

**The Effectiveness of Corporate Governance on Real Earnings Management in selected
Malaysian Companies**

By

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**A Master Dissertation Submitted to the Postgraduate Studies, Othman Yeop Abdullah
Graduate School of Business Universiti Utara Malaysia, in Partial Fulfilment of the
Requirement for the Degree of Master of Science in Finance**

DECLARATION

I hereby declare that the content of this thesis is solely based on my original work and has not been previously submitted for any other degree in Universiti Utara Malaysia or any other institutions. The quotations and citations used in writing this research have been duly acknowledged.

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ABSTRACT

The practice of real earnings management occurs at companies where investors' protection is high and stringent corporate governance measures are put to place. The study examines the relationship between corporate governance attributes and real earnings management. In this study real earnings management is measured using three proxies, abnormal discretionary expenses, abnormal production cost, and abnormal cash flow from operations. The corporate governance attributes examined are board structure characteristics and audit committee characteristics. The sample consist of top 100 companies rated high based on Malaysia Corporate Governance Index 2011 (MCG Index) on best practices of corporate governance. Financial companies are excluded resulted to a final sample of 78 companies. The relationships of board structure and audit committee are tested using Ordinary Least Square regression. The results reveal that certain corporate governance variables are effective in constraining real earnings management activities. The findings of the hypothesised variables, board structures and audit committee. The study find that only board size and directors expertise constrain earnings management, but none of the audit committee variables show significant relationship with real earnings management. It can be conclude that board size and directors expertise are constraining factors in constraining real earnings management. The finding of the study is important for market participant and policy makers in defining effective corporate governance mechanism that could address the issue of real earnings management.

ABSTRAK

Amalan pengurusan perolehan sebenar berlaku di syarikat-syarikat di mana perlindungan pelabur adalah langkah tadbir urus korporat yang tinggi dan ketat diletakkan ke tempat. Kajian ini mengkaji hubungan antara ciri-ciri tadbir urus korporat dan pengurusan pendapatan sebenar. Dalam kajian ini, pengurusan perolehan sebenar diukur menggunakan tiga proksi, perbelanjaan budi bicara yang tidak normal, kos pengeluaran yang luar biasa, dan aliran tunai yang tidak normal daripada operasi. Ciri-ciri tadbir urus korporat yang diperiksa adalah ciri-ciri struktur papan dan ciri-ciri jawatankuasa audit. Sampel terdiri daripada 100 syarikat diberi nilai tinggi berdasarkan Indeks Malaysia Tadbir Urus Korporat 2011 (MCG Index) mengenai amalan terbaik tadbir urus korporat. Syarikat-syarikat kewangan dikecualikan mengakibatkan sampel akhir 78 syarikat. Hubungan struktur lembaga pengarah dan jawatankuasa audit diuji menggunakan Biasa kurangnya Square regresi. Keputusan menunjukkan bahawa pembolehubah tertentu tadbir urus korporat yang berkesan dalam mengekang aktiviti-aktiviti pengurusan perolehan sebenar. Hasil pembolehubah hipotesis, struktur lembaga pengarah dan jawatankuasa audit. Kajian ini mendapati bahawa saiz papan sahaja dan kepakaran pengarah mengekang pengurusan perolehan, tetapi tiada pembolehubah jawatankuasa audit menunjukkan hubungan yang signifikan dengan pengurusan perolehan sebenar. Ia boleh membuat kesimpulan bahawa saiz papan dan kepakaran pengarah mengekang faktor yang mengekang pengurusan perolehan sebenar. Penemuan kajian ini adalah penting bagi peserta pasaran dan pembuat dasar dalam menentukan mekanisme tadbir urus korporat yang berkesan yang boleh menangani isu pengurusan perolehan sebenar.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Companies around the globe are mandated to produce financial statement in the form of annual reports at the end of their financial year. Financial statement of a company displays the picture of an organization's outcome and consequence of its activities. Management often uses this report for planning and control. Of this information, reported earnings are important elements that reflect the past operations and predict the future. Reported earnings are the addition of cash flow from operation and accruals.

In preparing the financial statement various statutory requirements and regulatory rules are adhered to, such as company law, accounting standards, taxation law etc. Among the preparers of the reported earnings, managers and auditors of company play very magnificent roles and these roles may be influenced by the economic settings of the environment that they operate.

The reported earnings are metrics that portray company status, effectiveness of management and depict its economic realities and financial prospects. Reported earnings numbers are important and serve as a candle light in providing costly, applicable and pertinent information to users, be it internal and external (e.g., shareholders, employees, investors, debt holders, managers and financial analyst) in making business decisions.

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