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COMPANY CHARACTERISTICS AND OPPORTUNISTIC BEHAVIOUR IN MALAYSIAN SHARIAH-COMPLIANT COMPANIES

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Abstract

Managerial opportunistic behaviour is normally viewed to have negative impact as managers have advantage to use information asymmetry to redistribute benefits from economic transactions unilaterally. In applying their estimates and judgements, managers may opportunistically manipulate earnings through adoption of accounting policies and accounting estimates. Consequently, there will be inefficient resource allocation which will affect companies' performance. Shariah-compliant companies are expected to engage in minimal earnings manipulation since they are bound by the Shariah rules. This study examines whether profitability, financial distress and leverage are determinants of opportunistic behaviour in Malaysian Shariah-compliant companies after controlling for the size and liquidity of the companies. This study is based on 110 companies in industrial product sector during 2012 till 2016. Applying agency theory, the results of this study confirm that Shariah-compliant companies with financial distress, high leverage and bigger size engage more in opportunistic behaviour.

Keywords: financial distress, leverage, opportunistic behaviour

1.0 INTRODUCTION

Opportunistic behaviour is generally perceived to be negative since managers may make decision for their private benefits that mislead users of financial information (Rezaei & Roshani, 2012). Even though managers are anticipated to consider the interest of the shareholders, they may manage earnings and embark on making decision that does not in line with the shareholders. Even though the companies are classified ad Shariah-compliant companies, the managers are still exposed to the issue of opportunistic behaviour and make decision that adversely affects the shareholders' interest. Farooq and AbdelBari (2015) propose that Shariah-compliant companies should engage in fewer opportunistic activities since such companies supply better quality of reported earnings to draw investment from outsiders and they are closely scrutinised by regulators. Applying agency theory, this study examines whether opportunistic behaviour of managers measured by discretionary accruals in companies that are classified as Shariah compliant companies are being influenced by the companies' characteristics such as profitability, financial distress and leverage.

2.0 LITERATURE STUDY

2.1 Shariah-compliance and Opportunistic Behaviour

Companies that conduct activities in accordance to the Shariah rules and regulations are classified as Shariah-compliant companies (Kazemian, Hanif, Sanusi & Che Haat, 2018). Such companies are perceived as free from earning manipulation and matters that might have adverse effects on their activities. The Islamic practices through Shariah rules and regulations are fundamental to good corporate governance. The right barriers and fair treatment given to shareholders as well as managers' accountability and transparency are important in providing high quality earnings (Dadgar and Naderi, 2009). Farooq and AbdelBari (2015) report that Shariah-compliant firms have low earnings management during the crisis period. Shariah-compliant firms in Malaysia have greater earnings quality, which represents low opportunistic behaviour (Wan Ismail, Kamarudin & Sarman, 2015). However, Ibrahim et al (2015) suggests that sustainability reporting is not being manipulated to cover earning management practices.

2.2 Profitability, Financial Distress, Leverage and Opportunistic Behaviour

Previous literatures propose that profitability has a significant relationship with opportunistic behaviour (Wasiuzzaman, Sahafzadeh & Nejad, 2015). It is suggested that the degree of opportunistic behaviour is related to firm's size and profitability. Managers tend to disclose inappropriate amount of assets when the sales is low (Lee, Shin, Vetter, & Kim, 2017). Most firms manage earnings' ups and downs to meet their prescribed threshold in every quarter (Mindak, Sen, & Stephan, 2016).

Financial distress due to a persistent and significant decline in financial performance may expose a company into insolvency. Financial distress may induce aggressive behaviour in managers to act unethically and to cause harm to the debt holders (Nagar & Sen, 2017). Managers of financially distressed firms can expect to have their bonuses being cut besides impairing their reputation as top managements (Liberty & Zimmerman, 1986).

A company can conduct an aggressive earnings management to prevent violations of the debt contract (Watts & Zimmerman, 1986). Therefore, the debt amount of the company will motivate management to manage earnings. Leverage is one of the management motivations to practise earnings management (Othman & Zhegal, 2006). However, the study by Dade and Linda (2015) reveals that there is no significant relationship between the level of debt and earnings management practices.

2.3 Firm Size and Liquidity

Firm size may relate to effective internal control system whereby large firms may have comprehensive control, which will impair earnings management compared to smaller firms. It leads to the reliability of financial statements to public (Warfield, Wild, & Wild, 1995). Large firms have to manage their earnings due to greater pressure from the investors and to meet the expectations of analysts (Barton & Simko, 2002). Maintaining liquidity on daily basis is crucial to ensure smooth running operation and meets its obligation (Bhunia, Khan & Mukhuti, 2011). In the risk and return theory, more risky investment will result to more return. Thus, higher liquidity firms may have low risk then low profitability.

It can be concluded that company characteristics such as profitability, financial distress and leverage may have impact on the opportunistic behavior of the management. Thus, this study will examine the impact of such company characteristics on the opportunistic behavior in Malaysian Shariah-compliant companies after controlling for firm size and liquidity.

3.0 METHODOLOGY

3.1 Sample Selection

The sample of this study was taken from Shariah-compliant companies listed on Bursa Malaysia. The companies from industrial product sector were selected and the period under study was from year 2012 to 2016. In order to avoid biasness, non Shariah-compliant companies during the period were excluded from the sample. The final sample of this study was 110 companies.

3.2 Data Collection

This study used secondary data to examine the influence of company's profitability, financial distress and debt on managerial opportunistic behaviour. The annual reports were used since they were the formal communication means commonly used by companies. The data were regarded as more reliable as compared to those obtained through databases.

3.3 Variables of the study

The dependent variable in this study is opportunistic behaviour which is measured by discretionary accruals using the modified Dow Jones model. Even though discretionary accruals can be regarded as good facet (Houqe, Ahmed & Zijl, 2017), this study assumes that discretionary accruals are bad facet.

In estimating total accruals, non-discretionary accruals and discretionary accruals, the following equations are used:

$$\frac{TAC_{t,i}}{TA_{t-1}} = \alpha_1\left(\frac{1}{TA_{i,t-1}}\right) + \alpha_2\left(\frac{\Delta SALES}{TA_{i,t-1}}\right) + \alpha_3\left(\frac{PPE}{TA_{t-1}}\right) + \varepsilon$$

$$NDA_{i,t} = \alpha_1\left(\frac{1}{TA_{i,t-1}}\right) + \alpha_2\left(\frac{\Delta SALES - \Delta REC}{TA_{i,t-1}}\right) + \alpha_3\left(\frac{PPE}{TA_{t-1}}\right) + \varepsilon$$

$$DA_{it} = \frac{TAC_{t,i}}{TA_{t-1}} - NDA_{it}$$

Where DA is discretionary accrual, NDA is non-discretionary accrual, $TAC_{i,t-1}$ is total accruals for firm i in year t-1, TA_{it} is total assets of firm i in year t-1, ΔSALES is changes in earnings of firm i in period t, ΔREC is changes in receivables firm i in period t, and ε is error terms.

The independent variables of the study are a few company characteristics namely profitability, financial distress and leverage. Profitability has significant influence on opportunistic behaviour particularly in performance based bonus scheme (Wasiuzzaman et al., 2015). Managers of less profitable companies are motivated to behave opportunistically. Profitability in this study is measured by Return on Assets (ROA) ratio.

Management in financially distressed companies may have higher motivation to manage earnings (Hrp et al. 2017; Mohammadi & Amini, 2016). Such firms are anticipated to improve the poor financial position by adopting aggressive operating decisions to mitigate losses and enhance the future prospects. Financial distress is measured using AltmanZ-Scores approach using the following formula:

z-score = 1.2 (working capital/total assets) + 1.4 (retained earnings/total assets) + 3.3 (earnings before interest and tax/total assets) + 0.6 (market value of equity/total liabilities) + 1.0 (sales/total assets)

It is opined that the tendency for high leverage companies to involve in earnings management activities is higher (Abbadi, Hijazi & Rahahleh, 2016). Sun and Rath (2009) suggest that management may adopt income increasing accruals to prevent violating the debt limit. Leverage is measured as total debts divided by total assets.

Firm size may have negative influence on earnings management since big companies are inclined to adopt accounting standards and procedures which results in smaller profits for tax purposes. Similarly, liquidity may have impact on earning management as companies with different liquidity position tend to manipulate earnings (Moghaddam & Abbaspour, 2017). Thus, this study includes firm size and liquidity as the control variables. The measurement for firm size and liquidity are natural log of total assets and current ratio respectively.

The regression model that has been used to investigate the influence of company's characteristics on opportunistic behaviour is as follows:

$$OB = a + \beta 1PROFIT + \beta 2DISTRESS + \beta 3LEV + \beta 4SIZE + \beta 5LIQ + \varepsilon$$

Where OB is opportunistic behaviour measured by discretionary accruals, PROFIT is profitability measured by ROA, DISTRESS is financial distress measured by Altman Z- Score, LEV is leverage measured by debt equity ratio, SIZE is firm size measured by total assets and LIQ is liquidity measured by current ratio.

4.0 RESULT AND DISCUSSION

4.1 Descriptive Statistics

Based on Table 1, on average the managerial opportunistic behaviour (OB) is 0.0791 and the range of opportunistic behaviour is from -1.0274 and 16.8661. In relation to independent variables, the mean of profitability (PROFIT), financial distress (DISTRESS) and leverage (LEV) are 0.0288, 2.1964 and 0.3580 respectively. Generally, RM0.29 profits is generated from every RM1 of assets held by companies. Most companies are reasonably financially stable and not highly geared as suggested by Altman Z-Score value of 2.19 and leverage ratio of 0.3580.

Table 1: Descriptive Statistics

	OB	PROFIT	DISTRESS	LEV	SIZE	LIQ
Mean	0.0791	0.0288	2.1964	0.3580	7.9903	2.9462
Min	-1.0274	-1.2963	1.0000	0.0114	4.6947	-2.7723
Max	16.8661	1.5611	3.0000	1.0000	10.6270	49.6277

4.2 Multiple Regression

The results from regression model are presented in Table 2 below:

Table 2: Multiple Regression

Variables	β	t	Sig	
Constant	-1.353	-4.187	0.000***	Adjusted R^2 = 0.046 F-value = 6.336**
PROFIT	-0.153	-0.562	0.575	
DISTRESS	.266	5.104	.000***	
LEV	.927	3.747	.000***	
SIZE	.062	1.992	.047**	
LIQ	.009	1.033	.302	

***, ** and * indicate significance at the level of 1%, 5% and 10% respectively

The multiple regression results indicate that while profitability has no influence on opportunistic behavior; financial distress and leverage have positive and significant influence on opportunistic behaviour. For control variables, only size of the company has influence on opportunistic behaviour. Liquidity does not have any influence on management activities in managing the reported earnings.

4.3 Discussion of Findings

This study suggests that companies' profitability has no influence on opportunistic behaviour. Even though the finding is inconsistent with literatures such as Ghazali et al. (2015), it is consistent with Moshi (2016). Lower profitable companies may have less reason to manipulate earnings because such companies may involve in "bath-taking" activities. This study also proposes that financial distress has positive and significant influence on opportunistic behaviour. Consistent with previous studies such as Kazemian et. al. (2018), Hrp et al. (2017), Mohammadi and Amini, (2016), this study indicates that managers in financially distressed companies have incentives to conceal deteriorating performance for higher profit. There is also positive and significant relationship between opportunistic behaviour and leverage in Shariah-compliant companies. The result supports the finding in Ghazali et al. (2015), that Shariah-compliant companies with high leverage engage in opportunistic behaviour to achieve their earnings targets.

Using size of company and the liquidity as control variables, this study opines that the management of the Shariah-compliance firms tends to behave opportunistically based on the size of company. Consistent with Moghaddam and Abbaspour (2017), this study confirms that larger companies including Shariah compliance companies tend to involve in opportunistic behaviour activities in order to have smaller profits. On the other hand, this study does not support the findings in Kazemian et al. (2018) as company's ability in meeting its financial obligation has no influence on opportunistic behaviour.

5.0 CONCLUSION AND FUTURE WORKS

This study infers that financial distress and leverage have affected the opportunistic behaviour of Malaysian Shariah-compliant companies. However, the profitability of the company has no effect on managers' opportunistic behaviour. With respect to control variables, larger companies are observed to have more opportunistic behaviour and liquidity has no impact on such behaviour.

There are several limitations pertaining to this study. In this study, Modified Dow Jones model is used to detect opportunistic behaviour. Other accruals models should be adopted to provide result's robustness. The sample of this study is based on Shariah-compliant companies in industrial product sector. The findings may be different if the study employs a sample of other specific nature of sector. Hence, this will offer more general and conclusive inferences on the variable examined. Future research should include corporate governance mechanisms as evidence suggests that they will curb opportunistic behavior.

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