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Family Control and Earnings Management: Malaysia Evidence

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Abstract. This study examines the relationship between the proportion of family members in corporate boards and earnings management of 236 sample companies listed on the Main Market of Bursa Malaysia in 2009. Emerging literature supports the notion that family control would constrain earnings management and positively influence corporate performance. Consistent with previous studies, we use discretionary accruals as a proxy for earnings management. The regression result shows that proportion of family members on the board is positively associated with discretionary accruals. This reflects that the effort to mitigate earnings management is significantly reduced when family members are present on corporate boards, especially when family members dominate the corporate board. The findings also provide evidence on board size, audit committee size, number of audit committee meeting and company size influence on discretionary accruals. The rest of explanatory variables; board independence, audit committee with financial expertise, auditor type and leverage were not significant.

Keywords: earnings management, discretionary accrual, family control

1. Introduction

Prior empirical studies document that family controlled companies is associated with higher earning quality and greater earning informativeness [1], [2], [3], [4]. This has attracted considerable interest from researchers especially in East Asia since family controlled company is a common phenomenon in the region [1]. It is argued that controlling families conceal their self-oriented behavior by manipulating earning numbers resulting in agency problem [1]. As noted by reference [5]: “earnings management occurs when managers use judgment in 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”. The example can be evidenced by well-publicized cases of accounting improprieties at Enron and WorldCom which have captured the attention of investors and regulators [6].

Although previous studies have made attempts to investigate factors affecting earnings management, there is limited empirical evidence that link family-controlled business with earnings management [7]. For example, in Malaysia, the studies on family control have been focusing on its effect to voluntary disclosure [8], [9] and company performance [10]. The need for such research is critical considering family control is a common characteristic of public listed companies in Malaysia [10]. Hence, the primary aim of our study is to investigate the relationship between family control and earnings management in Malaysian public listed company. We also investigate the effects of eight explanatory variables namely board independence, board size, audit committee – size/financial expertise/meeting, external auditor, leverage and size on earnings management.

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The remaining part of the paper is structured in the following manner. Section 2 discusses our sample selection and regression model. Section 3 presents our empirical results, with our concluding comments presented in Section 4.

2. Data and Methods

2.1. Sample selection

The population for this study is drawn from companies listed on the Main Market of Bursa Malaysia in the year 2009. After excluding 52 companies from the finance, exchange traded funds and real estate investment trust sector classifications due to different statutory requirements, a sample of 236 companies or 30.1% of total population (evenly divided between family and non-family companies) is randomly selected. The financial data used in this study are obtained from the Emerging Market Information Service database whilst non-financial data are extracted manually from the 2009 annual reports of each company downloaded from the website of Bursa Malaysia.

2.2. Regression model

The following ordinary least square regression model is used to estimate the relationships between earnings management and potential explanatory variables based on the following equation:

$$EM_i = \alpha + \beta_1 \text{BodFam} + \beta_2 \text{BodInd} + \beta_3 \text{BodSize} + \beta_4 \text{AcSize} + \beta_5 \text{AcFe} + \beta_6 \text{AcMeet} + \beta_7 \text{ExtAud} + \beta_8 \text{Lev} + \beta_9 \text{Size} + \varepsilon_i \quad (4)$$

where

- EM_{*i*} represents the discretionary accrual of company *i* derived from the Jones Model as a proxy for earnings management, using the equation $DAC_{it} = TAC_{it}/A_{it-1} - NDAC_{it}$ where:
 DAC_{*it*} represents the discretionary accruals in year *t* for company *i*;
 TAC_{*it*} represents the total accruals in year *t* for company *i*;
 A_{*it-1*} represents the total assets in year *t-1* for company *i*;
 NDAC_{*it*} represents the non-discretionary accruals in year *t* for company *i*
- BodFam represents the total number of directors which have any family relationship with any other director and/or major shareholder of the company;
- BodInd represents the total number of independent non-executive directors on board;
- BodSize represents the total number of board of directors;
- AcSize represents the total number of audit committee members;
- AcFe represents the total number of audit committee members who possess accounting background;
- AcMeet represents the total number of audit committee meetings;
- ExtAud is a dummy variable equal to one if IPO engage a Big-Four audit firm and zero otherwise;;
- Lev represents book value of total debt divided by the book value of total assets;
- Size represents the total revenue as a proxy for company size; and
- ε_{*i*} represents the residual term

3. Empirical Analysis

3.1. Descriptive statistics

The descriptive statistics for the dependent and independent variables are presented in Table 1. The mean and median value of discretionary accruals is -0.084 and -0.063 respectively. The mean numbers of directors from the same family are 22.3%. The average number of directors on a board is 7, and approximately 45.1% of board members are independent. From the sample data, the mean number of audit committee members is 3.22 with the average number of audit committee members with financial expertise is 40.2%. The average

number of audit committee meetings is 4.77. With respect to leverage, the mean leverage of the companies' IPO in the year 2009 is at 2.07. Total sales as a proxy for company size shows an average amount of RM9,508 million. Approximately 53% of the companies in our sample are audited by Big-Four audit firms.

Table 1: Descriptive statistics and correlations

Variables	Mean	Median	Std. Deviation	Minimum	Maximum
DAC	-0.084	-0.063	0.114	-0.960	0.080
BodFam	0.223	0.125	0.244	0.000	0.860
BodInd	0.451	0.428	0.120	0.170	0.800
BodSize	7.010	7.000	1.897	4.000	15.000
AcSize	3.220	3.000	0.583	1.000	6.000
AcFe	0.402	0.333	0.158	0.000	1.000
AcMeet	4.770	5.000	1.003	1.000	9.000
Lev	2.070	1.595	1.625	-3.200	11.590
Size	9508.097	1780.723	50949.614	46.05	713630.000
Dichotomous variable			0		1
ExtAud			111 (47%)		125 (53%)

3.2. Regression results

Table 2 presents the empirical results for the regression analysis. The F-test result of 7.001 indicates that the estimation of regression model is significant at the 1% level and is sufficiently robust. The adjusted R² of 18.8% suggest that the model has reasonable explanatory power. This study also utilises both Pearson and Spearman correlation coefficient to provide preliminary information regarding interrelationships between the variables in the samples. Overall, the results (not tabulated) suggest that except for a few significant correlations are observed between independent variables, the correlation coefficients is not higher than 0.8, thereby multicollinearity is not a major problem [11]. However, to be certain, the study also calculated variance inflation factor (VIF) scores to establish that the regression model is not plagued with multicollinearity. None of the VIF scores (the highest calculated VIF is 1.402) exceeds 10, suggest that multicollinearity is not an issue in interpreting the regression results, as in [11].

Table 2: Regression analysis

Variable	Coeff.	t-Stat.
BodFam	0.008	1.986**
BodInd	0.013	0.210
BodSize	0.060	1.960*
AcSize	0.039	2.972***
AcFe	-0.002	-0.042
AcMeet	-0.030	-5.520***
ExtAud	0.010	1.022
Lev	0.000	-0.310
Size	0.184	2.578**
Summary Statistics:		
Intercept	-0.145	
R ²	21.9%	
Adjusted R ²	18.8%	
F-test	7.001***	

* Designates statistical significance at the 0.1 level, one-tailed test.
 ** Designates statistical significance at the 0.05 level, one-tailed test.
 *** Designates statistical significance at the 0.01 level, one-tailed test.

Prior research findings support the notion that family control can reduce earnings management [4] and has a positive impact on corporate performance [12], [13]. On the contrary, our study finds that proportion of family members on the board is positively associated with discretionary accruals ($p < 0.05$). The results suggest that bigger presence of family members on corporate boards may significantly reduce the attempt to mitigate earnings management. According to reference [1], the larger the insider ownership of controlling families, the stronger the motivation of controlling families to expropriate minority interest and the higher the degree of earnings management. A possible justification for this is because earnings management is perceived as an opportunity to signal better performance to investors especially when family members dominate the board.

Empirical studies e.g. [14], [15] have found a significant relationship between board size and earnings management. While larger boards are claimed to be better in mitigating earnings management, the problems of coordination [14], [16] may lead to ineffective board monitoring functions [17]. Consistent with previous studies, we find that board size is positively associated with discretionary accruals ($p < 0.1$). This implies that the increase in number of directors is less effective in controlling earnings management despite the large composition of independent directors on board (mean=45.1%).

The studies exploring on the relationship between audit committee size and earnings management have mixed findings. While reference [18] claimed that larger audit committee may effectively control the earnings management activity; reference [15] and [19] found that audit committee size was not an explanatory factor for earnings quality. This present study finds a significant positive association ($p < 0.01$) between audit committee size and discretionary accruals. The results imply that even if the number of audit committees is increasing, their existence seems not to provide much incentive in restraining earnings management. A plausible explanation is due to the fact that the audit committee members with financial expertise are still lacking (mean=0.402). As such, they would struggle to better understand and interpret financial information. Audit committee which includes a financial expert has higher likelihood to reduce aggressive earnings management [20].

Frequency of meeting is an important resource in improving the effectiveness of the audit committee members [21]. Other studies e.g. [19], [20] however find no association between frequency of meeting and earnings management. Similar to reference [15] result, our study find that the number of meetings is negatively associated with discretionary accruals ($p < 0.05$). This suggests that audit committee members that meet frequently are more likely to perform their duties diligently in mitigating earnings management.

In regard with the size variable, we find that discretionary accruals is positively related with company size ($p < 0.05$). The results show that the large companies have less likelihood of engaging in earnings management than small companies. In other words, the findings from the present study agree with reference [14] and [22] conclusion that large company are less likely to engage in earnings management as a result of capital market scrutiny [23].

4. Conclusion

This study investigates the effect of nine potential explanatory variables on earnings management. For that reason, we have randomly selected 236 companies listed on the Main Market of Bursa Malaysia. Using discretionary accruals as a proxy for earnings management, our results suggest that the factors with most influence on the discretionary accruals are board with family relationship, board size, audit committee size, number of audit committee meeting and company size. At the same time, board independence, audit committee with financial expertise, auditor type and leverage do not affect the discretionary accruals. We extend the existing research by providing valuable insights on the relationship between the proportion of family members in corporate boards and earnings management since there is limited studies that have explored in this area.

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