

## The Influence of Real Earnings on Malaysian Corporate Board Structure

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**Abstract:** The objective of this study is to examine the real earnings management (by using discretionary expenses) that should capture the effect of real operations on the elements of corporate governance (board size and board independence). The sample of the study is Malaysian Public Listed Companies in year 2009-2012. Data were hand collected from the annual reports. Interestingly, this study contributes to the literature on earnings management by presenting evidence on the management of operational activities which has received little attention to date. Managers have the tendency to manipulate real activities during the year to meet certain earnings targets. However, this study evidences that corporate governance mechanism's helps to combat real earnings management activities. A large board size and high number of independent non-executive director's help to minimise the earnings management activities.

**Key words:** Corporate, real earnings management, board size, independent, non-executive directors

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### INTRODUCTION

Corporate governance has been argued to affect the firm performance (Chuanrommanee and Swierczek, 2007) and contribute to the integrity of financial reporting process (Petra, 2007). The main mechanism in corporate governance that is board of directors that have the fiduciary responsibility to monitor management against manager's opportunistic behaviour. However, do actually the boards able to exercise their power to combat the activities of earnings management? Many studies measure financial reporting quality (based on accrual basis) and corporate governance elements (Iqbal and Strong, 2010; Manaf *et al.*, 2015). However, this study is differs in terms of the definition of earnings management. This study uses real earnings (based on discretionary expenses) with corporate governance elements.

#### Literature review

**Real earnings manipulation:** 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 practices. A number of studies discuss the possibility that managerial intervention in the reporting process can occur not only via accounting estimates and methods but also through operational decisions (Healy and Wahlen, 1999).

Roychowdhury (2006) define real activities manipulation as departures from normal operational practices, motivated by manager's desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations. These departures do not necessarily contribute to firm value even though they enable managers to meet reporting goals. Certain real activities manipulation methods such as price discounts and reduction of discretionary expenditures are possibly optimal actions in certain economic circumstances. However, if managers engage in these activities more extensively than is normal given their economic circumstances with the objective of meeting/ beating an earnings target, they are engaging in real activities manipulation.

Studies evidence that the financial executives have greater willingness to manipulate earnings through real activities rather than accruals (Burns and Merchant, 1990; Graham *et al.*, 2005) through at least two possible reasons that are accrual manipulation is more likely to draw auditor or regulator scrutiny than real decisions about pricing and production and relying on accrual manipulation alone entails a risk.

There are many ways on how managers try to manage the real earnings (Bens *et al.*, 2002) find evidence that managers partially finance repurchases by reducing R&D. (Dechow and Sloan, 1991; Dechow *et al.*, 1998) find that CEOs reduce spending on R&D toward the end of their tenure to increase short-term earnings (Baber *et al.*, 1991;

Bushee, 1998) also find evidence consistent with reduction of R&D expenditures to meet earnings benchmarks. Graham *et al.* (2005) survey, a larger number of respondents admit to reducing discretionary expenditures and/or capital investments than engaging in other manipulation methods. Bartov (1993) documents those firms with negative earnings changes report higher profits from asset sales.

**Board size:** Board size refers to the number of board members. The size of the board also influences the extent to which the board is able to reach consensus and take advantage of the knowledge and expertise of the individuals. Jensen (1993) suggests that a board should have a minimum of seven or eight members to function effectively. However, to date, there is still no consensus over the size of the board that best govern a company. It is argued that large board is more effective as large board has more external linkage and expertise. Furthermore, large board has more capabilities and resources to solve group tasks (Dalton *et al.*, 1999).

On the other hand, another competing view in the literature suggests that small board is more effective than large board as a small number of individuals are likely to agree on a particular outcome (Lange *et al.*, 2004) and to engage in genuine interaction and debate (Firstenberg and Malkiel, 1994). It is also argued that large board is value reducing because large members make coordination, communication and decision making more complicated and hence, less efficient (Yermack, 1996; Eisenberg *et al.*, 1998; Hillman and Dalziel, 2003). Based on the arguments, we therefore hypothesize that:

- H<sub>1</sub>: Discretionary expenses are inversely related to board size

**Board independence:** Board independence refers to the composition of the board of directors with majority non-executive members and independent members of the board. Studies have shown the presence of non-executive directors on board provides an independent opinion and objective monitoring of companies operations and direction. It further contributes to higher quality financial reporting thereby reducing the incidence of earnings management (Lo *et al.*, 2010; Teferi, 2012).

The board is independent when there are a significant proportion of independent non-executive directors (Cornett *et al.*, 2008). Non-executive directors are expected to behave independently of managers and to bring greater breadth of experience to firm (Cravens and Wallace, 2001), effective in monitoring managers and protecting the interest of shareholders, thereby reducing agency

problem (Fama and Jensen, 1983), enhance the effectiveness of internal control as most non-executive directors are important decision agents in other corporations (Peasnell *et al.*, 2000).

Prior studies Dechow and Dichev (2002), Marra *et al.* (2011) and Williamson (1981) have documented how board independence can reduce earnings management because independent directors do not pursue self-interests such as executive compensation and the misappropriation of assets, pressure from shareholders to meet or beat expectations of firm performance and the need to maintain personal reputation to the public. Roe (1991) argues that the independence of the board is needed to control managerial activities to protect the interest of investors. Board independence can also prevent manager's abuse of power and to dampen investor's interest.

Kantudu and Samaila (2015) find that firms with a greater percentage of independent directors have higher financial reporting quality. Thus, a significant proportion of independent non-executive directors are a necessary control and monitoring mechanisms for quality financial information. Hassan and Ahmed (2012) conducted a study of independent directors in the ratio of board composition in Nigerian manufacturing firms and found that percentage of independent directors in the composition of the board of Nigerian manufacturing firms is positively related and statistically significant with financial reporting quality that is consistent with board size and the effect. It implies that independent directors play an important role in monitoring management to reduce their opportunistic behavior in managing earnings.

Peasnell *et al.* (2005) find that a higher proportion of outside directors in the UK can better constrain income-increasing discretionary accruals to avoid earnings management. Bowen *et al.* (2005) find that earnings management is lower when the percentage of outside directors is higher in the board. Davidson *et al.* (2005) provide evidence that Australian firms with higher board independence have more incentive to manage earnings.

However, studies in Malaysia find that there is no relationship between non-executive directors and earnings management (Saleh *et al.*, 2005; Rahman and Ali, 2006; Manaf *et al.*, 2014). Agency theory suggests that higher proportion of non-executive directors increases the effectiveness of the board. Prior studies indicate that firms with higher proportion of non-executive directors on board have better earnings management (Beekes *et al.*, 2004; Ahmed and Duellman, 2007; Lim, 2011). Hence, in line with the agency theory, the following hypothesis is posited:

- H<sub>2</sub>: Discretionary expenses are inversely related to board independence

**MATERIALS AND METHODS**

**Data:** This study includes Malaysian Public Listed Companies dated in year 2009-2012. This study excludes the financial institutions as these companies have different regulations. The data were hand-collected through the annual reports and Thomson Datastream.

**Research design:** Discretionary expenses are defined as the sum of advertising expenses, research and development expenses (R&D) and Selling, General and Administrative expenses (SG&A). BSize represents the number of members sitting on the board, INED represents number of independent non-executive directors on the board. We include leverage and FSize as the control variables. Leverage is measured as total liabilities divided by total assets. FSize is firm size that is measured by natural log of total assets and eit is the residual term.

We use the model in Dechow, Kothari and Watts (Manaf *et al.*, 2014) to derive normal levels of expenses for every firm-year. Deviations from the normal levels are termed as abnormal discretionary expenses. We focus on the effects on the abnormal levels on reduction of discretionary expenditures:

$$\text{DiscExp}_{it} = \beta_0 + \beta_1 \text{Bsize}_{it} + \beta_2 \text{INED}_{it} + \beta_3 \text{Leverage}_{it} + \beta_4 \text{Fsize}_{it} + \epsilon_{it}$$

**RESULTS AND DISCUSSION**

Based on Table 1, the mean for abnormal discretionary expenses is about 1.8 millions based on the sample collected. In terms of corporate governance item, the mean for board size is 8 people and the maximum number is 15 people in a board. This finding is in line with Jensen (1993). The mean of Independent Non-Executive Directors is 3 and the maximum number is 8 people. The mean for leverage is 0.53 and the firm size is 5.02. Based on Table 2, the correlation between the variables in the study is below 0.75 for the rule of thumb. The variables have no multicollinearity problems. The highest correlation identified is between BSize and BINED which is 0.41.

With reference to Table 3, the board elements are significant with discretionary expenses. Bsize has a negative and significant with discretionary expenses. It explains that larger board size is capable of discharging their roles in combatting the discretionary expenses involved in the companies. Thus, this finding is in line

Table 1: Descriptive statistics

Variables	Mean	Median	Min.	Max.
Discexpd	-1891604	-369080.3	-8.85e+07	7.11e-07
BSize	7.502846	7	3	15
INED	3.311828	3	1	8
Leverage	.5266095	.0095	-281.501	429.605
FSize	5.024045	5.191	0	7.499

Table 2: Correlation

Variables	DiscExp	BSize	INED	Lev	Fsize
Discexp	1				
BSize	-0.2175	1			
INED	-0.1824	0.4128	1		
Leverage	0.0115	-0.0051	0.0178	1	
FSize	-0.3299	0.2604	0.1378	0.0108	1

Table 3: Regression results for abnormal discretionary expenses on board structure

Variables	Hypothesis	Coef.
BSize	H <sub>1</sub>	-319552.8*** (0.001)
INED	H <sub>2</sub>	-586317.8*** (0.005)
Leverage		5173.485** (0.024)
FSize		-1554259*** (0.000)
Constants		1.03e+07*** (0.000)
Adjusted R <sup>2</sup>		0.1361
Number of observations		1589

\*\*\*Significant at 1%, \*\*significant at 5% (figures in the parentheses are the p-values)

with past study (Dalton *et al.*, 1999). INED is negatively and significant with discretionary expenses. It explains that when more independent non-executive directors sitting on the board, the activities of discretionary expenses is lower as they can exercise better monitoring and controlling. Hence, this evidence supported previous studies (Hassan and Ahmed, 2012; Peasnell *et al.*, 2005; Bowen *et al.*, 2005; Davidson *et al.*, 2005; Marra *et al.*, 2011). Leverage is positive and significantly relates with discretionary expenses. It shows that company with higher debts tends to manipulate more on discretionary expenses. FSize has a negative and significant with discretionary expenses. It indicates that the larger the company is less discretionary expenses being exercised.

**CONCLUSION**

Real earnings management can be curbed by having strong corporate governance mechanisms. In this study, it was found that board size and composition of independent non-executive director’s help to curb real earnings management (as measured using abnormal discretionary expenses) among Malaysian Public Listed companies. However, this study only covers for four year (2009-2012) and the measurement of real earnings is limited to one measurement. In future, it can be measured using other indicators such as cash flow from operations and production costs. Also, the time horizon can be extended further to see the long run effect of the real earnings management on corporate governance variables.

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