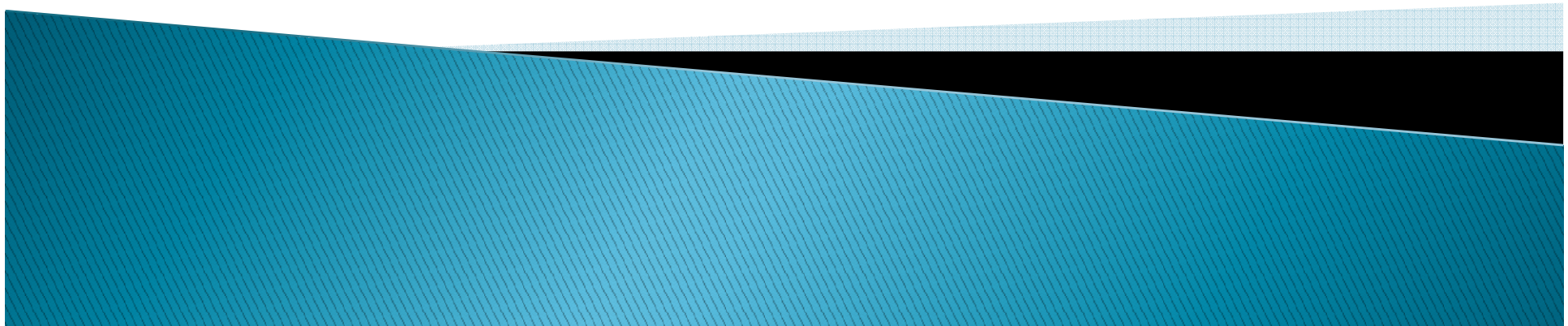


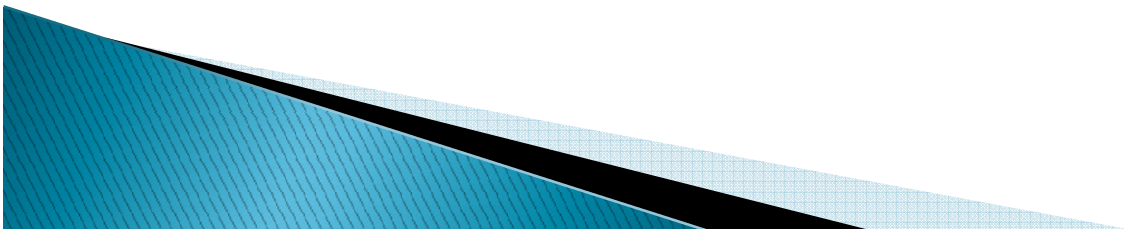
# Earnings Management in Small Listed Firms in Malaysia

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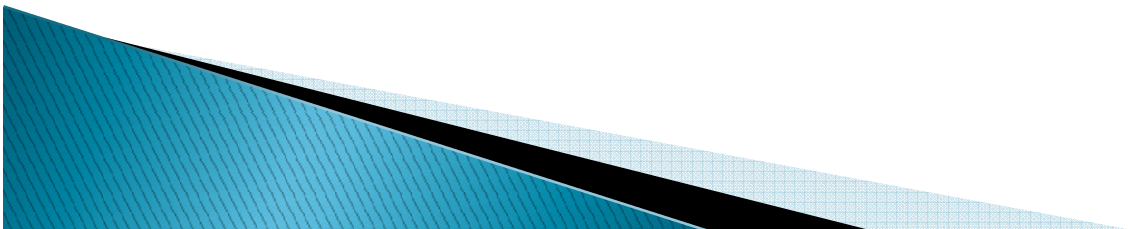
# Introduction

- ▶ Corporate governance (CG) has been a hot issue in Malaysia since the Asian Financial Crisis (AFC) in 1997
- ▶ In 2000, the government via the Securities Commission issued a Malaysian owned Malaysia Code on Corporate Governance (MCCG), modeled after the UK Cadbury Code (1992) and the Hampel Report (1998)
- ▶ It was subsequently revised and reissued in 2007 (following the Enron's case in the US in 2001 and the Transmile's case in 2007)
- ▶ It was further revised and reissued in 2017
- ▶ The main focus of the MCCG (in fact CG) is on the board of directors (BOD) (esp. the chairmanship and composition) and the audit committee (AC) (esp. the composition and the qualification of the members)



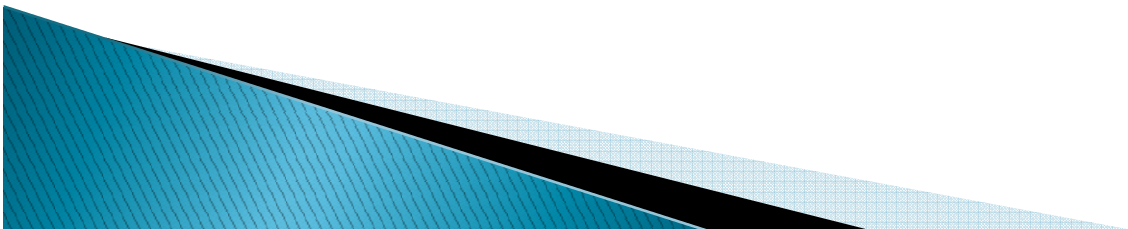
# Earnings Management

- ▶ Earnings management (EM) is a deliberate attempt by the management of a firm to distort the underlying economic reality of the firm (Healy and Wahlen, 1998)
- ▶ The main motive of managing earnings is to ensure the management reports the desired earnings for their own self-interest (Merchant and Rockness, 1994)
- ▶ While earnings management, which is usually achieved either via accrual management or via changing accounting policies, is legal, it is considered as unethical as the main objective is to mislead the users of the financial reports or the stakeholders of the firm about the “true” underlying economic conditions of the firm



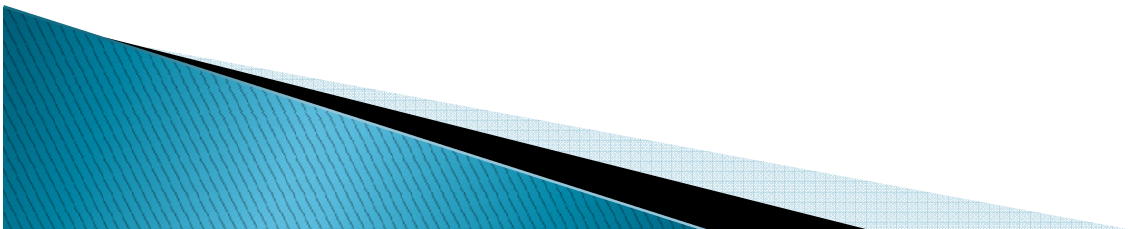
# Motivation of the Study

- ▶ CG influences EM because the AC oversees the preparation of a firm's financial statements and the BOD endorses the firm's financial statements
- ▶ The general hypotheses – the independence of the BOD (and AC) is associated positively with the quality of the financial statements (usually proxied by the quality of earnings)
- ▶ Currently, listed firms on Bursa Malaysia are traded on 3 markets (or boards) – the Main market (large firms), ACE market (small firms), LEAP market (SMEs, but their shares are only accessible by sophisticated investors
  - i.e. high net worth investors – i.e. entities with total net assets exceeding RM10 million (USD2.4 million), or individuals whose net personal assets exceed RM3 million (USD0.75 million) or whose gross annual income exceed RM300,000 (USD75,000) the individual concerned must have a total net personal assets exceeding RM3 million or its equivalent in foreign currencies)

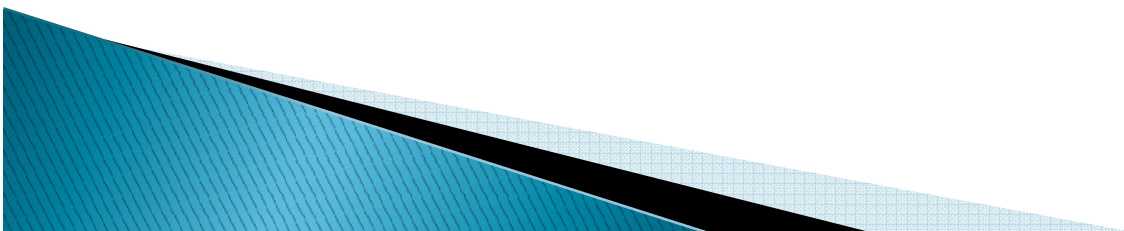


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- ▶ Studies on CG and EM in Malaysia have focused on large firms (e.g. Abdullah and Mohd Nasir, 2004, Abdullah and Ku Ismail, 2016, Buniamin et al., 2012, Hashim and Dewi, 2009, Mohd-Salleh et al., 2005)
- ▶ Large listed firms are closely followed by analysts and subjected to greater scrutiny by both the relevant regulatory authorities and the stakeholders as opposed to small listed firms
  - ▶ This could be the reason why the findings showed that discretionary accruals (a proxy for earnings management) in large Malaysian listed firms are very close to zero

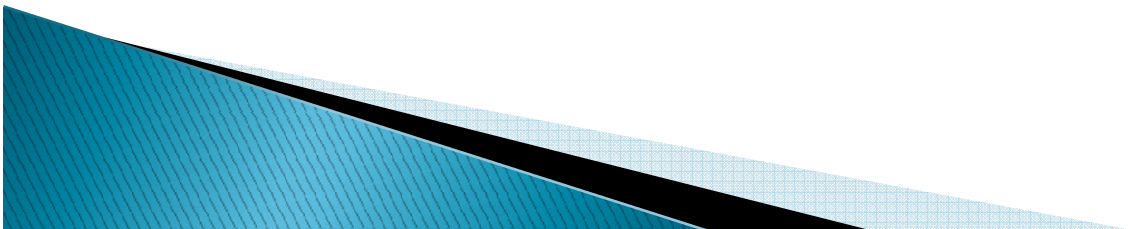


- ▶ Further, the listing requirements for listing on the ACE market are less stringent than the Main Market
  - In fact, institutional investors do not have the mandate to invest in companies in ACE Market
  
- ▶ Hence, due to less public scrutiny, small listed firms may have a higher tendency to apply aggressive accounting procedures or accrual management as opposed to large listed firms
  
- ▶ Therefore, since evidence on the role of CG on EM in small listed firms is non-existent (in Malaysia and elsewhere), it is of interest to study on the effect of BOD and AC on EM in small listed firms in Malaysia



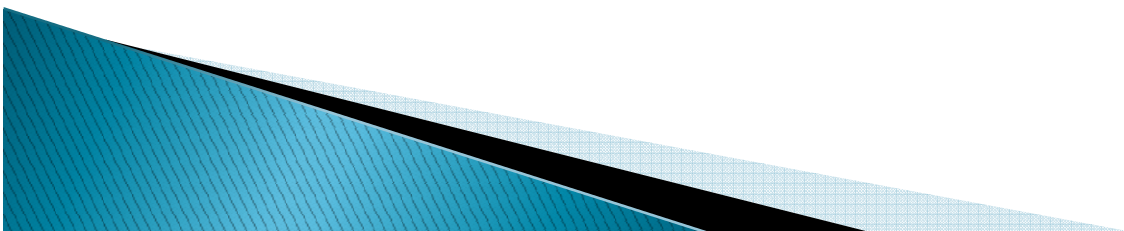
# Research Objectives

- ▶ The objectives of this study are:
  - to determine the incidence of earnings management (i.e. the amount and direction of discretionary accruals) in small listed firms in Malaysia
  - to determine the influence of board independence and audit committee expertise in accounting on earnings management in small listed firms in Malaysia



# Hypothesis Development

- ▶ Smaller listed firms are generally tightly controlled by families or individuals
- ▶ Therefore, the appointment of the family member of the firm's controlling shareholder in the firm's top management is common (Claesens et al., 2000, Mok et al., 1992)
- ▶ It is argued that agency problem in these firms usually leads to the expropriation of wealth by the controlling shareholders at the expense of the minority shareholders due to weak investor protection (Cheung et al., 2006, Leuz et al., 2003, Fan and Wong, 2002)





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- ▶ Evidence in developed countries reveal that private firms (i.e. small firms) have a higher tendency to manipulate earnings than public firms (large firms) (e.g. Burgstahler et al., 2006; Stockmans et al. 2010; Hope et al., 2013)
- ▶ Ball and Shivakumar (2005) revealed that due to the less reliance on the financial statements of private firms in the UK, their earnings are of low quality compared public firms
- ▶ Therefore, in the Malaysian context, it is predicted that the incidence of earnings management is predicted to be high in small listed firms as opposed to large listed firms
- ▶ *H1a. The propensity of earnings management in smaller listed firms is high*
- ▶ *H1b. Earnings management in small listed firms is predominantly for income-increasing*

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- ▶ Board independence is the most important internal corporate governance mechanism of a firm
- ▶ Board independence indicates the extent to which the board is independent of its management and in the case of concentrated ownership such as Malaysia, board independence refers to the extent to which the board is free from the influence of the controlling shareholders
- ▶ With the voting rights in the hands of the controlling shareholders, the appointment of directors to a board is usually dominated by the family shareholders who are also the controlling shareholders due to risk aversion (Anderson and Reeb, 2003; Abdullah et al., 2012)

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- ▶ In family-owned firms, the main objective of appointing independent directors is to seek their expertise and advice on strategic directions rather than for control-monitoring purposes (Andersen and Reeb, 2004; Johnson et al., 2006)
- ▶ Jaggi et al. (2009) reveal that for Hong Kong firms, while board independence reduces earnings management, the association becomes weaker for family-controlled firms
- ▶ Therefore, board independence is not expected to reduce earnings management in smaller listed firms in Malaysia because of the influence of family directors
- ▶ *H2. Board independence does not affect earnings management in the smaller listed firms in Malaysia*

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- ▶ Since the main role of the audit committee is to oversee the financial reporting process, having financially literate audit committee members is important
- ▶ DeZoort and Salterio (2001) reveal that the likelihood of material misstatements being detected and reported in a timely manner increases when the audit committee is comprised of members with financial expertise
- ▶ Mohd Saleh, Iskandar and Rahmat (2007) documented that when audit committee members are more knowledgeable, there is a lower incidence of earnings management practices in large listed firms in Malaysia
- ▶ *H3. Audit committee expertise in accounting reduces earnings management*

# Research Design

- ▶ Sample
  - Data were collected from non-finance firms listed on Bursa Malaysia ACE Market for 2012 until 2014 financial years, inclusive
  - The data were hand-collected from the annual reports of the firms which were available on the Bursa Malaysia website
  - As at December 31, 2014, a total of 107 firms were listed on the ACE market out of 906 listed firms on Bursa Malaysia
  
- ▶ Variables
  - The discretionary accruals were calculated using the modified Jones model developed by Kothari, Leone and Weasley (2005)
  - The modified model is used because it incorporates firm's return on assets, which improves the reliability as earnings management changes with performance (Kothari et al., 2005)
  - In addition, the model reduces the problem of heteroscedasticity and misspecified issues (Sun et al., 2010)

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## ▶ Hypothesis testing:

- $H_{1a}$  was tested using a t-test to determine whether the absolute discretionary accruals were significantly different from 0
- $H_{1b}$  focussed on the direction of the discretionary accruals. Hence, a t-test was used to determine if the “signed” discretionary accruals were significantly different from 0.
- H2 and H3 were tested using the following regression model:
- $DACC_{it} = \alpha_{0it} + \beta_1 \cdot BODIND_{it} + \beta_2 \cdot ACEXPRT_{it} + \sum \beta_n X_{it} + \epsilon_{it}$

# Cross-sectional two-stage panel least squares (TSLS)

- ▶ To address the issue of endogeneity in the present study, cross-sectional two-stage panel least squares (TSLS) is used whereby in the first stage, board independence is regressed on the other independent variables together with lagged return on assets
- ▶ The predicted values of board independence from this regression are then used in the second stage in order to test the hypotheses
- ▶ Both signed and absolute discretionary accruals were tested in the model
  - Absolute discretionary accruals to test the propensity of earnings management
  - Signed discretionary accruals to test the direction of earnings management

# Results

- ▶ Out of a total 107 firms were traded on the Malaysian ACE Market, 90 firms were included in the sample after excluding firms that were classified under finance or distressed (i.e. PN17 or GN3)
- ▶ After collecting data from the annual reports of these firms from Bursa Malaysia website, 255 firm-years with complete data for 2012 until 2014 financial years were available for analysis



**Table I**  
 Descriptive statistics (n=255)  
*Panel A: continuous variables*

Variable	Mean	Std. deviation	Skewness
Discretionary accruals (DACC)	0.6850	2.4443	4.6111
Absolute Discretionary Accruals (ABSDACC)	1.0589	2.3075	6.957
Board independence (BODIND)	0.504	0.115	0.357
Firm size (LNAST) (Log natural of total assets)	17.1154	0.9806	0.050
Return on Assets (ROA)	-0.1832	1.4122	-11.949
Gearing (GRG)	0.1648	0.4568	8.986
Return on Assets of previous year (ROA <sub>t-1</sub> )	-0.3327	2.1655	-8.282

*Panel B: t-tests*

Variable	Mean	t-statistics	p-value
DACC	0.6850	4.562	0.000***
ABSDACC	1.0589	7.470	0.000***

\*\*\* Indicates statistical significance at the 0.01 level.

\*\* Indicates statistical significance at the 0.05 level.

\* Indicates statistical significance at the 0.10 level.

*Panel C: Dichotomous variables*

Variable	0 (No)	1 (Yes)
Big Audit Firm (BGAUDTR)	90.6%	9.4%
Audit committee expertise in accounting (ACEXPERT)	76%	24%
Family on the Board (FAMBOD)	75%	25%

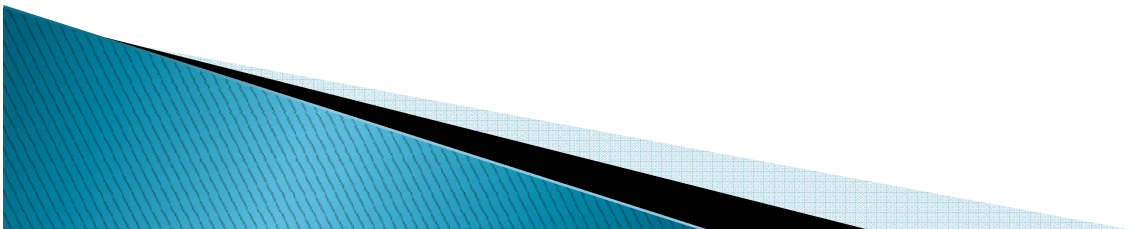
*Panel D: Direction of Discretionary Accruals*

Number of firms	Direction of Discretionary Accruals	Percentages
230	Positive	90%
25	Negative	10%
255		100%

- ▶ Results in Panel A of Table I show that the magnitude of earnings management in ACE listed firms is very high compared to previous studies in Malaysian Main Board firms, both the absolute discretionary accruals and signed discretionary accruals (e.g. Abdullah et al., 2014, Abdullah and Ku-Ismael, 2016, Abdul-Rahman and Mohamed Ali, 2006, Ishak et al. 2011, Mohd-Salleh et al., 2005 and 2007)
- ▶ For instance, Mohd-Salleh et al. (2005) found that the mean discretionary accrual was  $-0.007$ , Hashim and Devi (2009) revealed that the average discretionary accrual was  $0.133$ . Further, Abdullah and Ku Ismael (2016) found that the mean discretionally accrual was  $0.0014$

- ▶ Evidence in Chinese listed firms shows that mean discretionary accruals were 0.007 for privately-owned firms (and -0.001 for State-owned firms) (Ding, Zhan and Zhang, 2007)
- ▶ Hence, H1a is supported
- ▶ Panel B presents the results from t-tests for the discretionary accruals
- ▶ Both absolute discretionary accruals and signed discretionary accruals are statistically and significantly different from zero and the sign of the mean is positive. Therefore, discretionary accruals are used by small listed firms to inflate earnings

- ▶ In Panel D, out of 255 valid observations, 230 observations reported positive discretionary accruals (i.e. 90 percent). Hence, based on these findings
- ▶ H1b is supported where small listed firms have a higher tendency of managing earnings upwards through discretionary accruals



**Table II.**  
Pearson's correlation analysis

	DACC	ABSDACC	BODIND	LEV	ROA	LNAST	FAMBOD	BIGAUDTR
DACC	-							
ABSDACC	.635**							
BODIND	.028	.125*						
GRG	-.185**	.057	.057					
ROA	.202**	-.121	-.097	-.159**				
LNAST	.310**	.005	-.072	-.203**	.316**			
FAMBOD	-.001	-.070	-.314**	.047	.052	-.018		
BIGAUDTR	.037	-.009	-.086	-.010	.048	.148*	-.170**	
ACEXPRT	.069	.003	.011	-.112	.070	.032	.049	.091

Pearson's correlation analysis

\*\*\* Indicates statistical significance at the 0.01 level.

\*\* Indicates statistical significance at the 0.05 level.

\* Indicates statistical significance at the 0.10 level.

**Table III.**

Results (Two-Stage Panel Least Squares Employing Random Effects)

$$\text{Model 1: } DACC_{it} = \alpha_{0it} + \beta_1 \cdot BODIND_{it} + \beta_2 \cdot AC EXPERT_{it} + \sum \beta_n X_{it} + \varepsilon_{it}$$

$$\text{Model 2: } ABSDACC_{it} = \alpha_{0it} + \beta_1 \cdot BODIND_{it} + \beta_2 \cdot AC EXPERT_{it} + \sum \beta_n X_{it} + \varepsilon_{it}$$

Variable	Predicted Sign	Model 1 (coefficient)	t-statistics	Model 2 (coefficient)	t-statistics
Constant	?	-6.1714	-2.8694***	-13.3797	-5.5464***
BODIND	-	-0.8105	-2.9937***	-2.0939	-5.9913***
ACCT_AC	-	-0.8237	-0.9580	0.0224	0.0210
FAMBOD	+	-0.2854	-0.6060	-0.0496	-0.0840
GRG	+	2.5872	1.8112*	-1.6784	-1.2275
ROA	?	0.7197	2.9008***	0.1376	0.4923
BIG_AUDTR	-	-0.7080	-0.4051	-0.3394	-0.1547
LNAST	+	0.5090	5.0142***	0.9049	8.3210***
F-statistics		289.115***		2475.02***	
Adjusted R <sup>2</sup>		0.9553		0.9067	

\*\*\* Indicates statistical significance at the 0.01 level.

\*\*Indicates statistical significance at the 0.05 level.

\*Indicates statistical significance at the 0.10 level.

- ▶ Results in Table III of Model 1 (i.e. using absolute discretionary accruals as the dependent variable) indicate that board independence associated with lower earnings management
- ▶ Therefore, H<sub>2</sub> is not supported
- ▶ Results in Table III of Mode2 1 (i.e. using signed discretionary accruals as the dependent variable) show that board independence is associated with income decreasing, which supports agency theory where independent directors are effective monitors of management (Jensen and Meckling, 1976).
- ▶ Thus, combining the results in Model 1 and Model 2, independent directors are not only effective in reducing the incidence of earnings management, but they also ensure earnings are not overstated
- ▶ Hence, the appointment of independent directors to the board is not only to tap their expertise and to serve as “window” to the outside world, which is consistent with resource dependency theory, but also for monitoring management as argued by agency theory



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- ▶ Results in Table III for both models reveal that the presence of members of the audit committee who are competent in accounting is not associated with the extent of earnings management
- ▶ Hence, H3 is not supported
- ▶ This evidence is consistent with prior studies in Malaysia involving large firms (e.g. Abdullah and Ku Ismail, 2016, Abdul Rahman and Mohamed Ali, 2006, Mohd-Salleh *et al.*, 2007, Ong, 2015)
- ▶ Therefore, having members who are expert in accounting on the audit committee do not appear to help to mitigate earnings management in small listed firms in Malaysia

# Conclusions

- ▶ Discretionary accruals of small listed firms are found to be very high, i.e. 0.6850, which is 17 times higher than the average discretionary accruals reported by Abdullah and Ku-Ismael (2016)
- ▶ Thus, the incidence of accrual management in small listed firms is more prevalent than in large listed firms
- ▶ Accrual management was predominantly income-increasing as 95 percent of observations recorded positive discretionary accruals

- ▶ The results indicate that board independence reduces earnings management and that board independence is associated with income-reducing accrual management
- ▶ Hence, compared to large listed firms, board independence is found to be effective in monitoring managers and also, board independence in small listed firms also deters overstatements of earnings
- ▶ However, having accountant on the audit committee does not help in mitigating earnings management
- ▶ Hence, efforts should focus on strengthening board independence in small listed firms in Malaysia, for instance, by encouraging boards to be led by independent directors rather than just by non-executive directors