

## Earnings Management in Malaysian Public Listed Family Firms

(Pengurusan Pendapatan di Firma Keluarga Tersenarai di Malaysia)

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### ABSTRACT

*The rise of accounting-related scandals has highlighted the prevalence of earnings management in financial markets. This paper offers empirical evidence on the motivations for earnings management in Malaysia public listed family firms. A sample of 100 family firms were randomly selected from Bursa Malaysia from the years 2010 to 2014, which resulted in 500 observations in total. The results indicate that the equity ownership held by a controlling family is associated with the earnings management in the firm, since the controlling family has greater power and rights in decision-making. However, the involvement of the controlling family as board of directors is not associated with earnings management in the family firm, since the non-executive member of the board will become the chairman to oversee and monitor the business operations of the family firm. The indirect ownership of the controlling family in family firms does not provide greater opportunity for them to manage earnings through direct equity shares held by other family members because they have limited power through indirect ownership.*

*Keywords: Earning management; family firms; financial performance; Malaysia*

### ABSTRAK

*Skandal perakaunan yang semakin berleluasa telah menyerlahkan amalan pengurusan perolehan di pasaran kewangan sejak sekian lama. Kajian ini menawarkan bukti empirikal mengenai motivasi untuk pengurusan pendapatan di kalangan firma keluarga yang tersenarai di Malaysia. Sebanyak 100 firma keluarga telah dipilih secara rawak dari Bursa Malaysia bagi tahun 2010 hingga 2014, iaitu mewakili 500 pemerhatian secara keseluruhan. Dapatan kajian menunjukkan bahawa pemilikan ekuiti dengan kuasa kawalan oleh keluarga mempunyai hubungan dengan pengurusan perolehan kerana keluarga yang mengawal mempunyai kuasa dan hak yang lebih besar dalam pembuatan keputusan. Walau bagaimanapun, penglibatan keluarga yang mengawal sebagai lembaga pengarah tidak dikaitkan dengan pengurusan pendapatan di firma keluarga kerana anggota lembaga bukan eksekutif akan menjadi pengerusi untuk mengawasi dan memantau operasi perniagaan firma keluarga. Pemilikan tidak langsung keluarga yang mengawal dalam firma keluarga tidak memberikan peluang yang lebih besar kepada mereka untuk mengurus perolehan melalui saham ekuiti langsung yang dipegang oleh ahli keluarga lain kerana mereka mempunyai kuasa terhadap melalui pemilikan tidak langsung.*

*Kata kunci: Pengurusan perolehan; firma keluarga; prestasi kewangan; Malaysia*

### INTRODUCTION

Earnings reflect the overall financial performance of a firm, and thus, many firms strive to achieve high earnings to prove that they are operating well. The users of financial statements are interested in the earnings, since they may need to make economic decisions based on the financial performance of a firm. Thus, the management is attentive towards making decisions on choosing accounting policies and making operating decisions for the firm within the boundaries of the approved accounting standards so that the earnings are more stable and meet the targeted financial results. According to Healy and Wahlen (1999), abusive earnings management occurs when managers of SMEs are found wanting to be in financial reporting and organizing transactions in order to alter financial reports to mislead various users and stakeholders about the core

financial performance of the firm, or affecting contractual results that are contingent upon the stated financial figures. Earnings management practices may bring both positive and negative impacts to a firm, and therefore, much concern should be placed on earnings management practice so that it is carried out appropriately.

Many studies have shown the importance of earnings management in terms of managerial discretion in the preparation of financial statements and the use of accounting policies to influence earnings levels, which in turn will influence contractual outcomes that depend on the reported accounting earnings. Empirical evidence suggests that earnings management is carried out mainly to achieve smoother earnings (Buckmaster 2001), with a view to boosting the acceptance of financial results from firms by the stakeholders, debt covenants violation

avoidance (Jaggi & Lee 2002; Watts & Zimmermann 1986), and increment in managerial rewards to deserving employees (Guidry, Leone & Rock 1999; Holthausen, Larcker & Sloan 1995).

Indirectly, earnings management has been identified as one of the reasons that leads to accounting scandals. Many firms manage their earnings beyond the boundaries of GAAP to boost financial results. For example, in the United States, Enron and WorldCom are among the severest corporate accounting scandals. Cotton (2002) estimated that the \$460 billion loss in market capitalization was caused by fraudulent financial reporting in five companies, namely Enron, WorldCom, Quest, Tyco, and Global Crossing. Of equal importance is also the revelation that Tesco, a prominent grocery public company in the United Kingdom, had an interim profits overstatement of £250 million, which by implication was put at 25% above the actual result, thus casting further aspersions on the integrity of published financial statements (Felsted, Oakley & Agnew 2013).

In Malaysia, 17 cases of earnings manipulation from 1996 to 2012 have been reported by the Malaysia Securities Commission. PwC reported that through their survey, 48% of Malaysian companies were the victims of white collar crime, and only 25% of them were willing to strengthen their internal auditing system and technique. Furthermore, the PwC survey revealed that for two years prior to the survey, the average loss from fraud per company in Malaysia was US \$173,303 (Ung et al. 2014).

In a related circumstance, Transmile Group Bhd with base in Malaysia had an overstatement of its group income to the tune of RM530 million between the 2005 and 2006 financial periods (Fong 2007) which resulted in the shareholders losing value in the prices of their shares (Oh 2010) and subsequently delisted from the Bursa Malaysia on the grounds of employee dissatisfaction, image loss, decline in reputation, and corporate relationships (PricewaterhouseCoopers 2011).

Research on earnings management mainly referred to public listed companies in general, but to our knowledge, no study has examined earnings management in family firms specifically, which have unique features. As an important organizational form, family firms account for 44% of large firms in Western Europe (Faccio & Lang 2002), over 66% of firms in East Asian countries including Malaysia (Claessens et al. 2000), and 33% and 46% of the Standard and Poor (S&P) 500 and 1500 index companies, respectively (e.g., Anderson & Reeb 2003; Chen et al. 2008; Amran & Ahmad 2013). According to the study of Claessens et al. (2000) Malaysia has the third highest concentration of control after Thailand and Indonesia. Family control in Malaysia increased from 57.7 to 67.2% as the cut off level of voting rights increased from 10 to 20%. Examples of Malaysian family controlled firms are Hong Leong Group, Genting Group and Oriental Holding Berhad.

The current study provides an interesting platform to study the issues related to earnings management.

In addition, due to the severe implications of earnings management, it is very important for a research in earnings management to be conducted, as it may bring large impacts to the users of financial statements and the firm itself. The motivation to study family firms in Malaysia is that the ownership of family firms is highly concentrated within the controlling family. Therefore, the controlling family might intend to manage earnings to achieve self-interest objectives and goals. This study aims to determine the likelihood of earnings management to be practiced in the context of Malaysian public listed family firms. Besides that, this study also aims to identify the types of family ownership in public firms and investigate the relationship between the types of family ownership and earnings management practices in Malaysia.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### AGENCY THEORY AND FAMILY FIRMS

Jensen and Meckling (1976) described agency theory as the principal-agent relationship between shareholders and the management team in a firm. According to Salvato and Moores (2010), there are two types of agency problems: conflict between shareholders and managers (Type I agency problem) and conflict between controlling shareholders and non-controlling interests (Type II agency problem).

Type I agency problem exists when there is a separation between ownership and control. It enables the managers to perform tasks or make decisions in opportunistic ways to obtain personal wealth in terms of incentives or bonuses at the expense of the shareholders (Jensen & Meckling 1976). On the other hand, type II agency problem occurs when there is a conflict between the controlling and non-controlling shareholders. The non-controlling shareholders can be misappropriated by the unscrupulous conducts of the controlling shareholders, since the latter have majority rights in making economic and non-economic decisions. Villalonga and Amit (2006), as well as Ali et al. (2007) opined that a majority of agency problems are a result of the clash between controlling and non-controlling shareholders (Type II agency problem).

Research also claimed that in family firms, higher benefits and costs are borne by the same owner when ownership is high and concentrated (Demsetz & Lehn 1985). Family companies usually invest most of their private wealth in the company. That is one of the reasons why families are more concerned with the firm's survival because the risks are not fully diversified, and they have strong incentives to monitor management closely. The monitoring cost tends to be lower in companies controlled by family than by non-family (Fama & Jensen 1983; Fleming, Heaney & McCosker 2005). As a result, this study emphasizes Type II agency problem.

## STEWARDSHIP THEORY AND FAMILY FIRMS

In stewardship theory, managers act as “stewards” in performing their tasks in the firms. In addition, stewardship theory perceives a range of non-financial motives that can affect the managerial behavior of the managers. In this theory, stewards are motivated by higher-level needs. For instance, they may wish to obtain intrinsic satisfaction from job performance, the need for self-achievement, recognition from others, and so on. These concepts in stewardship theory are supported in previous literature (Argyris 1964; Herzberg 1966; McClelland 1967).

In this theory, executive directors are seen as highly valuable to boards because they provide specialized knowledge and expertise about their organizations and are better at evaluating the CEO due to their familiarity with the quality of his/her decisions (Baysinger & Hoskinson 1990; Wagner, Stimpert & Fubara 1998).

Previous studies indicated that family firms can apply stewardship theory very well because most of the controlling families usually have a personal attachment and a close relationship with the firm (Anderson & Reeb 2004; Miller & Le Breton-Miller 2006). In family firms, controlling families are less likely to be involved in managing the earnings to the best interest of the firms in the long run. Therefore, for studies related to family firms, stewardship theory is more appropriate in answering the research questions. It is expected that the independent variables (such as firm characteristics, board size, independent non-executive director, director’s qualification, director’s expertise, and leadership structure) could influence the company’s performance.

## FAMILY FIRMS IN MALAYSIA

In East Asian corporations, firms are usually controlled by families through the use of pyramids and participation in management (La Porta, Lopez-De-Silanes & Shleifer 1999). A study by Claessens, Djankov and Lang (2000) in nine East Asian countries including Malaysia reported that more than two thirds of the firms are controlled by single shareholders. About 60% of concentrated firms’ top management relate to the family of the controlling shareholder. The extensive family control is more than half of East Asian firms. In Malaysia, share of most Malaysian companies are commonly concentrated by the ownerships of the families. Accordingly to Abdullah and Mohd Nasir (2004), 73% of the shareholdings are owned by the top twenty shareholders and most of them are family members. In this study, the more appropriate description of family firms is that a big number of the share capital of a firm belongs to the family or/and families associated by near affinity, which enables them to make economic and management decisions. Based on Shleifer and Vishny (1997), family firms that have concentrated ownership are able to monitor the operations more efficiently.

There are many past studies that have been done on the relationship between the influence of family ownership

structure and the financial result of the firms in Malaysia. According to Rahman (2006), numerous public listed firms in Malaysia are family-owned or controlled. These firms are dominated by family founders and their descendants. According to Ngui (2002), family firms supplement more than 50% of the Malaysian Gross Domestic Product (GDP). Daily and Dollinger (1992) indicated that family firms often have different organizational structure, operating process, and strategic management compared to professionally managed firms. Moreover, Daily and Dollinger (1992) also claimed that managers who are also the owners or shareholders in the family firms perform their work differently from those of professional managers. They are more likely to make decisions for the longer view of the firms. The findings from Ishak et al. (2011) indicated that the efforts to mitigate earnings management are significantly reduced when family members are present on a corporate board, especially when they dominate it. Abdullah and Ku Nor (2016) indicated that among listed companies, the representation of women on the boards (WOMBDS) and audit committees are not connected to a decline in the practice of earnings management. The authors further argued that family ownership does not moderate the relationship between the presence of WOMBDS, audit committees, and earnings management. Sa’adiah et al. (2013) found the non-linear relationship between family ownership and earnings quality. The authors suggested that firms are more likely to report higher earnings quality with smaller family ownership levels in firms. However, as family ownership becomes more significant, expropriation activities through related-party transactions then substantially and negatively affect the earnings quality of firms.

## EARNINGS MANAGEMENT (EM)

According to Schipper (1989), EM is a cautious interference in the process of preparing financial reports to gain some personal advantages or benefits. Commonly, EM happens “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 & Wahlen 1999).

Nelson et al. (2003) and Cheong et al. (2015) indicated that EM are normally exercised by manipulating some specific costs such as provisions for risks and charges, cost capitalization, impairment of assets and depreciation, as well as amortization expenses. EM can be done by real EM affecting the firm’s cash flows and by accruals EM changes in accounting estimates and accounting policies (Lo 2008). According to Dechow et al. (2010), there are six categories of determinants for earnings quality: (1) firm characteristics, (2) financial reporting practices, (3) governance and controls, (4) auditors, (5) equity market incentives, and (6) external factors. This study aims to determine the likelihood of Malaysian family controlled and listed firms in earnings management practices.

## EARNINGS MANAGEMENT AND FAMILY OWNERSHIP

There are two contrasting perspectives in relation to the influence of family ownership on EM. There are two different approaches that family ownership could disturb the EM, i.e. the entrenchment and alignment effects (Wang 2006).

Jensen and Meckling (1976) explained that more equity ownership by the manager may increase corporate performance because it means better alignment of the monetary incentives between the manager and other equity owners. As a result, when managerial ownership increases, there is a greater alignment of interests of managers and outside shareholders. Given their unique and influential positions within their firms, family owners significantly impact agency conflicts. On one hand, because the agency problems between owners and managers tend to erode firm value, family owners may seek to align managers' incentive with those of shareholders to alleviate such agency problems (the incentive alignment effect) (Chen et al. 2011). This type of disposition suggests that the benefits of the controlling owners are consistent with other minority shareholders, since the founding families possess big quantities of the equity shares, and they hold the shares of the firms for a long-term prospect. Based on studies in developed nations, a majority of family firms are likely to have less EM practices (Wang 2006; Ali et al. 2007; Tong 2007; Jiraporn & Dalt 2009; Cascino et al. 2010). In family firms, the controlling families are expected to have greater efforts in monitoring managerial behaviors and operating procedures effectively and thus, managerial opportunities to manage earnings can be minimized.

Entrenchment effect expects that family ownership is positively related with earnings management. It is because controlling families may opportunistically manage earnings. Consistent with the agency theory, concentrated ownership in family firms may have greater incentives for controlling shareholders to expropriate wealth from other shareholders. Prior empirical studies found that family firms are associated with higher earning quality and greater access to earning information (Fan & Wong 2002; Bartholomeusz & Tanewsk 2006; Warfield et al. 1995; Wang 2006). Besides that, there are some evidence from Europe that indicated that family firms exercise a higher level of earnings management (Principe et al. 2008; Principe et al. 2011).

Controlling families cover up their self-oriented behaviors by manipulating earnings figures (Fan & Wong 2002). They may practice earnings management to alter the transactions of the firms to the sake of their self-interest. It is because they are more concerned with the family and firm's reputation. Family firms are more likely to manage their earnings to retain the current family-controlling position and the related benefits received from the firms (Principe et al. 2008). Thus, the findings by Fan and Wong (2002) indicated that the larger the family ownership are in family firms, the stronger the motivation of controlling families to expropriate minority shareholders and the higher the degree of earnings management.

In furtherance of the alignment effect, the family firms ensure that the controlling families put in greater efforts at monitoring managerial behaviors and operating procedures to effectively minimize the managerial opportunities required to manage earnings. Controlling families have more obligations in ensuring the firms inherited to them are being operated in the best interest of the overall firm. Therefore, controlling families will monitor the performance of managers to prevent them from managing earnings for their private benefits.

Furthermore, according to stewardship theory, earnings management practices are less likely to occur in family firms, since the controlling families would identify their interests more closely with the firms' wealth (Tosi Jr. & Gomez-Mejia 1989). Controlling families will make economic decisions that can benefit the firms the most, rather than motivated by self-benefits. They will not manage earnings merely to show high revenue in order to receive better compensations.

The results of studies on earnings management in family firms are conflicting and cannot easily be generalized. Thus, the directional relationship between earnings management and family firms remains an empirical question. Based on the hypothesis on entrenchment effect (Jensen & Meckling 1976; Fama & Jensen 1983; SáenzGonzález & García-Meca 2014) and the empirical evidence that shows that controlling families have a long-term orientation in operating family businesses (Anderson et al. 2003; Gomez-Mejia et al. 2007; Jiraporn & DaDalt 2009; Salvato & Moores 2010), as well as the aspiration to pass family firms onto succeeding generations in the future (Berrone et al. 2012; Achleitner et al. 2014), they conclude that family firms are less intent to manage earnings.

The theories and results of previous studies relating to earnings management in family firms can be applied to earnings management in the context of Malaysian family firms. As the controlling families hold the majority of the shares in the family firms, they can have significant influence on the practice of managing earnings. It is because controlling families are more concerned with the family reputation and wealth maximization. They can achieve the two motivations by managing the earnings of the firms to make the firms' performance appear more favorable to them. DeAngelo and DeAngelo (2000) claimed that controlling families tend to reduce dividends of non-controlling shareholders while distributing themselves with high dividends. It indicates that controlling families have the likelihood of exploiting wealth from non-controlling shareholders to benefit themselves.

The results of studies on earnings management in family firms are conflicting and cannot be easily generalized. As the controlling families hold the majority shares in the family firms, they can have a significant influence on the practice of managing earnings. It is due to the fact that the controlling families are more concerned with the family reputation and wealth maximization.

In addition, the equity ownership of controlling families is associated with the earnings management in

family firms. When there is twenty percent or more of the equity shares in a firm owned by the members of the same family, the firm is classified as a family firm. La Porta et al. (1999) indicated that when there is a larger equity ownership of controlling family in family firms, it is more likely that the controlling family will exploit the interest of non-controlling shareholders. They have the right in choosing accounting policies and deciding the extent to which accounting information are to be disclosed to the stakeholders. As a result, this study focuses on the equity ownership of controlling family in a more specific manner.

Family firms are the firms in which the founding families or a minimum of one family member in the controlling families is in the highest management as board of directors in the firms. The involvement of controlling families as board of directors enables the controlling families to monitor the actions of the managers. Besides that, some of the controlling family members who are involved as board of directors do not possess sufficient and professional knowledge in managing a firm. When the performance of the firm is not as expected due to management ineffectiveness, the controlling families may practice earnings management to uphold their family reputation.

Besides direct equity ownership, when the shares of the firms are also indirectly owned by the members of the same family, the controlling families can have influence on the decision-making of the firms. They can indirectly influence the decisions made by the firms on the operating policies and procedures of the firms through the direct equity shares held by the other family members. Therefore, the controlling families may manage earnings in the family firms to satiate their own personal self-interest through the indirect ownership of equity shares. As a result, the proposed hypotheses are as follows:

- H<sub>1a</sub> Equity ownership of controlling family is positively associated with EM.
- H<sub>1b</sub> Involvement of controlling family as board of directors is positively associated with EM.
- H<sub>1c</sub> Indirect ownership of controlling family is positively associated with EM.

#### FIRM SIZE AS CONTROL VARIABLE

Moses (1987) discovered that firm size is associated with the changes in the accounting method to smooth (as opposed to decrease) earnings. Watts and Zimmerman (1986, 1990) suggested that large firms are more likely to engage in EM practices, as they wish to reduce their political costs, including tax liabilities (Koh 2007). Managers in larger firms tend to manage earnings through the perspective of reducing high political costs.

However, a different viewpoint opines that, since large firms are able to grab additional consideration from financial analysts and the stakeholders, they are more difficult in concealing EM practices (Sánchez-Ballestaand & García-Meca 2007). As such, large firms are less likely

to manage earnings compared to small firms (Doyle et al. 2007; Swastika 2013). Since the firm size can affect the result of this study, it is placed as the control variable throughout this study. Although there are others control variables (such as types of industry, profitability, CEO tenure and number of years in operation) that might influence the earning management, it is not the main intention of this current study to investigate the effects of control variables. More importantly, this current study would like to focus on the major effect of family firm on earning management in Malaysia.

## METHODOLOGY

### SAMPLE

This study focuses on the non-financial public listed firms from Bursa Malaysia from the years 2010 to 2014. Family firms were identified based on the percentage of family members' equity holdings. Thus, companies without family ownership are excluded from the sample. This current study emphasizes on the extent of family control, rather than the existence of significant family control in a firm. The types of public listed family firms in Bursa Malaysia were identified according to the following criteria: equity ownership of controlling family, involvement of controlling family in board of directors, and direct and indirect ownership of the controlling family. The companies without a full 5 years of annual reports were excluded from the selection. 100 samples from the public listed family firms were then randomly selected to perform multiple regression. Hair et al. (2007) suggested that a sample of 100 cases is sufficient to perform multiple regression. As a result, a total of 500 (5 years x 100 companies) observations were obtained. Annual reports of the sample companies are the main source of data.

### RESEARCH VARIABLES

The research variables are presented in Table 1.

#### MODIFIED JONES MODEL (1991)

In this study, Modified Jones Model (1991) is used to explain the discretionary accruals (DACC), which indicates the extent of earnings management in family firms (Dechow et al. 1995). The discretionary accruals are calculated as the difference between the total and non-discretionary accruals. The total accruals can be determined as follows:

$$\text{Total Accruals (TACC)} = \text{Net profit after tax (NPAT)} - \text{Net cash flow from operations (CFO)} \quad (1)$$

To estimate the discretionary accruals for firm *i* in year *t*, the cross-sectional regression for each company is performed as shown below:

TABLE 1. Operationalization of the research variables

Variables	Proxies	Labels	Operationalization
Family Firms (FF- Independent Variables)	Equity ownership of controlling family	EO	To determine whether the controlling family owns 20% or more of the equity share, the suggested measurement of equity ownership is as follows:  Equity ownership = (number of shares owned by controlling family, including top officers, non-executive directors, and large shareholders) / (number of total outstanding shares for the firm)
	Involvement of controlling family as board of directors (IBOD)	IBOD	Percentage of controlling family members as board of directors = number of controlling family members in BOD / total number of directors in BOD
	Indirect ownership of controlling family	IO	The control rights can be computed by:  Sum of indirect control right in the terminal of each chain of control by its controlling shareholding in percentage
Earnings Management (EM-Dependent Variable)	Discretionary accruals	DACC	Modified Jones Model (1991)
Firm Size (FS-Control Variable)		FSIZE	The logarithm of assets aggregation of the firm. It is measured by:  log (total assets)

$$\frac{TACC_{i,t}}{AT_{i,t}} = \alpha_0 \left( \frac{1}{AT_{i,t-1}} \right) + \alpha_1 \left( \frac{\Delta REV_{i,t}}{AT_{i,t-1}} \right) + \alpha_2 \left( \frac{PPE_{i,t}}{AT_{i,t-1}} \right) + \varepsilon_{i,t} \quad (2)$$

The non-discretionary accruals (NDACC) are calculated as follows:

$$\frac{NDACC_{i,t}}{AT_{i,t}} = \alpha_0 \left( \frac{1}{AT_{i,t-1}} \right) + \alpha_1 \left( \frac{\Delta REV_{i,t} - \Delta AR_{i,t}}{AT_{i,t-1}} \right) + \alpha_2 \left( \frac{PPE_{i,t}}{AT_{i,t-1}} \right) \quad (3)$$

Hence, using the estimated coefficient in Modified Jones Model (1991), the discretionary accruals are estimated as shown below:

$$\frac{TACC_{i,t}}{AT_{i,t}} = \alpha_0 \left( \frac{1}{AT_{i,t-1}} \right) + \alpha_1 \left( \frac{\Delta REV_{i,t} - \Delta AR_{i,t}}{AT_{i,t-1}} \right) + \alpha_2 \left( \frac{PPE_{i,t}}{AT_{i,t-1}} \right) + \varepsilon_{i,t} \quad (4)$$

where:

$\alpha_0, \alpha_1, \alpha_2$  = estimated coefficients of Modified Jones Model (1991);

$TA_{i,t}$  = total accruals for sample firm *i* in year *t*;

$\Delta REV_{i,t}$  = change in net revenue for firm *i* in year *t*;

$\Delta AR_{i,t}$  = change in accounts receivable for firm *i* in year *t*;

PPE = property, plant, and equipment for firm *i* in year *t*; and

$TA_{i,t}$  = total assets for firm *i* in year *t*.

#### MULTIPLE REGRESSION MODEL

This study used a multiple regression model to test the relationship between the research variables. It is used to

estimate the value of a dependent variable based on the value of independent variables, as shown in Equation 5.

$$\text{Multiple Regression Model: } EM = \alpha + \beta_1 EO + \beta_2 IBOD + \beta_3 IO + \beta_4 FSIZE + \varepsilon \quad (5)$$

Where:  $\alpha$  - Intercept;  
 $\beta$  - Regression coefficient;  
 $\varepsilon$  - Error term;  
 EO - Equity ownership of controlling family;  
 IBOD - Involvement of controlling family as board of directors;  
 IO - Indirect ownership of controlling family;  
 EM - Earnings management, with DACC as its proxy; and  
 FSIZE - Firm Size.

#### RESULT AND DISCUSSION

Table 2 shows the various sectors of the companies. A majority of the family firms (33%) were engaged in industrial products, followed by consumer products (19%), and technology and trading services at 12%. This indicates that industrial products are more popular among family firm in Malaysia.

Table 3 indicates the descriptive analysis of EO, IBOD, FSIZE, and DACC. As shown in Table 3, the skewness and kurtosis values indicate that the data is normal and meet the

TABLE 2. Sectors of sample family firms

Sectors	Percentage (%)
Consumer Products	19
Industrial Products	33
Technology	12
Trading Services	12
Others	24
Total	100

range of -1.96 to +1.96 (Ghasemi & Zahediasl 2012). The mean values of the research variables range from -0.033

TABLE 3. Descriptive statistics

Variables	Skewness	Kurtosis	Minimum	Maximum	Mean	Standard Deviation
EO	0.658	2.361	20.11	71.84	36.561	12.663
IBOD	-0.129	2.085	12.50	60	37.941	12.526
IO	0.828	2.375	0	90.88	24.402	27.561

Table 4 reveals the Pearson correlation test of the research variables. The correlation between all variables were less than +/- 0.6, indicating that the variables were not highly correlated. This also indicates the non-existence of multicollinearity problem.

TABLE 4. Summary of correlation analysis

Variables	DACC	EO	IBOD	IO	FSIZE
DACC	1				
EO	0.055	1			
IBOD	-0.020	0.299	1		
IO	0.048	-0.039	0.117	1	
FSIZE	0.109	-0.125	-0.100	-0.081	1

## TEST FOR MULTICOLLINEARITY

Table 5 shows the VIF and tolerance values used to determine the multicollinearity issue. From there, it is implied that the values are under the cut-off level of rule of thumb, since the VIF values are smaller than 5 or 10, and the tolerance values are greater than 0.2 or 0.1. It suggests that there is no association between the independent variables, which are equity ownership of the controlling family, involvement of the controlling family as board of directors, and indirect ownership of the controlling family. Thus, multicollinearity does not occur between the independent variables and the reliability of the data can be assured.

Table 6 presents the Multiple Regression Analysis of this study. It suggests that the adjusted R<sup>2</sup> of the model is 0.0146. This low R<sup>2</sup> is also consistent with Noor and Ayoib (2013) which shown a 2% adjusted R<sup>2</sup>. It also indicates

to 36.561. On average the equity ownership of controlling family is slightly higher than 36% and this number is also consistent with the mean value of involvement of controlling family as board of directors which is slightly below 38%. The finding also reveals that around 24% equity are through indirect ownership of controlling family. In general, family owned companies in Malaysia are comfortable to own more than 24% to maintain the controlling state of the firm.

TABLE 5. VIF and tolerance values

Model	Variables	Collinearity Statistics	
		VIF	Tolerance
Independent Variables and Dependent Variables (Family Firms and Earnings Management)	EO	1.123	0.890
	IBOD	1.116	0.896
	IO	1.021	0.979
	FSIZE	1.020	0.980

that only 1.46% of the dependent variable (discretionary accruals) can be jointly described by the independent variables in this research, which are equity ownership of the controlling family, involvement of the controlling

TABLE 6. Summary of multiple regression analysis

	Unstandardized Coefficients		t-Value	Sig
	B	Std. Error		
Model: Family Firms and Earnings Management				
DACC (Constant)	-1.413	0.514	-2.75	**
EO	0.005	0.003	1.78	**
IBOD	-0.002	0.003	-0.85	ns
IO	0.002	0.001	1.29	ns
FSIZE	0.150	0.058	2.60	**

R<sup>2</sup> = 0.0225

Adjusted R<sup>2</sup> = 0.0146

F Value = 2.85

F Significance = 0.0235

Note: \* represents P < 0.05 (significant); \*\* represents P < 0.01 (significant); ns represents non-significant.

family as board of directors, and indirect ownership of the controlling family. On the other hand, the remaining 98.54% of the dependent variables can be indicated by other variables, since not all variables are used in this research. This study aims to study the outcomes of the dependent variable that resulted from specific independent variables, rather than the general outcome, hence the non-discussion of the result of the control variable. Another possible reason for this low  $R^2$  could be due to only one control variable i.e. firm size used in this study.

Unstandardized coefficients (B) are used to predict the impact of independent variables towards dependent variable by developing a regression equation. The figures shown in Table 2 are employed to form a regression equation as follows:

$$Y (\text{DACC}) = -1.413 + 0.005 (\text{EO}) - 0.002 (\text{IBOD}) \\ + 0.002 (\text{IO}) + 0.150 (\text{FSIZE})$$

In this model, it examines the association between the family firms and EM. No statistically significant linear dependence of the mean of discretionary accruals on involvement of the controlling family as board of directors and indirect ownership of the controlling family is detected. However, the equity ownership of the controlling family is statistically significant ( $p$ -value  $< 0.1$ ) and positively associated with the discretionary accruals with a  $t$ -value of 1.78. This result is consistent with the past study by Chi et al. (2015), which suggested that the controlling families may opportunistically manage earnings for their families' self-interest. Since the controlling families hold the majority shares in family firms, they are motivated to manage earnings so that the financial reports are more favorable to them.

Moreover, this model implies that firm size is statistically significant ( $p$ -value  $< 0.01$ ) and positively associated with discretionary accruals with a  $t$ -value of 2.6. The result is consistent with previous studies done by Koh (2007) and Yang (2010), which stated that earnings management is more likely to be exercised by large firms, since a larger number of investors pay more attention to them. Hence, larger firms tend to manage their earnings to reduce the political costs such as income tax liabilities.

From the research findings, it implies that the equity ownership of the controlling family is positively associated with EM. Hence, the hypothesis  $H_{1a}$  is supported when the firm size is being controlled. When controlling families effectively control the family firms by holding a majority of the shares, they are motivated to make decisions for their own interests. Thus, type II agency problem between controlling shareholders and non-controlling shareholders is more likely to occur. Besides that, there is less transparency of information. The non-controlling shareholders may not receive complete information, which reflects the true underlying situations of the firms. Controlling families may manage earnings without the supervision of non-controlling shareholders to fulfill their self-interest.

However, this study shows that the involvement of the controlling family as board of directors does not have statistically significant association with EM. Therefore, the hypothesis  $H_{1b}$  is not supported when the firm size is being controlled. In Malaysia, Bursa Malaysia Listing Requirements requires all listing firms to comply with the Malaysian Code on Corporate Governance 2012, which states that "the positions of chairman and CEO should be held by different individuals, and the chairman must be a non-executive member of the board". It is to ensure that the board of directors' oversight and monitoring of the business operations of a firm is independent. In family and public listed firms in Malaysia, the controlling family members who are involved as board of directors are less influential in managing earnings for self-interest. They are less likely to have conflict of interest in their roles and responsibilities, and hence, they may find it difficult to manage earnings at the expense of other non-controlling shareholders.

A new Malaysian Code on Corporate Governance 2017 (MCCG) was released by the Securities Commission Malaysia in relation to having more effective monitoring process such as (1) strengthening independence of the board that at least half of the board must comprise of independent directors and, for large Companies, there must be a majority of independent directors and discourages an independent director from serving for more than 9 years; (2) strengthening the independence of the audit committee whereby the chairman of the audit committee must not be the chairman of the board; and (3) MCCG reinforces the need for the transparency of board remuneration and accountability to the shareholders.

Furthermore, the findings in this study showed that the indirect ownership of the controlling family in family firms does not have statistically significant association with EM. Therefore, the hypothesis  $H_{1c}$  is not supported when the firm size is being controlled. The indirect ownership of the controlling family in family firms does not provide greater opportunity for them to manage earnings through direct equity shares held by other family members. It is because the decisions to select accounting policies and procedures are made by the direct shareholders of the firm. The controlling family has limited power to influence the accounting policies and procedures to be implemented in a family firm through their family members, and they may not be persuaded to resort to the practice of EM.

## IMPLICATIONS AND CONCLUSION

This study determines the association between types of family ownership and earnings management in Malaysian public listed family firms. The research findings showed that family firms are more likely to engage in managing earnings in order to achieve their objectives. When controlling families have the majority equity ownership in family firms, they are more likely to manage the earnings of the firms.



Some theoretical implications can be derived from this research. From the research findings, it is implied that agency theory is more aligned with earnings management practices in family firms. Agency theory states that there is a conflict of interest between shareholders and managers, as well as majority shareholders and minority shareholders. Hence, type II agency problem occurs when majority shareholders in family firms, which are made up of controlling family members, manage earnings at the expense of the non-controlling shareholders. They may reduce earnings to reduce the fluctuation of financial performance of the family firms.

When stewardship theory is applied in this study, it indicates that controlling families and managers will monitor and operate the family firms for the best interest of the firms for the long-run. They will not engage in earnings management for their self-interest such as income smoothing and wealth maximization. Instead, they have a great sense of responsibility and desire for high job performance, which can in turn benefit the firms. However, the findings in this research fail to support stewardship theory, since the controlling family tends to manage earnings in family firms for their own purposes.

This study provides some implications for the management of family firms. As family firms have the characteristics of concentrated ownership, the corporate governance mechanism of family firms should be strengthened. An effective corporate governance mechanism can improve firms' financial and non-financial performance, hence making them more sustainable in the long-run. When effective corporate governance mechanism is implemented in a family firm, the controlling shareholders will make decisions for the best interest of all the stakeholders. It can increase the confidence and trust level of outside investors so that they will retain their investments in family firms.

Moreover, this study also provides some implications for the regulators. Since the ownership of family firms is concentrated, the financial reports of family firms are highly reflective of true economic conditions. Therefore, the regulators need to develop suitable accounting policies to ensure that family firms have clear guidelines and rules of operations. Besides that, it can prevent the controlling families from exercising abusive earnings management.

Earnings management can be done by making decisions to adjust discretionary accruals. The decision to adopt accounting policies and procedures rely upon the controlling family, which has the majority power and rights in the firms. Hence, they will manipulate the accounting information to tweak the financial results of the family firms as if the pre-set financial targets are achieved. For instance, increasing earnings can boost the financial results as if the firms are operating well. On the other hand, decreasing earnings for a financial period is used in income smoothing to stabilize the share price and reduce income tax liabilities.

According to Abdul Rahman (2006), there are many public listed firms in Malaysia that are owned and

controlled by family. Family firms play an important role in the Malaysian economic growth. Thus, the practice of earnings management in family firms should be given more attention because it can affect the financial results of the firms. When family firms manage their earnings within the boundaries of approved accounting standards, the earnings of the firm become higher, and it is beneficial for the investors, as they can get good return from their investments.

However, the controlling shareholders in family firms may abuse their controlling rights to manage earnings without considering the interests of other non-controlling shareholders. When outside investors do not possess the complete information, they will make investment decisions based on the information disclosed in annual reports or financial statements. If the investors made investments decisions based on the materially misstated financial reports, they may incur losses.

While this current study hope to contributing to an important line of research that examines the issues relating to earnings management, we also recognise that it has several limitations. Firstly, the framework only considers family firm in Malaysia, it should involve more countries so that the generalisation of the findings is open to question. Secondly, only one control variable which is size and future research should include other control variables such as types of industry, profitability, CEO tenure and number of years in operation. Thirdly, this study have applied only simple statistical methods to analyse the relationship between family ownership structure and earning management. Certainly, more complete causal modelling techniques such as structural equation modelling could be used in other studies. These limitations notwithstanding, we hope this study has made a small contribution in an important area of earning management.

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