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CORPORATE GOVERNANCE MECHANISM AND EARNINGS MANAGEMENT

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Abstract

This study will support the claim that corporate governance (CG) mechanisms are able to overcome earnings management (EM) activities. The ownership structure will be tested from the perspective of family firm and non-family firm. Managers manage their earnings for various reason that would involves either for their incentives such as bonus and salary. While for the company purposes the earnings management may affected or vise-versa from the debt to equity or leverage. The purpose of the study is to examine the relationship between corporate governance and earnings management in Malaysia. In addition to examining the relationship, this study will also investigate the impact of ownership structure toward earnings management. The data for the study will obtained from secondary data (annual report and data stream).

Keywords: *Earnings management, ownership structure, corporate governance, executive remuneration and leverage.*

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TADBIR URUS KORPORAT DAN PENGURUSAN PENDAPATAN

Abstrak

Kajian ini akan menyokong bahawa mekanisma tadbir urus korporat (CG) mampu untuk mengatasi aktiviti pengurusan pendapatan (EM). Struktur pemilikan turut akan diuji daripada perspektif syarikat milikan keluarga dan syarikat bukan milikan keluarga. Pengurus mengurus pendapatan mereka untuk pelbagai sebab sama ada untuk insentif seperti bonus dan gaji. Manakala bagi tujuan syarikat, pengurusan pendapatan mungkin terjejas atau sebaliknya daripada hutang ke atas ekuiti atau leveraj. Tujuan kajian ini ialah untuk memastikan hubungan antara tadbir urus korporat dan pengurusan pendapatan di Malaysia. Sebagai tambahan untuk menguji hubungan, kajian ini turut akan mengkaji kesan struktur pemilikan terhadap pengurusan pendapatan. Data bagi kajian ini akan diperolehi daripada data sekunder (laporan tahunan dan data stream).

Kata Kunci: *Pengurusan pendapatan, struktur pemilikan, tadbir urus korporat, saraan eksekutif dan leveraj.*

INTRODUCTION

The users of financial report would expect a true and fair view of financial information and non-financial information that provided by the company. That would help them to make wise decisions and judgments. In the real practice or in the business environment, the company usually wants to give positive information to its stakeholder. It is important in order to gain their trust and to show the company's high performances and reputations. Therefore, manager will manipulate the financial report in order to show their desire result that will cause to accounting distortion through earnings management. Theory and evidence indicate that managers concern about their current performance that motivates them to engage in manipulating current period earnings at the expense of future period earnings (Kim & Sohn, 2013).

There are various theoretical definitions and classifications to understand earnings management practices, motivations and consequences. Management can manage earnings by increase period income, take a big bath by markedly reducing period income and reduce earnings volatility by income smoothing. Besides that, management also used these strategies to achieve their long term objectives. For examples, the previous research found that managers improve reported earnings by using price discounts to temporarily increase sales, by engaging in overproduction to report lower costs of goods sold, and by reducing discretionary expenditures to improve margins (Al-khabash & Al-Thuneibat, 2009). Meanwhile, previous researchers said that usually managers will transfer some profit to reserve in period of good performance to use them to increase earnings in periods of poor performance. Therefore, it will make the actual reported earnings less variable than the true company's economic performance.

There are several reasons for earnings management, including manager self-interest to increase their incentive (Siregar & Utama, 2008), increase in stock price to show company good performance, for tax avoidance and lobbying government subsidies. Managers are concerned with boosting current performance, such as stock prices, they have incentives to inflate current earnings by borrowing future earnings for use in the current period (Kim & Sohn, 2013), through stock sales, job security, operational flexibility, or control (Hazarika, Karpoff, & Nahata, 2012). However, the reason to manage the earnings also depends on the ownership structure that would influence the monitoring of earnings management activity (Siregar & Utama, 2008). Thus, there is necessity of corporate governance to overcome the reliable of financial statement.

BACKGROUND OF STUDY

The loopholes in the accounting regulation and standard give an option to the management to engage to earnings management behaviour. However the motivation to manage the earnings may differ depends on the certain factors such as ownership structures and corporate governance. Conflict of interests between the management and the shareholders can be justified through the agency theory (Kazemian & Sanusi, 2015). The agency problem incurred due to separation of ownership and control that give agencies an opportunity to manage their earnings by making the decision that would maximize shareholders' interests or management's satisfactions. In accordance with the agency theory, manager has incentives to choose the methods and accounting techniques that can increase their own wealth.
However the type of company ownership would affect the decision to manage the earnings. The ownership may influence monitoring and governance elements for the shareholders and further increase firm's earnings and performance (Chu & Cheah, 2004). Previous researchers predict that, the intention to earnings manipulation would decrease when management ownership increase (Mohd Ali,Mohd Salleh & Hassan, 2008). Therefore monitoring cost family firm are lower than non-family firm (Fama & Jensen, 1983). This issue has become more essential, as more firms are listed in Bursa Malaysia.

Increase in management ownership would decrease the interest gap between the shareholder and management. The incentives that reached optimum level of management satisfaction would affect the management decision in earnings management whether to increase their interest or shareholder interest. However, companies' profits depend on managers, who works and try hard to make sure companies growth their profit. Thus, from the hard work and firm performance, as a return the managers expect to receive incentives, bonuses and shares (Amran & Che Ahmad, 2013).

The investor and other stakeholder would engage in earnings management and distort the economic result when they are unable to make optimal decision to

satisfy their benefits. The acts are purposely to inhibit the stakeholders from making the financial decision that would affect their benefit or interest. Previous studies also recommend that the higher the firm's debt to equity ratio, the higher expectation to managers engage in earnings management and choose income increasing (Noor et al., 2015). Companies that unable to make payments on their external debt have higher leverage and face the risk of insolvency.
The motivation and opportunity to manage the earnings does not occur from a single factor. This pressures may involves various consideration such as access to debt financing, competition, contractual accountability, new financial transactions, management compensation, personal bonuses, promotions, focus on team, and job retention are among the reasons that are mentioned in the previous literature.

LITERATURE REVIEW

The studies indicate the relationship between the types of ownership and effect of corporate governance mechanism toward the earnings management. Family firm and non-family firm have varied monitoring and control because of agency theory. The principle and agent conflict of interest occur because of different motivation or goal in the organization. Both have a purpose to manage the company earnings and disclosed in the way that benefit them.

Earnings Management

The used of accounting techniques and limitation in accounting standard to produce desired financial reports that may disclosed an overly positive picture of a company's business performance and financial position. Management takes advantage of how accounting rules can be applied and are legitimately flexible when companies can incur increase or decrease in reported earnings (Park & Shin, 2004). Besides, management also involve to report greater economic value of the firm (Noor et al., 2015). Thus, the firm manage their earnings in order to make their financial desirable and more attractive (Iatridis & Kadorinis, 2009).

It can be difficult to identify these allowable practices from this earnings manipulation or management. Companies with large amount of accrual and opportunity use aggressive earnings management to increase their earnings (Iqbal & Strong, 2010). Meanwhile, income smoothing will help companies to smooth out fluctuations in earnings to make tradeoffs between how much to report in the current and future period, and such tradeoffs depend on managerial reliance about future financial performance (Bouwman, 2014). Enormous fluctuations in income and expenses may be a normal part of a company's operations, but the changes may alarm investors regarding company stability. Others strategy that company used to manage their earnings are through big bath, where the company save the income to be disclosed in the subsequent event accounting period without effecting their reputation and performance (Bornemann, Kick, Pfingsten, & Schertler, 2015).

Earnings management occurs with the presence of agency problem arising from the conflict of interests between shareholders and managers (Noor et al., 2015). The factors to manage the earnings are varying for the companies. Each company had their motive to manipulate the earnings and both shareholder and managers have their own interest and to fulfill their targets towards company financial performance (Yang, Hsu, & Yang, 2016). The pressure and motive to engage in earnings management came from various factors. Hamid, Hashim and Salleh (2012), classify the motive of earnings management to three categories are altruistic, speculative and pressure from affiliated parties.

Corporate Governance

Ownership structure influences the monitoring mechanism a company uses, including the monitoring of earnings-management activity (Siregar & Utama, 2008). Meanwhile, Kazemian and Sanusi (2015) suggest that ownership structure has an impact towards earnings management and quality. Previous researcher also suggest that, the controlling shareholders would have incentives to monitor managers and make sure that company earnings management within proper bounds to preserve their share in the firm (Francoeur, Ben Amar, & Rakoto, 2012). Thus, the ownership structure is important to shape corporate governance of the firm. In Malaysia, the firm usually concentrated by the ownership of the family and non-family (Amran & Che Ahmad, 2013).

Family firms and non-family firms are not the same in term of leverage, capital and size. Family firms are less leverage, have lower capital intensity (PPE), and are smaller than non-family firms. However, they are the same in the presence of net operating loss or intangible assets for non-family firms (Chen, Chen, Cheng, & Shevlin, 2010). The motivation to manage their earnings may occur from different types of ownership structure, which from the previous research most of listed companies in Malaysia concentrated by the family, individual, government or institutional (Amran & Che Ahmad, 2013). This can give rise to principal–agent conflict since family owners with unique opportunity may use their concentrated ownership to expropriate the earnings of minority shareholders. There are also differences in company performance because of motivation of manager to work hard for companies they will assure the companies increase their income. Thus, from their hard work managers will hope to receive remuneration or incentive from the companies as a reward for the work done (Amran & Che Ahmad, 2013). The level and types of management ownership can limit earnings management motivation (Mohd Ali et al., 2008).

Executive Remuneration

Remuneration and bonuses plans give a strong motivation and encouragement to manager to engage in earnings management (Hamid et al., 2012). Most of the companies paid bonuses to the managers based on earnings performance. Usually, U.S firms paid their remuneration using salaries, cash bonuses, and stocks as their scheme of incentive for their directors (Kim, 2013). Previous researchers clarify that agent or external directors have a relevant role in monitoring and provide and protect the reliability and integrity of the financial reporting procedures and disclosure (Iqbal & Strong, 2010). Company performance also shows differences for different types of company ownership, because managers that work for companies will work towards to achieve companies' goals and making profit. Hence, through the hard work that have been done by managers, they expect to be rewarded and compensate by bonuses and shares from the companies (Amran & Che Ahmad, 2013).

Conflict of interest between shareholders and managers also create agency costs. Agency theory suggests that, the need of the managers to secure their position in the job would affect to remuneration contract that bias management's preferences (Kasipillai & Mahenthiran, 2013). Thus, companies have a few determinants of bonus plan that can be used to measure the bonuses. The factors of determinants are performance measurement, standard, and pay–performance indicator. Managers may use accrual to manipulate earnings to increase personal interest or gains. The benefit may arise through the remuneration that depends in income (Iqbal & Strong, 2010). Besides that managers have also greater remuneration to achieve personal satisfaction and minor interest to increase organization value if they have smaller portion of the ownership. Therefore, by increase the share held by managers, it will reduce the agency costs (Amran & Che Ahmad, 2013).

As insurance for managers low remuneration payoff, they will maximize performance serve, hence weakens incentive to use costly effort. Therefore, companies with high possibility to manage the earnings should have more high remuneration scheme to reward the managers (Sun, 2014). The non–executive directors are not supposed to be compensating by excessive incentive and financial because it can be seen as negative effect toward their independence in the companies. This situation can be relates to situation in Italy compared to the European, which the excessive incentive and financial to non-executive directors may limit their independence (Campa et al., 2014).

Debt to Equity

Companies involving high levels of financial debt experience increase levels of non-family firms monitoring, which would decrease the company's capability to manage its profits (Mansor et al., 2013). The negative relationship total diversification and leverage is more robust for government-controlled businesses on average, government-controlled businesses have less influence than non-government controlled businesses (Su, 2010). Previous studies indicate better non-family environments and business operating have a propensity to use lower leverage (An et al., 2016). Using financial leverage may bring about insolvency and agency cost of debt though financial leverage may serve as an external monitoring and control in reducing the issues occur from the ownership and control in associating with earnings manipulation (An et al., 2016).

The manipulation cost may arise due to more rigorous corporate governance, in the environment where managerial efforts influences the output and the manager has more vigorous incentive to expend productive hard work and prevent unfavorably distortion costs incurred during symptoms of weak performances. Previous researchers suggest that, less financial incentive is required in remuneration to motivate hard work (Sun, 2014). This higher leverage may reduce agency costs through the threat of liquidation, which might cause losses to managers in reductions of salaries, reputation, perquisites, and, the pressure to generate cash movement to pay interest expenditures.

Debt thus serves as a mechanism to prevent managers from increasing their gains and benefit through investment decisions. The companies which have higher leverage face the risk of insolvency if they not able to make payments on the external debt obligation. From the prior studies, explains the positive association between earnings manipulation and leverage even controlling for the differences across firms. This indicate that the possibility relationship of higher leverage with higher earnings management in some firm (An et al., 2016).

RESEARCH FRAMEWORK

This study examines whether types of ownership structure that are family firms and non-family firms and have a significant relationship with earnings management for listed companies in Bursa Malaysia. Furthermore, this study also attempts to examine corporate governance of the listed companies which are executive compensation, debt to assets and accrual based whether it may affect the opportunity to manage earnings. From the framework below, it can be clearly seen that the dependent variable for this study is the earnings management. Meanwhile, the independent variables are ownership structures and corporate governance.

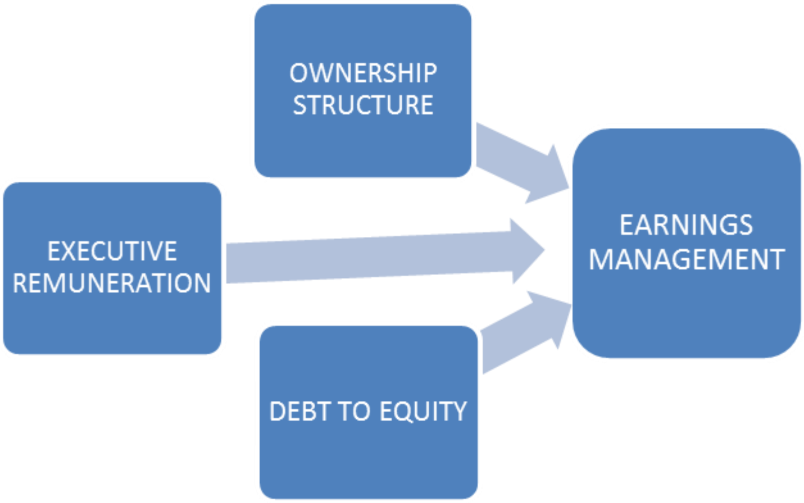

Table 1: Research Framework.

RECOMMENDATIONS AND CONCLUSIONS

This study aims to examine whether the types of ownership may affect the opportunity to manage the earnings, which companies manage their earnings when there is opportunity. The different types of ownership have an influence through the decision to manage earnings. For this study, the population comprises of the companies that listed in Bursa Malaysia for the year 2015 ranging from various industries excluding finance sector. It is due to finance sector is a regulated industry and the behavior of earnings from finance sector is different and required different type of method to recognize (Hamid et al., 2015).

The data is extracted either directly from the Companies' Annual Report or taken from Data stream. The secondary data will be collected from the companies' annual reports, which available at Bursa Malaysia's website (www. bursamalaysia.com.my). The number of companies in this study which will randomly selected in the list of Bursa Malaysia and the availability of data based on the characteristics of the company. The following criteria are used in selection of the companies:

1. Selected companies must be listed and disclosed their annual report in Bursa Malaysia website for 2015 and available to be accessed. Public Listed Companies (PLCs) are chosen because the published annual reports have been audited by the public auditors and the reliability of the data is assured.
2. All the listed firms are required to disclose the information regarding corporate governance compliance in their annual reports.
3. Companies in the Finance, REITS and Closed-End Funds sectors are excluded from the study as they are subject to some unique regulations and

the accruals behavior is different compared to other firms. These companies have very high leverage with significantly different in the regulatory requirements, financial reporting standard and compliance (Kazemian & Sanusi, 2015).

4. Companies that are categorized under PN17 in the Bursa Malaysia are also omitted from the study, as the companies are under public reprimand by Bursa Malaysia which facing regulated market constraint.
5. Newly listed companies are excluded because newly listed firms (new IPO listing) tend to manage their earnings in their first year of listings (Mohd Ali et al., 2008).
6. Outliers are excluded from this study to minimize the influence on the result of the regression.

The samples will consist of listed companies' observations for the year 2015. These companies ranging from consumer products, industrial products, trading and services, construction, technology, properties, hotel and plantation industry. All the financial accounting data will obtain from Data stream database. Data for executive remuneration, accrual and types of ownership will manually collected from the notes to the financial statement in the annual reports.

The researchers proposed an analysis of ownership structure and corporate governance on earnings management whether types of ownership structure that are family firms and non-family firms and have a significant relationship with earnings management for listed companies in Bursa Malaysia. The researcher also will get some information corporate governance of the listed companies which are executive compensation, debt to assets and accrual based whether it may affect the opportunity to manage. The data obtained will be analyzed by the researchers. This study will contribute to the regulators (standard setters), investors and researchers as published literatures on earnings management relationship with ownership structure and corporate governance to meet in the Malaysian context. This study also helps the stakeholder to determine the actual practices amongst listed companies.

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