UNIVERSITI TEKNOLOGI MARA

REAL ACTIVITIES MANAGEMENT, FINANCIAL DISTRESS AND CORPORATE GOVERNANCE: MALAYSIAN EVIDENCE

MOJTABA SHAYAN NIA

Thesis submitted in fulfilment
of the requirements for the degree of
Doctor of Philosophy

Faculty of Accountancy

August 2016

ABSTRACT

Positive accounting theory predicts that firms approaching deteriorating financial performance may make income-increasing accounting choices. The firms manipulate earnings upward in an attempt to ride out what is probably deemed by the management as a temporary bad period. The primary objective of this thesis is to examine real activities based earnings management among distressed Malaysian firms over the years, covering both prior and after being officially designated as "PN17 firms". Additionally, the study aims to investigate whether real activities management techniques among distressed Malaysian firms change across time and industries in which the firms operate. The study also aims to examine the moderating effects of corporate governance on real activities management. The study detects real activities manipulation by investigating patterns in cash flow from operations (CFO), discretionary expenses, and production costs. This study uses the Roychowdhury (2006) models to derive the normal level of CFO, discretionary expenses and production costs. Deviations from the normal levels are termed abnormal CFO, abnormal discretionary expenses and abnormal production costs. In addition, a review of the corporate governance literature revealed several attributes that may affect the degree of real activities management, simply because their role in enhancing monitoring mechanism. The corporate governance attributes are organized into two categories: 1) Ownership Structures; and 2) Board of directors' Composition. Imposing all the data availability requirement yields 4,130 firm-years over the period of 2001 to 2011, including matched samples of 295 distressed firms and 295 non distressed firms. The results complement the existing literature on earnings management in several ways. Firstly, the results document evidences that are consistent with real activities manipulation during the years preceding and succeeding PN17. The results reveal distressed Malaysian firms engage in sales manipulation and reduction of discretionary expenditures to improve their reported margins over the years prior to being officially designated as "PN17 firms". In addition, the results also indicate that the firms apply these techniques in a more aggressive manner in the years following the categorisation under PN17 list. Secondly, the results provide a new insight on the way managers from different industry engage in real activities manipulation. This study indicates that earnings management tools change according to the industry in which distressed firms operate and the number of years preceding the categorisation of PN17. Finally, the findings suggest that the degree of real earnings management among distressed firms are associated with corporate governance attributes, namely ownership structure and board of directors' composition. The primary contribution to knowledge of this research is its extension of the literature on the phenomenon of real activities management among the financially distressed firms. The findings of this study is applicable by stock market participants towards the evaluation of companies' board composition and the role of the ownership structures in constraining managerial opportunistic behaviours. Furthermore, the findings will also assist Bursa Malaysia in detecting the areas that are likely to be manipulated by managers.

ACKNOWLEDGEMENTS

All praise is to God, for having made everything possible and by giving me strength and courage to complete this work.

I am grateful to my principal supervisor, Associate Professor Dr. Huang Ching Choo. I cannot adequately express my gratitude to her for her invaluable guidance and motivation in completing the dissertation. Deep appreciation also goes to my co-supervisors, Professor Dr. Zubaidah Zainal Abidin and Dr. Radziah Mahmud for their constant support and encouragement. I would like to sincerely thank my supervisors for their expertise, knowledge and comments in directing my work. Their patience with me has undoubtedly contributed in the development of this thesis. I am truly grateful to have them as my supervisors.

I would like to thank Associate Professor Dr. Zuraidah Mohd Sanusi, Associate Professor Dr. Philip Sinnadurai and Dr. Winddy Pindah for facilitating the data analysis part of my thesis. Their guidance and professional assistance was crucial for the completion of my thesis. I am also indebted to Universiti Teknologi MARA and Ministry of Higher Education for providing the facilities for this study.

My deepest gratitude to my father, Ali Neghabi whose constant encouragement, devotion and support is unwavering, to my beloved mother, wife, sisters and brothers, who kept me motivated and supported me to complete this study.

TABLE OF CONTENTS

		Page
CONFIRMATION BY PANEL OF EXAMINERS		ii
AUTHOR'S DECLARATION		iii
ABSTRACT		iv
ACKNOWLEDGEMENTS		v
TABLE OF CONTENTS		vi
LIST OF TABLES		**xi**
LIST OF FIGURES		xii
LIST OF ABBREVIATIONS		xiii
CHAPTER ONE: INTRODUCTION		1
1.1	Chapter Description	1
1.2	Financial Distress and Real Earnings Management	1
1.3	Real Earnings Management across the Time and Industries	3
1.4	Corporate Governance and Real Earnings Management	4
1.5	Research Problem	5
1.6	Study Motivations	7
1.7	Research Questions	8
1.8	Research Objectives	9
1.9	Significance of Study	11
1.10	Structure of the Thesis	12
CHAPTER TWO: LITERATURE REVIEW		14
2.1	Introduction	14
2.2	Earnings Management	14
2.3	Incentives for Earnings Management	18
2.3.1	Management-Compensation Contract Motivations	18
2.3.2	Income Smoothing Incentives	20
2.3.3	Meeting or Beating Analysts'Earnings Expectations	21
2.3.4	Avoiding Debt Covenant Violation	23

2.3.5 Regulatory Motivations 24
2.3.6 Capital Market Motivation 25
2.3.7 Political Costs 26
2.4 Accruals Management versus Real Activities Management 27
2.5 Earnings Management Techniques 29
2.5.1 Big Bath Techniques 29
2.5.2 Cookie-Jar Reserve Techniques 31
2.5.3 Amortization, Depreciation, and Depletion 32
2.5.4 "Big Bet on the Future" & "Flushing" the Investment Portfolio 32
2.5.5 Selling Long-Term Assets 33
2.5.6 Sale and Lease Back 34
2.5.7 Shrink the Ship 35
2.5.8 Management of Operating Activities 36
2.6 Earnings Management Constraints 38
2.6.1 Corporate Governance 38
2.6.2 Balance sheet 39
2.6.3 Accounting Standards 39
2.6.4 Political Forces 40
2.6.5 Culture 41
2.7 Financial Distress 42
2.7.1 Causes of Financial Distress 42
2.7.2 Earlier Warning Signs of Financial Distress 44
2.7.3 Financial distress in Malaysia 45
2.7.3.1 Criteria of PN17 Companies 46
2.7.3.2 Regularization Plan 47
2.7.3.3 Disclosure Obligations of the PN17 Company 48
2.7.3.4 PN17 Companies Obligation to Regularize 49
2.7.3.5 Consequence of Non-Compliance 50
2.8 Financial Distress and Real Earnings Management 50
2.9 Corporate Governance 55
2.9.1 Corporate Governance and Earnings Management 55
2.9.1.1 Board of Directors'Composition 56
2.9.1.2 Ownership Structures 65
2.10 Summary 70