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# Leadership Structure, Gender Diversity and Audit Quality Influence on Earnings Management in Malaysian Listed Companies

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**ABSTRACT**

The aim of this paper is to examine the effect of CEO duality, women directors and BIG 4 audit firm on real earnings manipulation (REM) proxied by cash flow from operation and discretionary expenses (DE). The sample of the study was Malaysian Public Listed Companies in year 2009-2012 with a sample of 1597 firm-year observations. Using regression analysis, this study evidences that CEO duality promote REM. Interestingly, by having BIG 4 as auditors, firms failed to prevent managers from managing the earnings figure. Further, having women as directors in companies also do not help firms to mitigate the earnings manipulation problem. This paper contributes to the literature on earnings management by presenting evidence on the management of cash flows items and DE, which has received little attention to date.

**Keywords:** CEO Duality, Women Directors, BIG 4 Auditor, Real Earnings Management
**JEL Classifications:** M40, M42, M49

## 1. INTRODUCTION

MCCG 2012 stressed out that leadership structure of the board which are chairman and CEO should be held by different individuals. The code also suggests that board composition should be diversified in term of skill, nationality and gender (MCCG, 2012). Besides that, the Malaysian government had introduce a policy which stated that in year 2016, the board of directors should consist of at least 30% women participation specifically at the management level (Abdullah et al., 2013). Both suggestions proposed by MCCG regarding leadership structure and board composition are mainly to restrict the earnings manipulation by firms in order to instil investors confidents of accounting numbers produce by Malaysian public listed companies (PLCs). In addition to internal monitoring, the external auditor can play their role as company safeguard to review accounting figures produced by firms. This action is to ensure that the figures published in firms financial statements are prepared according to the reporting standard mandated by the MASB. This cross check activities by external auditor will help to prevent earnings manipulation by manager which in turn will increase the quality of firms' accounting figures.

The aim of this paper is to investigate the effect of internal monitoring by board focusing on CEO duality and the existence of gender diversity and the external monitoring by auditor firm on the activities of real earnings manipulation (REM). The remaining of the paper is structured as follows. A section on the theoretical perspectives and hypotheses development will be presented. Then, it is followed by research methodology section. Next, this paper will present the findings and discussions. Finally this paper summarizes the findings and future research in the conclusion section.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### 2.1. REM

Ahmed et al. (2014) discuss earnings manipulation as an internal process to tamper financial reporting with an intention to change its true picture of firm's economic performance. In other word, earnings manipulation can be described as the decision that made by some corporate managers by employing some accounting method or by directing operational activities in order to affect earnings with intention to meet firm's specific objectives. In order to meet firms' specific objectives, Enomoto et al. (2014) summarize that earnings manipulation can affect the process of accrual-based accounting or operational activities. As business activities become more complex and diversified, the detection of earnings management using accrual based accounting become less effective. Thus to overcome the shortcoming of accrual based accounting, Roychowdhury (2006) explains that REM can be a complementary to accrual based accounting to detect manager illegal practice. He discusses that, the REM is a process of managers that manipulate earnings and cash flow to be reported through manipulating real activities with cash flow consequences.

### 2.2. Board Structure and Real Earnings Management

#### *2.2.1. CEO/chairman duality*

MCCG (2012) requires to balance the power and authority between the chairman and the CEO and the code also recommends that a strong independent element should be induced and publicly disclosed in the event of CEO duality. Previous studies found that firms with CEO duality did not perform as well as their competitor and incline to do earnings management (Abdul-Rahman and Haniffa, 2005). Bradbury et al. (2006) claim that CEO duality reduces the check and balances on top management which leads to fraudulent behaviors of managers and increase intensity to manage earnings. Study in Indonesia by Murhadi (2009) reveals a positive association between earnings management and CEO duality. Similarly using 81 Malaysian firms listed in Bursa Malaysia, Hamad (2010) discovers a positive relationship between CEO duality and earnings management.

However, recent study by Mahad et al. (2015) using 334 sample for three consecutive years of 2010-2012 of Malaysian PLCs (2015) failed to accept that duality increase earnings manipulation. Their result showed that using both earnings management model, modified Jones and Kothari, the coefficient of duality exhibit insignificant relationship with discretionary accruals. They explain that duality or non-duality role has no effect on earnings manipulation. As duality may entrench board effectiveness which may result in higher earnings management this study proposed that:

$H_1$: Firms that exercise CEO/chairman duality are more likely to involve with REM.

#### *2.2.2. Gender diversity*

In Malaysia, women participation as a labour force contribute to Malaysia economic and nation development cannot be neglected as the rate of women participation in Malaysian labour force is expected to be increase from 47.3% in the year 2014% to 55% in the year 2015 (Labour Force Survey Report, 2015). However, the involvement of women in Malaysian PLCs position at the top management level is still low as Abdullah et al. (2013) report that women only occupied 7.7% of board seats for year 2008. In the same vein, Ahmad-Zaluki (2012) finds that women representation on board is only 8% for 228 Malaysian companies prior to the IPO. Further the figure of women involvement has increase to 19.9% in 2010-2012 as reported by Ishak et al. (2015).

Anderson et al. (2011) explain that gender diversity can affect the quality of monitoring and enhance corporate governance control which reduces the agency conflicts. Further, they argue that women directors enhance decision making process within the board. Adam and Ferreira (2009) assert that women participation in board can increase governance efficiency, help concentrated decision making and reduce the agency conflict. Moreover, Farrel and Herch (2005) claim that women directors are known to be tough monitors and contribute to the increment of possible viewpoints which enlarge the scope of governance decision. As women are regarded as monitor, thus this study proposed that the involvement women on board will reduce the REM.

$H_2$: Firms that appoint women as a board member are less likely to involve with REM.

#### *2.2.3. Auditor type*

DeAngelo (1981) finds that the size of audit firms determines the quality of audit. Audit quality is higher for larger audit firms as large audit firms are encouraged to provide high-quality audits in order to maintain to maintain their reputation (Francis and Wilson, 1988). Previous studies find that auditor type which refers to BIG 4 auditor companies (i.e., Ernst and Young, PricewaterhouseCoopers, KPMG and Deloitte) and non-BIG 4 does have significant influence on the quality of financial statement. This statement is supported by Ishak and Yusof (2013) as they find that firms audited by BIG 4 are less likely involved with financial restatement. Recent evidence by Abdul-Manaf (2016) reveal that based on 4,127 firm-year observations over the period 2003-2012, they find that earnings of firms audited by BIG 4 audit firms are more value relevant that earnings of firms audited by non-BIG 4 audit firms.

Ismail et al. (2015) investigate the association between BIG 4, auditors switch and earnings management by utilizing 334 quoted firms in Bursa Malaysia for the period of 2010-2012. Their result shows that likelihood of earnings managements is lower for firms that are audited by BIG 4. Thus, the following hypothesis is suggested:

$H_3$: Firms that audited by BIG 4 are less likely to involve with REM.

## 3. RESEARCH METHODOLOGY

The sample comprises 1,597 firm-year observations of non-financial firms which are listed on Bursa Malaysia from 2009 to 2012. This study excludes the financial institutions as these companies have different regulations. The data were hand-collected through the annual reports and Thomson Datastream. Roychowdhury (2006) classified REM into three elements namely cash flow from operation (CFO), production cost and discretionary expenses (DE) as proposed by Roychowdhury (2006). The principle of CFO method is to rise the volume of sales for the present period through the use of favorable credit terms and discounts. For DE, corporate managers may utilize expense at discretion such as selling, administrative and general expense; advertising expense; research and development expense for the purpose to attend short-term reported earnings. REM in this study is determined based on combination of abnormal CFO and DE. These abnormal CFO and DE are calculated as a different between actual figures minus the estimated figures based on formula provided.

$$REM=\beta_0+\beta_1 DUALITY_{it}+\beta_2 WOMEN_{it}+\beta_3 BIG4_{it}+\beta_4 FSIZE_{it}+\beta_5 LEV_{it}+e_{it}$$

Where,
REM=ABNCFO+ABNDE

ABNCFO=Actual CFO from operation−Estimated CFO (1)

ABNDE=[Actual R and D+advertising cost+sales, administrative and general expenses]−estimated DE (2)

$$\text{Estimated CFO}=CFO_t/A_{t-1}=\alpha_0+\alpha_1(1/A_{t-1})+\beta_1(S_t/A_{t-1})+\beta_2(\Delta S/A_{t-1})+\varepsilon_t \quad (1)$$

$$\text{Estimated } DEt/A_{t-1}=\alpha_0+\alpha_1(1/A_{t-1})+\beta(S_{t-1}/A_{t-1})+\varepsilon_t \quad (2)$$

DUALITY represents dual position of CEO and Chairman held by a single person, WOMEN represents number of women directors on the board. BIG 4 is a dummy variable that equals one if the firm is audited by BIG 4 audit firm and equals 0 otherwise. For the control variables, leverage (LEV) is measured as total liabilities divided by total assets, FSIZE is firm size that is measured by natural log of total assets, and $e_{it}$ is the residual term.

## 4. RESULTS AND DISCUSSION

Descriptive statistics in Table 1 explains the mean for REM is about 0.13 million based on the sample collected. Only 8.9% of sample firms practice CEO duality and 58% of firms involved women as their directors. More than half of the sample firms are audited by BIG 4 audit firms. The mean for firm size is 5.03 and LEV is 0.53.

Table 2 displays correlation between variables. There are a positive correlation between REM and duality, BIG 4 and firm size. These positive correlations explain that when the position of CEO and Chairman is held by single person, there is an intention by CEO/chairman to manipulate the earnings figures. Further, firms that are considered as large firms and audited by BIG 4 are more likely to involve in earnings manipulation.

Regression results in Table 3 shows positive and significant relationship between duality and REM which indicates that duality will increase possibility of REM as the position of CEO and chairman is held by a single person, it gives more room to the CEO/chairman to involve with firm operation. In order to increase their salary/remuneration, they may use their position as CEO cum chairman to manipulate the earnings figure. The existence of BIG 4 as an audit companies is expected to limit the practice of REM. However, the relationship between BIG 4 and REM is positive and significant at 10% level. This finding is contradict to previous

**Table 1: Descriptive statistics**

| Variables | Mean | Median | Minimum | Maximum |
|---|---|---|---|---|
| REM | 131226 | 14837 | −957572 | 7992500 |
| Duality | 0.089 | 1.000 | 0 | 1 |
| Women | 0.580 | 0.00 | 0 | 5 |
| BIG 4 | 0.530 | 1 | 0 | 1 |
| Fsize | 5.030 | 5.190 | 0 | 7 |
| Level | 0.530 | 0.01 | −282 | 430 |

REM: Real earnings manipulation

**Table 2: Correlation**

| Variables | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| REM | 1 | - | - | - | - | - |
| Duality | 0.07** | 1 | - | | - | - |
| Women | −0.01 | 0.04 | 1 | - | - | - |
| BIG 4 | 0.29** | −0.08** | 0.17** | 1 | | - |
| Fsize | | −0.01 | −0.01 | 0.12** | 1 | |
| Level | −0.02 | 0.01 | −0.02 | −0.05* | 0.011 | 1 |

**Significant at 5% level and *significant at 10% level

**Table 3: Regression results for REM on leadership, women and Big 4**

| Variables | Hypothesis | Coefficient | t-statistics | P value |
|---|---|---|---|---|
| Duality | $H_1$ | 0.065 | 2.705 | 0.007*** |
| Women | $H_2$ | 0.001 | 0.021 | 0.983 |
| BIG 4 | $H_3$ | 0.046 | 1.851 | 0.064* |
| Fsize | - | 0.297 | 12.330 | 0.000*** |
| Level | | −0.014 | −0.603 | 0.547 |
| Constants | | −495921 | −6.734 | 0.000*** |
| Adjusted $R^2$ | | 0.096 | | |
| Number of observations | - | 1597 | - | - |

***Significant at 1%, *significant at 10%, REM: Real earnings manipulation

studies which conclude that accounting figures that audited by BIG 4 is regarded as a high quality and less manipulation (Abdul-Manaf et al., 2016; Ishak and Yusof, 2013).

Participation of women as board members is expected to give a positive effects on earnings quality and help to prevent the REM. However, this proposition is failed to support by this study as the study find that the relationship is insignificant. One of the reason that this study can offer is that the low involvement of women as board members reduce the power of women acting as a monitor of the firms accounting performance. For control variable, firm size exhibits positive relationship with REM. This result indicates that earnings manipulation does exist in large firm. This is may be due to a large volume of transactions together with some complexities handle by large firms, give a room for managers to manipulate the transaction for their own benefits.

## 5. CONCLUSION, LIMITATIONS AND FUTURE STUDY

There is a possibility of REM practices in firms that are manage by CEO cum Chairman. Thus the suggestion of separation between CEO and Chairman by MCCG need to be enforced by regulatory body or listing requirement in order to restrain the REM. Furthermore, the firms also need to give some place for women to involve as board members so that they can practice their skill of monitoring and vigilant towards earnings management. Hiring a BIG 4 companies may involve more cost, however having them as an auditor do not restrict the practices of REM. This study is only limit for 4 years period (2009-2012) and only two element of corporate governance are tested. Thus in future, the time horizon can be extended further to see the long run effect of the REM on corporate governance variables.

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