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Board Profile and Earnings Quality: Malaysian Evidence

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Abstract

Investors and potential investors normally rely on the information contain in financial statement to make investment decision. These suggest that shareholders of company are concerned with board of directors' characteristics that might influence the reliability of financial accounting report. This paper examines how multiple directorships, financial expertise and board experience affect the quality of reported earnings. The sample consists of 113 MSWG ranked companies for the year 2007, 2008 and 2009. Using OLS, the results show that financial expertise and board experience are positively related to earnings quality in top 150 MSWG ranked companies. Overall, these results provide evidence that boards are important elements affecting the quality of financial report, particularly quality of earnings.

Keywords*: Earnings quality, Corporate governance, Board profile*

1. INTRODUCTION

Earnings quality refers to the situation where the reported earnings in the financial statement reflect the economic condition of the companies. The board of director presumes an important task in monitoring the process of preparing the financial statement and ensuring the financial statements are prepared based on accounting standards and complies with applicable law, rules and regulations. However, in the process of preparing financial statement, accountants are allowed to use judgment in selecting various accounting principles to suit with the nature of company's transaction. It is sometime suggested that the income reported in the financial statement is inaccurate due to the practice of earnings management. Earnings management activities are the situation where managers use the flexibility in the accounting techniques to manage the earnings with the purpose to reduce the variability or fluctuations in income of the company (Leuz, Nanda and Wysocki, 2003). The manipulation of earnings would cause the reduction in quality of reported earnings and would mislead the investors in their decision making (Abdelghany, 2005). Generally, Malaysian companies do practice earnings management. To prevent earnings management activities, Rashidah and Fairuzana Haneem (2006) claimed that board of directors should have some skill and expertise. Therefore, it is important for the company to have competent directors to ensure that financial statements prepared would reflect a true and fair view of the company affairs.

Prior empirical research in earnings quality has focused on board composition (Asteriou, 2010), ownership structure (Velury and Jenkins, 2006) and audit committee characteristics (Lin, Li and Yang, 2006). However, research to date, especially in Malaysia, shows that there is a little concentration on relationship among earnings quality and other board characteristics. Thus this study extends the existing literature on corporate governance, focusing on other board profile (such as multiple directorships, financial expertise and board experience) relationship with quality of reported earnings. The objectives of this study is a) to examine in detail the profile of board of directors including multiple directorships, financial expertise, board experience, and how these elements affect the firm earnings quality b) to examine whether the profile of the board of directors has significant impact on the earnings

quality. The findings of this study will provides contribution to the existing body of knowledge concerning the evidence that reflects the quality of earnings in Malaysia and, that may help regulators identify the causes of low quality of reported earnings and improve the quality of financial reporting in Malaysia.

2. LITERATURE REVIEW

Although the term "earnings quality" is widely used, there is no agreed definition that could represent the absolute meanings of the earnings quality. According to Dechow, Ge and Schrand (2010), the earnings are considered as of a high quality if reported earnings reflect the economic condition of the companies and grant the earnings information to be used in predicting future operating cash flow (Pinnuck and Potter, 2009). Earning quality could also be defined from earnings management perspectives (Abdelghany, 2005; Machuga and Teitel, 2007). High degree of earnings management implies that management is aggressively managing the reported earnings which would reduce the quality of earnings (Velury & Jenkins, 2006).

The issue of the quality of earnings is very crucial to the users of accounting information as it is the product of financial reporting system. It has been emphasized in the literature that company with good corporate governance practices would be able to maintain investors' confidence towards the company (Chang and Sun, 2010) and would produce better quality of accounting information (Jiang, Lee and Anandarajan, 2008). Marra, Mazzola and Prencipe (2011) provided evidence that corporate governance mechanisms especially board of directors, play an important role in providing high quality of reported earnings. From the view of agency theory, board of directors (the agent) is responsible to manage the company's affairs for shareholders (the principal). Since the board of directors is given the power to manage the company (Jensen and Meckling, 1976), shareholders are very concern in ensuring the boards are staffed with a competence and credible directors.

It has been found that expertise, skill and knowledge could influence the effectiveness of directors in monitoring management behavior (Lo, Wong and Firth, 2010). According to Ehikioya (2009), firm with board members that is having related skill would have the superior performance. Thus there is a need for firms to look at the potential board member's profile before appointment to the board. Therefore, this study is going to look into how directorship, financial expertise and experience of directors influence quality of earnings of Malaysian companies. Multiple directorship refer to the situation where directors sit on more than one board. Hampel Report (1998) emphasises that appointing directors from other companies on board would bring together their technical knowledge, their market knowledge and also their personal contacts to the companies. Sun, Liu and Lan (2011) provided evidence that the directors do help in enhancing the quality of earnings even though they are serving on more additional boards. However, Beasley (1996) provided evidence that multiple directorship would make the directors turn out to be very busy and increased the possibility of the occurrence of fraud in the process of preparing financial report. Thus, it is hypothesized that:

H_1. There is a significant relationship between multiple directorship and earnings quality

In addition, Higgs (2003) also suggested that director should regularly upgrade their individual skill and expertise as it would help them in fulfilling their obligations as a board member. In fact, the Malaysian Code on Corporate Governance, also state that the members of audit committee should be financially literate (MCCG, 2007). Competent directors are expected to play an effective monitoring function. Firms with financial expertise found to be effective in constraining the management behavior in manipulating the earnings (Norman, Takiah and Mohd Rohit, 2005). This situation would lead to high quality of

financial accounting system and produced reliable financial report. However, Lin *et al.* (2006) provided no evidence that financial expertise has any impact on quality of reported earnings. Thus, it is hypothesized that:

H_2. There is a significant relationship between financial expertise and earnings quality.

It is important for boardroom to have a knowledgeable director with wider expertise and skill, and led by a highly talented leadership team (Higgs, 2003). Therefore, besides having skill and knowledge, the board members should bring a wealth of experience to the company from a variety of industry either from private sectors or public sectors. Nor Hashimah, Norman, Romlah and Mohamat Sabri (2008) revealed that majority of directors in Malaysia have experience in accounting, finance and banking. In addition, Kim and Lim (2010) also found that outside directors with government experience enhances the firm's value. Supported by Labelle, Gargauri and Francoeur (2010), they found that firm with directors who poses various management experiences are more efficient in monitoring management behavior and are less likely to engage in earnings management activities, hence produced high quality of reported financial information. Thus, it is hypothesized that:

H_3. There is a significant relationship between experience background and earnings quality.

The theoretical framework underlying in this study revolves around the achievement of the firm earnings quality as measured by absolute discretionary accruals (DAC). The framework is developed in examining the relationship between the board profile and firm earnings quality. This study examines the relationship between earnings quality and board's profile (multiple directorships, financial expertise and board experience). The control variable used is size of the firm (based on their total assets).

3. METHODOLOGY

The sample consists of 113 MSWG ranked companies (MSWG. 2008) for the year 2007, 2008 and 2009. A total of 339 firm-years companies were sampled covering seven different industries. The data for board profile is collected from companies' annual reports. Meanwhile, financial data to measure earnings quality is obtained from the DataStream. The dependent variable – earnings quality was measured through earning management activities. Earnings management is calculated based on the level of discretionary accruals, calculated using the Jones Model modified by Dechow, Sloan and Sweeney (1995). Under this model, total accruals (TACC) are partitioned into non-discretionary accruals (NDAC) and discretionary accruals (DAC):

$$TACC_i = NDAC_i + DAC_i \quad (1)$$

TACC for firm *i* is computed as the difference between income before tax and extraordinary items (EARN) and operating cash flow (OCF):

$$TACC_i = EARN_i - OCF_i \quad (2)$$

NDAC for firm *i* is computed using the following equation:

$$NDAC_{ijt} = \alpha_j [1/A_{ijt-1}] + \beta_{1j}[\triangle REV_{ijt} - \triangle REC_{ijt}/A_{ijt-1}] + \beta_{2j}[PPE_{ijt}/A_{ijt-1}] \quad (3)$$

Where;

$NDAC_{ijt}$ = non-discretionary accruals for firm *i* in industry *j* in year *t*

α_j, β_{1j} and β_{2j} are industry-specific coefficients. By using SPSS, the industry-specific coefficients are generated from the following equation:

$$TACC_{ijt} / A_{ijt-1} = \alpha_j [1/A_{ijt-1}] + \beta_{1j}[\triangle REV_{ijt}/A_{ijt-1}] + \beta_{2j}[PPE_{ijt}/A_{ijt-1}] \quad (4)$$

Where;

$TACC_{ijt}$ = total accruals for firm *i* in industry *j* in year *t*
$\triangle REV_{ijt}$ = change in revenue for firm *i* in industry *j* between year *t-1* and *t*
PPE_{ijt} = net property, plant and equipment for firm *i* in industry *j* in year *t*
A_{ijt-1} = total assets for firm *i* in industry *j* at the end of the previous year
$\triangle REC_{ijt}$ = the change in receivables for firm *i* in industry *j* between year *t-1* and *t*
α_j, β_{1j}, β_{2j} = specific parameter (coefficient) for industry *j*

The coefficients for each industry are used to calculate NDAC for the selected firms. After calculating the NDAC from the equation (iii) above, the amount of DAC is calculated as follow:

$$DAC_{ijt} = TACC_{ijt} - NDAC_{ijt} \quad (5)$$

To capture the direction of earning management, which income-increasing and income-decreasing, absolute value of discretionary accruals are used as suggested by Yang, Chun and Ramadili (2009).

The independent variable - The profile of the board was measured through three proxies: multiple directorship, financial expertise and board experience. The first proxy of board profile is multiple directorships, measured based on the proportion of director who holds at least two additional directorships in other company. The second proxy is financial expertise, which is measured using the proportion of accounting expertise on board. For this study, director with accounting expertise is those who have experience as an auditor, accountant, chief accounting officer or chief financial officer. The third proxy is board career experience. This study measures the experience of directors in public sectors as the proportion of directors with experience in public sectors on board. Prior research suggested that firm size may influence the earnings quality. Dimitropoulos and Asteriou (2010) revealed that there is a positive and significant relationship between firm size and discretionary accruals. This is consistent with Chen, Lin and Zhou (2005), who revealed that in the IPO year, there is likelihood that large firm would have the high discretionary accruals. Thus, this study will use the firm size, measured as the natural log of total assets to control for this effect.

3.1 Regression model

This model is developed to test the relationship between earnings quality and board profile. The estimate logistic regression model is as follows:

$$EQ = \beta_0 + \beta_1 LOCK + \beta_2 FEXPERT + \beta_3 EXP + B_4 FSIZE \quad (6)$$

Where,

EQ = earnings quality
Proxy:
DAC = absolute discretionary accruals
LOCK = multiple directorship
FEXPERT = financial expertise
EXP = experience
FSIZE = firm size

4. DATA ANALYSIS

Descriptive statistics of firm earnings quality, board profiles and firm size is presented in table 1. DAC (earnings quality proxy) measures the extent manager manages the earnings using discretion. The table shows that, the reported mean is 0.1147. This finding shows that the magnitude of earnings management in selected sample has about 11% of prior year total assets. This finding suggests that Malaysian companies do practice earnings management. It can be seen from the table below the high ratio of multiple directorship compares to financial expertise and experience may reflect that in appointing new directors, the company would also consider candidates that have the directorship experience in other companies.

Table 1: Descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DAC	339	.0005	.7405	.114674	.1026617
LOCK	339	.0000	1.0000	.463950	.2564662
FEXPERT	339	.0000	.7500	.171515	.1425645
EXP	339	.0000	.8000	.279750	.1888523
FSIZE	339	19003	71363010	3296694	8202112

Table 2 reveals that there is a negative linear correlation between DAC and FEXPERT at 1% level. This is consistent with Chen, Elder and Hsieh (2007). This result shows companies with more financial expertise on board is more likely not to engage in earnings management activities, suggesting those companies would have the high earnings quality. In addition, LOCK has the positive linear relationship with FEXPERT and EXP. This suggests that company with more proportion of directors with multiple directorships would also have more financial expertise and more directors who have experience in public sectors. Table 3 also reveals a positive and significant correlation between firm size and LOCK and EXP. Thus, this result shows that large company have more directors who hold more directorships in other companies and have wide experience in public sectors.

Table 2: Correlations

	DAC	LOCK	FEXPERT	EXP	FSIZE
DAC	1				
LOCK	.043	1			
FEXPERT	-.144**	.126*	1		
EXP	-.085	.233**	-.124*	1	
FSIZE	-.025	.434**	.037	.168**	1

Note: ** is significant at 0.01 level (2-tailed), * is significant at 0.05 level (2-tailed).

4.1 Regression analysis

Regression analyses were employed to test the influence of three important variables of interest namely multiple directorships, financial expertise and board experience. The r-square statistic in the table 4 is 0.041. This infers that only 4.1% of the variation or changes in the dependent variable (namely earnings quality, proxy by absolute discretionary accruals) can be attributed to the three independent variables; however the remaining 95.6% is not known and need further investigation.

Table 3: Model summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.203[a]	.041	.030	.47948

Note: Predictors: (Constant), FSIZE, FEXPERT, EXP, LOCK, Dependent Variable = DAC

As observed in table 5, the significant level produced by the ANOVA table showed that p value is less than 5% implying that the model is valid and the result of the relationship is not by chance. Based on result in table 6, this study found that out of the three independent variables, multiple directorships does not provide enough evidence to influence the dependent variable. Only two remaining independent variables (FEXPERT : Beta = -0.172, p<0.01 and EXP: Beta= -0.124, p <0.05) has truly influence the absolute discretionary accruals. As per expectation in H2 and H3, this study revealed that there is a significant relationship between board profile (namely financial expertise and experience) and earnings quality.

Table 4: ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3.301	4	.825	3.590	.007[b]
	Residual	76.787	334	.230		
	Total	80.088	338			

Note: Dependent Variable: DAC
Predictors: (Constant), FSIZE, FEXPERT, EXP, LOCK

The table 6 below shows that, the coefficient for financial expertise (FEXPERT) is significantly negative (at 1% level) with absolute discretionary accruals (DAC). This finding is consistent with prior research (Chang and Sun, 2010), shows that high proportion of directors with financial expertise is associated with lower absolute discretionary accruals, suggesting higher quality of reported earnings. This finding suggests that the directors with accounting-related expertise are effective in monitoring the manager from manipulating the accounting earnings. Thus, the result of this study shows that financial expertise is essential in enhancing the quality of earnings.

Table 5: Regression result for firm earnings quality, board profile and firm size

Model		Standardized Coefficients Beta	t	Sig.
	LOCK	.114	1.864	.063
	FEXPERT	-.172	-3.137	.002
	EXP	-.124	-2.225	.027
	FSIZE	-.047	-.787	.432

Note: Dependent Variable: DAC

As observed in table 6, the coefficient for director's experience (EXP) is significantly negative (at 5% level) with absolute discretionary accruals (DAC). This finding shows that high proportion of directors with experience in public sector is associated with lower absolute discretionary accruals, suggesting higher quality of reported earnings. This finding is consistent with Labelle *et al.,* (2010), who found that firm with director who poses various management experience are less likely to engage in earnings management activities. This finding suggests that director's experience would reflect their ability to assume greater responsibility in ensuring high quality of reported earnings. This study shows no convincing evidence that there is a significant relationship between firm size and absolute discretionary accruals, suggesting no relationship between firm size and the firm's earnings quality in top 150 MSWG ranked companies.

5. CONCLUSION, LIMITATION AND FUTURE RESEARCH

The first objective of this study is to examine the relationship between board of director's profile and earnings quality. The findings from univariate analyses show that company with high proportion financial expertise is associated with lower absolute discretionary accruals,

suggesting high quality of earnings. Thus, the analyses provided evidence that financial expertise influence the quality of reported earnings. The second objective of this study is to examine the impact of board profile on the earnings quality. The regression result of this study revealed that financial expertise and board experience has the negative impact on absolute discretionary accruals. Thus, the analyses provided evidence financial expertise and board experience have a significant impact on the quality of reported earnings. Notwithstanding the finding, the current study has the limitations. The sample used was only restricted to top 150 MSWG ranked companies that are believed to have the good corporate governance practices. Hence, other companies which are not very good in disclosure of compliance of corporate governance practices were not taken into the sample. This study revealed that the adjusted r-square value is too small. Thus, in future research, other variables or other sampling techniques could be used to explain the relationship between board of director's profile and earnings quality. Future research also can be carried out by using other measurements of earnings quality; timeliness, earnings persistence etc.

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