UNIVERSITI PUTRA MALAYSIA

EARNINGS MANAGEMENT PRACTICES AND THE IMPACT OF INSTITUTIONAL OWNERSHIP, SHARE MORATORIUM AND RETAINED OWNERSHIP ON EARNINGS MANAGEMENT DISCRETIONARY BEHAVIOUR OF THE MALAYSIAN IPO COMPANIES

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By

SANI HUSSAINI KALGO

Thesis Submitted to Putra Business School, Universiti Putra Malaysia in Fulfilment of the Requirements for the Degree of Doctor of Philosophy

February 2015

DEDICATION

This thesis is dedicated to my friend Alhaji Bala Mohammed Shehu Azare and my children: Abdulrahman 1 (R.I.P), Dr. Maryam, Abdulkadir, Abdulsamad, Fatima-Zara, Amina, Abdulrahim, Halimatu-Sadiya, Abdulrahman, Abdullahi, Abdulmalik and Rukayya

ABSTRACT

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirement for the degree of Doctor of Philosophy

EARNINGS MANAGEMENT PRACTICES AND THE IMPACT OF INSTITUTIONAL OWNERSHIP, SHARE MORATORIUM AND RETAINED OWNERSHIP ON EARNINGS MANAGEMENT DISCRETIONARY BEHAVIOUR OF THE MALAYSIAN IPO COMPANIES

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Chairman: Assoc. Prof. Bany Ariffin Amin Noordin, PhD

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Initial public offering (IPO) is an extraordinary corporate event in Malaysia because apart from being a vital source of finance, it has also been extensively used in implementing government fiscal policy measures for redistribution of income, wealth creation and corporate ownership restructuring which are the cornerstones of the peaceful coexistence of its multicultural society. In the spirit of IPO's significance in Malaysia, this thesis examines four separate issues. First, it investigates real and accrual earnings management discretionary behaviour of Malaysian IPO firms listed on Bursa Malaysia in the period 2002-2013 in terms of nature, direction and quantum. Second, third and fourth issues relate to the impact of institutional ownership, moratorium regulation and retained ownership on IPO firm's earnings management (both real and accrual discretionary behavior) respectively.

Applying models developed by Dechow et al. (1995) and Roychowdhury (2006) to measure IPO firm's accruals and real earnings management respectively, the results

indicate that first, Malaysian IPO firms engage in both real and accrual discretionary behaviour around the IPO corporate event. Second, it confirms institutional shareholders' ability to constrain IPO firms' earnings management in line with international evidence. Third, the results indicate that share moratorium firms exhibit higher earnings management than non-share moratorium firms albeit statistically insignificant. This supports the Securities Commission Malaysia and Bursa Malaysia's policy guideline of subjecting all IPO firms to share moratorium regulations as a commitment device to reduce information asymmetry. Finally, the research document evidence of a significant negative association between retained ownership and real earnings management which is understandable given its impact on firm value.

Additionally, the results provide evidence of trade-off between accrual and real earnings discretionary behaviour among Malaysian IPO firms as a result of tightening of regulations and various regulatory reforms. It reflects the importance of individual line accounting items instead of relying solely on earnings for investors' valuation of the IPO firms apart from considering real earnings management activities in their investment strategy. Overall, the study adds to IPO earnings management literature by providing better understanding of Malaysian IPO firms' reporting behavior and reinforces the need to constrain real earnings management by regulators.

ABSTRAK

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doctor Falsafah

AMALAN-AMALAN PENGURUSAN PENDAPATAN DAN KESAN PEMILIKAN INSTITUSI, MORATORIUM SAHAM SERTA PENGEKALAN PEMILIKAN KEATAS GELAGAT PENGURUSAN PENDAPATAN BUDI BICARA OLEH SYARIKAT-SYARIKAT TAWARAN AWAL AWAM DI MALAYSIA

Oleh

SANI HUSSAINI KALGO

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Pengurusi: **Prof. Madya Dr. Bany Ariffin Amin Noordin, PhD**

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Tawaran awam awal (TAA) merupakan acara korporat yang luar biasa di Malaysia kerana selain daripada menjadi sumber penting kewangan, ianya juga digunakan secara meluas dalam melaksanakan langkah-langkah dasar fiskal kerajaan bagi pengagihan semula pendapatan dan kekayaan serta penyusunan semula hak milik korporat yang merupakan asas utama bagi kewujudan yang aman masyarakat pelbagai budayanya. Dalam semangat kepentingan TAA di Malaysia, tesis ini mengkaji empat isu berbeza. Pertamanya, ia mengkaji tingkah laku pengurusan pendapatan terakru sebenar dan pengurusan pendapatan budi bicara oleh syarikat-syarikat TAA di Malaysia yang tersenarai di Bursa Malaysia dalam jangka waktu 2002-2013 dari segi sifat, arah dan kuantum. Isu-isu kedua, ketiga dan keempat berkaitan dengan implikasi pemilikan institusi, peraturan saham moratorium dan

pengekalan pemilikan keatas pengurusan pendapatan terakru (sebenar dan budi bicara) oleh syarikat-syarikat TAA di Malaysia.

Menggunakan model berbeza yang dibangunkan oleh Dechow et al. (1995) dan Roychowdhury (2006) bagi mengukur pengurusan pendapatan sebenar dan pengurusan pendapatan terakru budi bicara oleh syarikat-syarikat TAA, hasil kajian menunjukkan pertamanya, syarikat-syarikat TAA di Malaysia terlibat di dalam kedua-dua cara pengurusan pendapatan sekitar acara korporat TAA. Keduanya, hasil kajian turut mengesahkan peranan pemegang saham institusi dalam mengekang amalan pengurusan pendapatan oleh syarikat-syarikat TAA sejajar dengan bukti antarabangsa. Ketiga, hasil kajian juga memberi indikasi bahawa syarikat-syarikat TAA yang tertakluk kepada peraturan saham moratorium menunjukkan pengurusan pendapatan yang lebih tinggi berbanding syarikat-syarikat TAA yang tidak tertakluk kepada peraturan yang sama, namun perbezaan tersebut adalah tidak ketara secara statistik. Hasil kajian ini menyokong garis panduan polisi yang dikeluarkan oleh Suruhanjaya Sekuriti Malaysia and Bursa Malaysia yang meletakkan semua syarikat-syarikat TAA di bawah peraturan saham moratorium sebagai peranti komitmen bagi mengurangkan maklumat asimetri. Akhirnya, kajian ini merekodkan bukti perhubungan negatif yang ketara diantara pengekalan pemilikan dan pengurusan pendapatan sebenar yang merupakan sesuatu yang boleh difahami memandangkan kesannya ke atas nilai syarikat.

Tambahan pula, hasil kajian turut memberikan bukti keseimbangan diantara gelagat pengurusan pendapatan akruan dan sebenar dikalangan syarikat-syarikat TAA di Malaysia akibat daripada peningkatan peraturan dan pelbagai pembaharuan institusi.

Ia juga mencerminkan kepentingan bagi para pelabur untuk melihat butiran individu perakaunan dan tidak hanya bergantung kepada nilai pendapatan sahaja dalam membuat penilaian ke atas syarikat-syarikat TAA selain daripada kepentingan mengambil kira aktiviti-aktiviti pengurusan pendapatan sebenar dalam strategi pelaburan mereka. Secara keseluruhannya, kajian menambah kepada kesusasteraan pengurusan pendapatan oleh syarikat-syarikat TAA dengan memberikan pemahaman yang lebih baik terhadap gelagat pelaporan oleh yarikat-syarikat TAA serta mengukuhkan keperluan bagi mengekang pengurusan pendapatan sebenar oleh para pengawal selia.

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CERTIFICATION

I certify that The Thesis Examination Committee met on 2nd July 2015 to conduct the final examination of **Sani Hussaini Kalgo** on **his Doctor of Philosophy** thesis entitled **"Earnings Management Practices and the Impact of Institutional Ownership, Share Moratorium and Retained Ownership on Earnings Management Discretionary Behaviour of the Malaysian IPO Companies"** in accordance with Universities and University Colleges Act 1971 and the Constitution of the Universiti Putra Malaysia [P.U. (A) 106] 15 March 1998. The Committee recommends that the student be awarded the Doctor of Philosophy degree.

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DECLARATION BY GRADUATE STUDENT

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This is to confirm that:

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LIST OF ABREVIATIONS

ACE	Access, Certainty and Efficiency (Market)
AEM	Accrual Earnings Management
ATM	Automatic Teller Machine
BIDS	Bond Information Dissemination System
CDS	Central Depository System
CG	Corporate Governance
CIC	Capital Issue Committee
CMSA	Capital Markets and Services Act
DBR	Disclosures Based Regulatory Regime
EM	Earnings Management
EPU	Economic Planning Unit
FDI	Foreign Direct Investment
FIC	Foreign Investment Committee
GLIC	Government Linked Investment Companies
IPO	Initial Public Offering
MCGC	Malaysian corporate governance code (MCGC)
MARC	Malaysian Rating Corporation

MASB	Malaysian Accounting Standard Board
MESDAQ	Malaysian Exchange of Securities Dealing and Automated Quotation
MFCCG	Malaysian Finance Committee on Corporate Governance
MIDFCCS	Malaysian Industrial Development Finance Consultancy and Corporate Services
MIDA	MIDA (Malaysian Industrial Development Authority
MITI	Ministry of International Trade and Industry
NDP	National Development Policy
PDS	Private Debt Securities
RAM	Rating Agency Malaysia
REM	Real Earnings Management
SC	Securities Commission
SEMS	stock exchange of Malaysia and Singapore
SOX	Sarbanes-Oxley Act
UDA	Urban Development Authority

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

At the beginning of the twenty-first century the global finance and accounting scene dramatically changed. First was the Internet debacle in 2000, then the stock markets that was hitherto bullish became bearish, and companies that were engaged in pernicious earnings management that tried to obscure their accounting reports through various earnings management practices became exposed and precarious. The corporate meltdown that followed culminated into heavy losses to investors. These scandals weakened the integrity of the capital market in the eyes of investors and other stakeholders. Governments worldwide intervened through the promulgation of, accounting standards, corporate governance codes, and securities listing rules and regulations to mention a few.

The new corporate environment raises a lot of challenges and questions that are of concern to academicians, regulators, and other stake holders. In in this study the issues involved are the firms' earnings management practices around initial public offering event and its impact on institutional ownership, share moratorium and ownership retention in the Malaysian emerging market. These are important concepts in Malaysia due to its unique economic architecture. The economic, social, political and regulatory environments of the country which are derivatives of its colonial legacies made these concepts fertile areas of research in finance literature.

The Initial Public Offering (IPO) event begins when a firm introduces its shares to the members of the public or potential stock investors. It is an important tool used by the capital market to accomplish the crucial role of resource allocation function of the financial system. Several studies have advanced many theories to explain the initial public offering event. Some of these early theories include the minimization of cost of capital and optimal capital structure pioneered by Scott (1976) and (Modigliani & Miller (1963). Then pecking order of financing advanced by Myers & Majluf (1984) emerged. There after the cashing-out hypothesis was postulated by Black et al. (2000). Yet again Maksimovic & Pichler (2001) hypothesized the IPO event as a tool for increasing the publicity and reputation of the company. Other theories include dispersion of ownership hypotheses and creation of analyst following proposed by Barau et al. (2006). Most of these studies are however based on developed capital markets. Emerging countries like Malaysia may have additional or even different motivations for the IPO event.

Whatever the motivation, the IPO event changes the structure of companies from being privately owned and unlisted, to public entities that are usually subjected to oversight supervision and enhanced monitoring. By going public, companies are publically traded which facilitate access to investors' funds to finance growth, production, innovation and investment. In addition to meeting listing requirements public firms are subjected to scrutiny by market participants, the gatekeepers and regulators. Through this facilitation strategic owners can dispose their stocks at competitive and reasonable prices during secondary offering. Going public makes market valuation of company shares feasible; facilitate performance measurement and makes information about the company available to stake holders. Initial public offering event makes it possible for the company to diversify its various sources of finance thereby reducing cost of capital, risk visibility and liquidity. (Ogden et al.2002)

IPO is an extra ordinary vital corporate event in Malaysian economy for several reasons. First, it serves as a weapon in the fiscal policy of the government. Malaysia is a country composed of several ethnic groups which include principally Malays, Chinese, and Indians in addition to the indigenous people of Sabah and Sarawak which include Kadazan, Dasun, Bajau, Murut, Iban, Bidayu, and Milanau (EPU, 2012). One major challenge of the Malaysian government immediately after independence was how to address poverty and income disparity amongst its various ethnic communities. Therefore a New Economic Policy (NEP) was launched in 1970 and its objective is to among other things: eradicate poverty irrespective of ethnicity and unite the Malaysian communities by de-emphasizing ethnic recognition through economic and social sectors. The core issue of these objectives was the integration of the Malaysian multiracial society through redistribution of income; employment generation, and equitable economic participation in areas of high productive capacity by the poor, thereby increasing their income in order to ensure equitable and peaceful coexistence.

The strategy used in achieving these objectives is through raising the people's participation in corporate ownership of private enterprises to boost capital formation in that sector. Secondly, through building a sustainable and virile local business communities among the indigenous people (Bumiputera) developing areas with high business potentials but are lagging behind in terms of business development. The government noted that as at 1970 ownership of corporate sector by Bumiputera stood at 2.4% and therefore came up with a policy of increasing the corporate ownership to 30% by the end of 1990 through the use of initial public offering (IPO). The National Economic Plan (NEP: 1970-1990) was later on replaced with the National Development Policy (NDP) in 1991 (Koon 1997). Among other measures, all companies going for Initial Public Offering (IPOs) are required to preserve 30% of their outstanding stocks for the indigenous investors (Bumiputera)

Furthermore, IPO was used in the Malaysian National Privatization Policy of 1983 which involves the sale or transfer of control of companies, agencies or industries that are owned or controlled by the government to the private sector. The aim of the exercise is to reduce unnecessary financial and administrative burden as well as to improve efficiency and productivity of the corporations. This is expected to accelerate economic growth, downsizing the public sector and reducing government involvement into the economy thereby improving efficiency. Here again IPO was used as a tool of fiscal policy for income distribution, wealth creation and capital formation and increasing corporate ownership. This makes the IPO corporate event occupy a special place in the Malaysian economic policy.

Having laid the foundation for equity market especially with increased public participation in corporate share ownership, the domestic equity market steadily developed with an influx of foreign direct investment (FDIs). Malaysian economy became a role model for the regional economies in terms of growth and stability. Even during the Asian crises of 1997/1998 Malaysia was able to internally stabilise its economy devoid of International Monetary Fund (IMF) imposed conditionalities which could have had negative consequences on the economic policies of the country. Malaysia was able to recover without ridiculously selling or auctioning its financial assets at low prices which would have reversed the gains of the National Policy of equitable distribution of private capital among different ethnic groups of the country (Shamsher &Annuar 2000).

1.1.1 Unique IPO Features in Malaysia

In Malaysia, most companies issuing shares use a firm commitment contract, and such offerings use a fixed pricing approach which is the most common pricing mechanism in Malaysian IPOs (Yong 2013). Under this method, investors specify the number of shares they intend to buy at a pre-determined price. Hybrid pricing method (i.e. comprising both fixed and auction pricing) are also used when shares are oversubscribed. Under the firm commitment contract, the underwriters provide assurance of buying all the stocks at the price that has been offered after subtracting the discount of the underwriter. However in case the issue is undersold, a market risk of uncertainty will be faced by the underwriter for these shares. However, only IPO shares that are made available for subscription by the investing public are fully underwritten in Malaysia.

Similar to the United Kingdom (UK), Hong Kong, Australia, and Singapore, potential investors are required to pay for all shares bided for in advance (Chowdhry & Sherman 1996b). The members of the board, representatives of the Malaysian Industrial Development Finance Consultancy and Corporate Services (MIDFCCS), the Foreign Investment Committee (FIC) and the Securities Commission (SC) meet and agree on the allotment parameters. The applicants are categorized according to the number of shares applied for; and whether Bumiputera or non-Bumiputera investors. Allocation of oversubscribed IPO shares is done through the investing public. The balloting process begins with Bumiputera investors first. Then unsuccessful Bumiputera applications in addition to the public portion will be subjected to the second round of balloting. This is envisaged to enhance and increase the chances of success for the indigenous investors. To minimise IPO costs, an integrated computerised electronic system was introduced for share application, balloting and share returned money instead of the tedious manual system. Shares can be applied for either electronically or on paper. Investors can use Automatic Teller Machine (ATM) cards to subscribe for shares at any of the participating financial institutions. Unsuccessful applicants are credited back into their account and the successful ones have the shares credited into their Central Depository System (CDS) accounts (Ahmad –Zaluki 2005).

According to Yong (2013), book-built IPOs are uncommon in Malaysia. In his sample of IPO firms in 2004-2011 less than 10 IPOs are book-built, the remaining 283 are fixed price IPOs. The pricing implication is that the offer price is not determined through solicitation from potential investors and therefore the issuing firm has very little knowledge of potential investors demand. In this situation both the firm and potential investors are in difficulty in determining the true value of the IPO. By implication it is irresistible to believe that at the time of fixing the price not all the necessary information about the true value is reflected in the price.

Some of the other unique features of IPO institutional setting include earning forecast, which is aimed at increasing transparency, it is mandatory for IPO companies to disclose prompt and relevant information, on their financial performance to potential investors therefore earning forecast in the prospectus for the next financial year is mandatory. This is in contrast to what obtains in UK, Canada and Hong Kong, where earnings forecast disclosure is voluntary. However as a result of liberalisation and deregulation of the stock exchange in Malaysia the mandatory earning forecast is now voluntary with effect from August 2008. Secondly as from January 1996, major shareholders requesting to be listed on the Main Board who are engaged in construction, services, or specialised activities and all major shareholders on the Second Board, were required to choose either a three-year profit guarantee or a three-year share moratorium. The aim was to protect IPO investors from being expropriated by the majority shareholders and to align their interests, thereby maximising the value of the company (Wan-Hussin 2005). The guarantee can take the form of a contingent liability or a lien on stocks deposited by the major strategic stockholders (the guarantors) with third party that is independent. The guarantors are liable in case of any shortfalls in the guaranteed profit. These unique features of Malaysian IPOs make them different from the rest of the world.

On the other hand the other alternative protective innovation is the share moratorium or lock up in which strategic shareholders covenant not to dispose, assign or even transfer any part of their stock holding in the firm from the date being listed up to one year. However, a maximum of 20% and 15% for the Main Board, and Second Board respectively an either be sold transferred or assigned (Policies and Guidelines 2003, Guidance Notes 10-19). These provisions have been maintained with slight variation from time to time. The bank profit guarantee was subsequently abolished in April 1999 due to the difficulty in obtaining bank guarantees and tight credit policy, and liquidity crises (Wan-Hussin 2005). As a replacement for this, a moratorium on selling shares is now the standard requirement. These share moratorium structures differ from those in the United States (US) market, which are generally for a shorter period of (180 days). In United Kingdom (UK) the lockup period ranges from six months to about three years. In addition, the lock-in agreements in the UK are more complex and diverse than in the US (Espenlaub et al. 2001, Algharaballi 2013). Another difference is that lock-in agreements are compulsory (for certain companies) in Malaysia. There is a general consensus by researchers that lockup period in IPO setting are meant to mitigate information asymmetry and moral hazard problems and ensure continued commitment of insiders in the affairs of the company (Brav & Gompers 2003, Krishnamurti & Thong 2000).

1.1.2 Ownership Issues in Malaysia

The enhanced corporate earnings, equity ownership and poverty reduction enjoyed by the local corporations and investing public encouraged opportunistic behaviour by investors, both institutional, family, government linked corporations and corporate managers. Through various moral hazard activities, controlling owners or owner managers promoted their private interest through expropriation of minority shareholders (Malaysian Finance Committee on Corporate Governance FCCG, 1999). Speculative trading on the exchange was also intensified resulting into excessive profit making before the government came up with various reforms after the 1997/1998 economic crises to stem the tide. In terms of ownership structure Malaysian firms unlike advanced countries substantially have concentrated ownership (Claessens et al. 2000). In addition there is also cross shareholdings and pyramidal structures (Bany 2010). This situation supresses the classic agency problem arising from ownership separation and control (i.e. managers vs. shareholders), what then become overt conflict is between the minority stock holders controlling owner managers (Shleifer &Vishny 1997). The tendency for expropriation is heightened in the case of "outright discrepancy in control and cash flow right through pyramidal holding structure on affiliated firm capital structure and investment policies and this have been confirmed to have consequences on firm valuation of the firm" (Bany et al. 2010).

Another unique future of Malaysian firms is the presence of sizeable government holdings (Khoo 2003) and existence of multiple directorship practices (FCCG 1999). In the Malaysia with the adaptation of privatisation in 1984 several governments' business entities are now privately owned and trading on Bursa Malaysia. Government involvement in the Malaysian capital market had its origin in the New Economic Policy with the establishment of Government Linked Investment Companies (GLICs) at federal level such as the Urban Development Authority (UDA) in 1971 and National Equity Corporation (Permodalan Nasional Berhad) in 1974. These organizations were established predominantly to help the local Bumiputera population adopt savings and investment habit in private companies. It was envisaged that with capital formation at grass root level the local population will be able to contribute to the economic growth of the country (Prasad et al. 2006). Similarly at state level, State Economic Development Corporations (SEDCs) were established such as the Selangor SEDC in 1964 and Kedah SEDC in 1965 (Gomez & Jomo 1999). These GLICs invest in equity on behalf of the Bumiputera, which ensures the control of the Government Linked Companies (GLCs). It is therefore not surprising that government affiliated institutions control about 37% of shares in listed companies.

The companies controlled by the government institutions are among the largest capitalised companies on Bursa Malaysia. Shareholding by institutions controlled by the government is in the region of 18%-86% for the largest top 10 companies (Zunaida and Fauzias 2008). The implication is that government institutions may control the capital market and decide the direction of events thereby compromising market efficiency. The government controlled companies ultimately become the leading price movers. These companies are likely to enjoy government patronage in form of lucrative contracts and infrastructural projects which will burst their income and share price in the market. It is therefore irresistible to conclude that this may give rise to moral hazard problems. The unique ownership structures have implication for earnings management and subsequent valuation of the firms since the market for corporate control may be rendered ineffective and give rise to entrenchment problem (Claessens et al. 2002).

1.1.3 Unique IPO Setting and Earnings Management (EM)

Apart from the Malaysia unique ownership structure, earnings management have become an important area of study in the Malaysian setting because of the following motivations. Firstly, since independence Malaysian economy have been steadily growing but suffered an economic crises between 1997 and 1998 which resulted into many companies experiencing dwindling earnings. According to (Mohd Saleh et al. 2008), non-financial firms profit after tax tumbled by RM3b and RM14b in 1997 and 1998 respectively. Since earnings is a signal device of firm value to investors and management has considerable discretion in reporting earnings (Fan 2007, DuCharme et al. 2004, Ahmed-Zaluki et al. 2011) earnings management is expected to have been pervasively utilised during the period of uncertainty to restore investors' confidence in dealing with their equity and new public offerings. Secondly, all Malaysian listed firms are governed by the same legal, economic and accounting regimes but they were subject to different listing requirements and supervisory monitoring depending on whether they list on Main Board or the Second Board. With less stringent rules and regulations on the second board, companies may feel the leverage of engaging in earnings management discretionary behaviour. However the second board have now been merged since 3rd August, 2009 but still relevant as the period of existence of the second board covers part of our sample period. Thirdly the mandatory regulatory requirement that all IPO firms must provide profit forecast in their prospectus and guarantee of meeting 90% of the forecasted profit for at least three years following the IPO is yet another motivation for earnings management to enable firms to meet the required bench mark. However the profit guarantee was relaxed in 1999 due to unenforceability and outright noncompliance (Wan- Husain & Ripain 2003) but the profit forecast requirement remained enforced until 2008.

In addition there is also provision for three-year share moratorium (share lock up). This is a fertile regulatory hook that may compel IPO companies to manage earnings. Malaysia is therefore a tempting ground for academic research in IPO, earnings management and ownership retention due to its unique corporate settings.

1.2 Problem Statement

In Malaysia there has been tightening of regulations, the mandatory requirement to provide profit forecast in IPO prospectus, profit guarantee (now abolished), share moratorium (still enforced and now extended to both Main and ACE markets), combining the Main and second Boards into one board called the Main Market (thereby strengthening and tightening listing requirements), the formation of Access, Certainty And Efficiency (ACE) Market in replacement of Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) , Corporate Governance reforms (CG reforms), introduction of accounting standards etc., all these are tighter regulatory initiatives introduced to ensure the Malaysian capital market remain an attractive platform for local and foreign companies (Bank Negara annual report 2010 and Economic Report 2009/2010).

That said, given the increasing interest in earnings management practices, recent research finds evidence that stronger regulation has a direct impact on managers' tendency to choose between accruals and real activity discretionary behaviour. Ewert & Wagenhofer (2005) provided evidence that real earnings management discretionary behaviour increases as accounting standards are strengthened. This evidence was further re-enforced by Cohen et al. (2010). They examined the impact of Sarbanes-Oxley Act (SOX) on earnings management discretionary behaviour and documented that United States companies switch in favour of real earnings discretionary behaviour from accrual earnings discretionary behaviour post-SOX. It was documented that more stringent regulation mitigates accrual-earnings discretionary behaviour leading to greater use of real activity management. It is therefore tempting to believe that Malaysian IPO firms must have switched over from accrual to real activity manipulation which partly accounts for the inconsistent research findings in the few studies on accrual management around the IPO corporate event notably, Abdul- Rahman et al. (2005) and Ahmed-Zaluki et al. (2011). While the former study, confirms pre IPO accrual earnings management but couldn't adduce any accrual earnings discretionary behaviour in the post IPO. Increasing income discretionary behaviour was however affirmed around the IPO corporate event in the later study but its pervasiveness was only during the 1997/98 financial crises. Both studies did not examine real activity discretionary behaviour thereby creating a literature gap.

Managerial decision to intervene in financial reporting can be through accounting estimates and methods or real operational decisions which influence stock returns and price. Fields et al. (2001) provided evidence that it will be wrong and fatal to the validity of the findings by examining only one technique of earnings management discretionary behaviour because it will be inadequate in explaining the whole impact earnings management discretionary behaviour. They contended that in a situation where there is substitution effect, complementarity or trade-off between the two earnings management strategies by just investigating one of the strategies in isolation it can lead to unreliable and faulty conclusions.

Furthermore studies on management earning forecast which is a requirement in IPO firms' prospectus in Malaysia (a mandatory requirement up to August 2008) continue to report earnings forecast errors (e.g. Jelic et.al. 2001 (24.38%), 1998 (33.37%) , Ismail & Weetman 2007 (-14.12%), Securities Commission 2005 reports that 72% of companies reported deviations exceeding 20%. Ahmed–Zaluki & Wan-Hussin 2010

(-+10%) etc.), which is an indication that Malaysian IPOs firms still engage in earnings management practices contrary to existing research findings of little or no earnings management based on accrual manipulation around the IPO corporate event. This provides support that perhaps Malaysian IPOs have resorted to real activity manipulation due to tightening of regulations instead of accrual manipulation to avoid detection by auditors.

Despite increasing importance of real activities discretionary behaviour in the Malaysian emerging market no study have examined the direction, magnitude and nature of accrual and real earnings discretionary behaviour contemporaneously in the context of the IPO corporate event. In addition, the pervasiveness of both real and accrual earning manipulation across institutional ownership structures that are unique to Malaysian corporate structure have also not been clearly investigated and documented. The only study Abdul-Jalil &Abdul-Rahman (2010) was based on accrual discretionary behaviour as the only proxy of earnings management. This study therefore, is intended to fill in this research deficiency.

Yet another unique innovative feature which distinguishes Malaysian corporate environment in the IPO context is the Share Moratorium regulation (it is imposed by Securities Commission and is mandatory). In order to ensure the commitment of the strategic shareholders in the running of the company after public listing to facilitate protection of new incoming investors, share moratorium (here after called share lockup) restrictions is imposed by Malaysian Securities Commission (SC) on major shareholders or IPO promoters as earlier specified. In Malaysian context the share moratorium period in the IPO event is intended to safe guard the problems of moral hazards, reduce to the barest minimum the information asymmetry, and to ensure the participation of the strategic shareholders in the affairs of the firm (SC guidelines, chapter 6.24, 2003) which is in agreement with the opinion of some researchers (e.g. Brav & Gompers 2003 and Krishnamurti & Thong 2008). However the policy makes IPO firms precarious to earnings management manipulation thereby rendering the expected benefits of alleviating information asymmetry and moral hazards problem questionable. According to Teoh et al. (1998b p. 1939) the desire to inflate income during lock up period after the IPO is based on the wealth protection hypothesis. The strategic owners may have the desire to recoup their investment after the moratorium period. Secondly they are under pressure to meet up with earnings forecast if only to maintain their integrity in the face of the investors, company reputation the underwriters and analysts.

Therefore, Malaysian strategic IPO issuers may likely engage in earnings management discretionary behaviour during the lock up period in accordance with the wealth maximization hypothesis. Contrary to the general notion that strategic owners opportunistically engage in earnings management discretionary behaviour to create wealth, the counter contention is that IPO issuers knowing fully they are going public, starts earnings manipulation from the pre-IPO period and due to reversal of accrual it become very difficult to embark on earnings manipulation for the entire lock up period (Chih-Jen & Chung-Gee 2007; Roosenboom et al. 2003; and Roychowdhury 2006). However it could be argued that firms may revert to real earnings management manipulation instead of accruals if they still have the desire to continue inflating earnings and of course mindful of the cost of real earnings manipulation.

The relationship between share moratorium, real and accrual earnings management practices in IPO context in Malaysia have never been investigated to ascertain the desirability or otherwise of maintaining the share moratorium regulation which still remains enforced and now extended on all applicants on the Main and ACE markets (Capital Markets and Services Act 2007, CMSA). Earlier studies by Ahmed-Zaluki et al. (2007) contended that differences in pervasive earnings management may be attributable to environmental and company specific factors and recommended future research in that direction. We therefore extend this study by investigating the relationship between share moratorium (a unique feature of Malaysian IPO setting) and earnings management practices (real and accrual discretionary behaviour) in the unique Malaysian corporate structure as elucidated earlier.

Another intriguing issue is the IPO ownership retention in Malaysia. Leland and Pyle developed a simple univariate model the “LP model’’ featuring financial equilibrium and capital structure in which the investors or entrepreneurs finances investments in which they have monopoly of the true value and qualities. The model was illustrated in a complex mathematical formulation. The idea is the quality of investment may be conveyed if the action and intention of the strategic investors can be discerned and verified. A credible signal to the investing public is the acceptance of the entrepreneur to maintain ownership of the firm through ownership retention of investment.

According to the LP the relationship between firm value and retained ownership by strategic investors is positive. The power of the ownership signal increases with ownership retention. Therefore utility of the entrepreneur changes with ownership retention as a result of the trade-off. In a nut shale, the market value of the investment, utility of entrepreneur or investor and ownership retention increase contemporaneously but with a loss of utility due to less diversification. The problem outlined by Leland and Pyle is particularly severe in Initial Public Offering (Ogden et al. 2000). According to the LP model therefore, in the initial public offering event an issuer that is risk averse could send a signal to the market by retaining part of his risk through equity retention. This frame work draws heavily from the seminal work of Akerlof (1970). One major issue that becloud the IPO corporate event is the problem of information asymmetry and adverse selection. It is only the management that have comprehensive information on investment opportunities, managerial skills and to a large extent future control of agency costs. This information monopoly need to be overcome through a market mechanism otherwise the market will fail (Akerlof 1970).

Fan (2007) extended the univariate signaling model of Leland and Pyle (1977) (here after called LP model) and added earnings management and ownership retained by strategic investors as signaling devices to convey IPO strategic issuer's private information. In the high concentrated and closely held ownership environment like Malaysia, ownership control may be an important issue (Ahmed-Zaluki et al. 2011).

The competing earnings management incentives in Malaysian context make it complex and difficult to predict the relationship between earnings management discretionary behaviour and retained ownership. For the current study, the LP framework and Fan (2007) models are extended to include real earnings and accrual earnings management contemporaneously in contrast to only discretionary accruals.

1.3 Motivation

From the various earnings management incentives in Malaysian IPOs enumerated above it is tempting for managers to utilise incentives depending on the period around IPO. Secondly, the competing and opposing issues are that, IPO issuers (shareholders) are inclined to take actions that will increase their share issue price before the IPO to increase their gains as well as the value of the company. Thirdly, the incentives are constrained by the capital market scrutiny through auditors, regulators, and analysts in the period around IPO. These notwithstanding, shareholders want to increase post IPO stock price which ultimately enhances shareholders wealth and firm value after the share moratorium period. Insiders therefore have interest in opportunistically using accounting discretion around IPO as confirmed in prior literature (Bhojraj et al.2009).

Furthermore, in setting the share price, earnings are given prominence and seen as the most important and in many instances as the only valuable accounting item in prior literature in both real and accrual management studies (see Gunny 2010, Teoh et al.1998b, Roychowdhury 2006 and Cohen & Zarowin 2010). Guo et al. (2005) asserts that individual accounting items are value relevant and not just as a means to an end for higher earnings. In essence the individual accounting items can be influenced by real activities management.

Graham et al. (2005) confirms that due to greater scrutiny managers prefer real activity discretionary behaviour over accrual manipulation because these techniques are difficult and costly to unravel by auditors, regulators, or analysts. In summary, the more the scrutiny, the stronger the motivation for using real activity management (REM) instead of accrual management (AEM) as confirmed in the study by Cohen &

Zarowin (2010). Pronounced scrutiny is present around IPO and prior literature usually does not test for real earnings management around IPOs, but this is essential since AEM and REM can be used as substitutes and not coercively as complements (Zang 2012 and Cohen &Zarowin 2010). Therefore, a closer look at different operating figures should give deeper insight into the discretion of companies going public.

Finally, companies differ depending on investment strategy, profitability, or growth prospects. Therefore, investors value accounting items that are specific to the company. For example, while managers and investors in profitable firms prefer high income, loss companies have to demonstrate their net worth through sales. In the years around IPOs there are apparent dissimilarities between companies in different business sectors. Usually, studies of earnings management combine various industries in one sample. However, they differ in having distinct company characteristics like age, leverage, capitalization, industry etc. Hence, the incentives of companies and the corresponding financial reporting goals are not only different but sometimes diametrically opposed to each other.

Taking all these perspectives into consideration can clarify the opacity of incentives and resulting earnings management around IPOs. While prior literature has already addressed many specific issues, there are some aspects that deserve further attention. The finance and accounting literature rarely differentiates between different incentives around the issue and interests of issuers in various industries concerning accounting numbers or line accounting items. This study intends to close that literature deficiency. The thesis aims at giving new insight into discretionary reporting in the years around IPOs in particular industries and in individual accounting items in terms of nature, direction and quantum. The outcome provides academics, investors, analysts, and regulators with a better understanding of discretionary behaviour around IPOs.

The study gives further insight into the discretionary behaviour of the concentrated ownership dimension (i.e. institutional ownership) unique to Malaysian corporate environment. The discretionary behaviour of institutional ownership depends on whether its investment is transient or long term in nature. On the other hand the discretionary behaviour of shareholders whose shares are under moratorium regulation depends on their level of commitment or alignment. Yet again, the discretionary behaviour in the case of the level of ownership retention is even more complex in Malaysia unique IPO setting. The standard argument in finance literature is that the lower the ownership retention the more the tendency to embark on income increasing earnings management (negative relationship) and vice vasa.

However in closely held ownership environment like Malaysia where there is control concern, complicated by IPO fixed pricing system and not so liquid capital market as compared to developed economies (giving rise to underpricing which leads to oversubscription), and in some cases demand stimulated through bandwagon effect (Yong 2011), the discretionary behaviour becomes an empirical question. In Malaysian emerging market therefore, the discretionary behaviour of the ownership structure, share moratorium period, and ownership retention appears to be non-directional. From the above problem statements and motivations for the study we arrive at the following objectives and corresponding hypotheses:

1.4 Objectives of the Study

1. To identify earnings management (EM) practices among Malaysian IPO companies in terms of nature, quantum and direction.

2. To examine the impact of institutional ownership on real and accrual earnings management discretionary behaviour of their investee firms in Malaysian IPO companies

3. To examine the impact of share moratorium regulation on real and accrual earnings management discretionary behaviour of Malaysian IPO companies

4. To examine the impact of ownership retention on real and accrual earnings management discretionary behaviour in Malaysian IPO firms.

From the above captioned research objectives the study draws the following research hypothesis:

H1: IPO firms in Malaysia engage in both real and accrual earnings management practices around IPO

H1b: There is a significance difference between earnings management proxies among the industrial sectors in terms of nature, direction and quantum.

H2a: there is systematic relationship between institutional investors and earnings management discretionary behaviour in Malaysian IPO firms.

H2b: There is positive relationship between Neutral Pressure group of institutional investors and earnings management practices in Malaysian IPO firms.

H2c: There is negative relationship between Conservative group of institutional investors and earnings management practices in Malaysian IPO firms.

H3: Malaysian IPO firms under share moratorium exhibit higher real and accrual earnings management than non-share moratorium firms

H4: There is a systematic relationship between ownership retention, real and accrual earnings management discretionary behaviour in Malaysian IPO firms.

1.5 Scope of the Study

Like any other research this study has its own delimitations and limitations. The study is delimited within initial public offering firms registered on Bursa Malaysia IPO stock exchange for the period 2002-2013. The privatised initial public offerings (PIPOs) which were very few (less than 15) during the sample period were not separated from IPOs.

Although 476 IPOs were registered on the IPO stock exchange during the period under study the sample was reduced to 253 after removing finance related firms (due to their different financial reporting system). In addition, firms with incomplete four year annual data post IPO (covering share moratorium period), and that change their financial year or incomplete firm year observations for calculating real and accrual proxies are also not considered. These exceptions which are equally applied in previous studies may result into survivorship bias of the sample since less successful firms with poor corporate governance and perhaps more earnings management may be excluded in favour of big and more successful firms. This may limit the variation in earnings management proxies giving rise to conservatism in testing our research objectives.

The study covers 2002-2013 time horizons and in that case all years and agents exhibit comparable discretionary behaviour over the years and are treated equally.

However, an IPO in 2002 might differ from one in 2013 in terms of accounting standards, corporate governance, and market condition. Hence, concentrating on specific time intervals might be of assistance and since there are many observations and substantial data for the models this shortcoming might be overcome. Furthermore, there are measurement errors that are associated with earnings management research. This study therefore inherits all the limitations of the models used and acknowledges the need to use several models for robustness of the result.

The sample period for share moratorium, institutional ownership and ownership retention the sample period covers covers 2002 to 2009 due to earnings management proxy measurement requirements and lack of sufficient ownership data. Secondly with tightening of listing rules and regulations coupled with merging of the second board with the main board of Bursa Malaysia in August 2009, all IPO firms were subjected to share moratorium. The study is limited to only the IPO corporate event thereby limiting its generalizability.

1.6 Significance and Contribution of the Study

These studies give further insight into real and accrual earnings management discretionary behaviour by investigating the combined impact of the two accounting choices during the IPO corporate event which have received little attention in the literature. The intervention of management in financial reporting can either be through operational decisions (that is real earnings management) or through accounting estimate and methods (accrual earnings management). Very little attention is paid to the former until after the Enron and Dotcom scandals which led to promulgation of Sarbanes Oxley Act. With tightening of regulations in Malaysia, understanding the implication of real activity manipulation is important for the stake holders of the firm and accounting standard setters. Investigating three types of real earnings management proxies and the line accounting items across industries complements previous research that examined the consequences of earnings management in Malaysian unique institutional setting. There are no studies in Malaysia documenting the occurrence of real earnings management in IPO setting despite studies on accrual earnings management.

The study contributes to earning quality literature because present and past earnings are vital in forecasting future cash flow and earnings which are necessary inputs in valuation models. Thirdly the study also contribute to the literature by documenting differences in real and accrual discretionary behaviour in the unique Malaysian corporate ownership structure and gives new insight into the roles that these firms play in financial reporting generally in the Malaysian corporate institutional setting. Such knowledge is important for creditors, investors, tax authorities, and other stakeholders who may rely on financial statements of firms to make economic decisions.

Academic researchers can also benefit from this knowledge. It provides further insights into the impact of the unique Malaysian corporate structure on real and accrual earnings management discretionary behaviour of the IPO companies which is useful to the investing public and other stake holders. It also provides potential benefits to accounting standard setters since the earnings management result serves as input in deciding on the amount of discretion that should be allowed to corporate managers to adjust reported accounting figures. This is necessary to deter managers from opportunistically using their private information to extract rent from shareholders or distort and deceive the market particularly in Malaysian concentrated ownership structure.

Signalling and Agency theories of earnings management have been extensively tested in developed economies with high investor protection especially due to various accounting scandals around the globe. This is among the few studies that investigated the association between retained ownership, real and accrual earnings management signals in Malaysian IPO context contemporaneously. Malaysia being an emerging market provided a convenient ground to test the applicability of these theories in a developing economy.

An analysis of earnings management practices around important corporate event like IPO, share moratorium and other regulatory requirements is of immense importance to regulators. Finally the study serves as an eye opener to investors when assessing and taking decisions to invest in public offerings. Investors and regulators should not only analyse the aggregate measures of real earnings management discretionary behaviour in abnormal expenses, production and aggregate real earning but individual line accounting items to evaluate the value of the company.

1.7 Structure and Organization of the Study

Chapter one discussed the background of the research, unique institutional features of IPO setting, ownership issues in Malaysia, the problem statement, objectives and significance of the study. Chapter two is the general information about Malaysian corporate environment while chapter three is the literature review, conceptual issues, the theoretical framework and research framework. Chapter four is the research methodology for the four objectives of the study. The thesis in line with the objectives of the study comprises of four inter-related studies on Malaysian IPO companies covering the period 2002-2013.

Chapter five examined the earnings management practices among IPO firms in Malaysia in terms of quantum, nature and direction with emphasis on industrial sectors and individual line accounting discretionary items. Chapter six investigated the earnings Management practices of the Malaysian unique institutional ownership structure while the third study in chapter seven explained the impact of share moratorium on earnings management discretionary behaviour of the Malaysian IPO firms. The fourth empirical study in chapter eight investigated the relationship between earnings management practices and ownership retention. Finally chapter nine is the summary, conclusion and recommendations of the studies.

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