EARNINGS MANAGEMENT SURROUNDING CEO TURNOVER IN THE CONTEXT OF MALAYSIAN FIRMS

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ABSTRACT

The responsibility of the preparation and presentation of financial accounts lies on the management of the firm. Above all the management team, the Chief Executive Officer (CEO) retains the overall accountability of the firms operation and performance. As such, the CEO should hold tight to his objective of managing in the best interest of the firm and its stakeholders. However, the recent spate of grand-scale corporate scandals has markedly shown how corporation leaders such as CEOs have gone astray by indulging in self interest practice through manipulation of reported earnings. Therefore, this research is an empirical study of whether CEOs manage earnings during the period close to Malaysian firms' CEO turnover event. This study also seeks to find the association between the earnings management behaviour of the CEOs and the executive succession process. Earnings management practice of the CEOs is examined based on cover-up, horizon problem and earnings bath theories. The sample of the study consists of 55 firms listed in the Bursa Malaysia with CEO change occurrence during the financial year end 2000 – 2003. Earnings management practice of the departing and incoming CEOs during the period prior to CEO change (t-1) and the year of CEO change (t), respectively were tested through discretionary accruals. Generally, this study provides weak evidence of earnings management practice of both the departing and incoming CEOs. There is an indication of upwards earnings management practice of the departing CEOs with non-routine departing CEO appears to be managing earnings upwards more than the routine departing CEOs. Similarly, non-routine incoming CEOs appears to be managing earnings downwards more than the routine incoming CEOs. These results partially support earnings management practice as elucidated in cover-up, horizon problem and earnings bath theories.

ملخّص البحث

أن إعداد و عرض القوائم المالية يعد من مسؤلية إدارة الشركات. والمهم في فريق الإدارة، هو المدير التنفيذي (سي إي أو) الذي يحتفظ بتحمل كافة المسؤلية عن عمليات وأداء الشركة. وعلية فإن المدير التنفيذي يجب أن يربط هدفة في الإدارة بما هو أفضل لمصلحة الشركة و المساهمين. ومع ذلك، فإن الكم الهائل من الفضائح الذي كشف عنه حالياً أوضح على نحو ملحوظ كيف أن قادة أو مدراء الشركات مثل المدراء التنفيذيين، إنحرفوا عن الجادة عن طريق إطلاق العنان لانفسهم لخدمة مصالحهم الشخصية عن طريق التلاعب في الإيرادات المفصح عنها. ولذلك، هذا البحث عبارة عن دراسة عملية فيما إذا المدراء التنفيذيين يعملون على إدارة الإيرادات (التلاعب في الإيرادات المفصح عنها) خلال الفترة القريبة من حدث تغييرهم (تسليم المنصب لخلفهم) في الشركات الماليزية. هذه الدراسة تسعى أيضا إلى البحث عن العلاقة بين سلوك المدراء التنفيذيين في إدارة الإيرادات و عملية الخلافة أو التعاقب. لقد تم إختبار ممارسة إدارة الإيرادات من قبل المدراء التنفيذيين في ضوء نظريات التغطية، المشكلة الافقية و غسيل الإيرادات. لقد تألفت عينة البحث من 55 شركة مسجلة في سوق ماليزيا للأوراق المالية والتي حدث فيها تغيير في المدراء التنفيذيين خلال السنة المالية المنتهية في 2000-2003. لقد تم إختبار ممارسة إدارة الإيرادات للمدارء التنفيذيين المغادريين و القادميين خلال الفترة السابقة (ت–1) و سنة التغيير للمدير التنفيذي (ت) على التوالي، عن طريق المستحقات لتغيير المدير التنفيذي دليل أو برهان ضعيف في ممارسة إدراة الإيرادات من قبل الإختيارية. عموماً، لقد أثبت هذا البحث على وجود كلٍ من المدراء التنفيذيين المغادريين و القادميين. هناك دلالة على الإتجاه لزيادة ممارسة إدراة الإيرادات من قبل المدراء التنفيذيين المغادريين بدون روتين (تغيير مفاجئ)، حيث أن هولاء المدراء يظهر عليهم إدارة الإيرادات بإتجاه الزياده أكثر من المدراء التنفيذيين المغادريين بالروتين (تغيير بحسب الخطة). على نحو مماثل، المدراء التنفيذيين القادمين بدون روتين يظهر عليهم إدارة الإيرادات بإتجاه التخفيض أكثر من المدراء التنفيذيين القادمين بالروتين. هذه النتائج تدعم جزئياً ممارسة إدراة الإيرادات كما أوضحت في نظريات التغطية، المشكلة الافقية و غسيل الإيرادات.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentations and is fully adequate, in scope and quality, as a thesis for the degree of Master of Science in Accounting.

Fatima Abdul Hamid
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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Name: AHMAD FAHMI BIN SHEIKH HASSAN

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To my family and those whom I have lost

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LIST OF ABBREVIATIONS

AbsDA: Absolute Value of Discretionary Accrual

AbsDAr: Absolute Value of Discretionary Accrual for Routine Sample

AbsDAnr: Absolute Value of Discretionary Accrual for Non-routine Sample

BOD: Board of Directors

CEO: Chief Executive Officer

CFO: Cash Flow from Operating Activity

CFOLagTA: Cash Flow from Operating Activities Lagged by Total Assets

DA: Discretionary Accrual

DArout: Discretionary Accrual for Routine Sample

DAnrout: Discretionary Accrual for Non-routine sample

eg.: for example

EMP: Eight Malaysian Plan

et al.: and others

etc: and so forth

FASB: Financial Accounting Standard Board

GAAP: Generally Accepted Accounting Principles

GDP: Gross Domestic Product

GPLA: General Price Level Adjustment

IAS: International Accounting Standards

MASB: Malaysian Accounting Standard Board

MD: Managing Director

MESDAQ: Malaysian Exchange of Securities Dealing and Automated Quotation

NP: Net Profit after Interest and Tax

NPLagTA: Net Profit after Interest and Tax Lagged by Total Assets

R&D: Research and Development

SC: Securities Commission

SPSS: Statistical Package for Social Sciences

TAsset: Total Assets

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

While accounting is said to be the business language from which managers of the firms communicate to external stakeholders, financial statements serve as the major source for firm's performance evaluation. Interestingly, the reporting of earnings and financial position involves the use of numerous valuation estimates and judgement from the array of Generally Accepted Accounting Principles (GAAP). As such, it provides managers with the opportunity to engage in self interest practice by using a variety of accrual options and susceptible to manipulation to arrive at some desired level of reported earnings. The recent spate of grand-scale corporate scandals involving Enron, World.Com, Global Crossing, Arthur Anderson and numerous others are prima facie evidence on the result of creative accounting consumption of the managers. Apparently, these series of corporate fiasco has given the accounting profession more public attention than any of its members wanted. Therefore, one area that has gained much attention in the accounting research is the study on earnings management.

Earnings management is said to take place 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" (Healy and Wahlen, 1999: 368). Following this malpractice, financial reports only provide firm's pictorial performance as the firm's reported profit might not necessarily reflect its real profit. Such malfeasance will only put the credibility of financial statements, in which shareholders and other users rely upon, into question.

As the responsibility of the preparation and presentation of financial accounts lies on the management of the firm, the study of earnings management practice by firm's executive from the perspective of management compensation plan seems justified. This is especially warranted in the case of Chief Executive Officer (CEO), for being the firm's top executive, the CEO retains the overall accountability on the firm's operation and performance. Moreover, it is argued that the period close to CEO turnover event provides best incentives for the executive to engage in earnings management practice.[1] Aiming at maximizing utility through maximum compensation, both the departing and incoming CEOs opportunistically alter firm's reported earnings tailored to their specific agenda. For example, it is suggested that the departing CEOs manage earnings upwards prior to CEO change to cover up poor previous performance, and, thus, delay resignation, or by bringing forward future earnings to increase retirement benefits. Meanwhile, during the year of CEO change, incoming CEOs would manage earnings downwards in order to deposit a low benchmark from which CEOs' future earnings performance will be judged, hence affecting their future compensation. These justifications have been the central focus of prior earnings management studies surrounding CEO changes (see for example DeAngelo, 1988; LaSalle, Jones and Jain, 1993; Murphy and Zimmerman, 1993; Pourciau, 1993; Detzler and Machuga, 2002; Wells, 2002 and Godfrey, Mather and Ramsay, 2003).

[1] CEO changes and CEO turnover are used interchangeably throughout the study. Also, 'critical corporate event' refers to the event of CEO change.

The present study attempts to find evidence of earnings management practice through the discretionary component of accounting accruals (defined as the difference between earnings and operating cash flow) during the period close to CEO turnover in the Malaysian context. Zmijewski and Hagerman (1991) asserted that managers are likely to be concerned with how combination of accounting methods, instead of single accounting method, affects earnings. Since accruals measure the net effect of all accounting choices, thus studying earnings management through accruals would help to reduce the problems associated with the inability to measure the effect of various accounting choices on earnings (Watts and Zimmerman, 1990). This study also attempts to find out whether the behaviour of CEO to manage earnings is influenced by the nature of the turnover/succession process. For the purpose of this study, firms listed in the Bursa Malaysia with CEO change occurrence beginning 1st January 2000 to 31st December 2003 were selected and tested. Evidence of earnings management was then explained according to the theories governing earnings management surrounding CEO change studies.

1.2 MOTIVATION OF THE STUDY AND RESEARCH OBJECTIVES

A CEO turnover event creates situation specific incentives for the executive to engage in earnings management practice. Opportunistically, the executive would deliberately alter reported earnings in order to secure tenure and maximize their personal compensation. Under such circumstances, the financial reports losses its pivotal role as a mean for stakeholders to make informed decisions on their resource allocation. Consequently, this give rise to governing issues and signals the security markets authority to closely monitor such key event amongst corporate players. Motivated by the implication brought by this issue, this study attempts at providing users of

Comment:

financial reports and the authorities with potential evidence of earnings management practices by the CEOs during the critical event of CEO turnover. To date, there has been no similar study on this subject in the Malaysian context.

The main objective of this study is to determine whether Malaysian firms which underwent a CEO change manage earnings during the period close to CEO succession process. It also aims at exploring the association between earnings management and CEO succession process. Based on the above research objectives, this study hopes to provide answers to the following questions:

1. Do Malaysian CEOs manage earnings opportunistically during the period close to CEO turnover event?
2. Does the nature of CEO succession process influence the earnings management practice of Malaysian CEOs?

1.3 ORGANIZATION OF THE STUDY

This study consists of five chapters. The first chapter is the introductory chapter which gives an overview of the whole research. In chapter two, I provide a review of prior studies on the subject matter. It begins with a discussion on the emergence of the concept of opportunistic behaviour and the theories governing earnings management studies surrounding CEO changes. Then, I looked into literature that specifically study on earnings management during the critical event of CEO turnover. In addition, since this study attempts to find evidence of earnings management practice surrounding CEO turnover in the Malaysian context, I also include discussion on the Malaysian business environment and the security market administration in Malaysia. Chapter three describes the research method of the present study. The detailed analysis and interpretation of the research findings are provided in chapter four. Chapter five is the conclusion chapter. It summarizes the findings of the study, examines the implication of the study and outlines the contribution brought by this study. In the end, the chapter discusses the limitations of the study and recommendations for future research.

CHAPTER 2

RELEVANT THEORIES, LITERATURE REVIEW AND MALAYSIAN BUSINESS ENVIRONMENT

2.1 INTRODUCTION

Variations in GAAP leave managers with considerable exercise of discretionary accounting choices. When managers take up this opportunity and exercise discretion to maximize their personal compensation, they are said to behave opportunistically. In this manner, earnings management is the result of managers' deliberate use of accounting choices, moulded by opportunistic behaviour, to arrive at certain desired level of reported earnings. Investigating and studying accounting choices and managements' opportunistic behaviour were the predecessors to earnings management studies. Hence, a seminal paper by Watts and Zimmerman (1978) on opportunistic behaviour is discussed first before reviewing studies on earnings management.

Historically, the concept of opportunistic behaviour among managers was forwarded by Watts and Zimmerman (1978). They studied how managers opportunistically respond to FASB's Discussion Memorandum on General Price Level Adjustment or GPLA. It was found that managers would support or oppose any proposed standard on the GPLA effect on income depending on the net benefit received by the managers and/or the firms. In the event that the proposed GPLA resulted in earnings decline, larger firms would support such a standard if the net benefit obtained is higher in order to distract the attention or minimize government intervention. Meanwhile, small firms would oppose the proposed standard as it yields lower return and would lead them to adjust the compensation plan to earn bonus they previously expected to earn. On the other hand, in the event when the proposed GPLA resulted in increase in earnings, the larger firms would oppose the proposed standards as it creates negative net benefit to the firm and managers. The rejection to such standards is to avoid government intervention through anti-trust and anti-monopoly proceedings, raise of future tax, or reduction in the public utilities revenue for regulated firms. Meanwhile, small firms would not be motivated to make submission to the proposed standard as it does not affect the managers' compensation.

This opportunistic behaviour, viewed from the perspective of agency theory, is generally the result of information asymmetry between the principals (e.g. shareholders) and the agents (e.g. management). Agents' use of private information to manage earnings opportunistically can be explained as: (a) to maximize their compensation (Healy, 1985; Holthausen, Larcker and Sloan, 1995; Guidry, Leone and Rock, 1998), (b) to influence short-term stock price performance (Teoh, Welch and Wong, 1998a, 1998b), (c) to prevent debt covenant violations (DeAngelo, DeAngelo and Skinner, 1994; DeFond and Jiambalvo, 1994; Sweeney, 1994). Arguably, this opportunistic behaviour of managers seems to compromise the concept of conservatism which, according to Hendricksen (1982) and Belkaoui (1993), originally attempted at offsetting managers' optimism.

This chapter provides an overview on earnings management studies surrounding the Chief Executive Officer (CEO) succession. The earnings management behaviour of the firm's top executive is explained in the light of management incentives from the compensation plan perspective and as expressed by the theories governing such opportunistic behaviour found in prior studies. The next section deals with the theories governing earnings management studies surrounding CEO changes. Then, the chapter draws on prior studies that specifically look into this critical corporate event of change in top executive and the earnings management practiced in the period close to the succession process. Then, the executive succession process is differentiated and discussed to gain an understanding on each succession process and the related executives' earnings management behaviour. Finally, an overview of Malaysian business environment, as the setting of the present study, is provided. The study of earnings management surrounding Malaysian firms' CEO change basically extends prior studies in the context of the Malaysian business environment.

2.2 THEORIES GOVERNING EARNINGS MANAGEMENT STUDIES SURROUNDING CEO CHANGES

Executive compensation plan is usually tied to some measure of firm performance (Smith and Watts, 1982). In relation to this, Watts and Zimmerman (1986) suggest three possible factors that motivate the use of accounting earnings-based compensation plans, namely: inability to observe firm market value; disaggregation of performances; and taxes. They asserted that the first factor arises as a result of corporate debt not being traded which consequently leads to the change in the total firm value not being able to be observed. As a replacement, firm's earnings, i.e. accounting earnings with interest expense added back, serve as an index of changes in firm value.

On the other hand, Watts and Zimmerman (1986) argued that disaggregation of performance occurs because only top managers' performance is being made responsible for the total value of the whole firm. As such, the market value of firm's subunits, for which other managers are responsible, cannot be observed, and therefore not attributable to the total firm's market value. However, according to them, the use of accounting earnings is feasible for various subunits of the firm, including for the purpose of rewarding the subunit managers.

Since executives compensation is very much correlated with the firm's reported earnings, executives will use their discretionary power to manage earnings. The flexibility given under GAAP on the choice of accounting procedures gives room for executives to manage earnings so that firm's performance coincides with executives' opportunistic behaviour. This section discusses the opportunistic behaviour of CEOs when managing earnings during the executive succession process. This opportunistic behaviour of CEO can be explained using the horizon theory, the cover-up theory, earnings bath theory and the coaching theory.[2] Each of these theories is discussed below first before reviewing the earnings management literature as these theories have to be referred to during the discussion of the relevant literature.

2.2.1 THE HORIZON PROBLEM THEORY

The term horizon problem was used by Smith and Watts (1982) to refer to executives who undertake earnings-based performance measures that will improve short-term performance during the years when he is approaching anticipated retirement. Under such circumstances, the incumbent CEO will boost the reported earnings at the expense of future earnings during his final years in tenure. The high compensation received during this final years for managing earnings coincide with the horizon

[2] Earnings management measures taken underlying each of these theories can either occur at the period prior to CEO succession or during the year of CEO transition. In other words, the earnings management strategy can either be performed by the departing CEO or the incoming CEO. Additionally, the earnings management strategy in each theory leads to different income direction, whether it resulted in an increase in reported income or a decrease in reported income.

problem, consequently, will affect the retirement benefit attainable by the CEO (Dechow and Sloan, 1991). Smith and Watts highlighted how executives make discretionary actions as elucidated in the horizon problem in the case of bonus plans:

> Bonus plans can affect the real investment and financing decisions of the firm. For example, because they are typically tied to annual profits bonus plans give managers incentives to turn down positive NPV projects with long pay back and to take negative value projects that impose expenses only after the manager retires (146).

Thus, the horizon problem suggests that, in order to portray high reported earnings, the CEO will formulate discretionary accounting decisions that will either increase earnings or decrease expenses.

2.2.2 THE COVER-UP THEORY

The cover-up theory implies that executives manage earnings to dismiss or delay forced resignation due to poor performance (see for example Murphy and Zimmerman, 1993; Detzler and Machuga, 2002 and Wells, 2002). Alternatively, this earnings management behaviour has been tested by Dechow and Sloan (1991) by referring to it as the poor performance hypothesis. Evidence of executives' tenure being terminated as a result of poor firm performance can be found in Coughlan and Schmidt (1985), Warner, Watts and Wruck. (1988) and Weisbach (1988).

Thus, similar to the horizon problem theory, the cover-up theory suggests that CEO will exercise discretionary accounting decision by increasing earnings or reducing expenses to achieve the targeted high reported earnings. However, prior studies findings posit that the discretionary accounting behaviour of executives at the time of poor firms performance should be interpreted with caution when attempting to associate them with CEO opportunistic behaviour during the succession period as