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Research paper

Investigating the effects of corporate governance on the relationship between earning management and corporate performance in the Bursa Malaysia

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Abstract

The lack of transparency in financial reports has several reasons, but the most important is earnings management practice which is implemented by managers. Indeed, managers by using Earnings Management tools manipulate accounting information to achieve some goals. Corporate governance, whose primary goal is to deal with identifying potential mechanisms in which the shareholders of a corporation have more power and exercise control over the managers to protect their interests. This study investigates whether corporate governance affects the relationship between earnings management and firm performance by using listed companies' data in Bursa Malaysia. Data from FTSE Russell has been used by applying the intersection function to the constituents of FTSE Top 100 Bursa Malaysia during the years 2011 to 2015, which includes 59 companies in the form of 295 company-year. The results show that discretionary accruals (DAs) have a significantly negative effect on return on equity and has significant positive effects on Tobin's q in the case of lack of consideration corporate governance moderating effect. On the other hands by considering the moderating effect of corporate governance variables, this equation has been changed, and the negative effect of earning management effects turns to neutral on ROE, and This effect has not been changed regarding Tobin's q.

Keywords: *Corporate governance, Earnings management, Corporate performance, Discretionary current accruals.*

1. Introduction

The increasing pace of globalization, the deregulation and integration of capital markets in 1997, the world witnessed what came to be known as the South East Asian financial crisis (Mitton, 2002). When all the ASEAN (Association of Southeast Asian Nations) countries ranging from Thailand to South Korea faced an economic crisis, which led to a deceleration of economic growth in the area (Lemmon & Lins, 2003). The series of recent financial scandals around the world, and the spectacular corporate collapses which took place in Europe and the USA (e.g., WorldCom, Enron, Parmalat, and Xerox), have driven the previously robust debate on how to reduce the conflict between shareholders and managers and draw an efficient corporate governance system that will encourage sustainable economic growth. (Grant & Visconti, 2006)

The growing importance of a robust corporate governance regulatory structure gathered momentum after the events aforementioned.

Furthermore, corporate governance, whose primary goal is to deal with identifying potential mechanisms in which the shareholders of a corporation have more power and exercise control over the managers to protect their interests, has recently brought the acute attention of academics and policymakers around the world. As a response to such scandals, and as a primary approach of protection for shareholders and stakeholders, an explicit strategy has developed concerning public listed companies adopting proper corporate governance standards. In fact, listed companies in most major markets throughout the world are now required to take high corporate governance standards. Particular attention is given to the corporate governance as it is widely regarded as one of the critical mechanism which affects firm performance. (Brav, Jiang, Partnoy, & Thomas, 2008)

Next, a brief overview of the evolution of the Malaysian Code on Corporate Governance is given. Here, this study aims to illustrate how corporate governance could be affected by the relationship between earnings management and firm performance and which part shall have more effects on this equation. However, by referring to previous research findings and also recent incidences of corporate performance and earning management, this study challenges the notion of effective corporate governance monitoring in Malaysian listed companies. In this dissertation, it will address two critical related questions on governance and firm performance, which have not been adequately answered in the existing academic literature. Individually, it will be examined (1) whether governance changes lead to an effect on the correlation between earning management and substantial performance changes, and (2) what causes firms to change their governance. This study will cover the academic literature related to this topic and, in particular, review the corporate governance mechanisms literature, focusing mainly on the agency theory impact. The significance of this study academically and practically will be demonstrated and established through further discussion. This introductory chapter will present the study background, its objectives, importance, and significance.

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2. Background of Study

The separation of management and ownership of the modern public corporation presents agency-related problems including conflicts of interest and management. Conflicts of interests and unethical management are represented by managerial behaviours devoid of any ethical principles. The operating strategy is the exploitation of opportunities for personal gain to the extent that no other consideration matters. Even legal and professional standards are viewed as barriers to be overcome rather than as guides for appropriate behaviours (Hellriegel, Slocum, & Woodman, 1989, p. 94).

The concept of corporate governance has been in existence for a long time, but it was formalized in the UK in the early 1990's. It all started with Cadbury Committee Report (1992) which was a committee formed in the UK due to a massive spate of financial scams and corporate failures in the 1980s. It was established by the London Stock Exchange, the Financial Reporting Council and the accountancy professionals. The main aim of the committee was to discuss financial aspects of Corporate Governance. This report was followed by Greenbury Report (1995) which was a study on Director's remuneration; Hampel Report (1998) was a committee on Corporate Governance and Turnbull Report (1999) which talked about obligations of directors. Till then most of the Asian countries did not have any legislation regarding corporate governance neither were they planning to move towards any in this area.

In 1997, the world witnessed what came to be known as South East Asian financial crisis when all the ASEAN countries ranging from Thailand to South Korea faced an economic crisis which led to a deceleration of economic growth in the area. Lot of research work has been done to find out the reasons that led to this crisis. It was thought that there was a relationship between corporate governance and the South-East Asian crisis. Did the crisis expose corporate governance problems, or did corporate governance problems trigger the onset of the crisis?

Equity theory of organizational behavior focuses on how feelings of unfairness and inequities in corporations could affect investor perceptions and actions. Inequity exists when corporate executives receive huge compensations including golden parachutes while investors lose significant fortunes of wealth. The assumption is that investors make investments and expect substantial financial results and would naturally compare their returns with others including corporate managers' to determine the equity of their situations. Equity theory predicts tension between investors and corporate executives when inequity is perceived to exist in public corporations. Investors would lose confidence in corporate executives and financial markets and would stop or reduce their investments in financial markets. Thus, investors would undoubtedly transfer investable funds to investable areas where equity is perceived to exist. As lack of confidence in financial markets and tension within public corporations causes a severe decline in investment performance, insolvency of financial institutions, and rising unemployment (Reinganum, 2009) efforts should be made to reduce such adverse events. Internal and external causes of corporate executive behaviour are attributed to excessive risk-taking, lack of transparency, insufficient board oversight, and remuneration systems that are not related to strategy and risk (Kirkpatrick, 2009). Good corporate governance is significant for the growth and survival of modern corporations.

Apart from helping corporations mitigate conflicts of interests and meet legal requirements, good corporate governance makes corporations attractive to wealthy and institutional investors. It also makes a corporation an attractive business alliance partner, which helps the corporation obtain profitable investment opportunities (De Nicolo, Laeven, & Ueda, 2006; Julien & Riegel, 2003). Corporate governance also increases accountability, reliability, and predictability of decision-making (Mehta, 2006). Mehta (2006) argued that corporate governance helps to build trust and ensure equal treatment of stakeholders.

Making a causal argument that better corporate governance leads to better firm performance is, therefore "jumping the gun," or at the very least, incomplete. It is believed that the steering agent for the survival and the growth of the company is primarily its 'Corporate Governance' policies. Corporate governance refers to the code of conduct through which companies are directed and controlled. Whether the company follows the stakeholder model (where all the stakeholders are considered equally important) or follows the shareholder model (where more importance is given to shareholders as they are the owners of the company), the practice of corporate governance is increasingly becoming vital. Charreaux and Desbrières (2001) discuss this very crucial point of difference between stakeholder value and shareholder value. The increase in financial and managerial scams has led the investors to increasingly look for transparency and professional management in handling the company's business. This was one of the original questions in front of the researchers. Some research works mentioned that lack of transparency and independent management were one of the reasons for the Asian crisis whereas some of the articles mentioned that the crisis exposed such problems and organizations like the IMF stressed on having good governance practices to prevent it in future. Thus, good corporate governance would help a corporation lower its weighted average cost of capital, improve market values, and reduce financial distress.

3. Methodology and Result

3.1. Methods of Diagnostics Tests

This section is going to describe the main finding of the data analysis. First, this study represents the descriptive statistics related to all variables which consist of the independent, dependent, control and mediator variables. Second, the results of diagnostics tests regarding the test of each hypothesis will be explained. The following diagnostic tests have been applied to test the hypothesis; VIF test has been used to examine multicollinearity, F-Limer test has been administered to choose pooled or panel model, Hausman test determines which model should be used if the result in last test(F-Limer) is panel data.

There are two options (Fixed effects & Random effects). In this step base on the fixed or random effects, the further tests will be changed. If the random effects are selected as results of the Hausman test so, if the random effects have been chosen, the Breusch and Pagan Lagrangian multiplier test should be applied to find out the pooled or random effects which will be selected. In this step, if random effects have been selected same as fixed effect model, it must check heteroskedasticity & autocorrelation of the variables for each model. In the end, the final model of each hypothesis will be tested to find out the coefficient of each variable on the model. The below diagrams explain the analysis steps.

3.2. Model One

First of all the relationship of DAC and ROE has been analysed by panel data diagnostic tests the results present the substantial effects of DAC on ROE, in continuing this study will test the relationship of DAC and ROE by considering the impact of corporate governance variable as moderator.

$ROE\ it = \alpha_0 + B_1 DACit + B_2\ LEV\ it + B_3\ LMV\ it + B_4 MB\ it + e\ it$

Where

– αi (i=1….n) is the unknown intercept for each entity (n entity-specific intercepts).

– ROE it represents Return on equity as the dependent variable (DV) where i = entity and t = time.

– DAC it represents Earning Management as moderator variable (IV),
– LEV it represents Leverage as a control variable (CV),
– LMV it represents Log Market Value as a control variable (CV),
– MB it represents Market-to-Book Value as a control variable (CV),
– β1 is the coefficient for that IV,
– eit is the error term

Table 1: GLS Test Result Model 1

Cross-sectional time-series FGLS regression						
Coefficients: generalized least squares						
Panels: heteroskedastic						
Correlation: no autocorrelation						
Estimated covariances = 59			Number of obs	=	236	
Estimated autocorrelations = 0			Number of groups	=	59	
Estimated coefficients = 5			Time periods	=	4	
			Wald chi2(4)	=	27.38	
			Prob > chi2	=	0.000	
ROE	Coef.	Std. Err.	z	P>z	[95% Conf.	Inter-val]
DAC D1.	-2965.256	1186.453	2.5	0.012	639.8521	5290.661
LEV D1.	-0.01626	0.030825	-0.53	0.598	-0.07667	0.044159
LMV D1.	0.009983	0.039872	0.25	0.802	-0.06817	0.08813
MB D1.	0.024384	0.006683	3.65	0.000	0.011285	0.037483
_cons	0.105856	0.004062	26.06	0.000	0.097895	0.113817

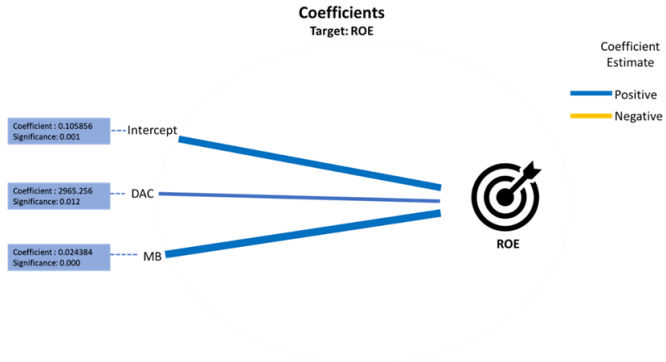


Fig. 1: Coefficient of the relationship between ROE and DAC

3.3. Model Two

Hypothesis of Model two: Corporate governance activities have a practical effect on the relationship among earning management and ROE inside the listed companies in Bursa Malaysia.

$ROE\ it = \alpha_0 + B_1\ DAC\ it + B_2\ CEOD\ it + B_3\ DS\ it + B_4\ SBS\ it + B_5\ BM\ it + B_6\ SBM\ it + B_7\ ID\ it + B_8\ NID\ it + B_9\ FO\ it + B_{10}\ SX\ it + B_{11}\ WB\ it + B_{12}\ AMG\ it + B_{13}\ NRCM\ it + B_{14}\ LEV\ it + B_{15}\ LMV\ it + B_{16}\ MB\ it + u\ it$

Where
– αi (i=1….n) is the unknown intercept for each entity (n entity-specific intercepts).
– ROE it represents Return on equity as the dependent variable (DV) where i = entity and t = time.
– DAC it represents Earning Management as moderator variable (IV),
– CEOD it represents CEO Duality as moderator variable (MV),
– DS it represents Board size as moderator variable (MV),
– SBS it represents Supervisory Board Size as moderator variable (MV),
– BM, it represents Board Meetings as moderator variable (MV),
– SBM it represents Supervisory Board Meetings as moderator variable (MV),
– ID it represents %Independent Directors as moderator variable (MV),
– NID it represents % Non-independent Directors as moderator variable (MV),
– SX it represents % Shares Executives as moderator variable (MV),
– FO it represents % Foreign Ownership as moderator variable (MV),
– WB it represents women on board as moderator variable (MV),
– AMG it represents Annual general meeting as moderator variable (MV),
– NRCM it represents Nomination and remuneration committee meeting as moderator variable (MV),
– LEV it represents Leverage as a control variable (CV),
– LMV it represents Log Market Value as a control variable (CV),
– MB it represents Market-to-Book Value as a control variable (CV),
– β1 is the coefficient for that IV,
– uit is the error term

Table 2: GLS Test Result Model 2

Cross-sectional time-series FGLS regression						
Coefficients: generalized least squares						
Panels: heteroskedastic						
Correlation: no autocorrelation						
Estimated covariances = 59			Number of obs	=	295	
Estimated autocorrelations = 0			Number of groups	=	59	
Estimated coefficients = 17			Time periods	=	5	
			Wald chi2(16)	=	1663.59	
			Prob > chi2	=	0	
ROE	Coef.	Std. Err.	z	P>z	[95% Conf.	Inter-val]
DAC	407.5176	478.5105	0.85	0.394	-530.346	1345.381
CEOD	-0.01579	0.004782	-3.3	0.001	-0.02516	-0.00641
DS	0.001687	0.000858	1.97	0.049	5.18E-06	0.003368
SBS	-0.0045	0.00091	-4.94	0.000	-0.00628	-0.00271
BM	-0.00022	0.000478	-0.45	0.652	-0.00115	0.000721
SBM	-0.00497	0.001189	-4.18	0.000	-0.0073	-0.00264
ID	0.018226	0.011575	1.57	0.115	-0.00446	0.040912
NID	-0.00035	0.009428	-0.04	0.971	-0.01883	0.018131
FO	0.093474	0.028741	3.25	0.001	0.037141	0.149806
SX	-0.03851	0.032	-1.2	0.229	-0.10123	0.024204
WB	0.003175	0.002236	1.42	0.156	-0.00121	0.007556
AGM	0.002922	0.004486	0.65	0.515	-0.00587	0.011714
NRCM	0.003635	0.001706	2.13	0.033	0.000291	0.006979
LEV	-0.00793	0.012287	-0.65	0.519	-0.03201	0.016156
LMV	-0.02167	0.005345	-4.05	0.000	-0.03215	-0.0112
MB	0.046513	0.001489	31.23	0.000	0.043594	0.049432
_cons	0.21848	0.05636	3.88	0.000	0.108017	0.328942

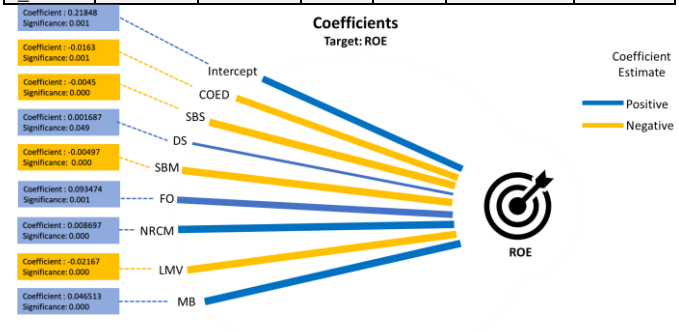


Fig. 2: Coefficient of the relationship between ROE and DAC by considering the effect of Corporate Governance as Moderator

3.4. Model Three

The relationship of DAC and TQ has been analysed by panel data diagnostic tests the results present the strong effects of DAC on TQ, in continuing this study will test the relationship of DAC and TQ by considering the effects of corporate governance variable as a moderator

$TQ_{it} = \alpha_0 + B_1DACit + B_2 LEV it + B_3 LMV it + B_4MB it + e it$

Where

– αi (i=1….n) is the unknown intercept for each entity (n entity-specific intercepts).

– TQit the ratio between a physical asset's market value and its replacement value as a dependent variable (DV) where i = entity and t = time.

– DAC it represents Earning Management as moderator variable (IV),

– LEV it represents Leverage as a control variable (CV),

– LMV it represents Log Market Value as a control variable (CV),

– MB it represents Market-to-Book Value as a control variable (CV),

– β1 is the coefficient for that IV,

– eit is the error term

Table 3: GLS Test Result Model 3

Cross-Sectional Time-Series Fgls Regression						
Coefficients: Generalized Least Squares						
Panels: Heteroskedastic						
Correlation: Common Ar(1) Coefficient For				All Panels (0.2084)		
Estimated Covariances = 59				Number Of Obs = 236		
Estimated Autocorrelations = 1				Number Of Groups = 59		
Estimated Coefficients = 5				Time Periods = 4		
				Wald Chi2(4) = 106.12		
				Prob > Chi2 = 0		
D.Tq	Coef.	Std. Err.	Z	P>Z	[95% Conf.	Interval]
Dac	1782.042	516.9468	3.45	0.001	768.8451	2795.239
Lev	0.666791	0.071878	9.28	0.000	0.525913	0.807669
Lmv	-0.02275	0.0269	-0.85	0.398	-0.07548	0.029971
Mb	0.037838	0.010967	3.45	0.001	0.016343	0.059334
_Cons	-0.06672	0.268376	-0.25	0.804	-0.59273	0.459288

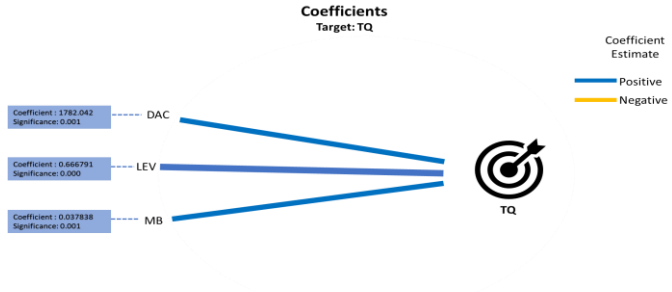


Fig. 3: Coefficient of the relationship between TQ and DAC

3.5. Model Four

Hypothesis of Model four : Corporate governance activities have a practical effect on the relationship among earning management and Tobin's inside the listed companies in Bursa Malaysia.

$TQit = \alpha_0 + B_1 DAC it + B_2 CEOD it + B_3 DS it + B_4 SBS it + B_5 BM it + B_6 SBM it + B_7 ID it + B_8 NID it + B_9 FO it + B_{10} SX it + B_{11} WB it + B_{12} AMG it + B_{13} NRCM it + B_{14} LEV it + B_{15} LMV it + B_{16} MB it + u it$

Where

– αi (i=1….n) is the unknown intercept for each entity (n entity-specific intercepts).

– TQit the ratio between a physical asset's market value and its replacement value as a dependent variable (DV) where i = entity and t = time.

– DAC it represents Earning Management as moderator variable (IV),

– CEOD it represents CEO Duality as moderator variable (MV),

– DS it represents Board size as moderator variable (MV),

– SBS it represents Supervisory Board Size as moderator variable (MV),

– BM, it represents Board Meetings as moderator variable (MV),

– SBM it represents Supervisory Board Meetings as moderator variable (MV),

– ID it represents %Independent Directors as moderator variable (MV),

– NID it represents % Non-independent Directors as moderator variable (MV),

– SX it represents % Shares Executives as moderator variable (MV),

– FO it represents % Foreign Ownership as moderator variable (MV),

– WB it represents women on board as moderator variable (MV),

– AMG it represents Annual general meeting as moderator variable (MV),

– NRCM it represents Nomination and remuneration committee meeting as moderator variable (MV),

– LEV it represents Leverage as a control variable (CV),

– LMV it represents Log Market Value as a control variable (CV),

– MB it represents Market-to-Book Value as a control variable (CV),

– β1 is the coefficient for that IV,

– uit is the error term

Table 4: GLS Test Result Model 4

Cross-Sectional Time-Series Fgls Regression						
Coefficients: Generalized Least Squares						
Panels: Heteroskedastic						
Correlation: Common Ar(1) Coefficient For				All Panels (0.6523)		
Estimated Covariances = 59				Number Of Obs = 295		
Estimated Autocorrelations = 1				Number Of Groups = 59		
Estimated Coefficients = 17				Time Periods = 5		
				Wald Chi2(16) = 668.32		
				Prob > Chi2 = 0		
Tq	Coef.	Std. Err.	Z	P>Z	[95% Conf.	Interval]
Dac	79.21989	1677.261	0.05	0.962	-3208.15	3366.59
Ceod	-0.06629	0.092472	-0.72	0.473	-0.24754	0.114948
Ds	0.001286	0.010501	0.12	0.903	-0.0193	0.021868
Sbs	0.010363	0.020933	0.5	0.621	-0.03066	0.05139
Bm	-0.01413	0.008394	-1.68	0.092	-0.03058	0.002327
Sbm	-0.01502	0.013544	-1.11	0.267	-0.04157	0.011523
Id	0.033711	0.132832	0.25	0.800	-0.22664	0.294057
Nid	0.234592	0.16789	1.4	0.162	-0.09447	0.563649
Fo	-2.06428	0.686627	-3.01	0.003	-3.41004	-0.71851
Sx	-0.11581	0.309735	-0.37	0.708	-0.72288	0.491264
Wb	0.087487	0.034129	2.56	0.010	0.020595	0.154378
Agm	-0.02325	0.031189	-0.75	0.456	-0.08438	0.037878
Nrcm	-0.00238	0.026388	-0.09	0.928	-0.0541	0.049341
Lev	1.005533	0.104395	9.63	0.000	0.800923	1.210142
Lmv	0.393384	0.075079	5.24	0.000	0.246233	0.540536
Mb	0.271545	0.01922	14.13	0.000	0.233876	0.309215
_Cons	-3.14623	0.763543	-4.12	0.000	-4.64275	-1.64971

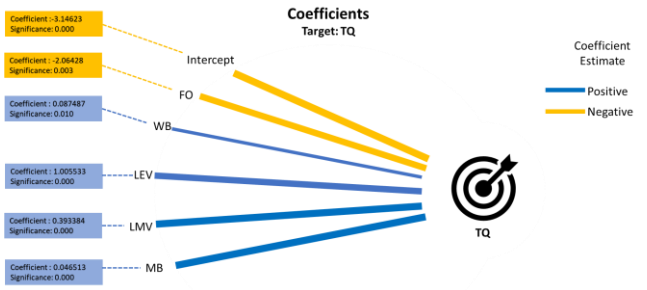


Fig. 4: Coefficient of the relationship between TQ and DAC by considering the effect of Corporate Governance as Moderator

4. Conclusion

According to the results of tests which show that the earning management activities have negative effects on firm performance, but whenever the corporate governance variables have played the role of moderating variables the effects of earning management activities have been covered, and it has been changed to neutral. In conclusion, this study has found that by applying the corporate governance strategies, it is possible to prevent management from abusing the firm performance.

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