CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT AMONG SHARIAH COMPLIANT COMPANIES IN MALAYSIA: A REVIEW OF LITERATURE

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Abstract: Corporate governance is one of the vital parts of any corporation’s development, as it plays a role in designing and promoting principles of fairness, accountability and transparency. There has been much debate and discourse on the issue of corporate governance for many years such as earnings management and others. The concept of corporate governance is becoming much more popular since there have been more corporate failures due to ineffective governance. As Islamic businesses are currently gaining worldwide acceptance, Malaysia is becoming a centre for Islamic business activities. The concerns for Shariah-compliance have brought a new dimension of governance which falls under the corporate governance framework called Shariah governance. The main purpose of this paper is to highlight the corporate governance and the occurrence of earnings management among the Shariah-compliant companies as discussed in literature. This paper extends the current literature on corporate governance in Malaysia. This paper should be able to assist the regulators, industrial players, Shariah advisors and researchers regarding the corporate governance and earnings management among Shariah-compliant companies in Malaysia.

Keywords: Corporate Governance, Earnings Management, Shariah-compliant, Shariah Governance

INTRODUCTION

The aim of corporate governance is to promote strong, viable competitive corporations accountable to stakeholders. Good corporate governance improves overall performance and promotes trust among shareholders and other stakeholders. Besides, good corporate governance also provides for sound strategic planning and better risk management. As Islamic businesses are currently gaining worldwide acceptance, Malaysia is becoming a centre for Islamic business activities. The concerns for Shariah-compliance have brought a new dimension of governance which falls under the corporate governance framework. Companies that embrace best practices for governance continually move toward long-term sustainability and Shariah-compliant companies also are not excluded. Good governance prevents litigiousness and provides far-reaching legal protections for Shariah-compliant companies.

The term governance has become an important concept in a variety of different disciplinary and practice arenas including management, public administration, public policy and others. It has its roots in a Latin word meaning to steer or give direction. Although
Corporate governance has long been in existence, the awareness of it grew in the later half of the 20th Century in the West.

And in Malaysia, corporate governance only became an issue during the 1997 economic crisis (Tze, 2003). The Asian Financial Crisis of 1997 particularly affected Malaysia, one of the main contributors being the weak corporate governance practices of Malaysian companies. Some of the weaknesses identified were lack of transparency, disclosure and accountability.

For example, the Asian Financial Crisis that started in 1997, many investors lost their investments in these Asian economies. Johnson et al. (2000) report that these economies were not only weak in their macroeconomic indicators but a major cause of the Asian Financial Crisis was their weak regulatory system. Thus, in order to restore the confidence of the investors, different countries revisited their regulatory environment to protect their investors such as the corporate governance’s codes.

CORPORATE GOVERNANCE STRUCTURE

The Malaysian Code of Corporate Governance (MCCG 2000) which sets out the principles and best practices of corporate governance for Malaysian public listed companies was released by the Finance Committee on Corporate Governance in March 2000. In January 2001, the Code was brought into effect with amendments to the Bursa Malaysia’s listing requirement. Corporate governance in Malaysia has developed since the enactment of the Malaysian Companies Act in 1965 which established a governance framework including issues such as corporate structure, disclosure requirement, duties and liabilities of directors, protection of shareholders in general and minority shareholders in particular, as well as the reporting and compliance requirements. Before the Asian financial crisis of 1997, efforts to strengthen aspects of good governance practices in Malaysian corporate sectors had commenced with the introduction of the Securities and Industry Act (SIA) 1983, the Banking and Financial Institution Act in 1989, and the Securities Commission Act in 1993. In addition, the Code of Ethics for Directors had been introduced in 1996 by the Companies Commission of Malaysia as an initiative towards creating better board of directors. The financial crisis in 1997 has provided an impetus for corporate governance reforms in Malaysia.

The Malaysian Securities Commission released a revised Code of Corporate Governance in 2007 which aims to strengthen Malaysia’s corporate governance framework, especially the roles and responsibilities of boards of directors and audit committees, and bring it in line with current global best practice. Furthermore, the revised listing requirements required directors of Malaysian listed companies to attend a compulsory training programme (known as the mandatory accreditation of directors) covering matters such as directors’ legal rights and responsibilities, operation of the board of directors, listing requirements, risk management and internal control, and relevant securities laws. Moreover, the revised Code details the composition of audit committees, the frequency of meetings and the need for members to attend continuous training in financial and other related development. In order to preserve the independence of the audit committee, the executive directors will no longer be allowed to become members of the audit committee.

The MCCG 2000 was revised in 2007 with the aim to strengthen the roles and responsibilities of boards of directors, audit committees and internal auditors in the financial reporting process, to assist them in effectively discharging their duties, and bring the code in
line with current global best practice (Anwar, 2007). Amongst the recommendations on best practice, is that the nomination committee should have the necessary skills, knowledge, expertise, experience, professionalism and integrity to strengthen the board and ensure the board discharges its roles and responsibilities effectively. Furthermore, the audit committee is required to comprise at least three members (all non-executive directors), a majority of whom are independent. In addition, the revised code recommends all audit committee members be financially literate (able to read, analyse and interpret financial statements) with at least one member being a member of an accounting association or body.

**EARNINGS MANAGEMENT**

The most common definitions of earnings management in academic writing on accounting are from Schipper (1989) and Healy and Wahlen (1999). Schipper (1989) defines it as, “an involvement in the process of preparing financial statements, purposely to acquire personal benefits”. A similar definition of earnings management as an opportunistic behaviour is expressed by Healy and Wahlen (1999) as follows: “...earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.” (1999, p. 368)

Similarly to Healy and Wahlen, Landsittel (2000) stated that earnings management is “where public companies inappropriately manage earnings by intentionally recording accounting misstatements in order to adjust reported earnings presumably to obtain a targeted earnings figure or facilitate an earnings growth”.

Earnings management involves the selection of accounting procedures and estimates that conform to generally accepted accounting principles (GAAP). Explicitly, firms that have earnings management would still be classified as within the bounds of accepted accounting procedure manipulation as conservative accounting, neutral earnings and aggressive accounting are all within the GAAP.

Parfect (2000) mentioned that improper earnings management is a bad and unproductive behaviour arising in a complex situation, one in which analysts and investors are key players along with corporate management. He made distinctions between ‘good’ and ‘bad’ earnings management, seeing ‘bad’ earnings management, or improper earnings management, as intervention by management to hide real operating performance by creating artificial accounting entries or stretching estimates beyond a reasonable point. However, the ‘good’ kind of earnings management involves reasonable and proper practices that are part of operating a well-managed business and delivering value to shareholders (Parfect, 2000).

A diverse definition by Giroux (2004) has earnings management comprise the whole range of accounting decisions from conservative to fraud and asserts that the huge range of accounting judgments provide incentives to management. The chief financial officer, in conjunction with executives and board members, develops a perspective on what the economic reality is and how it should be reported. This is a dynamic process that may change from quarter to quarter, as meeting financial analysts’ expectations is important. Within this approach, he further defines earnings management as a practice in financial reporting towards some objectives and plan (Giroux, 2004).
Meanwhile, Ronen and Yaari (2008) offer an alternative view of earnings management and summarize different definitions of earnings management by classifying them as white, gray and black. Earnings management is considered as beneficial (white) if it enhances the transparency of reports; pernicious (Hair et al.) if it involves outright misrepresentation and fraud, and gray if the manipulation of reports is within the boundaries of compliance with bright-line standards, which could be either opportunistic of efficiency enhancing (Ronen & Yaari, 2008). They further claim that earnings management can be beneficial if it signals long-term value, pernicious if it conceals short or long term value, and neutral if it reveals the true short term performance.

The definitions of earnings management actually differ depending on the instruments of manipulation, the purpose of the earnings management behaviour, and its timing. Although defined in a variety of ways, the previous literature on the definition of earnings management generally agree it comprises elements of an action purposely undertaken to alter the information in financial statements in order to mislead their user. As such indiscretion is normally performed by the managers with the objective of acquiring some personal benefits, this is an opportunistic behaviour and, as such, is prohibited in Islam (Al-Kashif, 2009).

On the other hand, financial fraud, which deliberately distorts the true economic performance of a business, clearly violates GAAP. Financial fraud has been defined by the Association of Certified Fraud Examiners as purposely misleading information prepared in order to influence the user of the information to change their decision, and therefore does not come under the umbrella of earnings management.

**Earnings Management in Malaysia**

Malaysia is definitely not lagging in the research of earnings management. Studies on subjects such as earnings management and debt renegotiation have been conducted by Mohd Saleh and Ahmed (2005), and Ahmed, Godfrey and Saleh (2008) while earnings management and corporate tax rate has been investigated by Roubi and Richardson (1998), and Adhikari, Derashid and Zhang (2005). In the same area, earnings management and initial public offerings has been examined by Ahmad-Zaluki, Campbell and Goodacre (2009), while, Johl, Jubb, and Houghton (2007) investigated the association of earnings management and audit opinion.

More recently, the association between several corporate governance practices (board of directors, audit committee, institutional investors and culture) and earnings management have been investigated by Abdul Rahman and Mohamed Ali (2008), Abdullah and Mohd Nasir (2004), Guan, Pourjalali, Sengupta and Teruya (2005), (Hashim & Devi, 2008b), and Mohd Saleh, Mohd Iskandar and Rahmat (2007), however, contradictory results were found in Malaysia.

According to Alkdai and Hanefah (2012), there were 17 cases of earnings manipulation from 1996 to 2012 have been reported by the Malaysia Securities Commission. The PricewaterhouseCoopers (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, PricewaterhouseCoopers (2011) reported that Transmile Group Bhd had an overstatement of its group income to the tune of RM530 million between the 2005 and 2006 financial periods. Hence resulted in the shareholders losing value in the prices of their shares and subsequently delisted from the Bursa Malaysia on the grounds of employee dissatisfaction, image loss, decline in reputation, and corporate relationships (PricewaterhouseCoopers 2011). Because of this corporate scandals and failures, corporate governance has become a common and controversial issue last few decades specifically on the role of board of directors in enhancing the performance of firms and mitigating earnings management activities.

Little research has been done on the influence of Shariah law on earnings management. The Islamic law requires accountability, transparency, justice, and honesty in all business transactions and prohibits opportunistic behaviour. As defined by Healy and Wahlen (1999), earnings management reflects opportunistic behaviour by management, hence, in Islam, it is prohibited. However, in a different socio-economic environment, Ali Shah et al (2009) obtained evidence of earnings management in the mainly Islamic Pakistani capital market.

EARNINGS MANAGEMENT IN SHARIAH COMPLIANT COMPANIES

The compilation of best practice for corporate governance involves value systems such as accountability, transparency, responsibility, integrity (Omar, 2005). Those values are actually paramount in Islam. The word ‘Islam’ stands for, among other things, peace, purity, submission and obedience. Islam does not separate religious deeds from political, economic or social affairs. Furthermore, Islam encourages individuals to be involved in business and hence has clearly articulated commercial law to guide Muslims regarding the types of businesses that are lawful and those that are unlawful. The fiqh (Islamic law) prescribes the nature of allowable trade and services which generally requires justice, fairness, and honesty in all business transactions. Fiqh explicitly forbids transactions which are unclear, unfair, unjust and fraudulent. Islam puts great emphasis on the need for Muslims to be accountable to God and that accountability encompasses man’s accountability to his fellow men. The following verses in the Holy al-Quran elaborate the notion of accountability in Islam.

“To Allah belongs all that is in the heavens and on earth. Whether you show what is in your minds or hide it, Allah calls you to account for it.” (2:284)

“And fear the Day when you shall be brought back to Allah, then shall every soul be paid for what it has earned, and none will be dealt with unjustly.” (2:2)

In addition, guidance for accountants in discharging their accountability is stated in the following verses:

“O you who believe! Do not betray the trust of Allah and the Messenger (Muhammad), and do not misappropriate knowingly things entrusted to you.” (8:27)

“And know you know that your possessions and your children are only a trial; and that it is Allah with whom lies your highest reward.” (8:28)

Islam also forbids every type of fraud and deception and requires transparency in any disclosure practices as explicated in the following verses:
“O you who believe! Stand out firmly for Allah, as witnesses to fair dealing and let not the hatred of others to you make you lean towards wrong and depart from justice.” (5:8)

“O you who believe! When you deal with each other, in transaction involving future obligations in a fixed period of time, reduce them to writing. Let a scribe (writer) write down faithfully as (a responsible person) between the parties: Let not the scribe refuse to write: As Allah has taught him, so let him write....Do not object to reduce to writing (your contract) of the future period, whether it be small or big: It is more just in the sight of Allah, more suitable as evidence, and more convenient to prevent doubts among yourselves...Take witnesses whenever you enter into commercial contract.” (2:282)

Once a decision is made and consensus has been obtained on any matters, especially with regards to commercial contracts, it needs to be put into writing. This ensures disclosure and transparency in every business transaction. The record should portray the exact happening and not the manipulated figures.

CONCLUSION

Corporate governance framework should ensure, in order to provide relevant information for investors’ decisions, that the disclosure is timely and accurate on all material matters, is in accordance with high quality standards of accounting and disclosure and the audit and review of these disclosures by independent, competent and qualified auditors is carried out. Moreover, there should be a high level of transparency and market discipline to build the trust of the shareholders and investors. It can be summed that the ultimate objective to achieve Shariah compliance can only be achieved by the collective supports from all involved parties. Employing good corporate governance helps the company to regulate risk and reduce the opportunity for corruption. Often, scandals and fraud within a company become more likely where directors and senior management do not have to comply with a formal governance code. A company without up to date books and registers is unlikely to attract the finest buyers. Additionally, companies are becoming increasingly aware of their public image and the need to behave ethically. By employing good corporate governance, holding board meetings and making decisions as a board, these goals can be kept in mind. Where company practices good corporate governance, with full disclosure, the public will feel that the company and brand can be trusted, ultimately helping the company reputation to grow.

REFERENCES


