Impact of Voluntary Disclosure on Earnings Management in Malaysian Companies: A Proposed Analysis

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Abstract— **Voluntary disclosure is considered as an important item of financial reporting. Therefore, the leading companies around the world voluntarily disclose an extensive amount of business information that appears to be useful in communicating information to investors, but some managements' may use voluntary disclosure to mislead stakeholders about the underlying economic performance. The planned study will contribute to increase awareness about the importance of voluntary disclosure to the regulatory authorities in Malaysia in order to improve the quality of the disclosure. It also identifies in detail the impact of all aspects of voluntary disclosure on earnings management, where prior studies mentioned that there is a possible relationship between voluntary disclosure and earnings management. The sample of companies for this proposed study will be from the Malaysian companies listed on the main board of Bursa Malaysia. The proposed study will use checklist instrument to measure the extent of voluntary disclosures in three aspects: (1) strategic information; (2) financial information; and (3) non-financial information. Also it will use discretionary accruals measures as proxies to evaluate earnings management. The paper proposes ordinary least square (OLS) for identifying the possibility impact of voluntary disclosure on earnings management.**

Keywords-Voluntary disclosure (VD), Earnings management (EM), Agency theory, Stakeholder theory

I. INTRODUCTION

The purpose of financial reporting is to provide stakeholders with information concerning the financial performance of a firm. The financial information provided in company financial reports is an important pillar. Annual reports are not limited to financial statements; they include other channels of information communication such as voluntary disclosure (VD) provided by the accounting system [1]. Therefore, VD is considered as a channel to build good ties with all information users.

Management has an incentive to provide voluntary disclosure to signal that managers are working in the best interests of stakeholders and to create a positive impact on the company's reputation. Companies are using voluntary information about details of earnings in order to provide evidences that they have not engage earnings management for manipulating in earnings, this, in turn, will not mislead shareholders and other users about performance of companies. Thus, voluntary information is one of the most widely used concepts to define the goodwill of the company and has been extensively used for attracting attention of investors [2].

Despite the advantages of voluntary disclosure, the management has tendency to use voluntary disclosure to distract stakeholders about the earnings management, and distract stakeholders' attention to other issues [2-4]. Healy and Wahlen [5] point out that earnings management (EM) exists when managements either "mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers". Thus, managers have motives to increase their own benefits by taking discretionary actions over reported earnings.

However, Voluntary disclosure in annual reports is deemed necessary to increase awareness of stakeholders about the extent to which voluntary disclosure (VD) helps in reducing or increasing earnings management (EM). Therefore, the objectives of the proposed study will be to i) evaluate the level of voluntary disclosure in financial reports of Malaysian companies, and ii) examine the impact of voluntary disclosure on earnings management among listed companies on the main board of Bursa Malaysia.

Prior studies in the literature address different aspects of voluntary disclosure; most of them focus on investigating the relationship between disclosure and firm-specific characteristics [6, 7]. In addition, a number of empirical studies, including studies set in Malaysia, demonstrate the influence of corporate governance on voluntary disclosure [8-10]. However, there are still limited empirical studies examining the relationship between voluntary disclosure (VD) and earnings management (EM).

Previous papers were limited to a few countries such as US and UK. Thus, the proposed study will contribute to the existing literature in two main ways. Firstly, this study focuses on Malaysia; therefore the findings of the study will increase awareness of the extent of voluntary disclosure among Malaysian companies. As a result, regulatory authorities in

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Malaysia may expand disclosure requirements in order to improve the quality of disclosure. Secondly, because of limited empirical studies on the relationship between all aspects of voluntary disclosure (VD) and earnings management (EM), the planned study will fill the gap in the literature by investigating the relationship between all aspects of voluntary disclosure (VD) and earnings management (EM).

II. IMPORTANCE OF VOLUNTARY DISCLOSURE

Voluntary disclosure is an issue of growing interest, and the reporting of any information voluntarily is becoming more important as shareholders, creditors, financial analysts and others find this information useful in making their future investment decisions [1] and achieve their needs [11]. According to financial accounting standards board (2001), leading companies around the world voluntarily disclose an extensive amount of business information that appears to be useful to investors. Thus, voluntary information or voluntary disclosure should be considered as an important item of financial reporting [12].

Salama [13] explained the benefits of voluntary disclosure (VD). The author mentioned that companies that disclose information about future strategies, share prices and sales/profit forecasts may be more likely to attract new shareholders compared to companies that do not disclose this information. Therefore, companies that perform voluntary disclosure have a better opportunity to maintain a healthy demand for shares. This, in turn, will cause the company to gain support and make a positive impact on the company's reputation.

Furthermore, the availability of more information helps stakeholders in making their decisions, such as: (1) social responsibility information, (2) forecast of cash flows, (3) liquidity ratios, (4) employee information, and (5) corporate strategy [14]. On other word, the existence of voluntary disclosure (VD) in annual report gives signal that management is working in the best interests of shareholders and other information users'. Therefore, voluntary disclosure (VD) plays a key role in establishing good ties with all stakeholders including shareholders who use annual report to make decisions.

Due to importance of voluntary disclosure (VD), the regulatory authorities in Malaysia adopted comprehensive disclosure requirements in order to improve the quality of disclosure especially that adoption of disclosures rules do not ensure higher level of disclosure [15]. Therefore, this study aims to increase awareness among regulatory authorities to improve the quality of disclosure by studying the extent of voluntary disclosure about the information that not covered by mandatory disclosure in Malaysian companies. This is because of the reason that the current requirements of mandatory disclosure may not provide enough information of company's details to the stakeholders.

III. LITERATURE REVIEW

This section discusses the theories and the literature reviewed on the relationship between voluntary disclosure (VD) and the company's earnings. Prior empirical studies investigated the relationship between voluntary disclosure (VD) and company's earnings, but they found variable results, such as: Chow and Wong-Boren [16], Omar and Simon [12] found that companies with profitability are more likely to disclose voluntary information, while McWilliams [17] did not conclude any relationship.

Earnings is important to users of financial statements in making their decisions about: (1) the company's performance, (2) the ability of the company to predict future earnings, (3) the ability of the company to generate earning in the long run, and (4) the assessment of the risk of investing and lending [18, 19]. Therefore, the management of a company provides information concerning the financial performance of a firm to stakeholders [20]. However, previous researchers have indicated four arguments that motivate management to use voluntary disclosure [21], and these are given as follows:

- Managements holds the responsibility and have to meet certain business and financial targets, therefore they are required to provide disclosure.
- Managements tend to disclose information about their performance in order to get favor in stock markets.
- Inadequate disclosure in annual reports of companies may motivate managements to provide voluntary disclosure for the reduction of cost of litigation.
- Managements may provide voluntary disclosures to show to investors that they are aware of the firm's economic environment and are able to respond quickly to changes.

There are researchers that provide discussion about the advantages of voluntary disclosure (VD) anchoring on the stakeholders' theory. The Stakeholder theory looks at the relationships between management and stakeholders such as customers, employees, suppliers, government, and others. It suggests that the management should make the information that stakeholders need to make decisions available [22]. Therefore, voluntary information is considered as a good tool to improve the ties with stakeholders.

The Management of a company can employ voluntary disclosure (VD) not only as the shareholders agent but also as an agent of other stakeholders [22]. Gray, et al. [23] points out that the information disclosed to the stakeholders might be regarded as a positive contribution made by companies. Managements engaged in earnings management (EM) tend to realize that voluntary disclosures can be used to improve and build a good relationship with stakeholders, thus voluntary disclosure (VD) is considered as a channel to inform all stakeholders that the companies' work is sound regarding stakeholders interests.

Alsaadi, et al. [18] argues that one of the important ways of communicating with stakeholders to obtain their support is through voluntary disclosure (VD). There are managers that have incentives to use voluntary disclosure (VD) to fulfill the expectations of all groups of users who used company' information to make decision. Hence, companies that expend effort and resources in providing voluntary disclosure (VD) to serve the stakeholders' interests are likely to engage less in earnings management (EM) and provide transparent and reliable financial reporting to various stakeholders [24].

Despite all of the management motivations that are mentioned above about voluntary disclosure (VD), managements also have the tendency to use voluntary information to divert stakeholders' attention from monitoring the earnings manipulation to other issues [4], and to mislead stakeholders about earnings [2-4]. Thus, managers may use voluntary disclosure (VD) to engage in earnings management (EM) [25, 26].

Agency theory focuses on the relationship between shareholders (principals) and management (agents). This relationship assumes that the management undertakes opportunistic actions, such as earnings management (EM), to achieve their interests rather than the owners' interests. Thus, earnings management (EM) has negatively impacted the stakeholders' decisions because the management does not reflect the real value of financial performance [27, 28].

Dechow, et al. [29] argues that the existing earnings management (EM) in a company will have effect on the stock price in a market due to the difference between real financial performance and what management shows in the annual report. Therefore, managers used voluntary disclosure as a tool to reduce pressure that managements receives from shareholders [14] by diverting the attention of shareholders from discovering earnings management (EM). Hence, voluntary disclosure (VD) helps mitigate agency problems, as companies that engage in voluntary disclosure reflect that they are making all efforts to satisfy the owners' needs. This, in turn, this will enhance price of the share [4].

Dechow, et al. [29], Hong and Andersen [30], and Roychowdhury [31] mentioned that earnings management (EM) is of two types. Firstly, management actions without making any change to real corporate activity, such as the estimation of a warranty liability, which managers use their discretionary powers to adjust the accruals portion of the company' earnings without having any real effect on future cash flows. Secondly, management actions have influence on the true economic reality, when managers modify few of the corporate's transactions to increase the company's earnings, therefore, it is considered as a real earnings manipulation, such as reducing training and advertisements cost to increase earnings.

Earnings management (EM) can change the reality of a company's value and its financial performance [28]. Earnings management (EM) has negative impact on current and future stakeholders' decisions; therefore companies that engage in earnings management (EM) face the risk of losing stakeholders support if the stakeholders discover these actions. This in turn will increase the risk of the survival of such companies [14]. However, managers can take certain earnings management (EM) actions in an attempt to raise and achieve their own interests rather than others interests. Nonetheless, stakeholders may and will respond to the management in case their own interests are affected by earnings management (EM) practices. Thus, managers may have incentives to provide more information to signal that management is working in the best interests of stakeholders, so as to minimize threats of being dismissed [4].

Few prior researchers have attempted to identify significant statistical association between one aspect of voluntary disclosure (VD) and earnings management (EM). Most of the research studies are done in corporate social disclosure and EM. Salewski and Zülch [32], Kim, et al. [24], and Prior, et al. [14] point out that companies which disclose information on social and environmental responsibilities present a good image and portray that management is working in the best interests of stakeholders. Therefore, they assert that the relationship between corporate social responsibility disclosure and earnings management is negative.

On the other hand, Berrone, et al. [33] argued that earnings management affects the interests of stakeholders. Thus, managers can mislead stakeholders by resorting to voluntary disclosure (VD), and it is considered as an encouragement to those managers that manipulate earnings. Therefore, the researchers hypothesized that there is positive relationship between corporate social responsibility and earning management. Also, Shaw [34] asserts that managers act opportunistically managing earnings when they find that companies with higher-quality disclosures use discretionary accruals to smoothen earnings more than companies with lower-quality disclosures.

The findings of most previous studies mentioned that there is a statistically significant negative relationship between one aspect of voluntary disclosure (VD) such as corporate social responsibility (CSR) disclosure and earnings management (EM) [24, 35, 36]. On other side, Sun, et al. [4] did not find any significant statistical association between various measures of discretionary accruals and environmental disclosure when they studied the relationship between environmental disclosure and earnings management (EM). Considering all of these evidences, it seems that there are conflicts between different aspects of voluntary disclosure (VD) and earnings management (EM).

The discussion above shows that voluntary disclosure by management can be driven by either the opportunistic behavior (negative way) or ethical considerations (positive way). The positive way is when the company with voluntary disclosure is motivated to build a good image among stakeholders. The negative way, is when the company with voluntary disclosure uses it to distract stakeholders' attention from other issues such as earnings management (EM). Overall, these studies highlighted that the relationship between voluntary disclosure (VD) and earnings management (EM) is possible to be negative or positive regarding voluntary disclosure (VD) uses.

However, previous studies; such as: Alsaadi, et al. [18], Kim, et al. [24], and Sun, et al. [4]; focus on the relationship between earnings management (EM) and one aspects of voluntary disclosure (VD) such as corporate social responsibility disclosure, environmental disclosure and corporate governance disclosure. There are few researchers that investigated the relationship between earnings management (EM) and all the aspects of voluntary disclosure (VD). Therefore, this study offers more evidence about management incentives to provide voluntary disclosure (VD) by studying the relationship between voluntary disclosure (VD) and earnings management (EM).

IV. Scope and Methodology of the Study

A. Sample

The sample of companies for the proposed study will be Malaysian companies (excluding financial companies, insurance and investments companies, and service companies) listed on the main board of Bursa Malaysia. The exclusion is necessary because of the difference in characteristics of some items of their financial statements [4]. As of the 1st of June 2015, there were 813 companies (Bursa Malaysia, 2015). Therefore, the final sample of the study only consists of (261) companies. Quantitative data will be collected by using the information disclosed in the companies' annual reports for the year 2014. The paper proposes ordinary least square (OLS) for the analysis.

B. Measurement of variables

1) Voluntary disclosure

The disclosure checklist developed by Madi, et al. [37] will be used to examine the voluntary disclosure among Malaysian companies. This checklist consist of 74 items to measure all aspects of voluntary disclosure (VD). It includes: strategic information, financial information and non-financial information.

The planned findings will be used an un-weighted approach to identify the numbers of voluntary disclosure (VD) items according to: Akhtaruddin, et al. [15], and Hossain [38]. The items of information are numerically scored on a dichotomous basis. Therefore, the company is scored "1" for an item disclosed in the annual report and "0" if it is not disclosed. The total index is then computed for each sample as a ratio of the total disclosure score to total number of items (74). The disclosure index for each firm is then expressed as a percentage.

2) Earnings management

Many previous studies use a modified Jones model to measure discretionary accruals (DA) as a proxy of earning management [29, 39, 40]. There are prior studies that the added returns on assets (ROA) to the modified Jones model in order to control the effect of company' performance on measuring DA [40], thus, enhancing the reliability of inferences from accrual estimates [18, 24]. However, the proposed study will use the following model to estimate discretionary accruals (DA):

$$\frac{TA_{it}}{A_{it-1}} = a_0\left[\frac{1}{A_{it-1}}\right] + a_1\left[\frac{\Delta REV_{it} - \Delta REC}{A_{it-1}}\right] + a_2\left[\frac{PPE_{it}}{A_{it-1}}\right] + a_3\left[\frac{IBXI_{it-1}}{A_{it-1}}\right] + \varepsilon_{it}$$

Where:

TA_{it}: the total accruals for company i at year t.

ΔREV_{it}: the change in net revenues in year t from year t-1

ΔREC_{it}: the change in net receivables in year t from year t-1

PPE_{it}: gross property, plant and equipment for company i at year t

$IBXI_{it-1}$: income before extraordinary items for company i from year t-1; and

A_{it-1}: total assets for company i at the end of year t-1.

C. Methods of analyses

In order to achieve the first aim, namely, evaluation of the level of voluntary disclosure in financial reports among Malaysian companies, the proposed study will use content analysis and a checklist instrument to rate voluntary disclosures. Ordinary Least Square will be used to investigate the impact of all aspects of voluntary disclosure (VD) on earnings management (EM) among Malaysian companies. The company size, leverage and return on assets will be used as control variables because they control the company's characteristics, this in turn, might have an impact on the relationship between voluntary disclosure (VD) and earnings management (EM).

V. Conclusions and Recommendations

Financial accounting standards board (2001) encouraged leading companies around the world to disclose voluntary information about businesses that appear to be useful in communicating information to investors. Despite the importance of voluntary disclosure, previous researchers mentioned that some companies may use voluntary disclosure to divert all the parties' attention from monitoring earnings manipulation to other issues. Limited empirical papers that have studied the relationship between different aspects of voluntary disclosure (VD) and earnings management (EM) have conflicts in their results. Some of those studies found that the relationship between one aspect of voluntary disclosure (VD), such as environmental disclosure and earnings management (EM) is negative, while some other studies failed to find any significant statistical association between them. Therefore, the propose study will fill the gap in literature by using Ordinary Least Square to examine the relationship between voluntary disclosure and earnings management.

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