

**Corporate Governance and Earnings Management:  
Incentives in Malaysian IPO Companies**

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**Abstract**

The main objective of this paper is to investigate the relationship between audit quality (measured by auditor size) and corporate governance mechanism (Audit committee and Board of Director) impact on earnings management for IPO companies in Malaysia. This current study employs the modified Jones model 1995. The findings reveal that the audit quality proxy by auditor size does not have any significant relationship with earnings management for IPO companies in Malaysia. In addition, the independence of audit committee and total number of non-executive directors has positive relationship with earnings management. The possible reasons are management dominance over board matters and lack of knowledge among the directors on the daily affairs of the company. Therefore, results of this study provide useful information for the accounting literature and practitioners on the effective practice of corporate governance mechanism (audit committee and Board of Directors) and the choice of auditors in Malaysian IPO companies.

**Keywords:** *Audit quality, Earnings management, Malaysian IPO companies, Corporate governance*

**1. INTRODUCTION**

Delivery of high quality audit is the key driver of success for all professional auditing firms. Quality audit service is at the core of business strategy, and is absolutely vital to the public interest responsibilities of professional accountants (IFAC Report 2007). According to Jensen and Meckling (1976), agency theory suggests that as a result of information asymmetries and self-interest, principals may have a lack of reasons to trust their agent and will seek to resolve these concerns by putting in place mechanisms such as auditing to monitor the agents. Therefore, auditing serves as a fundamental purpose in promoting confidence and reinforcing trust in the financial information (MIES-4 Report, Institute of Chartered Accountant of Pakistan 2005). Moreover, it also promotes accountability.

In promoting confidence and accountability, both, the auditing role of the external auditors and the monitoring function of the audit committee are important. This issue has become a heated debate (Mitchell, Singh and Singh 2008). In the United States (US), Sarbanes Oxley Act requires organizations to compose their audit committee solely of independent directors. However, in Malaysia, under section 344A (2) of the Bursa Malaysia Listing Requirement emphasize that audit committee should consist at least a minimum of three members and majority of the members should be independent directors. A number of prior studies have found relation between the audit quality and IPO firms setting (Becker 1998; Albring 2007; Lee *et al.* 2003). Limited published studies have examined the impact of audit committee independence, board of director's shareholding composition and audit quality issues mutually in mitigating the earnings management. Therefore, this study provides additional evidence on the choice of high quality (i.e. Big four) auditors by initial public offering (IPO) firms in Malaysia for two consecutive years, 2007 and 2008. In addition, this study

investigates the impact of monitoring role of the audit committee and Board of Directors in mitigating the issue of earnings management in IPO companies.

## **2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

Going public is a major corporate event for a company to raise additional capital funding the growth of the company and to enhance the entrepreneur's personal wealth (Chen *et al.* 2005). Kuala Lumpur Composite Index (KLIC) has provided a list of guidelines for companies interested to be listed in Bursa Malaysia (BM). One of the criteria to be listed in Bursa Malaysia is that companies could not be in a loss position for two consecutive years. Therefore, there is a tendency for the managers to manage the earnings if the financial condition does not meet the stated requirement. Prior studies have investigated audit quality and its relationship with earnings management (Becker, Defond, Jiambalvo and Subramanyam 1998; Becker 1998; Albring *et al.* 2007; Lee 2003; Chen *et al.* 2005). Chen *et al.* (2005) found that big firm auditors are related to less earnings management in IPO year. This evidence suggests that better quality auditors (proxied by the Big four audit firms) could constrain earnings management for Taiwan IPO firms.

Although, it is well understood that the company's profit to some extent depends on the business cycles and economic condition, managers have the incentives to manage the earnings towards some desired level. Accruals from revenue, expenses, gains and losses can be shifted from one year to another (Chung *et al.*, 2001). The impact of this behaviour is temporary because these accruals, which are discretionary usually reverse in a future period. According to Becker (1998), prior literature suggests that auditors are more likely to object management's accounting choice that increases the earnings (or decrease earnings).

Audit quality has been the main concern for the accounting world since the collapse of Enron to corporate scandals that happened in Malaysia for example the Transmile Bhd and Megan Media Berhad. Therefore, the emphasis now is on the quality of the auditor's work in performing their audit engagement. In fact, it has also raised concerns about audit quality among the Big auditing firms, which are normally considered the premier accounting firms associated with higher audit quality (Chen *et al.*, 2005). Hence, it is hypothesised that:

H1: *There is a significant negative relationship between audit quality and earnings management.*

The beginning of the twenty-first century is full with numerous accounting scandals globally. The series of events underscores the importance of good corporate management which associated to corporate governance (Mitchell *et al.* 2008). Much attention has been concentrated on the issue of the monitoring function of the audit committee on the the management. The audit committee and the internal audit department are the internal monitoring function of the company. They monitor the management on behalf of the shareholders. While the external audit function is expected to give reasonable assurance and confidence on the overall system and reports. Mitchell *et al.* (2008) suggest that interaction between external auditors and the audit committee can potentially improve the quality of information provided to the external stakeholders.

Prior research have examined the issue of audit committee and earnings management and found that the presence of a fully independent audit committee reduces earnings management practices in Malaysia (Mohd-Saleh *et al.* 2004). In another study, Lin *et al.* (2006) found that there is a negative association between the size of audit committees and the occurrence of earnings management. In fact, the remaining audit committee characteristics are not found to have a significant impact on the quality of the reported earnings. This contradict the findings of study conducted by Abdul Rahman and Fairuzana

(2006) which evidence that earnings management is positively related to the size of board of directors. The findings support that larger board of director appears to be ineffective in their role oversight monitoring duties relative to smaller board. Hence, based on the above arguments, it is hypothesize that:

H2: *There is a significant negative relationship between independence of audit committee and earnings management.*

The composition of the Executive and Non executive directors in the Board is another internal monitoring agent for the company. According to Agency theory (Jensen and Meckling 1976) in order to increase the independence of the Board composition is by increasing the number of outside directors of the non executive directors in the Board composition. Hence, the presence of the non-executive directors may influence the quality of the directors thought and decisions and hence could improve performance of the firms (Abdul Rahman and Fairuzana 2006). In Malaysia, based on the Revamped Listing Requirement 2001, all public listed companies must comprise of at least one-third of their board of directors with independent non-executive directors. This is to enhance the independence of board members from the management. A number of prior studies supports that monitoring role would be more effective with higher composition of non-executive directors in the Board (Agrawal and Knoeber 1996). Therefore, this lead to the following hypothesis:

H3: *There is a significant negative relationship between non-executive Board of Directors and earnings management.*

### **3. RESEARCH METHODOLOGY**

The initial sample data consist of 51 IPO companies in Malaysian that was listed in the year 2007 and 2008. These companies are then screened for the availability of data from the DATASTREAM site. In addition, some of the data are collected manually from the Prospectus and Annual Reports of the respective companies. This is due to the unavailable data from the DATASTREAM website. Data related to the total number of non-executive directors, auditors and Independent Audit committee members are gathered from the company's annual report and prospectus. Therefore, the final samples comprise of 39 companies and this is after eliminating companies from the financial institution and companies with incomplete data available from the annual report and prospectus as well as from DATASTREAM website.

#### **3.1 Measurement of earnings management**

Prior studies have used various methodologies to detect the effect of accounting choice on reported earnings (Becker *et al.* 1998). Therefore, based on modified Jones model by Dechow *et al.* (1995), the computation of the earnings management will be used in this study. This model is the most powerful tools to detect earnings management among the alternative models to measure the unexpected accruals (Dechow *et al.* 1995). In employing this model, the discretionary accruals (DACC) comprise of total accruals (TACC) minus the non-discretionary accruals or normal accruals (NACC).

The model is as follows:

$$\text{DACC} = \text{TACC} - \text{NACC} \quad (1)$$

Hence, to compute the TACC, modified model Jones (Dechow *et al.* 1995) are used in this study and the model is as follows:

$$TACC_{it} = (\Delta CA_{it} - \Delta CASH_{it} - \Delta CL_{it} - \Delta STD_{it} - DEP_{it}) / TA_{it-1} \quad (2)$$

$$NAC_{it} = a_1(1/TA_{it-1}) + a_2(\Delta REV_{it} - \Delta REC_{it})TA_{it-1} + a_3PPE_{it}/TA_{it-1} + \varepsilon_{it} \quad (3)$$

Where:

TACC <sub>it</sub>	=	Total accruals for firm i in year t, defined as above
ΔCA <sub>it</sub>	=	Change in current assets for firm i in year t
ΔCASH <sub>it</sub>	=	Change in cash for firm i in year t
ΔCL <sub>it</sub>	=	Change in current liabilities for firm i in year t
ΔSTD <sub>it</sub>	=	Change in short-term debt for firm i in year t
ΔDEP <sub>it</sub>	=	Change in depreciation for firm i in year t
ΔREV <sub>it</sub>	=	Change in revenue for firm i in year t
ΔREC <sub>it</sub>	=	Change in receivables for firm i in year t
PPE <sub>it</sub>	=	Net property, plant and equipment for firm i in year t
TA <sub>it-1</sub>	=	Total assets for firm i in year t-1
DACC	=	Discretionary accruals
NAC <sub>it</sub>	=	Non discretionary accrual or normal accruals

### 3.2 Measurement variables

Consistent with Becker *et al.* (1998) and Chen *et al.* (2005), this study incorporates the absolute value of DACC as the dependent variable. The direction of earnings management is disregarded to include the combined effect of income increasing and income decreasing earnings management (Abdul Rahman and Fairuzana 2006). The variables for audit committee and Board of Directors are measured during the year of IPO listing in Bursa Malaysia. The variable that represents the audit committee is the independence of audit committee. This is measured by the number of members that are independent in the audit committee board composition. This is similar method used in study by Abdul Rahman and Fairuzana (2006). Then the number is proportion to percentage before it is analyse in the SPSS software program. Same treatment is made for the measurement of non-executive member of Board of Directors. This method is consistent with study by Xie *et al.* (2003) and Peasnell *et al.* (2001).

However, for the audit quality, the measurement is using the size of the audit firms which comprise of Big four and non-Big four. This is consistent with other prior studies that used the same measurement for the audit quality variables (Becker *et al.* 1998; Chen *et al.* 2005; Tomezyk 1996). In addition, the log of total assets for the year of IPO listing is used as the control variable in this study. This control variable is proxy for size because smaller firms are less scrutinised by authorities and is therefore more inclined to manage earnings (Becker *et al.* 1998; Chen *et al.* 2005; Abdul Rahman and Fairuzana 2006). Therefore, inclusion of these control variables results in the following regression model:

$$DACC_{it} = \beta_0 + \beta_1 BIG4_{it} + \beta_2 INDAC_{it} + \beta_3 NEXBOD_{it} + \beta_4 SIZE_{it} + \varepsilon_{it} \quad (4)$$

The inclusion of ROA and LEV is usually necessary for control variable where:

DACC <sub>it</sub>	=	Total discretionary accruals for firm i in year t, defined as above
BIG4	=	1 if the auditor is audited by Big four audit firms; 0 if otherwise
INDAC	=	Proportion the total number of independent audit committee from the total number of audit committee members
NEXBOD	=	Proportion the total number of non-executive directors from the total number of Board of Directors
SIZE	=	Log of total assets for the current year of IPO

## 4. RESULTS

Results for the hypotheses are presented in Table 1 to Table 5.

### 4.1 Descriptive statistics

The sample of this study consists of 51 observations of new issuance for IPO for two consecutive years which are the 2007 and 2008 from the Bursa Malaysia website on IPO summary. These data have satisfied these criteria of i) IPO date and the auditor for the IPO are available from the DATASTREAM website or the prospectus and annual reports; 2) the necessary data used for computing the total discretionary accruals, total accruals, number of independent audit committee and number of non-executive directors are available from the DATASTREAM and annual reports. Table 1 provide details of the sample selection. After eliminating one financial services company and 11 companies with missing data, the final samples between 2007 and 2008 amounted to 39 firm-year observations.

Table 1: Sample selection

Industries	2007	2008	Total
Industrial	3	8	11
Trading/Services	12	10	22
Consumer Product	3	2	5
Technology	2	2	4
Properties	0	1	1
Construction	1	0	1
Reits	4	0	4
Plantation	2	0	2
Total	27	23	50
Missing Data	5	6	11
Total Sample			39

Table 2 provides detail type of auditors for IPO companies in 2007 and 2008. Surprisingly, the Big four auditors audited only 44 percent of the IPOs in the two selected years. It contradict the assumption that companies need the assistance from Big four auditors for the IPO listing year to ensure high quality of information provided in the prospectus and annual report. This is because Big four auditors are assumed to have the expertise and knowledge as compared to the non-Big four auditors. The result contradicts Chen *et al.* (2005) findings that evidence the total number of companies audited by the Big four auditors is higher than the total number of companies' auditor by the non-Big four auditors.

Table 2: Samples of IPO firms by year and by type of auditor

Type Of Auditor	2007	2008	Total
Big Four	13	4	17
Non-Big Four	9	13	22
Total	22	17	39

### 4.2 Test-of-mean

Table 3 shows the descriptive statistics for the dependent, independent and control variables of the study. As described here, the 49% of the sample firms audited by the Big four audit firms and approximately 44% of the Board of directors composition comprise of nonexecutive directors.

Table 3: Descriptive statistics of variables

	Min	Mean	Max	Median	Skewness	Kurtosis	Std Deviation
DACC	-59.51	-11.69	19.98	-10.792	-2.267	16.414	10.114
Big4	0.00	0.490	1.00	0.00	0.056	-2.114	0.507
INDAC	0.00	0.757	1.00	0.670	-1.009	4.123	0.198
NEXBOD	0.00	0.444	0.75	0.500	-0.577	0.058	0.188
LOGTA	0.00	5.099	6.49	5.053	-3.563	18.531	0.993

### 4.3 Correlations

As illustrated in Table 4 below, all the independent variables used in this study are not significantly related to earnings management except for the control variable which is the size of the company measured by the log of total assets. The size of company is significant at 0.05 with positive correlation of 39 percent. Hence, this evidence that the bigger the company size, there is a tendency for the manager to manage the earnings.

Table 4: Correlation analysis variables

DACC	1.000					
Big4	0.066	1.000				
INDAC	-0.209	-0.367*	1.000			
NEXBOD	0.078	-0.036	0.014	1.000		
LOGTA	0.390*	0.139	-0.337*	-0.285	1.000	

Note: \*Correlation is significant at the 0.05 level (2-tailed).

However, there is a significant negative correlation between the auditor and the independent of audit committee at 0.05 levels. This might be due to the lesser the independent directors in the audit committee therefore there is a tendency to hire auditor from Big four firms. This is in order to ensure that the quality of the financial reporting produce for the shareholders is higher of quality with the assistance of the Big four auditors. The highest correlation as disclosed in the table is between size of the company (LOGTA) and the earnings management (DACC) with the amount of 0.390. This confirms that there is no multicollinearity among the variables since none of the variables correlates above 0.8 or 0.9 (Pallant J. 2007).

### 4.4 Simple linear regression analysis

Table 5 below indicates that the Big four auditors do not reduce the earnings management for IPO firms in Malaysia for the selected two years of 2007 and 2008. This result is not consistent with prior studies that indicate the big auditing firms do reduce the earnings management of IPO firms (Chen *et al.* 2005; Becker *et al.* 1998; Copley and Douthett 2002). However, the result is consistent with study by Siregar S. and Utama S. (2008) evidence that the Big four auditors do not reduce the earnings management activity in publicly listed companies on the Jakarta Stock exchange, Indonesia.

Table 5 also indicates that there is no significant relationship between the earnings management and the independent of audit committee, non-executive directors and size of the IPO companies. Therefore, this result is consistent with findings of prior studies that evidence the negative relationship between the total independent number of audit committee and non-executive directors and earnings management among the IPO companies (Abdul Rahman and Fairuzana 2006; Lin *et al.* 2006 and Siregar S. and Utama S. 2008). However, there are studies that evidence the independent of audit committee has negative association with earnings management (Norman *et al.* 2005; Klein 2002). The control variable used in this study which is log of total assets as measurement for the companies size also do not indicate any significant relationship with earnings management.

Table 5: Multiple regression results between DACC and audit quality (big4), independence of audit committee, non-executive board of directors and size of the companies

Model	Coefficients	Standardized Coefficient	T	Sig
Intercept	-0.364		-0.026	0.979
BIG4	-2.312	-1.116	-0.648	0.522
INDAC	-14.574	-0.286	-1.514	0.140
NEXBOD	10.155	0.189	1.085	0.286
LOGTA	-0.722	-0.071	-0.389	0.700
R2	8.8			

## 5. SUMMARY AND CONCLUDING REMARKS

The main objective of this study is to examine the relationship between audit quality which is proxy by auditing firm size (Big four and Non-big four), Independent members of audit committee and non-executive Board of Directors and earnings management. Most prior research evidence that audit quality could reduce the earnings management activity. However, results of this study do not support this statement. Based on the samples selected for IPO companies in Malaysia for the year 2007 and 2008, big four audit firms only audited approximately 47 percent of the total companies listed in IPO. The rest of the companies are audited by the non-big four firms in Malaysia.

Other findings from this study that relates to the corporate governance mechanism issues are the independent of audit committee and the total number of non-executive directors and earnings management. According to Abdul Rahman and Fairuzana (2006), the explanation for insignificant relationship between corporate governance mechanism and earnings management may be based on the managerial '*hegemony theory*'. This theory is contradicting to the '*agency theory*' on the ground that the board of directors are seen as ineffective in discharging their monitoring role is because of the management dominance over the board matters. In addition, the outside board members are not familiar with the knowledge of the companies' daily affairs besides being too busy with their other commitments elsewhere (Abdul Rahman and Fairuzana 2006).

Limitation of the study is that this study is using a small number of data for the analysis of IPO companies in Malaysia. In addition, some of the data are not available in the DATASTREAM website or the prospectus of the respective companies. For future research, this area of study could be further investigated using a much more rigorous data with more number of years of observation to gain useful findings regarding IPO companies in Malaysia.

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