature debating corporate governance, for example, in principle of corporate governance regulation draft in Malaysia, it is recommended that in the combination of the members of the board there must be at least one outside member having B.A in accounting, fiscal policy or administration experiences. Fourth hypothesis of this research was rejected. Results of the studies of Chtourou et al. (2001) indicate that there lies a positive relation between earning management and the existence of managing director as chief executive of the board. In the view of the research worker the rejection of the hypotheses might be due to the fact that duty of managing director and the chief executive of the board of directors have not been differentiated fully. In Malaysia ,the board of directors, both traditionally and based upon the trade law, is liable to administrative and strategies duties (but in practice mostly executive responsibilities).Board of directors is supposed to compose strategy, gain assurance about the maintenance of fiscal and human resources while evaluating the performance of managers and controlling the risk. So chief executive of the board is liable to be sure of performing above mentioned duties and effective contact with shareholders while managing director is supposed to perform executive duties.

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