IPBJ Vol. 1 (1), 17 - 27 (2009)

WILL REPRESENTATION OF WOMEN ON THE BOARD OF DIRECTORS MITIGATE EARNINGS MANAGEMENT?

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ABSTRACT

Earnings management has been the subject of interest in recent years, more profoundly after the 1997/1998 financial crisis and soon after, following the collapse of major corporations such as Enron and WorldCom. Ineffective corporate governance mechanism is believed to be the main cause of earnings management. Based on agency theory, many studies have shown that earnings management is associated with board and audit committee characteristics. Findings (although mixed) provide evidence that boards and audit committees that are independent, knowledgeable, and active are less likely to be involved in earnings management. Another important corporate governance characteristic that has received growing attention is the representation of women on the board of directors (BOD). It is argued that women's representation on the BOD would alleviate the practice of earnings management. This is because, compared to men, women are believed to have higher ethical values, show less concern for money and advancement in their career, and place greater emphasis on harmonious relationships at the workplace. There is also evidence that top management of American companies with female representation is associated with lower earnings management practice. We believe that it is important that a similar study is conducted in Malaysia. This is because the issue of women holding top posts, both in the public and private sectors in Malaysia has become an important topic in recent years. To date, Malaysia has made significant improvements in promoting women's interests. Key catalysts towards this development is the establishment of a ministry which specifically promotes the development of women in Malaysia and the adoption of a policy to appoint 30% women at the decision making levels.

Keywords*: *Earnings management; corporate governance; women; Malaysia.

Introduction

The issue of earnings quality and earnings management has been the subject of intense research in recent years, more profoundly after the

1997/1998 financial crisis and soon after, following the much publicised corporate financial failures and fraud such as Enron and WorldCom. With the current economic turmoil, we expect that earnings management will be more prevalent, especially when companies are struggling to adopt fair value accounting. Ineffective corporate governance mechanism, among others, is believed to be responsible for the prevailing practice of earnings management among companies. Thus, recently much of the research centres on the influence of corporate governance characteristics on earnings quality and earnings management (Xie, Davidson, & DaDalt, 2001; Van Der Zahn & Tower, 2004). Subsequent to the financial crisis, regulators around the world undertook specific measures to tighten up their corporate governance mechanisms. In Malaysia, the Code of Corporate Governance was issued in 2000 to strengthen the roles and responsibilities of the board of directors and audit committees, and to ensure that they discharge their duties effectively. Among others, the Code recommends that independent non-executive directors should make up at least one-third of the board membership, and an audit committee should among others, be independent, financially literate, and meet regularly.

Earnings quality refers to the degree to which reported earnings reflect the economic reality of a company. 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 (Healy & Wahlen, 1999). Because managers' compensation and job security are usually dependant on earnings, there is a desire for managers to pursue their self-interest by altering the financial figures. Earnings are also managed to satisfy debt covenants, to meet analysts' forecast, and to reduce stock price volatility. Given that the agency problem or the separation of ownership and management is among the most important factors that promote earnings management, much of the early studies investigated the association between ownership structure and earnings management. (Dhaliwal, Salamon, & Smith, 1982; Salamon & Smith, 1979). Based on agency theory, these studies provided evidence that owner-controlled firms that have blockholders are less likely to manage earnings than are management-controlled firms that have a diffused ownership structure. However, following the 1997/1998 financial crisis, and the financial collapse of Enron and so forth in 2001 and 2002, earnings management is considered an ethical issue that warrants serious attention. Ineffective board of directors and other corporate governance mechanisms are believed to be responsible for the prevalent practice of earnings management.

In line with this development there has been growing research examining the association between corporate governance characteristics and earnings management; in Malaysia (Abdullah & Mohd Nasir, 2004; Mohd Saleh, Mohd Iskandar, & Rahmat, 2005, 2007; Abdul Rahman & Mohamed Ali, 2006) and other jurisdictions; Xie et al., 2001; Van Der Zahn & Tower, 2004). Again, based on agency theory, many of these studies showed that earnings management is associated with board and audit committee characteristics. Findings (although mixed) provided evidence that boards and audit committees that are independent, knowledgeable, and active are less likely to be involved in earnings management. One other aspect of corporate governance characteristics that has received growing attention is the issue of gender diversity in top management. Research has suggested that women play a significant role in enhancing board effectiveness and company performance. Previous findings, although mixed, provide evidence that women's participation in top management is positively associated with firm performance; for example in Australia (Nguyen & Faff, 2007), in Denmark; (Smith, Smith, & Verner 2006), and in US; (Erhardt, Werbel, & Shrader, 2003). Based on their ethical values, leadership styles and risk aversion, it was also argued that women's representation in top management would alleviate the practice of earnings management. Women are agued to have higher ethical values than men. While men show more concern for money and advancement in their career, women place greater emphasis on harmonious relationships at the workplace (Betz, O'Connell, Sheparol, 1989). Women are also found to be more risk averse than men in handling money matters (Krishnan & Parsons, 2008).

Women in Top Management

Across the globe, the representation of women on the board is not encouraging, despite the relatively high percentage of women in the workforce, and the persistent demand for increased appointments of women on the board. In the US, for example, women represented 16% of the directors in 2006 (Spencer Stuart, 2006). It appears that rising to the top by women is blocked by a "glass ceiling" in which aspiring women could see where they might go, but, in reality, they might not be able to be there. This is a phenomenon not only prevalent in Asian cultures but also in Western cultures and it is a widely accepted perception that "in any given occupation, and in any given public office, the higher the rank, prestige or influence, the smaller the proportion of women" (Hansard Society, 1990, p. 2).

Research has indicated that there has been a significant improvement in the proportion of woman directors over the last decade. For instance, in the US, the proportion of female directors was only 4.7% in 1987 but it rose to 13.6% in 2003 (Catalyst, 2003), and improved further to 16% in 2006 (Spencer Stuart, 2006). A similar pattern was also observed in the UK where the proportion of female directors on UK FTSE 100 has increased from a mere 3.7% in 1995 to 8.6% in 2003 (Conyon & Mallin, 1997; Vinnicombe & Singh, 2003). Considering that these developed nations are champions in promoting gender equality, the increase in women participation in the board is still not promising. In Norway, however, the picture is considerably different. The approach taken by the Norwegian government to increase female directorship on the boards is through legislation. Listed companies in Norway have been required to have at least 40% women on the board of directors since the law on this was passed in 2003. Smith et al. (2006) reported that the proportion of women directors increased from 6% in 2000 to 22% in 2003, that is, before the law was enforced. The deadline given to the listed firms to meet this requirement, a failure of which companies could be shut down, was 31 December 2007. As of at the end of 2007, the proportion of women directors increased to 37% (Oslo, 2007).

In Asia, evidence on women directors is very limited. This is because in the Asian culture, women are expected to play supporting roles rather than the leading role. In fact, gender equality is only a recent issue in the Asian countries compared to their Western counterparts. Traditionally, Asian families would expect males to be the breadwinner, while the women do the house chores. Even Japan, a developed nation, is still very far from other developed nations with respect to the appointment of women to the boards. In 1998, only 0.2% of the board seats in Japan were occupied by women (http://www.globewomen.com/cwdi/colloqium03.asp). One of the often cited reasons as to why women are not occupying the boards is that women do not have the operational experience required (Stephenson, 2004). Another reason is that in general women are not as ambitious and they do not have the drive to advance to the top. Thus, they are often invisible to male CEOs who are usually responsible for appointly board members. A survey by Burke (1997) on Canadian women directors revealed that the main reason for so few women directors on the board is that the CEOs do not know where to look for women directors. This is followed in turn by: companies are not looking for women directors; companies perceive that women are not qualified; and companies are afraid to take on women not already on boards. However, the situation is expected to change in the future as more females than males are in universities these days.

Women in Top Management: The Scenario in Malaysia

The issue of women's participation in top management in Malaysia emerges because the educational level of women has improved tremendously in recent years. In fact, it has been observed that the majority of students in tertiary education are females. For instance, in 2006, about 60% of students in the government-assisted universities in Malaysia were females. As a result, more women are entering into the workforce. Evidently, in 2006, 45.8% of women aged 15 to 64 were in the workforce and they represented 35.6% of the total workforce of 10.6 million in Malaysia (Ministry of Women, Family and Community Development-MWFCD, 2007b). Statistics also showed that 26.1% of the working women are professionals, legislators, senior officials, managers, technicians, and associate professionals. Thus, the pool of potential and qualified women who could serve on the board is large. However, women's representation on the board of Malaysian companies has not been reflective of the workforce statistics.

Despite being a small country, the government has taken several measures to ensure that the participation of women in the decision making levels is improved. One major effort was the establishment of a ministry by the Malaysian Government, which specifically promotes the development of women in Malaysia in 2001. Subsequently, in 2004, a Cabinet Committee on Gender Equality was formed by the Government, which is chaired by the Prime Minister of Malaysia. The objectives of the Committee are to ensure that gender equality is one of Government's top agenda, and that all Government rules and policies are sensitive to women. Among the terms of reference of the Committee are to advocate gender equality in both Government and private sectors, and to ensure and monitor the implementation of the country's obligations and commitments under international conventions on gender equality. Consequently, a policy to appoint at least 30% women at the decision-making levels, was adopted by the Government in 2004. This policy (though lacks legal backing like in Norway) is expected to improve the participation of women at higher levels and could serve as windows in the "glass ceiling". This is evident when the public sector has since seen a rise in the number of women taking up higher posts at various Government's agencies or authorities. In its 2004-2007 Achievement Report, the Ministry of Woman, Family and Community Development (MWFCD) reported that the percentage of women appointed at principal position levels (JUSA) in the public sector increased to 18% in 2004 and to 25% in 2007.

Notably, the current Central Bank Governor and Chairman of the Securities Commission are women. The percentage of women appointed as Vice Chancellors of Malaysian Public Universities also showed a remarkable increase, from zero in 2004 to 15% in 2007. In fact, the Vice-Chancellor of Malaysian's oldest university is also a woman. Previously, in 2001, Malaysia appointed its first female Attorney General. In politics, women participation has improved significantly. For instance, the percentage of women elected as parliament members increased from 4.5% in 1980 to 9.6% in 2004 (MWFCD, 2007a). The percentage of female senators increased markedly from a mere 9.5% in 1980 to 33.3% in 2004 (MWFCD, 2007a). However, the figures are not very promising as far as the corporate boards are concerned. A survey by the MWFCD on a sample of 50 Malaysian listed companies in 2007 revealed that the participation of women on the BODs from 2001 to 2005 was constant at about 10.2%. Surprisingly, the figure dwindled significantly to only 7.6% and 5.3% in 2006 and 2007, respectively. The government-linked companies (GLCS) appear to have adopted the Government policy more readily compared to other firms. For instance, statistics showed that there was an increase of women's representation on the boards of GLCs, from 11% in 2005 to 14% in 2007 (Ministry of Finance, 2008).

In the years to come, the situation is expected to reverse. Bridget Lai, Group CEO Alliance Bank Malaysia, argued that the current low percentage of women directors is due to the shortage of talent in the market. But she is confident the situation will improve as the number of women in universities outweighs the men, and thus companies will have to accept that women will become an equally important resource for human capital (Ang, 2008). The Group Managing Director and CEO of Hong Leong Bank, Yvonne Chia takes a different view on gender equality. She argued the top job must be based on merits rather on the fact that "we need a certain number of women in leadership" (Ang, 2008).

Gender, Leadership, and Attitudes Toward Ethics and Risks

In their paper, Gul, Srinidhi, and Tsui (2007) pointed out that women are different from men in their leadership styles and attitudes toward ethics and risks. These differences have led researchers to believe that women are less likely than men to engage in earnings management. Where leadership is concerned, Gul et al. described women in top management as having "trust building roles". Unlike men, women are believed to show greater concern for interpersonal relationships and rely on rules of fairness. The successful new generation of women leaders show that they succeed by "drawing on the skills and attitudes they developed from their shared experience as women" (Rosener, 1990, p. 119). While men adopt the "transactional" or command-and-control approach of leadership, women tend to adopt the "transformational', interactive, or the participative approach of leadership.

Under the "transactional" approach, leaders regard job performance as a series of transactions with subordinates in which the latter are rewarded for services rendered and punished for unacceptable performance. "Transformational" leaders on the other hand would transform the self-interest of the subordinates into the interest of the group. This approach of leadership encourages participation, share power and information, enhance self-worth of others, and energise subordinates (Rosener, 1990). Unlike men, women leaders are more interested in building relationships with their subordinates and they would rather be evaluated based on employee satisfaction than based on financial performance (Appelbaum & Shapiro, 1993). Based on these traits of leadership, it is less likely for women to manage earnings compared to men.

It is a widespread belief that women are more risk averse than men in financial decision making. It is also a general belief that men are more confident than women in dealing with financial matters, and women are more likely to shy away from competition. Although research findings are mixed, there has been evidence to support these beliefs. Surveying fund managers in the US., Germany, Italy, and Thailand, Beckmann and Menkhoff (2008) found that women are more risk averse, tend to be less overconfident, and are more likely to shy away from competition. Using laboratory experiment with monetary incentives, Fehr-Duda (2006) found that women are more risk averse than men. The finding is supported by Watson and McNaughton (2007), and Eckel and Grossman (2008). Since earnings management is associated with risks, we believe that women are less likely to be involved in earnings management.

It is argued that men and women have different ethical values. Gender socialisation approach argues that men and women bring different values into their workplace that will subsequently shape their decisions and practices (Betz et al., 1989). Because men regard money and advancement as their successful factors, and see achievement as competition, Betz et al. (1989) argued that men are more likely than women to break rules or be less ethical. Women, who show less concern for money and advancement, are more likely to adhere to rules and laws. Research that examines the association between gender and ethics is mixed. However, a number of empirical evidence indicated that men are more likely to engage in unethical behaviour (Albaum & Peterson, 2006; Betz et al., 1989).

Previous Studies on Gender and Earnings Management

Early studies that examined the association between earnings management and gender did not directly measure the actual behaviour of earnings management. Instead, the attitudinal survey method was adopted. In these surveys, hypothetical situations related to earnings management were presented and respondents were to state their attitudes towards each of the situations. Clikeman, Geiger, and O'Connell (2001) observed if the national origin and gender of accounting students in the US. influence their perception toward earnings management. Al-Hayale and Lan (2005) sought the views of managers and external auditors in Jordan on earnings management. As far as gender is concerned, both studies revealed that male and female respondents show similar attitudes toward earnings management. However, surveying students and business managers in the US., Giocomino, Bellorany, and Akess (2006) provided evidence that women tend to have a stricter view on earnings management compared to men. Since these findings are based on attitudes of students and do not reflect the actual behaviour of managers facing the actual business situations – the method has its limitation as far as reliability is concerned (Krishnan & Parsons, 2008).

To date, studies that directly observe the association between the representation of women in top management of companies and earnings management is only found in Gul et al. (2007), and Krishnan and Parsons (2008) in which the latter study determined if participation of women in senior management predicts the quality of earnings. Multiple measures were used to proxy earnings quality. Gul et al. (2007) examined the association between female board membership and earnings quality. They measured earnings quality by using several measures. Both studies provided evidence that top management with female representation is associated with lower earnings management practice. We feel that it is necessary for a similar study to be conducted on Malaysian companies. The study would be significant because the issue of women holding top posts, both in the public and private sectors in Malaysia has become an important topic in recent years. Malaysia, whose official religion is Islam and is part of the Eastern culture, strives to become a developed country by the year 2020. Although Islam does not encourage women to take the role of a leader and women in the Eastern culture do not usually hold leading roles as in the Western culture, Malaysia has made significant improvements in promoting women's interests. Key catalysts toward this development is the establishment of a ministry which specifically promotes the development of women in Malaysia and the adoption of a policy to appoint 30% women at the decision-making levels.

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