BOARD CHARACTERISTICS AND EARNINGS MANAGEMENT
An Empirical Evidence Form Malaysian Listed Companies

HOCINE BOUGHEZALA HAMAD

College of Business
Universiti Utara Malaysia
2010
BOARD CHARACTERISTICS AND EARNINGS MANAGEMENT
An Empirical Evidence Form Malaysian Listed Companies

By
HOCINE BOUGHEZALA HAMAD
802042

A Thesis Submitted to the Fulfillment of the Requirement for the Degree Master of Science (Finance) College Of Business (Division of Accounting and Finance) Universiti Utara Malaysia 2010

@ Hocine Boughezala Hamad, 2010. All Right Reserved
DECLARATION

I am responsible for the accuracy of all opinion, technical comment and illustrations in this thesis except for citations and quotations that have been adequately acknowledged. I bear full responsibility for the checking whether material has been previously or concurrently submitted for any other master's program at UUM or other universities. UUM does not accept any liability for the accuracy of such comment, report and other technical information claims.

BOUGHEZALA HAMAD HOCINE  802042

College Of Business

University Utara Malaysia

06010 Sintok Kedah, Malaysia

10 October 2010
PERMISSION TO USE

In presenting this thesis in partial fulfillment for a post graduate degree from the Universiti Utara Malaysia, I agree that University Library may make it freely available for inspection. I further agree that permission for copying of this thesis in any manner, in whole or in part, for scholarly purposes, may be granted by my supervisor or, in her absence, by the Dean of Research and Postgraduate Studies, College of Business. It is understood that any copying or publication or use of this thesis or parts thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to Universiti Utara Malaysia for any scholarly use which may be made of any material from my thesis.

Requests for permission to copy or to make other use of materials in this thesis, in whole or in part should be address to:

Dean of Research and Postgraduate Studies

College of Business

Universiti Utara Malaysia

UUM, 06010, Sintok Kedah, Malaysia
ABSTRACT

This thesis investigates the relationship between board's characteristics and earning management on the companies listed on bursa Malaysia's main board, which examine roles of independence board, outside directors, CEO duality and management ownership in constraining the earnings management activities. In general, the study contributes to the literature by testing the issue of boards and investigates major board characteristics are related to earnings management by the firm, and it aims to provide empirical evidence according to regulatory and business environments in Malaysia. Hence, I have used data of eighty one firms from major sectors are available in bursa Malaysia, as below: industrial products, properties, plantation, hotels, consumer products, trade & services, technology, and construction sector. In addition, the time of period covered for this study in 2009 within Bursa Malaysia. This study finds a negative significant result of board independence, CEO duality, and outside directors to earnings management, results also indicates that ownership management has positive relationship to earning management. This indicates that the more manager own companies, that excessive shareholding more than 25% by managers may induce managers to manage earnings. While the matter of combined CEO and Chairman (CEO duality) is not effective to earnings management practice in Malaysia firms. board composition (outside directors) is not common in Malaysia firms as results indicate that have some companies haven't any outside director in their board directors, as suggested by the Cod of corporate governance in Malaysia is not satisfactory to monitor the management from earnings quality.
ACKNOWLEDGMENT

All praise to Allah Subhanahu Wa Ta’ala. The lord of universe, blessing and peace upon our prophet Muhammad Sal Allahu Allahi Wa Salam for giving guidance, courage and spirit to us in order to complete this thesis.

This thesis was written during the third semester of 2010/1011 at University Utara Malaysia in fulfillment of the Master Program in Science Finance. Many people have helped me with completion of this study and made the work possible.

I would like to express my sincere gratitude to my supervisor Dr. Mohd Bin’ Atef Md Yusof for his advice, patience, support, knowledge and encouragement throughout the completion of my thesis, may special gratitude to my all post graduate lecturers, and my great appreciation to for their excited classes among other class. I also would like to acknowledge the assistance of staff from the library and main Office of COB for their help.

I would like to express my special thanks to my family for their support and encouragement throughout my life, and my friends, as well as my classmates. Not forgetting also those who have contributed my life especially my family and my friends.

Thank you for your support. Only Allah could repay all your help and kindness.

Boughezala Hamad Hocine

College of Business

University Utara Malaysia

iv
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>DECLARATION</td>
<td>I</td>
</tr>
<tr>
<td>PERMISSION TO USER</td>
<td>II</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>IV</td>
</tr>
<tr>
<td>ACKNOWLEDGEMENT</td>
<td>V</td>
</tr>
<tr>
<td>TABLE OF CONTENTS</td>
<td>VI</td>
</tr>
<tr>
<td>LIST OF TABLES AND FIGURES</td>
<td>VIII</td>
</tr>
<tr>
<td>LIST OF ABBREVIATIONS</td>
<td>IX</td>
</tr>
</tbody>
</table>

## CHAPTER ONE: BACKGROUND OF STUDY

1.1 Introduction  1
1.2 Problem Statement  5
1.3 Financial reporting environment in Malaysia  6
1.4 Board Characteristics and Earnings Management  8
1.5 Research Questions  10
1.6 Objectives of study  10
1.7 Significance of the Study  11
1.8 Organization of the Thesis  12

## CHAPTER TWO: LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1 Introduction  13
2.2 Earnings Management  13
2.3 Hypotheses development  18
   2.3.1 Board Independence and Earnings Management  18
   2.3.2 Outside directors and Earnings Management  25
   2.3.3 CEO Duality and Earnings Management  28
   2.3.4 Management Ownership and Earnings Management  34
CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY

3.1 Introduction 38
3.2 Theoretical Framework 38
3.3 Hypotheses Development 40
3.4 Data Collection 40
   3.4.1 Population 40
   3.4.2 Sample Selection 40
   3.4.3 Procedures 41
3.5 Research Model And Measurement of Variables 41
   3.5.1 Definition Variables 41
      3.5.1.1 Dependent Variable (EM) 42
      3.5.1.2 Independent Variable 44
3.5.2 Model Specification and Analysis 46

CHAPTER FOUR: RESULTS AND FINDINGS

4.1 Introduction 47
4.2 Descriptive Analysis 48
   3.4.1 Sector Classification 49
   3.4.2 Director's Non-independence 49
   3.4.3 Directors' Independence 50
   3.4.3 Managerial Ownership 51
4.3 Descriptive Statistics 52
4.4 Correlation Analysis 55
4.5 Multiple Regression Results 57
CHAPTER FIVE: CONCLUSION

5.1 Introduction 60
5.2 Summary of General Findings 60
5.3 Limitation of Study 62
5.5 Recommendation for Future Research 63
5.6 Conclusion 65

REFERENCES 66

Appendix

a. Listed of firms were selected in main board of bursa Malaysia

b. Regression analysis tables
LIST OF TABLES AND FIGURES

<table>
<thead>
<tr>
<th>Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 3.1</td>
<td>Independent variables and control variables</td>
</tr>
<tr>
<td>Table 4.1</td>
<td>Sample distribution based on sector classification</td>
</tr>
<tr>
<td>Table 4.2</td>
<td>Percentage of Non-Independence Director of Sample Companies</td>
</tr>
<tr>
<td>Table 4.3</td>
<td>Percentage of Independence Director of Sample Companies</td>
</tr>
<tr>
<td>Table 4.4</td>
<td>Managerial Share Ownership of Sample Companies</td>
</tr>
<tr>
<td>Table 4.5</td>
<td>Descriptive Statistics of Continuous Variables</td>
</tr>
<tr>
<td>Table 4.6</td>
<td>Descriptive Statistics of Dichotomous Variables</td>
</tr>
<tr>
<td>Table 4.7</td>
<td>Correlations Matrix</td>
</tr>
<tr>
<td>Table 4.8</td>
<td>Multiple Regression Results</td>
</tr>
<tr>
<td>Table 5.2</td>
<td>Acceptability Hypotheses</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Figure</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure 3.1</td>
<td>Theoretical Representations of Relationships</td>
</tr>
<tr>
<td>Figure 4.1</td>
<td>percentage of number of Audit Quality</td>
</tr>
<tr>
<td>Figure 4.2</td>
<td>percentage of number of CEO Duality</td>
</tr>
</tbody>
</table>
LIST OF ABBREVIATIONS

FRF = Financial Reporting Foundation
MASB = Malaysian Accounting Standards Board
MCCG = Malaysian Code of Corporate Governance
MICPA = Malaysian Institute of Certified Public Accountants
IAS = International Accounting Standards
IBC = Independent Board’s Composition
GAAP = Generally Accepted Accounting principles
EM = Earnings Management
BC = Board’s Composition (Outside Directors)
CEO = Chief Executive Officer
CEO Duality = Chairman and Chief Executive Officer
MO = Management ownership
EPS = Earnings per Share
TA = Total accruals in year t
NI = Net Income in year t
CFO = cash flows from operating activities in year t
DAC = Discretionary accruals
IND = Directors independence
DUAL = CEO duality
OWN = Managerial ownership
ROA = Return on assets
LEV = Leverage
SIZE = Size
OCF = Operating cash flows
AUDIT4 = Audit quality
Chapter I

BACKGROUND OF THE STUDY

1.1 INTRODUCTION

In the period between 1997-1998, where crisis of the emerging market has spawned an enormous body of researches on Corporate Governance issues in emerging markets, on the contrary with traditional literature such as Berle and Means (1932), and Jensen and Meckling (1976)\(^1\), where Concerns regard corporate governance in East Asian countries emerged as a outcome of the East Asian financial crisis in 1997/1998. The crisis exposed the consequences of weak governance and poor governance standards were blamed indirectly in part for the crisis that weakened foreign investors’ confidence in the East Asian capital market, including Malaysia (Leng, 2004, Abdul Rahman and Haniffa, 2005).

After the Asian financial crisis in 1997, business community started to asking and indicating about the effectiveness of Corporate Governance mechanisms within an organization. The crisis is followed by the two famous cases of Enron in 2001 and WorldCom in 2002, as a result, many studies are believes that the existing Corporate Governance Mechanisms are not able to provide sufficient control over the utility maximization behavior of managers through the practice of earnings management. In order to improve the monitoring function of corporate governance mechanisms in Malaysia, the code of corporate governance was drafted in 1999 and subsequently approved in 2000 by the Ministry of Finance. The Code outlines some necessary

---

\(^1\) Both argue that when ownership and control of corporations are not fully coincident, there are potential conflicts of interest between owners and controllers. Managers, by controlling the daily operating activities of a firm, may extract private benefits at the expense of the firm’s ultimate owners - the shareholders
The contents of the thesis is for internal user only
REFERENCES


Malaysian Code on Corporate Governance. (2000), Malaysian Institute of Corporate Governance


Internet Reference

http://www.klse.com.my