

Board Independence, CEO Duality and Accrual Management: Malaysian Evidence

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Abstract

This paper focuses on two important characteristics of board effectiveness: (1) the proportion of independent non-executive directors; and (2) CEO Duality. The objective of this study is to examine whether the presence of a majority of independent non-executive directors and the separation role between chairman and CEO, as recommended in the Malaysian Code on Corporate Governance (MCCG) 2000, effectively constrains the incidence of earnings management as measured by income-increasing and income-decreasing discretionary accruals. Using data from the top 200 non-financial companies listed on Bursa Malaysia's Main Board and Second Board for the year 2004, this study finds a positive significant result of board independence when firms undershoot target earnings. Although contradictory to the prediction of agency theory, the results show that a higher proportion of independent non-executive directors is associated with higher income-increasing earnings manipulations. Neither board independence nor CEO Duality was found significant in other models tested regarding income-increasing and income-decreasing earnings management. The results of this study cast doubt on the notion that the independence of directors and the role separation between the chairman and the CEO reduces the incidence of earnings management activity, especially with highly concentrated ownership as is typical in Malaysia.

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1. Introduction

In emerging economies such as Malaysia, implementing good corporate governance practices reduces the exposure to financial crises as well as

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contributing to sustainable economic development (The World Bank Report, 2005). The economic recession in 1997 resulted in a massive loss of confidence by foreign investors' in the Malaysian capital market (Abdul Rahman and Haniffa, 2005). The government established a high level Finance Committee on Corporate Governance that included government and industry representatives to establish a framework for corporate governance best practices. The high level Finance Committee on Corporate Governance was formed to identify and address weaknesses highlighted by the 1997 financial downturn. The committee carried out detailed investigations through a survey of Corporate Governance Best Practices of Public Listed Companies. This was jointly conducted by Kuala Lumpur Stock Exchange (KLSE) and PriceWaterhouseCoopers (PWC) to develop recommendations for corporate governance best practices for Malaysia (Ow-Yong and Guan, 2000). The report of the Committee focused on the board's monitoring role and highlighted the importance of the board of directors as corporate governance mechanisms to enhance shareholder value and protect shareholder wealth. A year after the issuance of the Finance Committee's Report on Corporate Governance, the Finance Committee then issued the Malaysian Code on Corporate Governance (MCCG) in March 2000. The board of directors is discussed as the first principle in the MCCG 2000 and under Part 2 of MCCG 2000, the role, composition and structure of the board of directors is viewed as the most crucial element for effective corporate governance mechanisms for Malaysian companies.

However, evidence of the effectiveness of the implementation of these mechanisms in Malaysia is inconclusive. This paper attempts to reconfirm extant studies by investigating the two important characteristics of board effectiveness: (1) the proportion of independent non-executive directors represented on the board, and (2) CEO duality.

This study contributes to the literature in three ways. First, this study adds to recent literature showing the links between corporate governance and financial reporting quality, in a different institutional setting. Despite the legislative reforms on corporate governance structure, the relationship between corporate governance and earnings management remains a relatively unexplored research issue and investigation of the association between corporate governance structures and the practice of earnings management in different international settings, specifically from a developing country, provides interesting evidence on this aspect of corporate governance research (Davidson et al., 2005).

Prior research on corporate governance issues focused more on corporate governance reporting rather than corporate governance practices. For example, Vafeas (2001) examines the characteristics that determine the probability of serving on an audit committee from 262 audit committee appointments in the US. He finds evidence that the likelihood of audit

committee appointment is positively related to the degree of outside director independence and negatively related to compensation committee membership, other committee memberships and the length of board tenure. He suggests for future research to examine whether these characteristics are linked to firm financial reporting quality as his study does not provide direct empirical evidence that these characteristics actually lead to improvements in financial reporting.

This study addresses the issue of corporate governance effectiveness after the Malaysian corporate governance reforms in 2000. Unlike the Abdullah and Mohd Nasir (2004) study, which focused on a sample during the Malaysian financial crisis in 1997/1998, wherein corporate governance practice was voluntary in nature, this study examines whether the presence of independent non-executive directors and the separation role between chairman and CEO reduces the incidence of earnings management activity when the companies are required to comply with the requirements of the Bursa Malaysia Listing Requirements and the Code for independent directors. Malaysia provides an interesting platform for examining this issue as MCCG 2000 includes the requirement for a well-balanced and effective board (i.e. having a balance of executive directors and non-executive directors including independent non-executive directors) and the separation of powers between the chairman and the CEO to ensure higher quality financial reports are conveyed to the users of the financial statement.

However, while prior studies show a linkage between better governance and lower earnings management, the results from this study indicate that neither board independence nor CEO duality effectively constrained earnings management, even after the corporate governance reforms were introduced. However, there is an exception as the study shows a positive significant result of board independence when firms undershoot target earnings. This finding is contradictory to the prediction of agency theory. Hence, this study raises doubt as to whether independent directors in Malaysia are truly independent when inside directors dominate the board. In fact, Coffee (2005) raises issues regarding the differences in the structure of ownership, between countries with a dispersed and concentrated ownership structure, which account for differences in corporate scandals. This implies governance reforms adopted in the United State may not be appropriate to countries with a concentrated ownership system. This is supported by Barton et al. (2004) who observe that the requirement for a majority of independent directors seems to be unrealistic for Asian corporations (although it is essential to have some) for various reasons: (1) a scarcity of qualified independent directors; (2) reluctance of the management to share inside information as the information will be used by the outside director against them; and (3) given that companies in Asia normally have a single majority owner, the requirements seem unattainable in substance.

Second, following prior work by Park and Shin (2004) and Peasnell et al. (2005), this study focuses on managerial incentives to manage earnings upwards and downwards. Abdul Rahman and Mohamed Ali (2006), in similar settings, used the absolute value of discretionary accrual to measure earnings management and problems associated with the use of this measure are well documented in prior literature (see e.g. Klein, 2002; Bedard et al., 2004). The use of the absolute value of discretionary accruals is non-directional and does not consider the upward and downward earnings management. Prior evidence suggests that managers either use earnings management to meet certain targets such as avoiding reporting losses or earnings declines (income-increasing approach) or delaying reporting profits to facilitate meeting targets easily in the future (income-decreasing approach).

Third, whilst extant literature based on western contexts demonstrates that having an effective board structure ensures better monitoring of management, which in turn enhances long-term shareholders' value, there is no study in the Malaysian context that empirically examines this using the earnings management phenomenon. Hence, this study investigating whether the independence of the board of directors and the separation of powers between the chairman and CEO, as recommended in the MCCG 2000, effectively constrains the incidence of earnings management, when the incentives for manipulation is high, provides further evidence from an Asian perspective.

The discussion in this paper is organized as follows. Section 2 discusses the relevant literature to develop research hypotheses. Section 3 outlines and explains the sample selection, research method and variable measurement. Section 4 analyses and discusses the research results. Finally, the limitations and suggestions for future research are considered in Section 5.

2. Literature Review and Hypothesis Development

Agency theory addresses the relationship between the principals and agents and suggests that where there is a separation of ownership and the control of a firm, the potential for agency problems exist because of the conflicts of interest between principals and agents. There are two main problems that are associated with agency problems – moral hazard and information asymmetry. Moral hazard refers to the lack of effort on the part of management to act in the owners' best interests while information asymmetry refers to the fact that the management has inside information about the true economic status of the firm that they may or may not share with stakeholders (Pergola 2005, p.178 & 179). Definitely, managers have obligations to pursue strategies that are consistent with maximizing shareholders' wealth, however, opposed to the shareholders that hold a diversified portfolio, managers' wealth is

not well diversified and relies mainly on the survival of the firm (Che Ahmad et al., 2003). One solution to ensure that managers act in the best interests of shareholders is by remuneration of managers according to share price movement or accounting based performance measures. Peasnell et al. (2000) state that shareholders commonly use earnings as a direct basis for awarding bonuses and indirectly as reference points for triggering the award of executive stock options for senior managers. As a result, managers may manipulate reported earnings to avoid unfavourable wealth consequence from an adverse earnings outcome. A study by Healy (1985) provides evidence that managers manipulate accruals to maximize earnings based bonuses. Although managers have an incentive to increase earnings in order to increase the bonus this action is only taken when unmanaged earnings are between the upper and lower bounds. Otherwise, when the unmanaged earnings are below the lower bound or above the upper bound, managers have an incentive to decrease earnings and reserve them for future periods. Additionally, a study by Burgstahler and Dichev (1997) shows evidence that firms manage reported earnings to avoid earnings decreases and losses to decrease the costs imposed on the firm in transactions with stakeholders. They estimate about 8-12% of firms with small pre-managed earnings decreases manipulate earnings to achieve earnings increases and about 30-44% of firms with small pre-managed losses manage earnings to create positive earnings.

Thus, to oversee the management operation and constrain the management opportunistic behaviour, the shareholders invest in information and monitoring systems including employing boards of directors, audit committees and auditors. The utilization of internal governance mechanisms such as monitoring the role of non-executive directors (Fama and Jensen, 1983) may help reduce the potential for agency problems created from the separation of ownership and control. Efficient monitoring from non-executive directors that is free from managerial influence is capable of improving the quality of financial information conveyed to the user of the financial statement (Higgs Report, 2003). The board of directors is presumed to perform the monitoring role on behalf of the shareholders (John and Senbet, 1998) and has the main duty of leading and directing the firm to achieve corporate goals by closely monitoring management activity so that the interest of the shareholders is well protected (Abdullah, 2004). Further, the board is regarded as the most powerful and cost effective governance mechanism for monitoring management in pursuing activities that increase a firm's value (Abdullah and Mohd Nasir, 2004). Under proper corporate governance mechanisms, the existence of a board of directors might prevent management from engaging in earnings management activity as their composition and characteristics might influence the monitoring function of the board and stockholders wealth (Kao and Chen, 2004).

However, creating a board that is effective in monitoring management actions is dependent on the composition of individuals who serve on the board of directors (Fama and Jensen, 1983). Lately, many countries have reformed their code on corporate governance of boards monitoring responsibilities and have focused mainly on independence, expertise and diligence of corporate directors for the purpose of protecting shareholders' interests (Hermanson, 2003). The following discussion focuses on studies that examine this phenomenon.

2.1. Board Independence

In order to be effective the corporate board must include outside members who can act as arbitrators during disagreements among internal managers (Fama and Jensen, 1983). Normally, the corporate board comprises senior managers from within the company to take advantage of their management expertise. However, the inclusion of inside board members brings a potential conflict of interest to run the company and hence the presence of outside directors is required as the guardians of stockholder's wealth (Peasnell et al, 2003). Fama and Jensen (1983) argue that the inclusion of outside directors increases a board's ability to be more efficient in monitoring its top management and to ensure there is no collusion with top managers to expropriate stockholder wealth as they have incentives to develop their reputations as experts in decision control.

Nevertheless, there are two conflicting views concerning the effectiveness of a board of directors, namely, the agency theory perspective and the managerial hegemony theory perspective (Abdullah, 2004). The proponents of the agency theory believe that having outside directors provides an effective monitoring tool for the board (Fama and Jensen, 1983), while proponents of the managerial hegemony theory argue that the capability of outside directors to fulfil their monitoring and overseeing role, when the management dominates and controls the board of directors, is questionable (Abdullah, 2004). Due to the dominant role played by CEOs in the director selection process, it is argued that outside directors are incapable of providing independent judgment and raises concern about the quality of independent directors (Abdullah, 2004).

As outside members do not play a direct role in the management of the company, their existence may provide an effective monitoring tool to the board and thus produce higher quality financial reports (Peasnell et al., 2000). Early studies explore the relationship between the composition of boards of directors' and financial fraud. Beasley (1996) tests the prediction of the agency theory, which suggests that having a higher percentage of outside directors increases the board's effectiveness and shows evidence that the inclusion of a larger proportion of outside members on the board of directors provides better oversight of management and thus significantly

reduces the likelihood of fraud incidence. He suggests that outside members on the board increases its effectiveness to prevent financial statement fraud by effectively monitoring management activity. Dechow et al. (1996) report similar findings for firms subject to the Securities and Exchange Commission (SEC) accounting enforcement actions and their study provides support for investigating the importance of corporate governance structures in enhancing the financial reporting quality.

Peasnell et al. (2000) extend the previous studies by investigating the role of governance in curbing earnings management. Using abnormal working capital accruals to proxy for earnings management, Peasnell et al. (2000) find evidence of a significant negative relationship between earnings management and the proportion of non-executive board members in the post-Cadbury period and suggest that a high proportion of non-executive directors do help constrain earnings management activity. Klein (2002) also reports similar findings for large US firms and her findings suggest that firms changing their boards from having a majority to a minority of outside directors are found to have higher adjusted abnormal accruals in the year of the change compared to their counterparts. Additionally, a study by Peasnell et al. (2005) that focuses on the incentives by managers to manage earnings upwards and downwards finds evidence that a higher proportion of outside board members is associated with less income - increasing earnings management. They continue to support that the existence of outside board members plays an important monitoring role *'to uphold the integrity and credibility of published financial statements'* (Peasnell et al. 2005, p.1339).

The role of outside directors in the protection of shareholders has long been a subject of much debate and research, especially in developing countries where the ownership structure is highly concentrated. Using a sample from Taiwan, Kao and Chen (2004) test whether outside directors play a monitoring role in the Taiwanese market where the ownership structure is highly concentrated and find significant negative evidence between earnings management and the presence of more outside members on the board. However, Park and Shin (2004) fail to find empirical support between the association of earnings management and board independence for their Canadian sample. They contend that firms with a highly concentrated ownership may harm outside shareholders through the dominant shareholders. Although the public equity markets in Canada are well developed, similar to those in the UK and the US, the ownership structure is highly concentrated and a large block holder controls public traded firms.

For Malaysian companies, Abdullah and Mohd Nasir (2004) investigate the roles of board independence to constrain accrual management prior to the 1997/1998 crisis to examine the impact of this internal governance mechanism when it is voluntarily in nature. The study reveals that Malaysian companies appeared to comply with the one-third requirements even before the issuance of Report on Corporate Governance in 1999.

However, in terms of the effectiveness of the board structure prior to 1997, they fail to find any significant evidence between board independence and accrual management. Additionally, using discretionary accrual as a proxy for earnings management, Abdul Rahman and Mohamed Ali (2006) fail to find any significant evidence between board independence and earnings management for Malaysian companies. The fact that discretionary accrual was used to measure earnings management may be the reason for the insignificant relationship found in the study as the use of absolute value of discretionary accruals is non-directional and does not consider the upward and downward earnings management.

In Malaysia, the MCCG 2000 requires one third of the board to consist of independent non-executive directors. As defined in Chapter 1 of the Listing Requirements of the Kuala Lumpur Stock Exchange (KLSE) an independent director is a director who is independent of the management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interests of an applicant or listed issuer. The Listing Requirements stipulate that at least two directors or one third of the board, whichever is higher, must be independent. Despite the conflicting result from prior studies, it is hypothesized that:

H₁: Firms with an independent board of directors are less likely to engage in earnings management activity.

2.2. CEO Duality

In addition to the requirement of a well-balanced board, the MCCG 2000 also recommends a separation of roles between the chairman and the CEO to avoid the considerable concentration of power where the same person performs both roles. With the separation between the position of the CEO and the chairman it is hoped to provide an essential check and balance over the management's performance. Furthermore, the Cadbury Report recommends that all listed companies should have no role duality to ensure a balance of power and authority leading to more independent boards (Ow-Yong and Guan, 2000).

There are two points of view on the issue of the separation of powers between the chairman and the CEO based on the agency theory and the stewardship theory (Abdul Rahman and Haniffa, 2005). Proponents of the agency theory believe that the separation of the two roles is crucial for the monitoring of the effectiveness of the board over management, by providing cross checking evidence against the possibility of over-ambitious plans by the CEO. Because, when the same person is holding two important positions, they are likely to pursue strategies which advance their own personal interests over those of the company. These views support the separation of

power, with two separate individuals holding the position of chairman and CEO, thereby allowing efficient monitoring by the board (Zulkafli et al., 2005). In contrast, proponents of the stewardship theory believe that the combination of the two roles enhance the decision making process and allow a CEO with strategic vision to guide the board to implement a company's objectives with the minimum of interference from the board.

Current empirical analyses yields mixed results on the impact of role duality on financial reporting quality. Kao and Chen (2004), Xie et al. (2003), Davidson et al. (2005) and Abdul Rahman and Mohamed Ali (2006) fail to find empirical support on the association between CEO duality and earnings management activity in their study. However, a study done by Abdul Rahman and Haniffa (2005) reveals significant evidence of the relationship between role duality and performance for pooled data for the years 1996 to 2000 for the Malaysian sample. Although the MCCG 2000 recommends a separation role to ensure balance and authority, surprisingly, the descriptive analysis reports a gradual decrease in the percentage of separation for the roles of chairman and CEO from 1996 to 2000. Despite these conflicting results, it is hypothesized that:

H₂: Firms with a separation role between the chairman and the CEO are less likely to engage in earnings management activity.

3. Methodology

3.1. Sample Selection

The sample in this study consists of the top 200 non-financial companies listed on Bursa Malaysia's Main Board and Second Board for the year 2004, ranked by market capitalization as at 31 December 2004. Due to different statutory requirements, all finance related firms were excluded from the population of interest. Since utilities companies possess different incentives and opportunities to manage earnings, this study also excludes them from the population of interest (Peasnell et al., 2005).

The Perfect Analysis Database was used to collect data on earnings and any missing financial data from the database was obtained manually from the respective annual report. Board data was hand-collected by examining the disclosures made in annual reports. After excluding 16 companies because of missing financial data, a further 13 companies that belong to industries with less than 8 firms (see e.g. Davidson et al., 2005; Abdul Rahman and Mohamed Ali, 2006) and 4 additional firms

with extreme value for discretionary accrual, the final sample consists of 167 firms.

3.2. Regression Model

This study used a linear multiple regression analysis to test the association between the dependent variable of earnings management and the independent variable of board independence and CEO duality.

$$EM = \beta_0 + \beta_1 BIND + \beta_2 CEODL + \beta_3 BDSIZE + \beta_4 BDMEET + \beta_5 BLOCK + \beta_6 SIZE + \beta_7 LEV + \beta_8 CFO + \beta_9 ABSCH + \varepsilon$$

where

EM	=	measured by discretionary accrual based on modified Jones model ¹
BIND	=	number of independent non-executive directors/total number of board members
CEODL	=	1 if the roles of the chairperson and CEO are separated, 0 if otherwise
BDSIZE	=	number of members on the board
BDMEET	=	number of board meetings
BLOCK	=	total percentage of shares held by owners of more than 5% of the firm's common stock
SIZE	=	log of total assets
LEV	=	leverage (ratio of total liabilities to total assets)
CFO	=	cash flow from operation divided by beginning of year total assets
ABSCH	=	absolute change in the net income between t and t-1 divided by total assets

Board independence is measured by the proportion of independent non-executive directors on the board expressed as a percentage. In the context of Malaysia, there are three types of directors including independent non-executive directors, non-independent non-executive directors and executive directors. Given that some non-independent non-executive directors are independent, whereas others are not (non-independent non-executive directors are sometimes a family member), following prior work by Che Haat (2006), this study focuses solely on independent and non-independent directors instead of executive and non-executive directors. If the independent non-executive directors fulfill their monitoring role in mitigating earnings

¹ Modified Jones (1991) model is explained in Section 3.3.

management activity, it is predicted that higher proportions of independent non-executive directors will be negatively associated with earnings management.

CEO duality occurs when the chairman of the board is also the CEO of the firm. In Malaysia, the MCCG 2000 recommends a separation of roles between the CEO and the chairman of the board. In this study, the variable takes a value of one if the roles of the chairman and CEO are separated; otherwise it takes a value of 0. This measurement is similar to the study by Davidson et al. (2005) and it is predicted that firms with a separation role between chairman and CEO are less likely to engage in earnings management activity.

Prior studies suggest that block holders (Bedard et al, 2004; Abdul Rahman and Mohamed Ali, 2006), firm size (Peasnell et al., 2000; Xie et al, 2003; Davidson et al, 2005), financial leverage (Park and Shin, 2004; Davidson et al, 2005) and cash flow from operations (Peasnell et al., 2000; 2005) are significantly related to board characteristics and earnings management. This study includes proxies for these potential determinants as control variables in the regression above.

Block holders represent the percentage of shares held by owners of more than 5% of the firm's common stock. While larger block holders are in a better position to monitor the financial reporting process to constrain earnings management activity (Bedard et al., 2004), there is evidence of greater earnings manipulation associated with block holders in Malaysia (Abdullah and Mohd Nasir, 2004). Park and Shin (2004) argue that in countries with a concentrated ownership structure, there is always a possibility that the controlling owners may expropriate the interests of minority shareholders. Individual and corporate controlling owners have a strong incentive to channel wealth from the publicly traded firms to their privately owned firms or ultimate controlling firm makes the overall effect of ownership concentration indeterminate.

The natural log of total assets is included in the regression to control for the effect of firm size (Peasnell et al., 2005; Abdul Rahman and Mohamed Ali, 2006). Larger firms are less likely to hide discretionary accruals and a negative relationship is predicted between firm size and discretionary accruals. Park and Shin (2004) find evidence on significant negative association between firm size and discretionary accrual and suggest larger firms are more closely scrutinized than smaller firms.

Similar to Davidson et al., (2005) and Abdul Rahman and Mohamed Ali (2006), leverage is measured as the ratio of total liabilities to total assets to capture the incentive to manage earnings when firms are experiencing financial difficulties. To avoid potential loss by disclosing financial problems, financially distressed firms may have an incentive to adjust earnings upward. However, as highly indebted firms are under close scrutiny by the lenders, distressed firms are less likely to practice

earnings management and the existence of a negative relationship between discretionary accruals and financial leverage is expected (Park and Shin, 2004).

Peasnell et al. (2005) include the cash flow from the operation scaled by the total assets to control for potential errors in the measurement of discretionary accruals and find a significant negative association between cash flow from operations and earnings management. Davidson et al. (2005) following Klein (2002) find a positive association between absolute change in the net income with earnings management and suggest that this factor is significantly related to the boards characteristics and earnings management.

Additionally, this study also controls for board size and number of board meetings given the evidence of the association between board size and earnings management (Abdul Rahman and Mohamed Ali, 2006; Peasnell et al., 2000; 2005) and association between the number of board meetings and earnings management (Xie et al., 2003).

Xie et al. (2003) argue that larger boards may be better in preventing earnings management compared to smaller boards as larger boards may be more likely to have independent directors with corporate and financial expertise. However, Abdul Rahman and Mohamed Ali (2006) argue that coordinating and processing problems becomes more difficult when the boards are too large. This makes larger boards more ineffective in performing monitoring functions. Based on both arguments, the direction of board size is indeterminate in this study. With respect to board meetings, Xie et al. (2003) argue that boards that meet more often could reduce earnings management activity as they are able to allocate more time on issues such as earnings management while boards that seldom meet are unlikely to focus on these issues. They found evidence of a negative association between a lower level of earnings management and the meeting frequency of the board and suggest that board activity provides effective monitoring mechanisms of corporate financial reporting. Board size is measured by the total number of board members (Abdul Rahman and Mohamed Ali, 2006) while board meetings are measured by the number of board meetings held per annum (Xie et al. 2003).

3.3. Earnings Management Variable

The manipulation of accruals is less costly, has no direct cash flow consequences and is difficult to detect. Hence, it is likely to be the most favoured manipulation instrument of managers (Peasnell et al., 2005). This study applies a cross sectional version of the modified Jones model that separates total accruals (TAC) into discretionary accruals (DAC) and non-discretionary accruals (NDAC) to detect earnings management (Dechow et al., 1995). The modified Jones model exhibits the most powerful test in

detecting earnings management compared to the original Jones (1991) model (Dechow et al., 1995; Klein, 2002; Davidson et al., 2005).

$$TAC_{ijt} / TA_{ijt-1} = \alpha_j [1 / TA_{ijt-1}] + \beta_{1j} [DREV_{ijt} / TA_{ijt-1}] + \beta_{2j} [PPE_{ijt} / TA_{ijt-1}] + \varepsilon_{ijt} \quad (1)$$

$$NDAC_{ijt} = [\alpha_j [1 / TA_{ijt-1}] + \beta_{1j} [DREV_{ijt} - DREC_{ijt} / TA_{ijt-1}] + \beta_{2j} [PPE_{ijt} / TA_{ijt-1}]] \quad (2)$$

$$DAC_{ijt} = TAC_{ijt} - NDAC_{ijt} \quad (3)$$

where

- TAC_{ijt} = total accruals for firm i in industry j in year t
 $DREV_{ijt}$ = change in revenue for firm i in industry j between year $t-1$ and t
 PPE_{ijt} = gross property, plant and equipment for firm i in year t
 A_{ijt-1} = total assets for firm i in industry j at the end of the previous year
 $DREV_{ijt}$ = the change in receivables for firm i in industry j between year $t-1$ and t

Following Klein (2002), Bedard et al. (2004) and Davidson et al. (2005), a cash flow approach (the difference between cash flow from operation and net income) was used to calculate total accruals (Equation 1), as this measure is considered superior compared to the balance sheet approach. Consistent with Abdul Rahman and Mohamed Ali (2006), the ordinary least squares (OLS) regression model was used to estimate industry specific parameters a and b . To estimate the industry specific parameter, Equation 2 was used comprising of data from all companies matched on the year of observation and categorized in the same industry grouping. Having estimated equation 2, the amount of discretionary accruals (DAC) is calculated as the difference between the firm's total accrual (TAC) and its non-discretionary accruals (NDAC). All variables in the accrual expectation model are deflated by total opening assets to reduce heteroscedasticity (Jones, 1991).

Following Burgstahler and Dichev (1997), Park and Shin (2004) and Peasnell et al. (2005), this study focuses on the likelihood of managers making income-increasing and income-decreasing earnings management. Two earnings targets were used; 1) zero target (0) and 2) last year's earnings ($EARN_{t-1}$). Unmanaged earnings (UME_t) are estimated by deducting the DAC from the reported earnings ($EARN_t$). Managers are assumed to manipulate earnings upwards when either $UME_t < 0$ or $UME_t < EARN_{t-1}$ and earnings downwards when $UME_t > 0$ or $UME_t > EARN_{t-1}$.

4. Results

4.1. Descriptive Statistics

As reported in Table 1, the magnitude of the absolute value of discretionary accruals of the companies in the sample has a mean value of 0.1519 with the minimum value of 0.002 and a maximum value of 0.51. The majority of companies (86.2%) meet the Bursa Malaysia Listing Requirements of having at least two directors or one third of the board of directors, whichever is higher, as independent directors. For CEO duality, 89.2% of companies choose to separate the role of chairman and CEO as chairman's role.

Table 1. Descriptive Statistics for Dependent and Independent Variables

	Mean	Median	Std. Deviation	Skewness	Kurtosis	Minimum	Maximum
DAC	0.1333	0.1368	0.12666	-0.336	2.567	-0.40	0.51
ABSDAC	0.1519	0.1462	0.10353	0.929	0.803	0.002	0.51
BIND	0.4158	0.4000	0.09951	0.894	0.442	0.27	0.73
CEODL	0.8922	1.0000	0.31104	-2.553	4.570	0.00	1.00

Evidence from prior literature suggests that the incidence for income-increasing earnings management appears to be stronger compared to income-decreasing earnings management (see e.g. Burgstahler and Dichev, 1997; Park and Shin, 2004; Peasnell et al., 2005). As reported in *Table 2*, 74.85% ($UME_t < 0$) of the firms use income-increasing earnings management to avoid reporting a loss and almost 85.63% ($UME_t < EARN_{t-1}$) of the firms use earnings management to avoid reporting earnings declines. The results were consistent with the study conducted by Burgstahler and Dichev (1997) that suggest that firms manage reported earnings upward to avoid earnings decreases and losses to decrease the costs imposed on the firm in transactions with stakeholders. The mean value of discretionary accruals when unmanaged earnings is below zero and less than last year's earnings is positive and consistent with the hypothesis that managers make positive discretionary accruals when unmanaged earnings are below targets (Peasnell et al, 2005). Although not particularly strong, a small percentage of firms, 25.15% ($UME_t \geq 0$) and 14.37% ($UME_t \geq EARN_{t-1}$) shift discretionary positive earnings to defer reporting profit. The mean of discretionary accruals is negative which suggests that managers manipulate earnings downward when unmanaged earnings are above targets. However, Peasnell et al., (2005)

argue that incentives for boards of directors to constrain earnings management behavior are stronger for upward earnings manipulation due to the greater penalties such as loss of reputation when overstating earnings compared to understating earnings.

Table 2. Discretionary Accruals as a Function of Earnings Target

	$UME_t < 0$	$UME_t < EARN_{t-1}$	$UME_t \geq 0$	$UME_t \geq EARN_{t-1}$
Mean	0.1740	0.1564	0.0123	-0.0042
Number	125 (74.85%)	143 (85.63%)	42 (25.15%)	24 (14.37%)

4.2. Multivariate Analysis

Table 3 presents the results from the multiple regression analyses. Four regression models were run. Model 1 is for observations of firms with unmanaged earnings below zero while Model 2 is for observations of firms with unmanaged earnings below last year's earnings. The first two models were related to income-increasing earnings management when unmanaged earnings fall short of target earnings. Model 3 is for observations of firms with unmanaged earnings greater or equal to zero while Model 4 is for observations of firms with unmanaged earnings greater or equal to last years' earnings. The last two models were related to income-decreasing earnings management when unmanaged earnings are greater than target earnings.

Table 3. Regression Results

	MODEL 1 ($UME_t < 0$)	MODEL 2 ($UME_t < EARN_{t-1}$)	MODEL 3 ($UME_t \geq 0$)	MODEL 4 ($UME_t \geq EARN_{t-1}$)
BIND	2.113**	1.634	1.028	0.835
CEODL	1.174	0.135	0.447	-0.498
BDSIZE	-0.433	-0.354	-0.159	-0.045
BDMEET	-1.552	0.909	-2.491**	0.458
BLOCK	2.262**	2.591**	-0.543	-1.878**
LEV	0.251	-0.758	-2.008*	-1.499
CFO	0.872	-1.726*	-0.726	-3.337**
LNSIZE	-0.009	0.020	1.371	0.658
ABSCH	-2.112**	-2.242**	-0.257	0.390
N	125	143	42	24
F-Ratio	1.915*	1.949**	1.451	3.097**

Note: *Significant at 0.1 **Significant at 0.05

With the exception of a positive significant result for the board independence in Model 1, when firms undershoot target earnings, results from the regression analysis show that neither board independence nor CEO duality influences the extent of accrual management. The proportion of board independence and separation of roles between chairman and CEO does not affect the level of earnings management activity. The results were consistent with findings by Abdullah and Mohd Nasir (2004) and Abdul Rahman and Mohamed Ali (2006) that found neither board independence nor CEO duality effectively constrained earnings management for the Malaysian sample. Abdul Rahman and Mohamed Ali (2006) argue that based on the managerial hegemony theory, the capability of independent directors to fulfil their monitoring role is jeopardized when the management also dominates and controls the board. Additionally, they further argued that Malaysian independent directors lack expertise and skills to understand financial reporting details. This explains the insignificant association between board independence and discretionary accruals. However, contrary to the predicted sign, it was found that a higher proportion of board independence is associated with higher earnings management when unmanaged earnings are below target earnings (Model 1). The plausible explanation for this finding is that since the roles of overseeing financial reporting process have been delegated to the audit committee, since 1993 (Abdullah and Mohd Nasir, 2004), a larger number of independent non-executive directors does not help constrain earnings management as their discussions are more related to the long-term aspects of the company rather than financial reporting issues.

Out of seven control variables used in the study, five were found to be significant. Block ownership was found significant in three out of four models tested in the study. The results were positively significant when firms undershoot target earnings and negatively significant when firms overshoot last year's target earnings. When firms undershoot earnings targets, higher block ownership is associated with higher income-increasing earnings management. Although contradictory with the prediction of the agency theory, the result was consistent with Abdullah and Mohd Nasir (2004) who suggest managers from firms with a more concentrated ownership structure are more likely to practice earnings management due to the incentives to show higher profits to their significant substantial shareholders. In contrast, when firms overshoot the earnings target, higher block ownership is associated with less income-decreasing earnings management and consistent with the prediction of the agency theory that firms with more concentrated ownership help constrain earnings management activities. The significant findings on the relationship between block ownership and earnings management suggest that the existence of a concentrated ownership structure in Malaysian firms does have a significant influence on the quality of financial reporting.

Leverage was found negatively significant when unmanaged earnings are above or equal to zero. High indebted companies are closely monitored by the lenders that make it difficult to practice earnings management (Park and Shin, 2004). Consistent with Peasnell et al. (2000; 2005), the coefficient on cash flow from operations is negative in both income-increasing and income-decreasing earnings management.

Absolute change in net income was found negatively significant when unmanaged earnings fall short of target earnings regarding board size and board meetings, none were found significant except for negative significant findings for board meetings when firms overshoot the earnings target. The higher the number of board meetings held, the less likely the manager is to engage in income-decreasing earnings management activities. Xie et al. (2003) argue that boards that meet more often could reduce earnings management activity as they are able to allocate more time for issues such as earnings management while boards that seldom meet are unlikely to focus on these issues

5. Discussion

The agency theory addresses the role of the ownership structure as a complementary mechanism to a board's effectiveness. Unlike the conflict of interest between outside shareholders and managers in a diffused ownership, such as that commonly found in the UK and US, the agency problem shifts away to conflicts between the controlling owners and minority shareholders in Asia where ownership concentration structure is more common (Claessens and Fan, 2002). The controlling owners, who are often also the managers, gain effective control of a corporation and have the power to determine how the company is run and may expropriate the rights of minority shareholders. Interestingly, block ownership was found to be significant in three out of four models tested in this study. Although the signs are mixed, the results show a significant influence of ownership concentration over the financial reporting quality of companies in Malaysia. The results bring further insights to the association between ownership concentration and earnings management levels in Malaysia and perhaps provide a platform to study the various components of ownership and its relationship with accrual manipulation.

The findings of this study warrant further investigation of the nature of the role played by independent non-executive directors, CEO and chairman of companies in the financial reporting process, to establish the link between a board's effectiveness and earnings management. Since it is argued that due to the lack of financial sophistication and expertise, independent directors in Malaysian companies may not be efficient in performing their monitoring role functions as they gain knowledge of the financial reporting process only as a by-product of their board services

(Abdul Rahman and Mohamed Ali, 2006), future research might investigate the relationship between financial expertise and its effect on earnings management activities. Furthermore, a study by Park and Shin (2004) for a Canadian sample suggest that financial sophistication is one of the most important attributes of outside directors to reduce the incidence of earnings management and effectively monitor the financial reporting process. Finally, future studies may employ current accrual quality models such as Dechow and Dichev (2002) that were found to be more powerful in detecting the quality of earnings.

6. Conclusion

This paper examines the effect of two important characteristics of board effectiveness; (1) the proportion of independent non-executive directors that sit on the board, and (2) CEO duality on the practice of earnings management in Malaysia. Due to the exception of a positive significant result for board independence, when firms undershoot target earnings, the study finds neither board independence nor CEO duality are significant in explaining the level of accrual manipulations through the analysis of income-increasing and income-decreasing discretionary accruals. The results do not support the notion that the existence of independent non-executive directors and separation of role between chairman and CEO, as recommended by the MCCG 2000, reduce the incidence of earnings management.

While confirming findings of one prior study, it does raise concerns as to whether the best practice corporate governance mechanisms, as determined by the Western world, are applicable to the Asian business environment. The key evidence on the association between ownership concentration and the earnings management level in Malaysia suggests the prominent impact of ownership structure and financial reporting quality.

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