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## Earnings Management: An Analysis of Opportunistic Behaviour, Monitoring Mechanism and Financial Distress

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### Abstract

The aim of this study is to analyze the relationship between opportunistic behaviors (free cash flow and profitability), monitoring mechanism (leverage) and pressure behaviors (financial distress) toward earnings management. There are indeed several factors that could motivate the managers to manage earnings. In this study, it is assumed that the management incline to manage earnings in order to avoid reporting losses or to avoid showing any decreases in the reported earnings. This empirical research with a sample of Malaysian public listed companies from year 2010 to 2012 shows that managers of the companies would engage in earnings management when the company is financially healthy and when the profit of the company is high. The result of this study would provide a valuable explanation on the relationship between variables, thus, would give relevant views to regulators in tightening the rules and regulation in order to promote public confidence in the reliability of financial reporting.

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*Keywords:* Earnings Management,; opportunistic behaviour; leverage, financial distress; monitoring mechanism

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### 1. Introduction

The primary purpose of reporting financial statements is to deliver annual company's financial information to both external and internal stakeholders in a reliable and timely manner. A major element of the report is accounting earnings, which are used to assist the users in developing corporate policies. Major decisions like capital raising,

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debt covenants, executive remuneration, are shaped based on the available information reported in annual reports. For external investors, they basically can make more informed investment decisions based on the information acquired in the reports. Ideally, the reported earnings should reflect a company's underlying operating economics and simplify efficient resource allocation within the company. Nonetheless, given the control advantages that managers have in reporting and collecting firm specific information over external information users, managers have the opportunity to present the company's earnings in a manner that is most suitable for the company or for themselves. Commonly known as earnings management (EM), this topic is of considerable interest to academics and practitioners (Hatam et al., 2013).

Earnings management occurs "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 information can be used by the managers to convey superior and useful information which they know about company performance to shareholders and debt holders. If this is the case, then, earnings management may not be harmful to the stockholders and the public. Nevertheless, the financial scandal at WorldCom and Enron changed the outlook of earnings management toward an opportunistic view. With regards to this view, managers manage earnings for their own private benefits rather than for the benefits of the stockholders (Watts & Zimmerman, 1986; Subramanyam, 1996; Holthausen, 1990; Healy & Palepu, 1993; Guay et al, 1996; Demski, 1998; Arya et al, 2003; Hao, 2010 & Jiraporn et al, 2008).

Unlike fraud, earnings management encompasses the selection of accounting and estimates that conforms to the generally accepted accounting principles (GAAP). This implies that companies that practice earnings management would manage their earnings within the limits of accepted accounting procedures (Rahman & Ali, 2006). However, certain monitoring mechanisms can prevent managers from inflating the earnings. The monitoring hypothesis acknowledges the impact of external monitoring (such as monitoring by creditors) on the practice of earnings management. Under constant monitoring, inflated earnings through management are likely to be detected and, therefore, unlikely to affect stock prices (Shih & Yueh, 2002).

Meanwhile, pressure from financial distress too has significant adverse effects of an economy, whereby investors and creditors could possibly suffer substantial financial loss. If the firm is in financial distress, managers would anticipate that having their bonuses cut, possibility of being replaced and suffer damage in their career, reputation (Liberty & Zimmerman, 1986; Gilson, 1989). Hence, for conservative management, managers would take opportunity to conceal such a deteriorating performance by choosing different accounting methods that increase income and could conceal the loss (Habib, Bhuiyan & Islam, 2013). Rosner (2003) reports that firms that become bankrupts ex post, but do not appear ex ante, engage in income-increasing earnings manipulation practices.

Therefore, the aim of this study is to analyze the relationship between opportunistic behaviors (free cash flow and profitability), monitoring mechanism (leverage) and pressure behaviors (financial distress) toward earnings management. The result of this study would provide a valuable explanation on the relationship between variables, thus, would give relevant views to regulators in tightening the rules and regulation in order to promote public confidence in the reliability of financial reporting. This study is also expected to provide useful information to current and potential investors as well as to regulatory authorities who are responsible in observing the quality of financial reporting of firms more closely.

## **2. Literature Review & Hypothesis Development**

### *2.1 Earnings Management*

From a broad perspective, accounting is all about the measurement and communication of economic information to the users of financial information. Depending on the type of the users of the information be it creditors, lenders, regulators or public at large, accounting is divided into internal and external accounting. While internal accounting is used for decision making within the firm such as project and profitability evaluation, external accounting is used to assist stakeholders in decisions concerning their relationship with the firm. Thus, external accounting should deliver useful information for investors, creditors, regulators, customers, suppliers and employees in their respective decisions regarding future investments, taxes, whom doing business and with whom to work for (Watts & Zimmerman, 1986; Spohr, 2005).

The responsibility for preparing and publishing external accounting information lies with the firm's managers. As an insider, managers apply their inside knowledge of the firm's current state and business circumstances to prepare the information, hence providing a true and fair view of the firm's financial state and performance. In order for the accounting information to be useful for decision making, it needs to be both relevant and reliable (Spohr, 2005). However, given the existence of information asymmetry between managers and external users of accounting information, it gives an opportunity for the managers to use their discretion in preparing and reporting accounting information for their own benefit. The use of discretion in preparing and reporting accounting information is what we called earnings management.

There are no specific or clear definitions of earnings management. Prior studies have provided a lot of definition for earnings management Schipper (1989) is among the first who give the definitions on earnings management. Schipper (1989) defined it as:

*"Purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain"*.

Healy & Wahlen (1999) provide a more extensive definition of earnings management. According to their definition:

*"Earnings management occurs 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 outcome that depend on reported accounting numbers"*.

On the other hand, Leuz, Nanda & Wysocki (2003) defined earnings management as the alteration in firms' reported economic performance by insiders to either mislead some stakeholders or to influence contractual outcome. Whatever the definition of earnings management, it agreed on the point that managerial intention is a prerequisite of earnings management; however, whether this intention should be opportunistic in nature is not totally clear. Some presentations on earnings management also use the term in connection with managerial discretion not opportunistic (e.g. Dechow & Skinner, 2000; Scott, 2003). Earnings management could be legitimate or illegitimate. Illegitimate earnings management would naturally result in fraudulent financial reporting, which in turn could mislead the users of financial reports.

This fraudulent financial reporting once revealed could cause severe punishment from regulators and could cause the company to be wound up and cease to exist as what had happened in the case of Enron. However, in the case of deciding whether earnings management is legitimate or illegitimate, this can be best referred to generally accepted accounting principles (GAAP). If the practices are within the GAAP, then it will be classified as legitimate earnings management. However, if the practices go beyond the GAAP boundary, it will result in illegitimate earnings management (Al Khabash & Al Thuneibat, 2009).

Yaping (2005) stated in his study that the employment of earnings management required the management judgment to change the accounting estimation and accounting policies. The ability of the managers to use their own judgment and discretion in accounting gives them the power to choose any allowable accounting method and any estimate in accounting method (Dechow & Skinner, 2000). One of the ways of managing earnings is through the use of accruals. Though, total accruals are closely related to earnings management, it should be noted that not all the portion of total accruals is related to earnings management. In the total accrual, it will be distinguished into two portions. The first portion is what we called non-discretionary accrual which also known as normal accrual based on the management estimation according to the economic performance of the companies (Abd. Rahman & Mohamed. Ali, 2006).

Meanwhile, the other portion of total accrual is discretionary accruals which are the part of the total accruals that has been managed by the management, within the constraint of accounting principles (Amman et al., 2006). Thus, the discretionary accrual will be used to determine the earnings management. Becker, Defond, Jiambalvo & Subramanyam (1998); Frankel, Johnson & Nelson (2002); Mohd.Saleh, Mohd. Iskandar & Hassan (2005) and Abd.Rahman & Mohamed Ali (2006) are the examples of studies that have been used discretionary accruals as a proxy for earnings management. Instead of using accruals, earnings also could be managed by using other various known techniques. Ratsula (2010) suggests that there are four techniques of managing the earnings. The first technique is known as taking a bath. By using this technique, management tends to report more loss in order to enhance the probability of future reported profit, especially during the situation of high organization stress or reorganization.

Second, is income minimization. Firm with high profit will be more likely practice this technique in order to avoid political pressure and income tax reflection because this technique would require the management to increase the expenses in order to minimize the reported income. The third technique is income maximization. This technique

is applied mostly for the benefit of individuals such as managers rather than for the benefit of shareholders. The last technique is income smoothing. The technique was purposely employed in order to decrease the volatility of reported income. In most cases, the management will refuse to portray the low reported earnings; hence they will smooth the earnings as a technique to manage earnings. The likelihood of the techniques to be chosen as a tool to manage the earnings will depend on the motive of the management (Ratsula, 2010).

There are indeed many factors that could motivate the managers to manage earnings. Duncan (2001) stated that earnings management occurred in companies which encountered a period of excessive profit or when they refused to report on income declining. Meanwhile, Aman et al. (2006) documented in their study that debt covenants, political cost, internal financing, and equity ownership as the factors that lead to manipulation of earnings. In this study, it is assumed that the management incline to manage earnings in order to avoid reporting losses or to avoid showing any decreases in the reported earnings. This is for the purpose of window dressing, putting up a show to the market and public indicating that the firms are able to compete and maintain good performance in the market (Shuto, 2007).

## *2.2 Opportunistic Behaviors*

The opportunist managers may manage the accounting numbers to camouflage the negative performance and reported it as a highly performed company. In this study, the opportunistic behaviors of the manager are discussed in terms of free cash flow and the profitability of the company. High free cash flow may create an opportunity for managers to manage earnings and create an agency problem. Initially, free cash flow is a surplus cash flow, which is readily available to be used to finance any project that can give positive net present value (Jensen, 1986). Agency problem will happen if free cash flow of a company is wrongly invested or expense in a way that the manager disregard to maximize the shareholders' wealth (Jensen, 1986). In other words, the manager can choose either to invest in a profitable investment or low-return investment. If the manager chooses to invest in an unprofitable investment or low-return investment, the company may be in the state of low growth position. Previous literature provides that when the surplus free cash flow is high, the manager will obtain their personal benefits (Ross, 1973; Jensen & Meckling, 1976; Jensen, 1986; Gul, 2001).

Normally, earnings management that occurred in the companies with surplus free flow can be connected to discretionary accruals (DAC). This is supported by the study of Bukit & Iskandar (2009) who argued that surplus free cash flow may create an incentive for the manager to engage in income-increasing management, financial flexibility signal. In other words, firms with high free cash flow and have a low growth opportunity is associated with the agency problem and the manager tend to use income increasing to boost the reported earnings (Gul & Tsui, 1998; Chung et al., 2005). Additionally, Stulz (1990) noted that the deficit free cash flow as the reason why company are more likely to issue debt as external fund. By having this free cash flow, the manager is expected to invest in profitable project and rather than left it unexploited. The presence of effective and efficient monitoring and disciplinary actions by institutional shareholders, lenders, board of directors, audit committee and others could restrain managers of firms with free cash flow and low growth opportunity to invest in wasteful investments (Gul, 2001).

Most of the times, the managers provided inflate reported earnings to enhance expectation of the investors regarding the future performance of the company and to increase the offer price (Rahman & Abdullah, 2005). Besides that, the managers of the company which having declined profitability are motivated to smooth earnings (White, 1970). Additionally, severe fluctuated income and declined profitability in a company is one of the strong incentives that would be engaged by the managers in smoothing the company's earnings (Ashaari, Koh, Tan & Wong, 1994). According to Dennis and Michel (1996), there are three objectives of earnings management, which are; to reduce political cost, the firm's financial cost and to maximize manager wealth and well being. Thus, earnings management employed by the managers should at least satisfy one of those objectives.

Thus, based on the above argument, this study proposed:

***H1: There is a significant relationship between opportunistic behaviors (proxied by free cash flow & profitability) and earnings management.***

### 2.3 Monitoring Mechanism

Monitoring mechanisms can be divided into internal monitoring and also external monitoring. Internal monitoring consists of parties within the corporation such as board of directors and the internal audit committee, which ensure the effectiveness of internal control in order to reduce the opportunistic behaviors of the management and earnings management itself. According to Van de Poel & Vanstraelen (2007), Dutch listed companies have a lower level of abnormal accruals resulting from adequate and effective internal control. On the other hand, external monitoring is a part of monitoring mechanism which is from outside the corporation such as lenders' monitoring and institutional monitoring.

Leverage referred to the amount of debt used to finance a company's asset and business operation other than equity. Leverage can be utilized as an efficient control mechanism to avoid the practice of excessive earnings management that would eventually harm the corporation. According to Andrade & Kaplan (1998), high leverage companies would have higher financial risks such as financial distress, default on debt payments and bankruptcy risk. In addition, Jensen (1991) argued that the establishment of new regulation and economy downturn crisis may give significant impact on high leverage companies. Hence, these high leverage companies are worsened off. The company might consider having a high leverage if the value of debt is more than the debt optimal value (Shubita & Alsawalhah, 2012). Thus, that the higher the debt ratio, the greater the risk, and thus the higher the interest rate will be (Shubita & Alsawalhah, 2012).

The management's ability to use the company's asset for personal benefits and to exploit the company's asset can be constrained by the existence of external lenders (Bilimoria, 1997). As they are concerned on the debt repayment ability of the company, lenders will ensure that the management will fully use of the cash available in the profitable investment. In other words, the monitoring activities will be carried out by the lenders in order to make sure that the company materializes the debt repayment. The lenders will eventually monitor the management's action because it is the main factors determining repayment (Leng 2008). Previous studies found that less long term emoluments are paid to the Chief Executive Officer (CEO) of the highly leveraged firm. That means, there is no room for the management to expropriate company's cash flow if there is presence of lender's monitoring. According to Cable (1985) and Nibler (1995) monitoring by lenders contribute to the profitability and growth of the company. While, Chirinko and Elson (1996) found an insignificant relationship between monitoring by lenders and the company's earnings.

Prior research has provided evidence that defaulting companies prefer to make more accounting changes as compared to the non-defaulting companies. Similarly, the study conducted by Sweeney (1994); Dichev & Skinner (2002) and Beatty & Weber (2003), reported that managers make an accounting choices in order to avoid debt covenant violations by applying income increasing motive. This is supported by Christie (1990) as leverage is one of the explanatory power in choices of accounting method. On the other hand, the lenders will demand and scrutinize several measures if high leverage companies wish to take out a new loan and this will put a lot of pressure to the manager to manage the earnings (Zagers-mamedova, 2009). Since the management is permitted to choose any allowable accounting method and estimates, the manager will use this opportunity to manage the earnings because the manipulation of accounting practice is difficult to measure (Dechow & Skinner, 2000).

There are mixed opinions on whether leverage may influence the potential of manager to exercise earnings management. A study of Aman et al. (2006) argued that the leverage has no influence on earnings management as refer to the period after the 1997 economic crisis. This is because the corporate sector in Malaysia heavily dependent on commercial bank financing in order to get external funds. Hence, the financial difficulties faced by companies might transpire managers to improve upon their performance through earnings management. In contrast, some literature claimed that the debt may discourage or restraining earnings management as monitoring mechanism. Having a debt, would disciplined the management in debt repayment in order to avoid debt covenant default and being sued by the lenders (Stulz, 1990). Similarly, a study from Balsam, Bartov, & Marquardt (2002) and Siregar & Utama (2008) claimed that lenders have more access to relevant and timely information that enable them to detect earnings management done by unethical managers.

Thus, based on the above argument, this study proposed second hypothesis:

***H2: There is a significant relationship between monitoring mechanisms (proxied by leverage) and earnings management***

## 2.4 Financial Distress

In general, distressed company means that in the near future, the company would not be able to fulfil its obligations. In that case, the company may go bankrupt or be reorganized (Ignatov, 2006). Md. Zeni & Ameer (2010) defined financial distress firms as a term used to designate a situation when agreements or contracts with creditors of a company are not working as expected or at difficult stage. Meanwhile, Hu & Ansell (2005), in their articles defined distressed firms as those that have a debt ratio greater than one ( $>1$ ) or, interest cover ratio (based on cash flow) smaller than one ( $<1$ ). The first definition is based on stock-based insolvency, which means its liabilities are higher than its total asset. Whereby, the second definition is based on flow-based insolvency, by which its operating cash flow is less than their minimum condition. For both situations, in case it is getting serious, may lead to bankruptcy.

Financial distress is a very complex and complicated situation that any organization would cope with. Complexities in measuring financial distress very often lead to an identification problem of whether and individual factor are a trigger of financial distress or somewhat its consequences (Outecheva, 2007). The difference of financial distress has its root in the variety of the sources of financial difficulties. The financial theory stated that these difficulties can be caused by exogenous or endogenous risk factors. Normally, the endogenous risk factors refer to the internal problems of the company. Hence, the risk only affects a particular firm or a small number of firms within the same business line. On the other hand, the exogenous risk factors are more pervasive which means they can affect all companies within the market. As a rule, the identification of sources of financial distress is attributed to the extended empirical research. Karels & Plakash (1987) split all potential causes of financial distress into two groups: internal risk factors and external risk factors. Poor management can be grouped under internal risk factors. Possible forms of the appearance of poor management are the absence of a need for a change, inadequate communication, overexpansion, unintentionally improper handling of projects, or fraud can be grouped under internal factors. Meanwhile, external factors are independent of managerial skills. It can be categorized into inefficiencies in regulatory development, turbulences in the labor market, or natural disasters.

Most of the unhealthy companies are distressed because of the recession, which is the common consequence of the financial crisis (John & John, 1992). On the other hand, despite the recession, certain firms are deteriorating because of increasing foreign competition and caused by an internal source of financial distress, the so-called “creative accounting” or changes in accounting techniques. Asquith, Gertner & Scharfstein (1994) suggested three reasons why a firm can be in a financially distressed situation. They highlighted poor firm specific performance as the most significant cause of financial distress, followed by poor industry performance, and lastly, they pointed out that high leverage as the other reasons of financial difficulties. Andrade & Kaplan (1998) reported similar results with Asquith et al. (1994) where in their study, they also found that high leverage transaction as the common cause of financial distress. High leverage is principally responsible for the lack of cash in the company due to the need of the cash to cover the expense that has to be paid due to high leverage. Furthermore, Opler & Titman (1992) demonstrated that the financial distress of highly leveraged companies has its seeds in an industry downturn and the firms are more likely to have an incentive to engage in hedging activities.

The choice of income-increasing or income-decreasing discretionary accruals depends on the rigorousness of the financial distress (Jaggi & Lee, 2002). If the financial distress is expected to be temporary, the probability for the management of a company to employ income-increasing discretionary accruals is higher and vice versa. As in the case of companies that goes into bankruptcy, the management of these companies will be more inclined to use income-decreasing earnings management in managing their reported earnings due to the fact that several years prior to the violations, companies have managed their earnings upward and thus have exhausted their means of upward earnings management. Hence, they are forced to resort to income-decreasing earnings management. Given the inconclusive evidence on the association between firm distress and earnings management strategies, this current study develops the following hypothesis:

***H3: There is a significant relationship between financial distress and earnings management***

### 3. Research Methodology

The data for this study were drawn from the public listed company in Bursa Malaysia covering the period of 2010 to 2012. A period of 2010 Sample of the study consists of seven industrial sectors listed on the main board of Bursa Malaysia. All the data associated with the study were downloaded using Thomson DataStream. The earlier sample consists of 1,498 firm years. The final usable sample is 1,166 after excluding 216 firms years data with missing value and 116 firms years were further eliminated after the normality test.

The study applied Kothari's 2005 Model for the measurement of earnings management. The use of this measurement is consistent with many studies of earnings management, such as Abdul Rahman & Wan Abdullah (2005); Antle (2006); Carramanis & Lenox (2008), Mohd. Ali, Mohd. Salleh & Hassan (2008), Ahmad-Zaluki et al., 2011 and Joubert & Fakhfakh, 2012. Discretionary accrual or abnormal accrual is widely used because of its ability to capture the quality of accounting information in a common sense and in a universal manner (Choi, Kim, Kim & Zhang, 2010). This is consistent with the study of Prawit, Smith & Wood (2009); Sun, Salama, Hussainey & Habbash (2010) and Choi et al. (2010).

Basically, there are many techniques to measure the financial condition of the company such as mentioned by Rosner (2003); McKewon et al. (1991), Hopwood et al. (1994), and Mutchler et al. (1997). Closely following Altman Z-Score which is the most popular method in measuring the financial condition of the company and it has been employed to measure financial distress by several studies (Maina & Sakwa, 2012). In a study by Demirkan & Platt (2009), they classified the financial condition of the company that measured using z-score into three categories. Company that scored smaller than 1.81 in z-score will be classified as a financial distress company while, the other companies may be classified as financially healthy when their score are greater than 2.67 or gray areas when their score are between the range of financially healthy and financially destroys.

On the other hand, the study uses free cash flow and profit as a proxy for opportunistic behavior. The calculation of free cash flow, followed the proposed method used by Lehn & Poulsen (1989). Prior studies proved that the profitability of the companies is closely related to the cash flow from operation and return on assets (ROA). In addition, ROA used in this study is from the current year studies. Therefore, reporting a good ROA might be the incentive for the manager to manage earnings and show future profitability of the company (Demirkan & Platt, 2009). Following a study by Rahman & Ali (2006), the study used ROA as a measurement for performance of the companies by operating income or earnings before interest and tax (EBIT) divide by total assets.

As for the measurement of monitoring mechanism, the study uses leverage as proxy by debt ratio (total debt/total asset) following the study done by Kim & Yoon (2008). In relation to the practices of earnings management, the size and liquidity of the client has a significant influence on the discretionary accruals (see Becker et al. (1998); Francis, LaFond, Olsson & Schipper (2005); Davidson, Goodwin & Kent (2005); Srinidhi & Gul (2007); and Sukeecheep et al. (2013). Thus, the size and liquidity of the company are used as a control variable in the study.

A simple descriptive statistic is conducted to compare the mean, median and standard deviations between variables. Additionally, for the testing of hypotheses, the study used regression analysis. The regression model is as follows:

$$DACC_{it} = \beta_0 + \beta_1 (FIN\_DISTRESS)_{it} + \beta_2 (FCF)_{it} + \beta_3 (LEV)_{it} + \beta_4 (PROFIT)_{it} + \beta_5 (SIZE)_{it} + \beta_6 (LIQUIDITY)_{it} + \varepsilon_{it}$$

Where;

DACC	Discretionary accrual (earnings management)
FIN_DISTRESS	Financial Distress (Z-Score)
FCF	Free Cash Flow (free cash flow scale by total assets)
LEV	Leverage (Debt Ratio)
PROFIT	Profitability
SIZE	Log transformation of total assets (LOG_TA)
LIQUIDITY	Liquidity

#### 4. Analysis and Discussion

Table 1 presents the descriptive statistic for the dependent variable, independent variable and control variable used in this study. The descriptive analysis statistically explains the variables used in the study. This table reports on the minimum, maximum, mean and standard deviation value for each variable in this study. The empirical results show that earnings management is reported in a range 0.000 to 0.160. Meanwhile, the mean value of earnings management is reported at 0.033. This value is slightly higher compared to the study of Abdul Rahman & Mohd. Ali (2006) who reported a mean value for earnings management in 0.0132 but lower than the study of Mohd. Yusof (2010) who reported a mean value for earnings management at 0.165. This provides the evidence that, in average the public companies in Malaysia is involved in earnings management.

The mean value of financial distress is reported at 0.734 which is lower than the required value of 1.8 for the company to be classified as healthy (Demirkan & Platt, 2009). The result, then indicates that 73.4% of the companies in the sample can be classified as either in the gray area or distress area.

Table 1. Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
EM	1166	0.000	0.160	0.033	0.030
FIN_DISTRESS	1166	-0.002	2.694	0.734	0.430
FCF	1166	-0.196	0.215	0.009	0.058
PROFIT	1166	-0.199	0.343	0.061	0.073
LEVERAGE	1166	0.000	1.391	0.197	0.165
SIZE	1166	4.403	7.946	5.600	0.618
LIQUIDITY	1166	-0.935	0.974	0.223	0.233

For the hypothesis testing, multiple linear regressions have been used. The summary of the result of multiple regression analysis is presented in Table 2.

Table 2. Multiple Linear Regression (2010-2012)

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Tolerance	VIF
	B	Std. Error					
(Constant)	0.083	0.009		9.065	0.000		
FIN_DISTRESS	-0.007	0.002	-0.100	-3.238	0.001*	0.869	1.151
FCF	-0.022	0.022	-0.041	-0.996	0.320	0.488	2.050
LEVERAGE	0.032	0.007	0.171	4.550	0.000*	0.583	1.714
PROFIT	0.040	0.018	0.097	2.205	0.028*	0.427	2.340
SIZE	-0.010	0.002	-0.196	-6.166	0.000*	0.820	1.220
LIQUIDITY	0.005	0.005	0.040	1.034	0.301	0.554	1.804
R Square	0.044						
Adjusted R Square	0.039						
F Change	0.000						

a. Dependent Variable: EM

b. Predictors: (Constant), LIQUIDITY, FIN\_DISTRESS, SIZE, FCF, LEVERAGE, PROFIT



The R square specifies the percentage of the variability in the dependent variable, which is accounted for by the independent variables. It indicates how many percent of the independent variable is attracted or explained in the dependent variable. In this study, FIN\_DISTRESS, FCF, LEVERAGE, PROFIT, SIZE and LIQUIDITY have explained for 4.4 percent of the variance of earnings management. Additionally, the result also provides evidence that the model in this study is well specified. Nevertheless, it should be noted that low R<sup>2</sup>'s are typical of this type of accruals regressions (Xie, Davidson & DaDalt, 2003; Geiger & North, 2006; Davidson et al., 2007; Meek, Rao & Skousen, 2007; Jenkins & Velury, 2008).

The empirical result in the table also indicates whether the Hypothesis 1 (H1), Hypothesis 2 (H2) and Hypothesis 3 (H3) are supported or rejected. This study hypothesized that if opportunistic behaviors (FCF & PROFIT) exist, then, earnings management also will exist (H1). Based on results in the table, H1 is partially supported since only profit shows a significant relationship ( $p=0.028$ ,  $p<0.05$ ) while free cash flow show otherwise ( $p=0.320$ ,  $p>0.05$ ). A positive relationship between profit indicates that if the current profit of the firm is high, managers would be inclined to manage their reported earnings merely to benefit from the positive reported earnings. Meanwhile, a negative relationship between free cash flow and earnings management signal that managers will employ earnings management when the flow of the cash is low for the sake of the company's survival and going concern (Bukit & Iskandar, 2009). In other words, the firms are trying to convey to the public that they are able to fulfill their obligation and the firms are not running in loss. The adverse effect of reporting losses would motivate the managers to use their power to manipulate the reported earnings, which could in turn mislead the user of reported income.

On the other hand, based on the result, H2 also is supported ( $p=0.000$ ,  $p<0.005$ ). H2 postulate that there is a relationship between monitoring mechanisms and earnings management. Significant and positive relationship between monitoring mechanisms proxied by leverage is not consistent with the expected result which expect a negative relationship between monitoring mechanisms and earnings management. Generally, when monitoring mechanisms by external parties is tighten then managers would be less likely to employ earnings management (Majumdar and Nagarajan, 1997; Bushee, 1998; Rajgopal and Venkatachalam, 1998; El-Gazzar, 1998; Ling et al., 2007).

Meanwhile, the H3 is supported as the result show a significant value of  $p=0.001$ ,  $p<0.05$  for financial distress which is the proxy for pressure behavior. A negative relationship between financial distress and earnings management demonstrate that the managers of the firm would practice earnings management when the company is not in distress condition and would do otherwise if the company is in distress. This study is consistent with the study by Demirkan & Platt (2009). Demirkan & Platt (2009) explained the main reason why the distressed companies do not engage in earnings management was simply that they have exhausted their means of manipulating and managing earnings prior to distress and perhaps they fail to perceive benefit from such manipulation.

On the other hand, most large Malaysian companies are supported by the government through Danaharta and Danamodal thus even during distress firms have other choices rather than to succumb to management of earnings in the reported statement (Aman et al., 2006). Through Danaharta and Danamodal, it has created credit bases business environment that is heavily dependent on banks to finance corporate financial needs, especially during distress periods for the survival of the company (Aman & Desa, 1998). Thus, this may be a peculiar feature of the Malaysian financial system which differs from the environment of other countries such U.S or the New Zealand.

## 5. Conclusion

This empirical research was done by using a sample of Malaysian public listed companies in the time span of 2010 to 2012. The regression analysis in testing all the hypotheses was only made on the final sample of 1166 firms' year observations after the process of cleaning missing data, excluding financial institution companies and deleting outliers after the test of normality. Two hypotheses were supported (H2 & H3) and one was rejected (H1). In other words, managers of the companies would engage in earnings management when the company is financially healthy and when the profit of the company is high.

The employment of earnings manipulation camouflages the firm's operating performance and reduces the reliability and accuracy of the reported earnings information. This then raises issues to policy makers as well as regulators since biased information provided to investors would give a negative impact on their decision making process, which in turn negatively affect smooth functioning of financial markets. These concerns have encouraged policy makers and regulators to develop and establish laws and regulations to ensure the accuracy and reliability of

reported information in order to protect the interest of stakeholders relying on reported information to make their economic decisions.

This study is subject to several limitations. First, the study only used one type of accrual model (Kothari, 2005) thus reduce the robustness of the study. Jaggi & Lee (2002) argue that the use of different accrual models will reduce errors in calculating discretionary accruals. However, limitation of time, make it quite impossible to collect all required data for the other accrual models. Second, this study used a sample of the three year period with final sampling of the 1166 firms' year observation, which considered too short as compared to the other studies. In addition, due to the limitation of data, this study only focuses on the sample company in general (except financial institution). The study does not focus on a specific industry or specific firm size. The result may provide different findings if the study used a sample of specific industries or specific firm size. The magnitude and composition of the variable used might differ between industries and firm size. Hence, this will provide more extensive and conclusive findings on the variable examined.

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