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Value Relevance of Earnings Components Following CEO or Managing Director Turnover

MOHAMAT SABRI HASSAN[a*], SHARIFAH ZARINA SYED AHMAD[b], ROMLAH JAFFAR[a] AND ABDULLAH JIHAD RABAYA[a]

[a]*Center for Governance Resilience and Accountability Studies, Universiti Kebangsaan Malaysia, Malaysia*
[b]*National Audit Department Malaysia, Federal Government Administrative Centre Putrajaya, Malaysia*

ABSTRACT

Many prior studies associate earnings management with the top management change (turnover). Prior studies also examine the association between earnings management and share price. The current study extends the literature by investigating the role of chief executive officer/managing director (CEO/MD) turnover on the association between earnings components (i.e. earnings management) and share price (i.e. value relevance of earnings management). This is due to the sample of the study comprises 98 Malaysian public listed companies that experienced CEO/MD turnover between 2009 and 2014. The observation was conducted during the turnover year, the first fiscal year after the turnover and a cumulative period after the turnover. The analysis indicates Malaysian companies tend to practice downward earnings management a year after the turnover. However, an upward earnings management activity among small companies also reported. The two-step system GMM estimation analyses indicate that the lag share price, *BVE* and discretionary accruals (*DACC*) are consistently associated with the share price of the companies (value relevant) over the three period of observation. The positive effect of *DACC* indicates investors value the earnings management practice during these periods as informative. The present of incoming CEO/MD has strengthened the value relevance of *DACC* during the CEO/MD turnover and a year after the turnover. However, it weakens the value relevance of *DACC* over the cumulative period. Findings are relevant for the strategic decision making since the presence of CEO/MD turnover might be associated with the opportunistic and informative earnings management which might affect the share price. Our findings might motivate the shareholders to actively involved in determining the direction of the companies.

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* Corresponding author: Email: msabri@ukm.edu.my

INTRODUCTION

In this study we examine the role of CEO/MD turnover on the value relevance of earnings management. CEO/MD plays a major role in the organization direction, objectives strategic choices, company's operation and performance and its share price (Qi et al., 2018; Syed Ahmad et al., 2018; Jalal and Prezas, 2012; Setiawan et al., 2011). Hence, the choice of the incoming CEO/MD is critical (Rhim et al., 2006). The newly appointed CEO/MD is under pressure to show better company performance, and therefore they will put efforts to gain the trust of the board and the stakeholders, meet targets, increase future earnings (at the expense of the current earnings in the year of turnover), earn credit for the company's recovery and performance (Murphy and Zimmerman, 1993; Pourciau, 1993). Therefore, CEO/MD might alter reported earnings (managed earnings) to gain benefits (Shen and Wang, 2019; Syed Ahmad et al., 2018; Mostafa, 2017). This is because they believe the reported earnings can influence stakeholders' decision (Mostafa, 2017).

Earnings management has become a concern for the accounting profession (Mostafa, 2017) as it is associated with opportunistic managerial considerations in structuring transactions aimed at changing the reported accounting income and misleading stakeholders (Healy and Wahlen, 1999) for personal gain (Deegan, 2014; Rahman, 2012; Wilson and Wang, 2010). Earnings management is performed because of the incentives available in selecting accounting methods (Mohd Saleh and Ahmed, 2005). Bonuses or management compensation, debt contracts, political costs, and loss avoidance are among the incentives associated with earnings management. In the Malaysian context, past studies review the relationship between earnings management and its motivational factors. Prior studies examine the association between earnings management and underinvestment (Hassan et al., 2016), control mechanisms (Mohd Ali et al., 2010; Mohd Saleh et al., 2007), corporate governance (Mohamad et al., 2012; Johari et al., 2009; Mohd Saleh et al., 2005), role of external auditors (Abdul Aziz, 2004), and motivation of debt contracts (Mohd Saleh and Ahmed, 2005).

Studies conducted in developed and developing countries demonstrate a significant relationship between opportunistic earnings management and CEO/MD turnover (Shen and Wang, 2019; Syed Ahmad et al., 2018; Mostafa, 2017; Bornemann et al., 2015; Choi, Kwak and Choe, 2014; Tokuga and Yamashita, 2011; Guan et al., 2005; Dahyaa et al., 2000). The findings consistently show that incoming CEO/MD tends to report better financial performance than their predecessors, potentially to gain the trust from internal and external company stakeholders. This potential gain encourages the incoming CEO/MD to engage in earnings management for personal interest. This assumption is in line with the view that high opportunistic behavior is associated with the incoming CEO/MD (Pourciau, 1993). However, earnings management not always being associated with opportunistic behavior. Some studies provide evidence of factors that lead companies to perform informative earnings management (Mostafa, 2017; Rahman et al., 2013). Mostafa (2017), in his study within the context of Egypt, indicates the opportunistic earnings management is likely to occur within the low operating performance companies. This is because CEO/MD has the ability to influence disclosure quality as such disclosure increase firm value (Li et al., 2018). Whether it is informative or opportunistic earnings management depend on a strong incentive to do so such as to seek higher compensation (Chang et al., 2010) or to boost their companies' share price (Mostafa, 2017) or to reduce cost of equity (Rahman et al., 2013).

The current study extends the previous studies on the association between CEO/MD turnover and earnings management practice. We look at the role of accounting numbers, in particular earnings management, as edifying information to users of the financial statements. Specifically, we examine the effect of earnings management, which might be contributed by the newly appointed CEO/MD, on the share price. Studies on the value relevance of earnings and book value have been established in prior literature including Malaysia. Most of these studies consistently provide evidence that book value and earnings are significantly related to share price. However, limited numbers are reported examine the value relevance of earnings management (example, Mostafa, 2017; Habib, 2004; and Marquardt and Wieldman, 2004). Nevertheless, none of these studies examine the moderating role CEO/MD turnover on the association between earnings management and share price.

The current study contributes to the literature especially in the context of Malaysia, one of the leading economics within the developing countries. However, according to Mohamad et al. (2007) even though Malaysia is a country with a growing capital and economy market, its legal system and capital market are considered well developed. Although good quality accounting standards are in place (Wan Ismail et al., 2013), the information environment in this country is still not rich (Ball et al., 2003), as compared to the developed

countries. In this case, the unresolved question is to what the extent investors react and alter their assessment of the accounting numbers during and after CEO/MD turnover. Specifically, this study attempts to estimate the value relevance of earnings components that are managed (proxies by discretionary accruals; *DACC*) and unmanaged (non-discretionary accruals; *NDAC*). The relevancy and reliability of the *DACC* and *NDAC* are reflected through the performance of a company's share price throughout the duration of the incoming CEO/MD management. In contrast with *NDAC*, which are mandatory, *DACC* reflects the flexibility and discretion of managers in selecting accounting methods to manage the reported income. Therefore, market response to *DACC* depends on an investor's assessment of whether the manager uses *DACC* for informative or opportunistic purposes (Rahman, 2012; Choi et al., 2011). Hence, this study explores the moderating role of CEO/MD turnover on the value relevance of earnings management.

Using two-step system-GMM estimation, our study indicates that lag share price, book value of equity (*BVE*) and managed earnings or discretionary accrual (*DACC)* are consistently value relevance to investors over the three periods of observation. This indicates Malaysian investors value such information as informative. However, our study provides inconclusive findings related to the moderating role of the incoming CEO/MD. This study reveals the presence of incoming CEO/MD strengthen the value relevance of *DACC* during the turnover year and a fiscal year after the turnover. Investors might perceive the incoming CEO/MD had informatively managed the earnings and hence correctly estimate the upward earnings management. However, over a longer observation (*TMCc*), the present of incoming CEO/MD reduce the value relevance of *DACC*. This study also reveals the present of incoming CEO/MD strengthen the relationship between unmanaged earnings (*NDAC*) and share price during the turnover period (TMC_{t0}) only. Meanwhile, the present of incoming CEO/MD weaken the relationship between *BVE* and share price during a fiscal year after the turnover (TMC_{t+1}) and over a longer observation (*TMCc*).

The rest of the paper is organized as follows. In Section two, we review previous studies and present hypotheses development. In Section three, we describe our research methodology undertaken. Section four presents result of the study and follow with conclusion in section five.

PREVIOUS STUDIES AND HYPOTHESES DEVELOPMENT

CEO/MD Turnover and Earnings Management

Previous studies indicate that CEO/MD turnover affects company earnings management. Specifically, prior studies indicate that the incoming CEO/MD may take a "big bath" and report lower earnings during the turnover year. This activity is then followed by an increase in revenue during the first full fiscal year of the incoming CEO/MD (Bornemann et al., 2015; Choi and Rhee, 2015; Tokuga and Yamashita, 2011; Kind and Schläpfer, 2010; Dahyaa et al., 2000; Murphy and Zimmerman, 1993; Pourciau, 1993). The above studies conclude that "big bath" intends to signal that a company was weak during the transitional year and becomes stronger in the fiscal year following the appointment of the new CEO/MD. With a low benchmark (due to lower earnings during the transitional year), the incoming CEO/MD can easily reach the earnings target during his/her first fiscal year. Meeting the target also improves company reputation among employees, competitors, and capital markets.

Incoming CEO/MD is under pressure to improve the performance of a company (Bornemann et al., 2015; Pourciau, 1993). Manipulating accounting numbers in the form of earnings management is used to illustrate that under the incoming CEO/MD leadership, he/she managed to improve the financial position of the company. Higher reported earnings during the accounting period following the turnover (TMC_{t+1}) helps the incoming CEO/MD meet the expectations set by the shareholders, demonstrating his/her ability to bring recovery and improvement to the company. In agreement with prior studies (e.g., Bornemann et al., 2015; Kim et al., 2014), we predict that incoming CEO/MD tends to manage earnings negatively during CEO/MD turnover (TMC_{t0}) in line with the big bath hypothesis and then manage the earnings positively to increase turnover in the succeeding year (TMC_{t+1}). However, as previous studies (e.g. Bornemann et al., 2015; Tokuga and Yamashita, 2011; Kind and Schläpfer, 2010) are derived in the context of developed countries, the relationship between CEO/MD turnover and earnings management has yet to be examined in Malaysia.

CEO/MD Turnover and Value Relevance of Earnings Components

Existing literature classifies earnings management into two perspectives: informative and opportunistic (Hassan et al., 2016). Opportunistic earnings management can affect the confidence of investors, as reflected by the decrease in the value and usefulness of the accounting numbers (Mostafa, 2017). However, many of prior studies in Malaysia focus on this perspective (e.g., Mohamad et al., 2012; Mohd Saleh et al., 2005, 2007; Mohd Saleh and Ahmed, 2005). Their results indicate that opportunistic earnings management lowers the relevance of *DACC* value, demonstrating that investors perceive opportunistic earnings management to influence the accuracy and quality of accounting information. This is consistent with a study on Egypt companies by Mostafa (2017). Other studies in Malaysia look from an informative perspective (e.g., Hassan et al., 2016; Rahman, 2012), in which managers use earnings management to deliver internal information that helps investors make better predictions on a company's future prospects. Positive and significant relationships with share prices are found for such earnings management, revealing that investors also evaluate earnings management as useful information in determining the company's share price.

Choi et al. (2011) provide evidence that *DACC* can be affected by specific situations, such as economic crisis. Unlike *NDAC*, the value of *DACC* information depends on the manager's incentive to manage earnings and how investors interpret the incentive, i.e., either informative or opportunistic (Mostafa, 2017; Hassan et al., 2016; Choi et al., 2011). However, in most cases, investors are critical to *DACC*, and previous findings indicate that the relationship with share price is either weak or insignificant (Choi et al., 2011; DuCharme et al., 2004; Louis, 2004). However, within the disclosure literature, CEO is said to have incentive and ability or power to influence information to be disclosed (Li et al., 2018; Axelson and Balinga, 2009) as they believe the disclosure quality will increase firm value (Li et al., 2018; Hui and Matsunaga, 2015). Therefore, it is believed that the incoming CEO/MD is motivated to provide informative earnings management to increase the share price of the company. Furthermore, incoming CEO/MD should be subject to stringent selection process by the board of directors which be driven by good corporate governance practice. Lin et al. (2016) indicate corporate governance has a positive impact on informative earnings management. Hence, the present of the incoming CEO/MD is expected to strengthen the value relevance of the accounting numbers especially *DACC*.

The CEO/MD turnover literature generally describes CEO/MD's actions in managing earnings in the years related to the turnover as opportunistic (Kim, et al., 2014; Tokuga and Yamashita, 2011; Guan et al., 2005; Dahyaa et al., 2000). This description is attributed to the reporting of accounting numbers that do not reflect the actual financial position of the company. However, Pourciau (1993) asserts that the earnings management by the CEO/MD during the period of turnover may contain useful internal information for investors, aiming to display the company's profitability prospects. A new appointed CEO/MD who intends to protect his/her position will manage the reported net income negatively (for example, by taking big bath) to lower the company's performance benchmark during the turnover year. This behavior is followed by positive earnings management activities to show better results in the following year (Bornemann et al., 2015; Pourciau, 1993). Incoming CEO/MD also tried to obtain the trust of the board by achieving the threshold or targeted earnings and to improve future earnings (at the expense of earnings during the turnover year) or credit for company performance recovery and improvement (Murphy and Zimmerman, 1993; Pourciau, 1993). Therefore, a solid foundation exists regarding the relationship between incoming CEO/MD with the opportunistic earnings management activities.

The general view concurs that the performance recovery of a company is driven by the replacement of an ineffective CEO/MD with a more efficient and capable CEO/MD (Ishak and Abdul Latif, 2012; Denis and Denis, 1995). In this regard, the company's performance in the post-turnover period is an important signal of the capability of the newly appointed CEO/MD. However, actual performance improvements may not be seen in the short term as the incoming CEO/MD needs time to align his/her new visions and strategies with existing operations. The incoming CEO/MD is likely to manage earnings opportunistically (negatively) during the first year of turnover and manage earnings positively a year after the turnover (Bornemann et al., 2015; Pourciau, 1993) to demonstrate his/her capability and enhance his/her reputation.

The current study predicts the CEO/MD turnover (*TMC*) can reduce the relevance of *DACC* value but not *NDAC* and book value equity (*BVE*). The incoming CEO/MD might influence manager to manage earnings for their own benefit. If the investors believe such behavior as an opportunistic, the coefficient for the interaction between CEO/MD turnover and *DACC* (*TMC* DACC*) is expected to be negatively and significantly associated with share price. This assumption indicates that the turnover reduces the value relevance of the *DACC*. At the same time, the coefficient for the interaction between CEO/MD turnover and *NDAC* (*TMC*NDAC*) and the

coefficient of the interaction between CEO/MD turnover and the book value equity (*TMC*BVE*) are not significantly affected. This conjecture illustrates that the turnover does not affect the value relevance of *NDAC* and *BVE*. Based on the discussion, whether the turnover may decrease or increase the value relevance of the accounting numbers, particularly *DACC*, is debatable. Accordingly, our hypotheses are:

H_1 *CEO/MD turnover moderate (strengthens or weakens) the value relevance of Book value of equity (BVE) and non-discretionary accrual (NDAC).*

H_2 *CEO/MD turnover moderates (strengthens or weakens) the value relevance of discretionary accrual (DACC).*

RESEARCH METHODOLOGY

Sample

The sample of the study comprises of public listed companies on Bursa Malaysia that have announced CEO/MD turnover from 2009 to 2014. The year of 2009 was selected as the beginning year of the study as it has surpassed the economic downturn that occurred around 2007 and 2008[1] (Tan et al., 2014). Consistent with Cools and Van Praag (2007) and Shen and Cannella (2002), the sample for this study was selected based on the top 300 companies based on the level of market capitalization as of December 31, 2014. Data on CEO/MD turnover was gathered from the Bursa Malaysia website. Information on *BVE*, earnings, total assets, and share prices were derived from DataStream data base.

A total of 105 turnover announcements by 105 companies were identified, representing 35% of the top 300 companies. This number is adequate because companies rarely undergo top management turnover, especially that of CEO (Pourciou, 1993). Forty-seven or 44.80 percent of sample companies belong to the large companies based on the highest market capitalization, whereas 34 and 24 companies belong to the top 200 and 300 companies, respectively. We excluded seven companies in the financial industry because their accrual behavior is different from that in other industries (Rahman, 2012; Peasnell et al., 2005), and are subject to different regulations by Bank Negara Malaysia (Abdul Aziz, 2004). The final sample comprises of 98 companies (Panel A, Table 1). Panel C Table 1 indicates that majority of companies in our sample is from trade services industry (33), and followed by companies from property industry (24). Whereas the lowest number of companies is from construction industry (4) and followed by plantation 5. Panel B of Table 1 reports the initial number of CEO/MD turnover observation as 588; however, 60 observations were excluded because of incomplete accounting data. We also excluded 40 observations due to an extreme value that could affect the accuracy of the regression analysis (Tan et al., 2014). Therefore, the final data utilized in the analysis are 488 observations.

Table 1 Sampel Selection Procedure

Panel A	**Number of companies involved in CEO/MD turnover**
Initial Sample (300 companies):	
Large companies	47
Next 101 – 200 companies	34
Next 201 – 300 companies	24
Exclude:	
Companies in the financial industrial	(7)
Total	**98**

Panel B	**Number of observation (2009-2014)**
Number of turnover announcements during 2009-2014	**588**
Eliminate:	
Incomplete and unavailable data	(60)
Data with extreme value	(40)
Obeservation ready for analysis	**488**

[1] Sample selection during the economic downturn can affect the results of the analysis as the economic slowdown has a major impact on share prices and company performance.

Time Frame of the Study

This study classifies periods surrounding the CEO/MD turnover into four periods. These periods are identified and labeled as TMC_{t-1}, TMC_{t0}, TMC_{t+1}, and TMC_C. This method is consistent with Bornemann et al. (2015), Hazarika, Karpoff, and Nahata (2012), Guan et al. (2005), Dahyaa et al. (2000), Pourciau (1993), and Murphy and Zimmerman (1993). TMC_{t-1} refers to pre-turnover period, TMC_{t0} indicates the year in which the CEO/MD turnover took place, (i.e. the year when the incumbent CEO/MD resigned and ceased control of the company's financial statements, and the role shifted to his/her successor/s or new CEO/MD) (Pourciau, 1993), TMC_{t+1} is the first fiscal year after the turnover, and TMC_C refers to a cumulative period (t_{+1} until t_{+3}) after the turnover occurred.

Measurement of Variables and the Analyses

CEO/MD Turnover and Earnings Management

Before we proceed with the hypotheses testing, this study needs to provide evidence on the incoming CEO/MD's tendency to manage earnings for his/her own interest. Previous studies such as Bornemann et al. (2015), Kim et al. (2014), Guan et al. (2005), Murphy and Zimmerman (1993), and Pourciau (1993) compare the direction and magnitude of earnings management among companies that experienced CEO/MD turnover for the three periods, i.e., TMC_{t-1}, TMC_{t0}, and TMC_{t+1}. Comparisons were performed to prove the opportunistic method of earnings management in the years associated with the CEO/MD turnover. Consistent with previous studies, this study predicts that incoming CEO/MD tends to manage earnings negatively on TMC_{t0} in line with the big bath hypothesis and subsequently manage the earnings positively to increase turnover the following year (TMC_{t+1}).

Following Bornemann et al. (2015) and Guan et al. (2005), this study seeks to investigate the differences in the mean of *DACC* by using t-test method. Managers are assumed to employ different accounting choices/methods when determining the accounting results of the previous year (TMC_{t-1}), during (TMC_{t0}), and after (TMC_{t+1}) the CEO/MD turnover. In this regard, most studies use an observation period of at least three years (e.g. Bornemann et al., 2015; Hazarika et al., 2012; Guan et al., 2005; Pourciau, 1993) or five years (e.g. Kim et al., 2014; Murphy and Zimmerman, 1993) to show the difference in earnings management behavior for companies that experienced CEO/MD turnover. In this regard, this study measures earnings management based on discretionary accrual (*DACC*) that employs a procedure suggested by Kothari et al. (2005). Kothari et al. (2005) extends the modified Jones model introduced by Dechow, Sloan, and Sweeney (1995) by incorporating return on assets (ROA) as a control variable in their equations.

According to Kothari et al. (2005) high financial performance companies tend to manage earnings, and therefore *DACC* can be associated or sensitive to the companies' performance. The *DACC* represents the earnings section that often illustrates how the discretion of the manager is used to manipulate financial reporting. Unlike in most of previous studies which more concern on the absolute value of *DACC*, the current study is interested to observe the direction effect of *DACC* on reported earnings (Mohd Ali et al., 2008). Therefore, measurement by Kothari et al. (2005) is appropriate. We estimated *DACC*, using the cross sectional approach of measurement suggested by Kothari et al. (2005). The estimation was performed separately for each for all companies in the same industry. There are 33 companies in the Trade services industry, 24 (Property), 17 (Industrial product/technology), 15 (Consumer product), 4 (Construction) and 5 (Plantation). *DACC* was determined through several steps. The procedure is also used in Hassan et al. (2016), and Ahmad-Zaluki, Campbell, and Goodacre (2011). The steps are as follows:

1. First, this study determines the total accrual based on the following equation.

$$TACC_{it} = EBEI_{it} - OCF_{it} \quad (1)$$

Where, $TACC_{it}$ is total accrual for company i at the end of year t, $EBEI_{it}$ is Earnings before extraordinary items for company i at the end of year t, and OCF_{it} is Operating cash flow for company i at the end of year t.

2. Based on Equation (i) this study determines the non-*DACC* (*NDAC*). However, prior to that the study estimates α_1, α_2, α_3, and α_4 using the following equation, which is based on Kothari et al. (2005):

$$\frac{TACC_{it}}{TA_{it-1}} = \alpha_1 \frac{1}{TA_{it-1}} + \alpha_2 \frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it}} + \alpha_3 \frac{PPE_{it}}{TA_{it-1}} + \alpha_4 ROA_{it-1} + \varepsilon_{it} \quad (2)$$

Where, TA_{it} is total assets for firm *i* at the end of year *t-1*, ΔREV_{it} is the change in revenue for firm *i* between year *t* and *t-1*, ΔREC_{it} is the change in receivables for firm *i* between year *t* and *t-1*, PPE_{it} is gross property, plant and equipment for firm *i* at the end of year *t* and ROA_{it-1} is return on assets for firm *i* at the end of year *t-1*. The other variables are as defined previously.

Next, this study determines the value of *NDAC* based on the following equation. The value of α_1, α_2, α_3, and α_4 from regression (ii) are incorporated in the following equation (iii).

$$NDAC_{it} = \alpha_1 \frac{1}{TA_{it-1}} + \alpha_2 \frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{it-1}} + \alpha_3 \frac{PPE_{it}}{TA_{it-1}} + \alpha_4 ROA_{it-1} \quad (3)$$

Where, $NDAC_{it}$ is nondiscretionary accrual for firm *i* at the end of year *t* and other variables are as defined previously.

3. Finally, this study determines the *DACC* using the following equation:

$$DACC_{it} = TACC_{it} - NDAC_{it} \quad (4)$$

CEO/MD Turnover and Value Relevance of Accounting Numbers

The current study extends Ohlson's (1995) model to measure the effect of top management turnover on the value relevance of earnings and book value. Earnings are separated into two components, i.e. managed earnings or discretionary earnings (*DACC)* and unmanaged earnings (*NDAC)*. The study also incorporate CEO/MD turnover variable in the original model. This variable is represented by a dummy variable *TMC.* The interaction variables between *TMC* and *BVE* (*TMC*BVE*), *TMC* and *DACC (TMC*DACC)* and *TMC* and *NDAC* (*TMC*NDAC)* also included in the Ohlson's (1995) model. The purpose of incorporating *TMC* is to enable us examine the role of incoming CEO/MD on the value relevance of accounting numbers, especially book value and earnings components. We are more interested on the role of incoming CEO/MD on the earnings management practice and how the Malaysian capital market reacts toward the accounting numbers reported in the companies' annual report. The regression model for this study is in Equation 1.

$$SP_{it} = \alpha_1 BVE_{it} + \alpha_2 DACC_{it} + \alpha_3 NDAC_{it} + \alpha_4 TMC_{it} + \alpha_5 TMC * BVE_{it} + \alpha_6 TMC * DACC_{it} + \alpha_7 TMC * NDAC_{it} + \varepsilon_{it} \quad (1)$$

Where;

SP_{it}	=	Price of share of a company *i* at four months after closing date of financial year
BVE_{it}	=	Book value of net assets deflated by outstanding share of company *i* at time *t*
$DACC_{it}$	=	Discretionary accrual of a company *i* at end of financial year *t*
$NDAC_{it}$	=	Non discretionary accrual of a company *i* at end of financial year *t*
TMC_{it}	=	Dummy variable 1 indicates period of CEO/MD turnover or 0 for otherwise of a company i at end of financial year *t*
$TMC * BVE_{it}$	=	Interaction between *TMC* and book value of equity deflated by outstanding share of company *i* at time *t*
$TMC * DACC_{it}$	=	Interaction between *TMC* and *DACC* of a company *i* at end of financial year *t*
$TMC * NDAC_{it}$	=	Interaction between *TMC* and *NDAC* of a company *i* at end of financial year *t*
ε	=	Error term

The above equation might be influenced by the endogeneity problems, especially in the case of highly priced firms and capable CEO/MD. Therefore, a lag share price is included in Equation 1 and the present of endogeneity problem is tested using a correlation analysis on the residual and a Granger Causality test. In the present of endogeneity may lead this study to re-estimate the relationship between independent and dependent variables using GMM estimation.

RESULTS

Table 2 shows the descriptive statistics for all variables. On the average, the share price (*SP*) is 3.2889 per share, with a maximum value of 18.52 and a minimum of 0.0870. A similar range is also reported for the book value of equity (*BVE*) with a mean value of 2.0639 per share, the highest value of 7.9400, and the minimum value of 0.0340. The mean, maximum, and minimum value for *NDAC* are 0.0776, 0.3957, and -0.0373, respectively. However, for *DACC*, the mean, maximum, and minimum value is -0.0649, 0.2827, and -0.3835, respectively. These results indicate that most companies in our sample tend to reduce their earnings by negatively managing their earnings. The negative value for *DACC* is consistent with prior Malaysian studies, such as Mohd Saleh et al. (2005; 2007) and Mohd Saleh and Ahmed (2005), and Kim et al. (2014).

Table 2 Descriptive Statistics of Variables

Variables	Mean	Median	Maximum	Minimum	Std Deviation
SP	3.2889	1.9250	18.5200	0.0870	3.5166
BVE	2.0639	1.5750	7.9400	0.0340	1.5763
NDAC	0.0776	0.0697	0.3957	-0.0373	0.0604
DACC	-0.0649	-0.0663	0.2827	-0.3835	0.0954

Note: SP=share price at four months after financial year end; BVE= book value of equity per share; DACC= Discretionary accrual (proxy for earnings management) calculated according to Kothari et al. (2005); NDAC= Non discretionary accrual.

Table 3 presents the results of the Pearson correlation matrix for all variables. Column 2 of Table 3 indicates that TMC_{t0} is negatively related to share price. However, this relationship is insignificant. This finding indicates that investors do not value the significance of the incoming CEO/MD in improving the company's performance. Similar results are also reported a year after CEO/MD turnover (TMC_{t+1}). However, different results are obtained when a longer period is considered (TMC_C). The difference can be seen from the positive and significant relationship between TMC_C and share price at $p < 0.01$. In this case, when longer periods are taken into account, investors react positively to the new CEO/MD, possibly because the company has benefited from the presence of the incoming CEO/MD in the long run (Setiawan et al., 2011; Rhim et al., 2006). Column 2 also indicates that *BVE* and *E* are positive and significantly related to *SP* at $p < 0.01$. These findings are consistent with previous studies (Hassan et al., 2016; Rahman, 2012).

Table 3 Pearson Correlation Matrix

	SP	*BVE*	*E*	*DACC*	*NDAC*	$\boldsymbol{TMC_{t0}}$	$\boldsymbol{TMC_{t+1}}$	$\boldsymbol{TMC_C}$
SP	1.0000							
BVE	0.6453***	1.0000						
E	0.6707***	0.6121***	1.0000					
DACC	-0.1643***	-0.0776*	0.0269	1.0000				
NDAC	0.3394***	0.1288***	0.2570***	-0.5494***	1.0000			
$\boldsymbol{TMC_{t0}}$	-0.0135	0.0011	-0.0361	-0.0777*	-0.0717	1.0000		
$\boldsymbol{TMC_{t+1}}$	0.0390	0.0184	0.0323	0.1808***	-0.0307	-0.1870***	1.0000	
$\boldsymbol{TMC_C}$	0.1777***	0.1305***	0.0976**	0.0695	0.1822***	-0.3197***	0.5848***	1.0000

Note: * , ** and *** indicate significant at $p < 0.10$, $p < 0.05$, $p < 0.01$ respectively. SP= share price at four months after financial year end; E = earnings per share; DACC= Discretionary accrual (proxy for earnings management); NDAC= Non discretionary accrual; BVE= book value of equity per share; TMC_{t0}= year of CEO/MD turnover; TMC_{t+1}= The first year after the occurrence of CEO/MD turnover (Dummy variable 1 indicates a year after CEO/MD turnover, or 0 for otherwise); TMC_c= The cumulative year after the occurrence of CEO/MD turnover (Dummy variable 1 indicates post transition years of CEO/MD turnover, or 0 for otherwise).

Table 3 also indicates that *DACC* and *NDAC* are significantly related to share price. Consistent with views on the opportunistic behavior of the incoming CEO/MD, *DACC* is negatively related to the share price at $p < 0.01$. This outcome is supported by the negative relationship between *DACC* and TMC_{t0} at the significant level $p < 0.10$, wherein the negative value indicates that in the year of CEO/MD turnover, companies tend to lower their reported earnings. However, *DACC* is positively and significantly associated with TMC_{t+1} at the significance level of $p < 0.01$. This finding indicates that the incoming CEO/MD tends to positively manage the earnings to increase company income in the year following the turnover. This result is consistent with the findings of previous studies that examine the relationship between CEO/MD turnover and earnings management.

Evidence of Earnings Management

The t-test analysis was carried out to compare the direction and magnitude of the mean for earnings management (*DACC*) at TMC_{t-1}, TMC_{t0}, and TMC_{t+1}. This approach is consistent with Mostafa (2017); Bornemann et al. (2015), Kim et al. (2014), Hazarika et al. (2012), Guan et al. (2005), Murphy and Zimmerman (1993), and Pourciau (1993). As the comparison is over three periods, the sample study can only take into account the CEO/MD turnover that occurred between 2010 and 2013. Accordingly, the number of samples for the t-test analysis has been reduced to 62 companies.

Table 4 presents the mean for earnings management for the three periods. As expected, the t-test result (column 3) indicates that the mean of *DACC* for CEO/MD turnover at TMC_{t0} is in a negative direction (-0.0762), revealing that CEO/MDs tend to manage earnings in line with the big bath hypothesis. However, the mean negative value of earnings management at TMC_{t0} is not significantly different with the earnings management value at TMC_{t-1}. Consequently, the practice of big bath during the turnover period cannot be proven in Malaysia.

Column 4 of Table 4 indicates the mean of *DACC* at TMC_{t+1} is also negative, with a magnitude of -0.0199. This does not meet the initial expectation that the incoming CEO/MD in his/her first fiscal year in the office (where the incoming CEO/MD has full power in decision making) has a tendency to positively manage earnings in order to increase reported earnings. Although the mean for earnings management is negative, the magnitude is much smaller than TMC_{t0}. The mean difference between the two periods is significant at $p < 0.01$, indicating that the companies included in the sample still tend to report earnings upward in the first fiscal year after the turnover. Therefore, our finding is not consistent with prior studies.

Table 4 Mean for Earnings Management Prior to, During and After the CEO/MD Turnover

		TMC	
	t-1	***t0***	***t+1***
Predicted sign	?	-	+
Mean	-0.0715	-0.0762	-0.0199
Standard deviation	0.0869	0.0635	0.1189
Test for mean differences (n=62) :			
$TMC_0 - TMC_{-1}$		*-0.0048*	
		(p=0.679)	
$TMC_{+1} - TMC_0$			*0.0562**** *(p=0.000)*

Note: (i) TMC_{-1}= pre turnover fiscal year; TMC_0=CEO/MD turnover fiscal year and TMC_{+1}= post turnover fiscal year, (ii) test of equality between pre turnover and turnover earnings management and turn over and post turnover earnings management, (iii) figure in ( ) represent t-statistic-t; *** indicates significant at $p < 0.01$.

The size of the company may affect the above findings as large companies are often financially stable and exhibit better corporate governance practices. Therefore, these companies are likely to have lower incentives for managing earnings (Mostafa, 2017). On the contrary, the political costs hypothesis can be linked to companies with a strong and stable financial standing, and tend to manage the earnings negatively to lower reported earnings. To determine whether the size of the company affects the company's earnings management practices, additional analysis was conducted. In this case, the existing samples were divided into two groups: (i) large companies (large public listed companies group based on the highest market capitalization) and (ii) small companies.

Table 5 presents findings for analysis of mean for earnings management for large and small companies. Our findings for the large companies (Panel A, Table 5) are consistent with those in Table 4. However, findings for small companies (Panel B, Table 5) indicate that the mean for earnings management at TMC_{t+1} is positively and significantly different from the mean for earnings management at TMC_{t0} (t-statistic 0.0748, $p<0.01$). This indicates that the earnings management practices of the small companies can be classified as positive earnings management undertaken to increase earnings at TMC_{t+1}. The findings are also consistent with previous studies (Murphy and Zimmerman 1993; Pourciau 1993), which find evidence that earnings management in the first year after the turnover is geared toward increasing related earnings to signal the new CEO/MD's ability to improve company performance (Bornemann et al., 2015).

Table 5 Mean for Earnings Management Prior to, During and After the CEO/MD Turnover (Analysis based on companies size)

Panel A: ***Sample large public listed companies***			
TMC	***t-1***	***t0***	***t+1***
Redicted sign	?	-	+
Mean	-0.0951	-0.0857	-0.0921
Standard deviation	0.0814	0.0742	0.1103
Test for mean differences : (n=21)			
$TMC_0 - TMC_{-1}$		*0.0094* *(p=0.519)*	
$TMC_{+1} - TMC_0$			*-0.0064* *(p=0.699)*
Panel B: ***Sample of companies outside the large public listed companies***			
TMC	***-1***	***0***	***+1***
Redicted sign	?	-	+
Mean	-0.0594	-0.0579	0.0169
Standard deviation	0.0881	0.0716	0.1065
Test for mean differences : (n=41)			
$TMC_0 - TMC_{-1}$		*0.0015* *(p=0.931)*	
$TMC_{+1} - TMC_0$			*0.0748*** *(p=0.000)*

Note: (i) TMC_{-1}= pre turnover fiscal year; TMC_0=CEO/MD turnover fiscal year and TMC_{+1}= post turnover fiscal year, (ii) test of equality between pre turnover and turnover earnings management and turn over and post turnover earnings management, (iii) figure in ( ) represent t-statistic-t; *** indicates significant at p < 0.01.

The above findings reveal contradicting evidence between the Malaysian study and the prior studies conducted in developed countries. Findings in the developed countries, especially the Western countries, indicate that big bath was performed during the year of CEO/MD turnover to give a bad image to the previous CEO/MD. The current study provides evidence to support this prediction only for groups of smaller size of companies. During the first fiscal year after the turnover, the results show that the incoming CEO/MD is incentivized to manage earnings to reflect his/her positive image to shareholders and market players (Panel B). Further, the study believes these companies might have a similar characteristic of low performance companies. Mostafa (2017) indicates low performance companies have strong incentive for opportunistic earnings management to hide their low operating performance. According to Mostafa (2017) the companies tend to display positive and higher discretionary accruals relative to high operating performance. Our observation on data for both types of companies confirms the characteristics of non-top 100 companies as low performance companies and top 100 companies as high performance companies. We therefore believe that small companies managed earnings upward to hide their low performance.

CEO/MD Turnover and Value Relevance of Earnings Management *(DACC)*

Before this study examines the relationship between CEO/MD turnover and the value relevance of *DACC*, a correlation analysis between all variables and the residual was conducted. Results of the correlation analysis are presented in Table 6. Table 6 indicates that there is no correlation between all variables and the residual, therefore a Granger Causality Test was performed. Table 7 presents results for the Granger Causality Test. Table 7 indicates that only *NDAC* and *DACC* have a significant value with residual. This indicates that the endogeneity problem exists.

Table 6 Correlation Analysis between All Variables and Residual

	SP	***BVE***	***E***	***DACC***	***NDAC***	***TMC_{t0}***	***TMC_{t1}***	***TMC_C***	***SP1_RES***
SP	1								
BVE	0.6453	1							
E	0.6707	0.6121	1						
DACC	-0.1643	-0.0776	0.0269	1					
NDAC	0.3394	0.1288	0.257	-0.5494	1				
TMC_{t0}	-0.0135	0.0011	-0.0362	-0.0777	-0.0717	1			
TMC_{t1}	-0.0316	-0.0139	-0.0056	0.0037	-0.0908	-0.187	1		
TMC_C	0.1776	0.1305	0.0976	0.0695	0.1822	-0.3197	-0.296	1	
SP1_RES	0.6478	0	0	0	0	0	0	0	1

Note: * , ** and *** indicate significant at p < 0.10 , p < 0.05 , p < 0.01 respectively. SP= share price at four months after financial year end; E = earnings per share; DACC= Discretionary accrual (proxy for earnings management); NDAC= Non discretionary accrual; BVE= book value of equity per share; TMC_{t0}= year of CEO/MD turnover; TMC_{t+1}= The first year after the occurrence of CEO/MD turnover (Dummy variable 1 indicates a year after CEO/MD turnover, or 0 for otherwise); TMC_c= The cumulative year after the occurrence of CEO/MD turnover (Dummy variable 1 indicates post transition years of CEO/MD turnover, or 0 for otherwise). SP1_RES = share price residual.

Table 7 Granger Causality Tests

Pairwise Granger Causality Tests	**Lags: 1**	**Sample: 2009 2014**
Null Hypothesis:	F-Statistic	Prob.
RESID01 does not Granger Cause SP	10.5652	0.0012
SP does not Granger Cause RESID01	11.3102	0.0008
NDAC does not Granger Cause SP	4.8194	0.0287
SP does not Granger Cause NDAC	23.1438	0.0000
DATEID does not Granger Cause SP	2.4863	0.1156
SP does not Granger Cause DATEID	0.5674	0.4518
DACC does not Granger Cause SP	4.0069	0.0460
SP does not Granger Cause DACC	17.1273	0.0000
BVE does not Granger Cause SP	1.5515	0.2136
SP does not Granger Cause BVE	0.7444	0.3888
NDAC does not Granger Cause RESID01	**15.3785**	**0.0001**
RESID01 does not Granger Cause NDAC	**11.0476**	**0.0010**
DACC does not Granger Cause RESID01	**8.5038**	**0.0037**
RESID01 does not Granger Cause DACC	**8.2162**	**0.0044**
BVE does not Granger Cause RESID01	1.2654	0.2613
RESID01 does not Granger Cause BVE	0.8342	0.3616
DATEID does not Granger Cause NDAC	157.0490	0.0000
NDAC does not Granger Cause DATEID	2.2997	0.1302
DACC does not Granger Cause NDAC	8.1828	0.0044
NDAC does not Granger Cause DACC	28.6322	0.0000
BVE does not Granger Cause NDAC	3.9113	0.0486
NDAC does not Granger Cause BVE	1.2003	0.2739
DACC does not Granger Cause DATEID	0.4392	0.5079
DATEID does not Granger Cause DACC	24.8610	0.0000
BVE does not Granger Cause DATEID	0.3612	0.5482
DATEID does not Granger Cause BVE	0.7579	0.3845
BVE does not Granger Cause DACC	7.6051	0.0061
DACC does not Granger Cause BVE	2.0085	0.1572

Notes: ***, ** and * denoted the significance level of 1%, 5% and 10%, respectively. *SP= share price at four months after financial year end; SP (-1)= previous year SP; DACC= Discretionary accrual (proxy for earnings management); NDAC= Non discretionary accrual; BVE= book value of equity per share;* TMC_{t0} *= year of CEO/MD turnover;* TMC_{t+1} *= first year after the occurrence of EO/MD turnover (Dummy variable 1 indicates a year after CEO/MD turnover, or 0 for otherwise);* TMC_C *= the cumulative year after the occurrence of CEO/MD turnover (Dummy variable 1 indicates post transition years of CEO/MD turnover, or 0 for otherwise).*

Since the endogeneity problem exists, this study re-estimates the relationship between independent variables and dependent variable using Two-Step System-GMM estimation (Table 8). Columns 2, 3, and 4 of Table 8 present the results for the above analyses for the three periods of observation, during the CEO/MD turnover (TMC_{t0}), a year after the turnover (TMC_{t+1}), and a cumulative period of three years (TMC_C), respectively. Rows 2, 3 and 5 indicate that the lag share price [*SP (-1)*], *BVE* and *DACC* are regarded as value relevant over the three periods of observations. However, the *NDAC* was not associated with the share price during these periods. This indicates *NDAC* is not relevant in determining the share price of the company. Table 8 also shows that the coefficients of *SP (-1)*, *BVE*, and *DACC* are positively and significantly associated with the share price at the level of significance $p < 0.01$ over the three period of observation. However, this study fails to provide any evidence on the value relevance of *NDAC* throughout the period of observation (row 4 Table 8).

Our analyses indicate that the value relevance of these variables is not consistent after considering the interaction between CEO/MD turnover with *BVE*, *DACC*, and *NDAC* during the period of study. Column 2 row 8 and row 9 Table 8 indicates the present of incoming CEO/MD increase the value relevance of *NDAC* (TMC_{t+0}**NDAC*) and *DACC* (TMC_{t+0}**DACC*), respectively. The relationship between both variables and share price are positive and significant at $p < 0.01$. The present of the incoming CEO/MD has strengthened the relationship between both earnings components and share price, hence the *DACC* and *NDAC* are more value relevance. These findings indicate that Malaysian investors aware that the incoming CEO/MD is motivated to transform the company for better earnings during the turnover. They may have confidence that the incoming CEO/MD has a strong understanding of the company's surrounding environment and able to anticipate the possibility of the success (Chang et al., 2010).

Row 11 and 13, column 3 and row 15 and 17, column 4 Table 8 indicate the CEO/MD turnover has moderate the relationship between book value of equity (*BVE*) and *DACC* and share price, respectively. While CEO/MD turnover strengthen the relationship between *DACC* and share price at $p < 0.10$, it weakens the relationship between *BVE* and share price during TMC_{t+1} at $p < 0.01$. However, over the longer period of

observation (*TMCc*) the CEO/MD turnover weakens the relationship between both variables with the share price at $p < 0.01$. These findings indicate over the longer period of time the CEO/MD tends to reduce the quality of earnings (Mostafa, 2017), therefore the market react negatively towards the *BVE* and *DACC*. The findings support both H_1 and H_2. This study also indicates the present of the incoming CEO/MD does not have any implication on the relationship between *NDAC* and share price. This is consistence with the Null hypothesis on the moderating role of CEO/MD turnover on the relationship between *NDAC* and share price.

Table 8 Two-Step System-GMM Estimation

Variables	**TMC_{t0}**	**TMC_{t+1}**	**TMC_c**
SP (-1)	0.9528***	0.9696***	0.9651***
BVE	0.2099***	0.02679***	0.0753**
NDAC	0.2237	-0.0764	-1.1039
DACC	1.0220***	0.8872***	2.0865***
TMC_{t0}	0.0096		
TMC_{t0}**BVE*	0.0248		
TMC_{t0}**NDAC*	4.8361***		
TMC_{t0}**DACC*	**5.7466*** **		
TMC_{t+1}		0.1809	
TMC_{t+1}**BVE*		-0.1586***	
TMC_{t+1}**NDAC*		0.2796	
TMC_{t+1}**DACC*		**2.1488***	
TMC_c			-0.0207
TMC_c**BVE*			-0.0631***
TMC_c**NDAC*			1.0929
TMC_c**DACC*			**-2.0844*** **
Constant	0.0392	-0.1308*	0.3757***
AR(1) (p-value	0.0210	0.0210	0.0280
AR(2) (p-value)	0.7720	0.7540	0.9970
J-test (p-value)	0.1750	0.3150	0.1830
No. of groups	82	82	82
No. of instruments	56	56	52
Prob > chi2	0.0000	0.000	0.0000

Notes: ***, ** and * denoted the significance level of 1%, 5% and 10%, respectively. SP= share price at four months after financial year end; SP (-1)= previous year SP; DACC= Discretionary accrual (proxy for earnings management); NDAC= Non discretionary accrual; BVE= book value of equity per share; TMC_{t0}= year of CEO/MD turnover; TMC_{t+1} = first year after the occurrence of EO/MD turnover (Dummy variable 1 indicates a year after CEO/MD turnover, or 0 for otherwise); TMC_C = the cumulative year after the occurrence of CEO/MD turnover (Dummy variable 1 indicates post transition years of CEO/MD turnover, or 0 for otherwise).

The above result can be explained by findings from previous studies (Bornemann et al., 2015; Guan et al., 2005; Murphy and Zimmerman, 1993; Pourciau, 1993), which relate top management turnover to manipulation of accounting figures by individuals who took over the position (new CEO/MD), and such circumstances undermine the value relevance of accounting numbers (Hassan et al., 2016). A newly appointed CEO/MD is faced with the pressure to produce better performance than the previous CEO/MD, because when the turnover occurs, the company replaces the old CEO/MD with individuals who are believed able to contribute to the company. In this case, the incoming CEO/MD is likely to use earnings management during the early period of his/her appointment to demonstrate company performance recovery and improvement throughout his/her control (Bornemann et al., 2015). However, the company's actual performance recovery may not be seen immediately (Ishak, Ku Ismail, Abdullah, 2013; Dahyaa et al., 2000). The results show that earnings managements at TMC_{to} and TMC_{t+1} are interpreted by investors as informative action, but as an opportunistic action over a longer period of time TMC_c. As such, the *DACC* no longer exerts a relevant effect on investors to determine the value of firms which measured by the share price.

CONCLUSION

Prior Malaysian studies provide evidences on the association between earnings management and its motivational factors such as underinvestment, corporate governance, debt contracts and control mechanisms. However, in addition to the Malaysian studies, prior studies in the developed countries provide evidences on the role of CEO/MD turnover and earnings management practices which had not been explored in the Malaysian setting.

Therefore, the current study extends the above studies by examining the role of CEO/MD turnover on the value relevance of earnings management. First we provide weak evidence on the earnings management practice among Malaysian companies which is contradicted findings to prior studies in developed countries. Instead of reporting lower earnings during the turnover year, Malaysian companies do report lower earnings during the first fiscal year after turnover. However, additional analysis indicates that small companies tend to manage earnings upward in a year after the turnover as compared to the large companies. This is consistent with most of prior studies in developed countries. Incoming CEO/MD of small companies have the incentive to increase earnings to take credit from investors, to get higher compensation as well as to increase share price.

We then investigate whether the turnover moderate the value relevance of earning management. Overall, the main findings indicate that lag share price [SP (-1)], *BVE* and *DACC* are value relevant over the period of study, however not for *NDAC*. The current study indicates the present of incoming CEO/MD has strengthened the value relevance of earnings management (*DACC*) and unmanaged earnings (*NDAC*). Although initial investigation on earnings management behavior indicates a downward earnings management been practiced, our finding provides a similar reaction of upward earnings management (positive earnings management) among investors toward the interaction between CEO/MD turnover and earnings management practice. Investors may believe downward earnings management as an opportunistic action of the incoming CEO/MD, hence the information is considered as less informative. This action is consistent with the earlier findings that the CEO/MD has the ability to influence informative information disclosure (Axelson and Baliga, 2009) as such disclosure may increase the company's value (Li et al., 2018).

We believe our findings might be relevant for the strategic decision making which involves the corporate management of public listed companies, especially the decision related to CEO/MD turnover by board of directors. Board should be more concerned on the characteristics of the incoming CEO/MD as they might have their own incentive. The findings also useful for both current and prospective investors in their investment decision making, which involves companies experiencing CEO/MD turnover. These findings might be relevant to the shareholders as they should actively involve in determining the direction of the companies.

This study is subject to some limitations. First, the sample of CEO/MD turnover involving 98 companies does not reflect the overall turnover for public listed companies on Bursa Malaysia. Future studies may want to extend this. In addition, the study does not carry out a detailed analysis of the accounting variables subject to manager's discretion (e.g., research expenditure, advertising, and capital expenditure). Future research can extend these findings by incorporating companies which are not experiencing CEO/MD turnover and other incentives such as political influence or other corporate events. Without in-depth analysis, the earnings management of the sample company involved is likely to be influenced by other factors apart from CEO/MD turnover. In this regard, the researchers suggest that these limitations should be taken into account in the generalization of findings.

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