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Board Structure and Earnings Management in Malaysian Government Linked Companies

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Abstract

With increasing number of corporate scandals and failures, corporate governance has become a common and controversial issue last few decades specifically on the role of board of directors in enhancing the performance of firms and mitigating earnings management activities. Numerous research have investigated the relationship between earnings management and board structure in Public Listed Companies (PLCs), but limited study has focused on Government Linked Companies (GLCs). The current study examines relationship between corporate governance mechanism being board structure and earnings management. This study used a sample of 26 Malaysian listed GLCs from various industries excluding the finance industry. Data were collected from the annual report for a period of six years from year 2005 until 2010. Multiple regression analysis was used to test the hypotheses. The results provide significant support on the association between boards of directors' composition towards earnings management.

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Keywords:

1. Introduction

Since its independence in 1957, Malaysia has been an economically open country. However, in favour of greater

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state intervention, Malaysia has abandons partially the laissez faire style of economic management. GLCs are established to play a significant role in economic development and these companies are given a variety of supports to achieve the nation's vision. The aim of GLCs are more likely the same with other public companies whereby to maximize their profit, but still serving community as a whole. However, with various forms of protection and supports from the government, their management may not deem reducing cost of production as priority.

Among the reasons why GLCs are performing poorly is due to them having a high sense of humanity where they will prioritize the public concerns, which may not be in line with the profit motive (Ahmed et al, 2001). In addition, the owners of GLCs are the public, while the boards are the agents who manage the company. Also, it is not the owners who exercise governance, but the boards. There is no personal interest for the boards in ensuring that an organization is running efficiently or governed well since they do not get any benefit from good governance.

GLCs are argued to perform worse than private sector because their managers are civil servants who lack business characteristics and their investment may be politically rather than economically motivated (Ramirez & Tan, 2004). Since there are no attractions for the board of directors to increase the performance of the company, GLCs can be said as lacking corporate governance. They did not perform in terms of financial positions because they were backed up by the government as a fund provider. This means motive for earnings management will differ.

The current study examines the effectiveness of board of directors in alleviating earnings management practice within the regulatory and business environments in Malaysia. The study investigates several board characteristics (BOD composition, BOD size, cross directorship and senior government officers) and evaluates whether these characteristics have any relationship with the practice of earnings management.

2. Literature Review and Hypotheses Development

2.1. Earnings Management and Its Motivation

A research done by Standard and Poor (2011) found that a large number of companies are using earnings management either to maintain steady earnings growth or to avoid reporting adverse performance. Earnings management may be defined as reasonable and proper activities that are part of a well-managed business that delivers value to shareholders (Mulford & Comiskey, 2002). Managers are trusted by shareholders to manage company's fund which is provided by them. The shareholders put high hopes on managers to make full use of it in order to increase their income. Therefore, trust given by shareholders may cause tense to managers to maintain or increase the income of the company.

General Accepted Accounting Principles (GAAP) allows many accounting choices and requires much estimation. Since there are many choices of ways to present the company's income, there is no clear posted limit beyond which a choice is illegal, thereby; the management have the flexibility to choose which ever ways to report earnings, as long as they comply with the GAAP. In order to show good performance, managers will choose for example, to adopt a longer depreciable life for a machine which is high end in industry norms in order to lower the depreciations expense and thus will maximize reported income for future periods and share price of the company (Albrecht et al., 2006).

The motives of earnings management can come from different angles, which are inside and outside entities. Failure to meet financial goals is one of the pressures from inside entities. When a management fails to meet financial goals, this can be a personal consequence for them because usually, a firm will reward their management by using the financial rewards system (Stringer, Didham, & Theivananthampillai, 2011). At any levels within an entity, financial incentives are based directly or indirectly on accounting results. At some point, the motivation to increase personal benefit may become a priority for the management to manage earnings (Othman & Zeghal, 2006).

2.2. Board Quality

The board of directors relies solely on the management for information. However, information received by the board of directors might be different from actual situation, which is known as information asymmetry. In addition, one of the responsibilities of the board of directors is to monitor the management; nevertheless, the sources of information must be reliable and independent. Hence, there are many duties to be performed in an organization, which includes selecting and monitoring other committee members. Board of directors can choose not to have an individual committee and can choose to perform their job as a whole. However, it may involve a lot of time, especially in a complex organization. As a result, the Malaysia Code of Corporate Governance has been established a guideline on corporate governance structure. The current study focuses on board structure, one of corporate governance mechanisms.

2.1.1 Board Structure towards Earnings Management

A principle in MCCG requires companies to have board balance between executive directors and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision-making. Previous study by Petra and Dorata (2008) focused on the role of the composition on board of directors. The board of directors is considered as first defence for shareholders interest against aggressive management actions. Board Structure does not mainly consist of board composition and board size. The current research has included cross directorship and proportion of senior government officers as important factors related to earnings management. A few samples of literatures (Pombo & Gutierrez, 2011; Jiraporn et al., 2008; Saleh et al., 2005) exist to support their effectiveness, though no prior study has investigated direct relationship between these attributes and earnings management. Therefore, it is important to identify whether these proposed attributes of boards structure have a bearing on the incidence of earnings management.

2.1.2 Board Composition and earning management

A research by Fama and Jensen (1983) suggested that the board of directors have role of monitoring the top management. However, Peasnell et al. (2000) suggest that to be an effective monitor, the board needs to include outside director as members who are expected to behave independently as managers. Moreover, Cornett et al. (2008) supported Peasnell et al. (2000) that outside members bring greater breadth of experience to the firm. With regards to the relationship between board composition effectiveness in deterring earnings management, previous studies have shown mixed results (Osma & Noguer, 2007; Peasnell et al., 2005; Park & Shin, 2004; Klein, 2002; Xie et al., 2003).

Results of the study by Peasnell et.al (2005) on the influence of board monitoring role on incidence of earnings management shows there is a negative relationship between the possibility of managers making income increasing abnormal accruals and proportions of outsiders on the board. While Klein (2002) found that the increase in board independence provides an essential tool to reduce magnitude of earnings management. Xie et al. (2003) examined the role of the board of directors in constraining earnings management and revealed that the proportion of outside directors with corporate experience have a negative significant relationship with discretionary accruals. Previous study done by Osma & Noguer (2007), found that board members who are independent from management can have a positive effect on the governance of a company, particularly in relation to fraud and discretionary accounting accruals.

In Malaysia, the importance of board structure has been discussed in the requirement by Securities Commission to have a minimum of 33% ratio of independence director in a board. This shows high awareness among the companies on the need to institute the best practice of corporate governance. Greenbury (1995) also stressed on the importance of independent director sitting in as board member. Therefore, consistent with the previously mentioned study, board composition is operationalised in this study as proportion of independent directors to total number of

board members. Due to varying size of boards, a percentage variable provides a more accurate and comparable measurement. The relevant hypothesis is:

H1 (a): There is a significant association between board composition and earnings management in Malaysian listed GLCs.

2.1.3 Board Size and Earning Management

The MCCG stated that every board should examine its size, to determine impact of the number upon its effectiveness. Board size has been seen to have an impact on earnings management. Such impact can be positive or negative and mainly depends on board structure of the board or whether the board size is small or large.

Managers can make opportunistic choices to advance their self-interests at the expense of shareholders in such a weak board culture (Vafeas, 2000). He proposed smaller board can as it enhance the quality of financial reporting hence information quality will be higher for firms with a smaller board. His research provides evidence supporting the view that smaller board is more effective in adding value to earnings quality. Moreover, Ahmed et al. (2006) show the same results as Vafeas (2000), which reveal that a smaller board is more effective in monitoring earnings quality. In other words, small board size is positively associated with earnings informativeness and larger board size is negatively associated with the earnings informativeness. While a research done by Rahman and Ali (2006) as evidence from Malaysia, found that management and board size creates a positive relationship, which means smaller board is more effective in deterring earnings management.

Inversely, the larger board is expected to be less effective as the monitoring responsibility will be diffused among many directors, which suggest that the burden will be less amongst them (Vafeas, 2000). This could be because less personal responsibility is assumed by each director. Beasly (1996) showed that the increases in board size are related to the likelihood of increases in fraudulent financial statements.

From an agency perspective, larger boards are more likely to be vigilant for agency problems because a substantial number of experienced directors can be deployed to monitor and review management actions (Kiel & Nicholson, 2003). In addition, in GLCs regulatory requirements, board size should not exceed ten directors, unless there is a need with a proper justification to increase the board up to twelve directors.

In short, both large and small sized boards have their shortcomings. Smaller boards may suffer from having fewer independent directors and are more likely to be captured by management or dominated by management or outsiders, thus making them less effective in detecting earnings management. Larger boards may suffer from bureaucracy and from conflicting interests and views that may not help independent directors to discharge their monitoring duties. To examine this effect, the current study uses the number of members on the board as a measure of board size. Therefore, the relevant hypothesis is as follows:

H1 (b): There is a significant association between the board size and earnings management in Malaysian listed GLCs.

2.1.4 Cross Directorship and Earning Management

Cross directorship is known as interlock, which is defined by Pombo and Gutierrez (2011). An interlocking directorship is present when a person serves on the board of more than one corporation, and thereby generates a link or interlock between the companies. They are also known as busy directors, which is valuable in the market because of their specific knowledge and management experience. Moreover, study done by Jiraporn et al. (2008) also stated that directors with more outside board seats may be more experienced, provide better service and offer better monitoring.

However, when there is too much directorship across companies, the positive effect may offset the over commitment of the most well connected director. This is confirmed by a research done by Pombo and Gutierrez (2011), stated that directors who have more directorship influence positively on firm performance. However, an over

committed director losses a leadership controlling role because too many active appointments imply a rent seeking behaviour.

However, a research done by Saleh et al. (2005) founds that a negative relationship between multiple directorships held by directors with earnings management. While, Chtourou et al. (2001) found that directorship is inversely related to the level of earnings management.

In Malaysia, the Bursa Malaysia's requirements permits a director to hold up to twenty five directorships at one time, of which ten directorships are in public listed companies and fifteen directorships in unlisted companies (Rahman& Ali, 2006). However, according to PGC, the cross directorship held by each director in other firms should not exceed five directorships in other listed firms excluding the subsidiaries of GLCs, which is fewer by five directorships than the number recommended by Bursa Malaysia.

H2 (c): There is a significant association between the cross directorship and earnings management in Malaysian listed GLCs.

2.1.5 Senior Government Officers and Earning Management

Most GLCs will include senior government officers (SGO) as directors and managers. This is because most GLCs are owned by the federal government and state agencies. They are either retired or are currently serving as senior officers of government departments and subsequently seconded to helm GLCs.

In line with the resource dependency theory, the presence of SGO as directors could bring in resources, favourable contracts and business opportunities into firms. However, their contribution to GLCs may not be positive as government officers do not have the appropriate business acumen compared to their counterpart in the private sectors. Their job may be involved in assisting firms as "door openers" in securing business opportunities and resources from the government.

As in today, no study has been done relating to senior government officers and earnings management. Therefore, this study will add value to the literature on senior government officers in relating to earnings management. The current study measures the proportion of senior government officers, whether they are formerly or currently working in government agencies, divided by the total number of directors. Therefore, the current study hypothesizes that:

H1 (d): There is a significant association between the proportion of senior government officers in the board and earnings management in Malaysian listed GLCs.

3. Research Design

3.1. Population and Sample

Similar to Mohamad et al. (2010), the current study applied a sample of all the GLCs firm listed in Bursa Malaysia. Initially, there were 33 GLCs listed in Bursa Malaysia. However, the current research excluded the finance industries. This is because the industry is governed by the different Acts which distinguish them from the industries that adopt different sets of accounting principles and concepts. Thus, the final sample consists of only 26 GLCs.

The data were collected from the annual report of the GLCs from year 2005 to year 2010. The data collected from the annual report is relevant to the non-financial data such as board composition, board size, cross directorship and government agents. The financial data which was used to calculate the discretionary accruals as per Kothari's Model was collected from the Data Stream Thompson Reuters.

3.2. Dependent Varibale and Independent Variable

The dependant variable for the current study is earnings management. The study adopts Kothari's Model as a measurement for discretionary accrual. Additionally, this study used the absolute value for the abnormal accrual (earnings management). This is consistent with Rahman and Ali (2006). The absolute value of discretionary accruals or earnings management is used to show the mix effect of increased and decreased in income.

To determine Total Accruals (TACC), items related to current accrual, long term accruals were calculated. The TACC calculations are divided into two, which are non-discretionary accruals (NDAA) and discretionary accruals (DACC). In the regression model, the non-discretionary accrual is the expected accruals which are explained by the variables, and discretionary accruals are the unexpected accruals which are not explained by the variables selected. Thus, total accruals are:

$$TACC\ it = DACC\ it + NDACC\ it \quad (1)$$

The heteroskedasticity of the regression is reduced by deflating each component in the total accruals by lagged total assets (Cheung et al., 2005; Bukit & Mohd Iskandar, 2009). Therefore, total accruals are calculated as follows:

$$TACC = \frac{(\Delta \text{ Cash} - \Delta \text{ Current Assets}) - (\Delta \text{ in Current Liabilities} + \Delta \text{ Current portion of long term debt}) - \text{Depreciation and Amortization}}{\text{Lagged total assets}} \quad (2)$$

Where:
Δ represents the changes from year t-1 to year t.
Lagged total assets represent the total assets of firm i at the end of year t -1.

To decompose total accruals into the discretionary accruals and non discretionary accruals, this study applies the Kothari's Model. This model includes the ROA it or ROA it - 1, which stands for ROA current year and last year as to control the firm's performance. The reason why this model has included ROA is to compare the effectiveness of performance matching versus the regression based approach (Kothari et al., 2005).

$$TACC\ it = \alpha_0 + \alpha_1 (1 / TA\ it - 1) + \alpha_2 (\Delta SALES\ it / TA\ it - 1) + \alpha_3 (PPE\ it / TA\ it-1) + \alpha_4 ROA\ it\ (\text{or } it-1) + \varepsilon\ it \quad (3)$$

Where:
TACC *it* = the total accruals of firm*i* in year *t*; TA *it* – 1 = the total assets of firm *i* at the end of year *t -1;*Δ SALES*it* = sales change in net of the change of account receivable of firm*i* between years t and *t – 1*; PPE *it* = the level of gross property, plant, and equipment of firm*i* in year *t;*ROA*it* = ROA of firm*i* at the end of year *t*

Therefore, non-discretionary accruals are defined by the fitted value obtained from the regression model, whilst the discretionary accruals are defined by residual value obtained from the regression model (Gomez, Okumura, & Kunimura, 2000). This value is the difference between total accruals and non-discretionary accruals.

Table 1 summarizes the independent and dependent variables and their measurement.

Table 1. Measurement of Independent Variables and Dependent Variables

Variables	Measurement
Dependent Variable	
Earnings Management	Discretionary Accruals (Kothari Model)
Independent Variable	
Board composition	Proportion of independent directors in a board
Board size	Total of board of directors
Cross directorship	Proportion of multiple directorship
Senior government officers	Proportion of senior government officers in a board

4. Findings and Discussion

4.1. Relationship between Management Incentives and Board Structure towards DACC

In order to examine the relationship between earnings management and board structure, regression model was employed as follows:

$$DACC = \beta_0 + \beta_1 (BODcomp)\ it + \beta_2 (BODsize)\ it + \beta_3 (CrossDir)\ it + \beta_4 (SGO)\ it + \varepsilon it$$

Where:

DACC = discretionary accruals (earnings management); BODcomp = proportion of independent directors in a board; BODsize = total board of directors; CrossDir = proportion of cross directorship in a board; SGO = proportion of senior government officers in a board

Table 2. Relationship between board structure characteristics and DACC

Model	Standardized Coefficients	t	Sig.	R^2	Adjusted R^2	F (p-value)
BODComp	0.241	-2.925	0.004	0.058	0.051	9.025 (0.003)
BODSize	-0.049	-0.598	0.551	0.002	-0.004	0.358 (0.551)
CrossDir	-0.056	-0.679	0.498	0.003	-0.004	0.461 (0.498)
SGO	-0.031	-0.374	0.709	0.001	-0.006	0.140 (0.709)

Table 2 depicts that there is a significant relationship between earnings management and BOD composition. The results is consistent with the research done by Klein (2002), Osma and Noguer (2007). Thus only hypothesis 1 (a) is accepted. This indicates that the number of independent directors on boards leads to greater earnings management.

The relationships between board size, cross directorship and senior government officers towards earnings management indicate insignificant relationship. The insignificant relationship between board size and earnings management is paralleled with the research done by Chen et al. (2006) where they found board size in China has no significant relationship with earnings management. This indicates that the size of the board does not influence the managers to manage earnings. In addition, the insignificant relationship between cross directorship and earnings management was supported with the research done by Chtourou et al. (2001). The busyness of the directors does not influence the other directors to manage earnings. The insignificant relationship between senior government officers and earnings management implies that combination of SGO as directors and managers in the GLCs has no influence over earnings management. Therefore, hypothesis 1(b), 1(c) and 1(d) are not accepted.

5. Conclusion

This study focuses on the direct relationship of corporate governance mechanism which is boards' structure and earnings management. Some of the research findings are coherent with the extent literature, while some provide interesting and new empirical evidence in understanding the relationship with earnings management. The results of the current study adds to the current literatures such as the work conducted by Cornett et al. (2008), Peasnell et al. (2000), Vafeas (2000), Ahmed et al. (2006), Pombo and Gutierrez (2011) and Sarkar et al. (2008), which affirm that board structure effectiveness is a tool in deterring earnings management.

In light of the 1997 Asian financial crisis, the effectiveness of good governance in Asian economies has been a confronting issue. Agency problems arise when ownership is separated from management. This situation raised the key issue in corporate governance of how to effectively monitor managers and to exercise control so that managers act in the best interest of the shareholders (Zhuang et al., 2001). Amongst others, the existence of a board of director is an important system for shareholding monitoring and control where board composition is the most common aspect discussed. Despite the survey indicating preference for good corporate governance, empirical research examining governance mechanisms in relation to performance has revealed mixed and inconclusive findings. Thus it is hoped that the findings of the current study offers some information to the policy makers and the government on

the matters pertaining to the effectiveness board structure in increasing their firm performance and mitigating earnings management.

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