THE EFFECTS OF FIRM'S RISK, INDEPENDENT DIRECTORS AND AUDIT COMMITTEES ON INCOME INCREASING AND INCOME DECREASING EARNINGS MANAGEMENT

RESEARCH MANAGEMENT INSTITUTE
UNIVERSITI TEKNOLOGI MARA
40450 SHAH ALAM
MALAYSIA

BY:

PROF. DR HJH RASHIDAH ABDUL RAHMAN
MASLIZA WAN MOHAMAD
NIK MOHAMAD ZAKI NIK SALLEH

AUGUST 2011

ACKNOWLEDGEMENT

Sincere appreciation and gratitude are conveyed to those who have assisted us directly or indirectly in successful completion of this research project.

Among others are:

Universiti Teknologi MARA
(for financial assistance)

Accounting Research Institute

Research Management Institute Technical Committee Members

and

List of Tables

Abstract

This study examines the association between board characteristics, ethnicity and the level of risks and its effect on discretionary accruals as a proxy of earnings management. The sample of the study comprises of 298 randomly sampled firms over the year 2004 to 2009. The 6 year period of the study covers the revised code of corporate governance in 2007 which requires independent directors to be at least financially literate, possessed qualification and be a member of professional accounting bodies. Contrary to the commonly-held belief that highly-qualified and experienced directors effectively act as deterrent to earnings management, the results revealed that higher earnings management is associated with more qualified and experienced directors measured by independent directors qualification and CEO tenure. However an independent director who is a member of professional accounting is negatively associated to earnings management. A new finding of this study is the importance of chairman independence. The result revealed that chairman independence is more effective in reducing earnings management in comparison to independent directors. Issue on ethnicity is equally interesting as earnings management is observed to be lower when there is greater ethnic diversity in the composition of board members and ethnic-wise, appears nominally balanced in the number of representatives. Malaysian manufacturing firms, predominantly owned by the Chinese entrepreneur, may therefore potentially reduce agency conflicts and earnings management by muting its partiality to own ethnic when appointing board members, broadening instead its acceptance to other ethnic backgrounds. However, the findings of this study also indicate a positive association between Malay directors and earnings management, necessitating a further study on the factors that may have attributed to the scenario. One possible explanation is that the existence of Malay directors is merely in fulfilling the KLSE requirement rather than executing the monitoring tasks of the board of directors.

Keywords: Discretionary Accruals, Corporate Governance, Risk, Ethnicity

We would like to thank Research Management Institute (RMI) for the research grant in conducting this research.

1. Introduction

The 1990's witnessed Malaysia's rapid growth, both economically and socially, in the earlier part of the decade before the crippling 1997 financial crisis and stock market crash, along with the negative repercussions felt thereafter, stifled progress. As a direct consequence of the crisis, shareholders were made more conscientiously aware of the importance of corporate governance in the Malaysian stock market(Claessens & Fan, 2002; Liew, 2007). Correspondingly, in the year 2000, the Code of Corporate Governance was established by the Ministry of Finance and it outlined conditions for the structure and functioning process of the board of directors, audit committee and external auditors in safeguarding the interest of shareholders (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Norman, Takiah, & Mohd, 2005). The existing Code was then revised on 1st October 2007, and it defined corporate governance as '... a set of relationships between a company's board, its shareholders and other stakeholders. It also provides it structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance, are determined' (OECD, 1999). The definition serves to accentuate the key role played by independent directors in accomplishing corporate objectives since constant monitoring of firms activities is an intrinsically key element in achieving these objectives.

The moves made by the Code are a step to clarify director's fiduciary duties. S132 of the Companies Act 1965(CA) has laid down the roles of directors to act in "the best interest of the company" and "no conflict rule" where directors avoid putting themselves in the position of personal conflict with regards to their decision making. Establishment of internal governance processes is essential to maintain the credibility of firms' financial statements and safeguarding against earnings manipulation (Dechow, Sloan, & Sweeney, 1996). The presence of qualified independent directors may thus reasonably allude to the existence of appropriate "check and balances" process in the firm. On the other hand, a weak governance structure specifically due to lack of knowledge and expertise may provide an opportunity for financial statements preparers or managers to involve in irregularities behavior. Managers may prefer to use discretionary accruals to manage the reported earnings as it is less likely to be detected by financial statement users.