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## Mitigating Earnings Management: Adoption of IFRS and Corporate Governance Practices in Malaysia

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### Abstract

This study examines the effects of IFRS adoption and corporate governance practices on the qualities of financial reporting in Malaysia. The sample comprises a balanced panel of 360 firm-year observations of Construction firms under the Main Board of Bursa Malaysia from 2013 to 2016. This study accesses the effectiveness of effort by the Malaysian Accounting Standard Board (MASB) to improve the financial reporting by the revision process of the standard and their mandatory application. In addition, this study measures the relationship between of board of directors and the level of earnings management. The composition of board of directors is an important corporate governance mechanism in mitigating earnings management. The Malaysian Code of Corporate Governance (MCCG) has been issued in year 2000 and was revised in 2007 and the latest revision is in 2012 in order to enhance good governance by corporation. Besides MCCG, the year witnessed the full convergence of IFRS effective starting from 1<sup>st</sup> January 2012. One of the standards of MFRS 111 Construction Contracts focuses on construction companies. Therefore, this study is to examine the impact of IFRS adoption and corporate governance practices on the level of earnings management of Malaysian Construction companies. The results show that there is a significant relationship between the characteristics of board of directors with the level of earnings management during the years after the adoption of IFRS in Malaysia. This suggests the adoption of IFRS and corporate governance practices by that Malaysian construction companies contribute to higher accounting qualities. Thus, the results of this study are expected to provide early evidence of the impact of adopting IFRS and corporate governance practices and give further direction for the regulatory bodies regarding the accounting standards and financial reporting practices in Malaysia. Future research perhaps could analyze the relationship of the characteristics of audit oversight board in mitigating earnings management.

**Keywords:** *Earnings Management, Financial Reporting Standards, Corporate Governance*

### Introduction

In November 2011, the Malaysian government, through the Malaysian Accounting Standard Board (MASB) has issued the implementation of Malaysian Financial Reporting Standard (MFRS).

MASB is implementing its policy of full convergence by adopting IFRS as issued by the International Accounting Standards Board (IASB) for application, for annual periods beginning or after 1 January 2012. One of the standards of MFRS 111 Construction Contracts focuses on Construction Companies.

Due to their unique features and nature of their business activities, the construction industries have special financial reporting standards. The most unique feature that makes this industry different is that their activities are carried out over more than one accounting period. In addition, the recognition of the revenue during the development or construction involves the estimation during these periods (MASB 2007). On top of that, the outcome of a construction project cannot be estimated reliably during the early stages of the project. Finally, the nature of this industry requires a huge amount of current assets especially materials and non-current assets for their operations which indirectly contribute to a large amount of accruals.

Companies in the Property and Construction sectors are found to be more likely to manage their earnings as compared to companies in other industry sectors (Wan Abdullah, 2013). The above mentioned features are believed to provide greater opportunities for managers to manage their earnings through the recognition of revenues and expenses. Since the nature of this industry invariably covers more than one accounting period, and the uncertainties inherent in the estimation of the cost and/or stage of completion of their project, managers have the discretion to manage their earnings. The involvement of large amounts of current and non-current assets also gives the management greater opportunities to manage the discretionary accruals through accounts payable, accounts receivable and depreciation, while the nature of the sales process for the property industry has consequences for the recognition and measurement of the revenues and expenses (Wan Abdullah, 2013).

The most common explanations of earnings management in the academic writing on accounting are from Schipper (1989) and Healy and Wahlen (1999). Schipper (1989) defines it as, “*an involvement in the process of preparing financial statements, purposely to acquire personal benefits*”. A similar definition of earnings management as an opportunistic behaviour is expressed by Healy and Wahlen (1999) as follows:

*“...earnings management occurs when managers use judgment in the financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.”* (1999, p. 368)

Ronen and Yaari (2008) offer an alternative view of earnings management and summarize the different definitions of earnings management by classifying them as white, grey and black. Earnings management is considered as beneficial (white) if it enhances the transparency of the reports; pernicious if it involves outright misrepresentation and fraud, and grey if the manipulation of reports is within the boundaries of compliance with bright-line standards, which could be the opportunistic of efficiency enhancing (Ronen & Yaari, 2008). They further claim that earnings management can be beneficial if it signals long-term value, pernicious if it conceals short or long term value, and neutral if it reveals the true short term performance.

Mainly, earnings management can be classified into two categories: accruals earnings management and real earnings management. Accruals earnings management happens when

managers manipulate reported earnings by exploiting accounting discretion which is allowed under the Generally Accepted Accounting Principles (GAAP) to try to hide the true economic performance (Dechow & Skinner, 2000). On the other hand, real earnings management happens when managers attempt to alter reported earnings by adjusting the timing and scale of the underlying business activities, such as financing, investment or operating activities, in an effort to influence the output of the financial reporting (Roychowdhury, 2006). This study measures the quality of earnings through discretionary accruals. A low level of discretionary accruals, present a high quality of earnings information provided by a company.

Significant industry differences were found by Gu et al. (2005) in their research on the variability of accounting accruals, suggesting that different accounting choices are made by management in different industries. This study provides ongoing evidence on the impact of IFRS adoption on the earnings quality of Malaysian construction companies since little research has been conducted focusing on this industry, through discretionary accruals. Therefore, this study examines the level of earnings management of the construction companies in Malaysia during the period before the full adoption of IFRS and the period after the adoption.

There are some advantages and disadvantages of converging with IFRS. Sidik and Abd Rahim (2012) provide evidence from the perspective of accounting practitioners in Malaysia that IFRS has brought substantial benefits to business organisations, especially with regards to the investor confidence, because the adoption of the IFRS has led to greater transparency and comparability. They documented that the high costs was the biggest challenge faced by the respondents because they needed to pay for staff training, engaging the specialists, upgrading their system and bear higher audit fees.

The research findings by Abdullah and Sapiei (2013) highlighted the advantages and disadvantages of IFRS from the perspective of practitioners in Malaysia. Their results suggested although the full convergence with IFRS benefitted Malaysian companies, there are problems and challenges that will be faced by companies in complying with IFRS. Such problems are, increasing complexity in the work scope for auditing, involving higher costs and consuming more time in training the accounting staff and employing experts, contributing higher compliance cost as undeveloped capital market did not facilitate compliance with the fair value of the accounting standards.

### **Literature Reviews**

International Financial Reporting Standards (IFRS) are issued by the International Accounting Standards Board (IASB) since April 2001, when the IASB took over the responsibility of the International Accounting Standards Committee (IASC). The IASC issued International Accounting Standards (IAS), which were later revised and adopted to IFRS. IASB was established in order to produce a single set of high quality, understandable and enforceable international financial reporting standards to improve the quality of financial information. To achieve this goal, IASB has issued principles-based standards, limited allowable alternative accounting practices and required accounting measurements that better reflects a firm's underlying economic position and performance (IASC, 1989).

There are growing numbers of studies investigating on the adoption of IFRS with various perspectives at different background settings. The studies conducted by previous researchers found that countries that adopt IFRS have lower level of earning management. A prior study

done by Ewert and Wagenhofer (2005) presents evidence that tightening the accounting standards that limits opportunistic discretion result in accounting earnings that are more reflective of a firm's underlying economics, therefore, improve reporting quality. The study done by Barth, Landsman, and Lang (2007) further explores the quality of accounting amounts for IAS firms after applying IAS. Barth et al. (2007) find that firms adopting IFRS have lesser earnings management, more timely loss recognition and more value relevance of earnings, all of which they interpret as evidence of higher accounting quality. Similarly, Chua, Cheong and Gould (2012) find that the mandatory adoption of IFRS in Australia has resulted in better accounting quality than under the Australian Generally Accepted Accounting Principles (GAAP) previously. The findings indicate that the pervasiveness of earnings management by way of smoothing has reduced, while the timeliness of loss recognition has improved as well as the value relevance of financial statement information has also improved.

Furthermore, Zhou, Xiang and Ganguli (2009) show that adopting firms in China are less likely to smooth earnings in the post adoption period and suggest that the improvement in the quality of accounting information is related with the adoption of IFRS. Meanwhile, Iatridis (2010) who examines the implementation of IFRS in the U.K. shows evidence that it reduces the scope for earnings management which is related to a more timely loss of recognition which leads to more value relevant accounting measures. The evidence should be able to assist investors in making informed and unbiased judgements. On top of that, Landsman, Maydew and Thornock (2012) present evidence that suggests information content increased in 16 countries that mandated the adoption of IFRS relative to 11 that maintained domestic accounting standards. Three mechanisms are found by them that show that IFRS adoption increases information content, reduces reporting lag, increases analyst following, and increases foreign investment.

A more recent study by Brochet, Jagolinzer and Riedl (2013) measures the effects of mandatory IFRS adoption in financial statement comparability in U.K. Their findings are consistent with the mandatory IFRS adoption which improves comparability and thus leading to capital market benefits by reducing insiders' ability to exploit the private information.

However, there are contradicting evidences with the findings in earlier studies which suggest that IFRS adoption might lead to the increase in accounting quality. Previous study by Jeanjean and Stolowy (2008) finds that the pervasiveness of earnings management did not decline after the introduction of IFRS, and in fact, increased in France. In addition, Callao and Jarne (2010) provide results that suggest earnings management has increased in the period following the adoption of IFRS in the European Union. They assume that the variations in earnings management might be due to some room for manipulation under the international standards when compared to the local standards. A more recent study by Capkun, Collins and Jeanjean (2016) reported that an increase in earnings management (smoothing) from pre-2005 to post-2005 for firms in countries that allowed early IAS/IFRS adoption, as well as for firms in countries that did not allow early IFRS adoption. They claim that the IFRS standards that went into effect in 2005 provide greater flexibility of accounting choices because of the vague criteria, with the lack of clear guidance on how to implement these new standards that led to greater earnings management (smoothing). Besides the adoption of IFRS, good corporate governance is believed to help in mitigating earnings management. Board of directors characteristics and audit committee characteristics are importance mechanism in good governance. The Malaysian Code on Corporate Governance 2000 states that the *"optimum number of board members should be appropriately determined by the*

*whole board to ensure that there are enough members to discharge their responsibilities*". Pierce and Zahra (1992) suggest that there is a relationship between size of the board and firm performance, with Jensen and Meckling (1976) and Yermack (1996) further claiming that smaller boards are more effective because they have less difficulty coordinating their efforts. However, larger boards are also claimed to have better access to information and better overall expertise compared to a smaller board. Ebrahim (2007), Peasnell et al. (2005) and Xie et al. (2003) find that having a larger board is associated with less earnings management, with Xie et al. (2003) arguing that larger boards bring together a greater number of experienced directors and the resulting combined expertise plays a role in limiting earnings management. Conversely, Beasley (1996) finds that as board size increases, the likelihood of financial statement fraud also increases, hence smaller boards provide more of a controlling function than do larger boards. Similarly, in Malaysia, Abdul Rahman and Mohamed Ali (2008) reveal that earnings management is positively related to size of the board of directors. They claim that larger boards appear to be ineffective in their oversight duties relative to smaller boards, but, Cornett et al. (2008) find no significant relationship between board size and earnings management.

Fama and Jensen (1983) state that board independence can be achieved through the inclusion of outside directors. In order to develop their reputations as expert decision makers, outside directors have more incentives to effectively monitor top management. In Malaysia, the Bursa Malaysia Revamped Listing Requirement (2001) states that all Malaysian listed companies must ensure that at least one third of their board of directors consists of independent non-executive directors, thus enhancing board independence. As defined by Bursa Malaysia, an independent director is a director who *"is independent of the management and free from any business or other relationship which could interfere with the exercise of the independent judgment or the ability to act in the best interest of the stakeholders"*.

A number of studies have reported a link between a higher proportion of independent non-executive directors and financial reporting quality. Beasley (1996) and Dechow et al. (1996) found that the proportion of independent directors on the board is negatively associated with the likelihood of financial statement fraud, suggesting that independent directors enhance a board's ability to properly execute its oversight function. Several studies have found that outside directors are negatively associated with earnings management (Bedard et al., 2004; Ebrahim, 2007; Klein, 2002; Mulgrew & Forker, 2006; Niu, 2006; Chen et al., 2015)

Prior research posits that religiosity is associated with fewer incidences of financial reporting irregularities, i.e. earnings management (Dyrenge, Mayew, & Williams, 2010; Grullon, Kanatas, & Weston, 2010; McGuire, Omer, & Sharp, 2012). Using sample companies in the U.S., their results suggest that firms headquartered in areas with strong religious social norms generally experience lower incidences of financial reporting. Therefore, McGuire et al. (2012), Dyrenge et al. (2010) and (Grullon et al., 2010) claim that religious social norms act as an alternative monitoring mechanism over corporate financial reporting irregularities.

The Malaysian Code on Corporate Governance 2000 requires that the board should establish an audit committee that comprises of at least three directors. Davidson et al. (2005) and Xie et al.

(2003) find that size of audit committee is insignificantly related to earnings management. Similarly, Mohd Saleh et al. (2007) failed to show a significant relationship between audit committee size and the occurrence of earnings management in Malaysia. Consistent with Klien (2002), Davidson et al. (2005) finds a majority of independent directors on the audit committee is related to a reduction in earnings management, but that an entirely independent committee has no meaningful relation with earnings management. On the other hand, Mohd Saleh et al. (2007) find evidence that the presence of a fully (100 percent) independent audit committee reduces earnings management. While Abdul Rahman and Mohamed Ali (2008) obtain insufficient evidence of a relationship between proportions of independent directors on the audit committee and earnings management. They deduce that the establishment of an audit committee in listed companies in Malaysia has yet to achieve success in its monitoring role.

Based on the above arguments and conflicting findings, this study hypothesises that:

H1 The adoption of IFRS and good corporate governance practices mitigates earnings management.

This study can be extend to the existing knowledge of earnings management and the adoption of IFRS as the area of investigation is very unique: specifically that of Construction companies in Malaysia, a sector in which still little studies have been undertaken to date. It is predicted that firms with higher earnings quality exhibit less earnings management. This study, therefore, examines the level of earnings management of the construction companies in Malaysia during the period before the full adoption of IFRS and the period after its adoption. When the level of earnings management is reduced, this should improve the financial information or earnings quality provided by the company.

## **Research Methodology**

### **Sample and Data Collection**

The population of interest in this study covers all construction companies listed on the Main Board, of Bursa Malaysia for the year 2013 that are continuously listed until 2016. The convergence of IFRS is applicable and effective starting from 1<sup>st</sup> January 2012. As a result, we define before IFRS adoption era for construction companies in Malaysia from 2008 to 2011, while after adoption period comprises the years 2013 to 2016. Year of implementation, 2012, is not chosen because there is a possibility that the construction firms may not be able to comply with the requirements of the new set of accounting standards during the year of transition.

Data regarding corporate governance characteristics was obtained from published annual reports that are available on the Bursa Malaysia website while financial data was obtained primarily from the Datastream System databases from 2013 to 2016. The population of this study consists of all the firms listed under the Construction Industry on Main Board of Bursa Malaysia. Those companies being unlisted during the study period as well as those with incomplete data were excluded from the studies. A final sample of 90 firms, which generate a balanced panel of 360 firm-year observations.

### Measurement of Earnings Management

The main objective of this study is to examine the impact of IFRS adoption and corporate governance practices on the level of earnings management of Malaysian Construction companies. To this end, a well-recognised earnings management models, Modified Jones Model by Dechow, Sloan and Sweeney (1995) have been employed. Although some argue the ability of Modified Jones Model to detect earnings management, Dechow et al., (1995) and Guay, Kothari, and Watts (1996) contend that the modified model is the most powerful mechanism to detect earnings management in the context of managers exercising their discretion over revenue recognition.

Where;  $DACC_{it}$  is the discretionary accruals in year t,  $TACC_{it}$  is the total accruals in year t,  $NDACC_{it}$  is the nondiscretionary accruals in year t,  $TA_{it-1}$  is the total assets in year t-1,  $NI_{it}$  is the net income in year t,  $CFFO_{it}$  is the net cash flow from operations in year t,  $\varepsilon_{it}$  is the error term in year t, and  $i$  is the individual firm in year t. The coefficients in equation 2 for each year are applied in equation 3 for each company accordingly. DACC is the error terms in equation 3.

This study will use discretionary accruals (DACC) as the measurement of earnings management. All variables in the regression model are deflated by total assets to reduce heteroscedasticity problems (Abdul Rahman & Wan Abdullah, 2005; Dechow et al., 1995; Jones, 1991; Klein, 2002; Kothari et al., 2005).

A multiple regression analysis was employed to examine the hypothesis. The regression is as follows:

$$DACC_{fit} = \alpha + \beta BS + \beta B I + \beta BM + \beta ACS + \beta ACI + \beta ACM + f(\text{control variables}) + \xi$$

Where,

#### Dependent variable:

$DACC_{ft}$  Magnitude of discretionary accruals of firm  $f$  in year  $t$  computed on the basis of Modified Jones Model,

#### Independent variable:

$BODSIZE_{ft}$  The number of directors on the board,

$BODIND_{ft}$  The proportion of independent directors on the board,

$BODMUSLIM_{ft}$  The number of Malay/Muslim directors on the board

$ACSIZE_{ft}$  The number of directors on the audit committee,

$ACIND_{ft}$  The proportion of independent directors on the audit committee,

$ACMUSLIM_{ft}$  The proportion of Malay/Muslim directors on the audit committee,

#### Control variables:

$BIG4_{ft}$  1 if a firm is audited by Big-4 audit firms and 0 otherwise,

$SIZE_{ft}$  Natural log of total assets of firm  $f$  in year  $t$ ,

The following section presents and discusses the findings of the study.



## Results and Discussion

### Descriptive Statistics

Table 1 presents the descriptive statistics for discretionary accruals (DACC as a proxy of earnings management) and board of directors' characteristics for the year 2013 to 2016.

**Table 1: Descriptive Statistics of Earnings Management and Corporate Governance practices.**

	Minimum	Maximum	Mean	Std Deviation
DACC	-1.1068	0.5292	-0.1711	0.24627
BODSIZE	4.00	12.00	6.9361	1.6348
BODIND	2.00	8.00	3.3139	0.8980
BODM	0.00	9.00	2.3556	2.0307
ACS	3.00	7.00	3.2056	0.4859
ACI	1.00	6.00	2.8806	0.5532
ACM	0.00	4.00	1.3639	1.0807

The results show that on average the companies had a negative DACC, a proxy for earnings management. The results suggest that the majority of the companies manage their earnings via income decreasing accruals. A possible reason for income decreasing accruals is to avoid higher expectations from investors and/or to reduce income taxes.

**Table 2: Multiple Regression Results**

Variables	Predicted Sign	Coefficient	t-statistic	p-value
Intercept			-6.007	0.000***
Board Size	+/-	0.064	1.208	0.228
Board Independence	-	0.035	0.547	0.585
Board Muslim	-	-0.233	-2.356	0.019**
AC Size	+/-	-0.024	-0.419	0.676
AC Independence	-	0.156	2.406	0.017**
AC Muslim	-	-0.007	-0.071	0.943
BIG4 Auditor	-	-0.137	-2.569	0.011**
Firm Size	+/-	0.155	2.705	0.007***
R <sup>2</sup>		0.136		
Adjusted R <sup>2</sup>		0.199		
F-Value			7.975***	
Durbin Watson		1.309		
N		360		

\*\*\* Significant at 0.01 level, \*\* Significant at 0.05 level, \* Significant at 0.10 level

The results presents that there is a significant negative relationship between the numbers of Muslim director on board with the level of earnings management of construction companies in Malaysia. This provides evidence that having majority Muslim members on the board influenced the action of company and has a significant role in mitigating earnings management. This suggest

that, having a majority of Muslim members on the audit committee influenced the behaviour and action of the company in accord with the tenets of Islam.

The results also provide a significant positive relationship between audit committee independence with the level of earnings management of construction companies in Malaysia. This suggest that, in other words, the greater the audit committee independence, the less their efficiency in monitoring the financial reporting process. This suggests that, with bigger audit committee independence sizes, they have to compromise on their shared understanding of the required level of effective control. Therefore, it is concluded that audit committee independence is a significant determinant of earnings management.

Consistent with other research, the results also reveal that there is significant relationship between control variables, firm size and Big4 Auditors on earnings management. The results suggest that Big4 Auditors plays a significant role in mitigating earnings management. It is therefore concluded that firm-specific characteristics are significant determinants of earnings management.

This study contributes to the knowledge on earnings management and the adoption of IFRS, as the area of the study focuses on the construction industry with unique features and nature of business as compared to the other industries in Malaysia.

### **Conclusion**

This study measures the effectiveness of the effort in mitigating earnings management after the adoption of IFRS by the issuance of MFRS 111 for the construction industry in Malaysia. The findings indicate that the adoption of IFRS on MFRS and the corporate governance practices does reduces the level of reported discretionary accruals of Malaysian construction companies. Thus, the results of this study is expected to provide early evidence of the impact of adopting IFRS, corporate governance practices and give further direction for the regulatory bodies pertaining to the accounting standards and financial reporting practices in Malaysia. Finally, future research could analyze the relationship of the characteristics of audit oversight board in mitigating earnings management.

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