EFFECTS OF OWNERSHIP STRUCTURE AND MONITORING MECHANISMS ON EARNINGS QUALITY AND MARKET ASSESSMENT

by

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ABSTRAK

EFFECTS OF OWNERSHIP STRUCTURE AND MONITORING MECHANISMS ON EARNINGS QUALITY AND MARKET ASSESSMENT

ABSTRACT

This thesis is motivated by the move towards a market-based regulation or self-regulation for the Malaysian capital market. In such environment the quality of information is important. Against a background of companies’ ownership structure that allegedly exacerbates the separation of ownership and control conflict, and that possibly limits transparency of information to the public, this thesis examines if such ownership structure leads to lower earnings quality. Earnings ia an important information to the market. And if indeed the market is self-regulating this thesis examines if the market is assessing earnings quality and the elements of governance; ownership structure and the monitoring mechanisms (audit committee and substantial shareholding). The market assesses these elements by requiring a certain return, the cost of equity, where accordingly these elements are perceived to be an information risk. This study is based on a sample of listed companies for the accounting year end 2004. The earnings quality measures used are accrual quality, discretionary accruals, persistence and predictability. It is found that substantial shareholding, a market mechanism, to be significantly associated with the discretionary earnings quality which suggests the substantial shareholders is an important monitoring mechanism. This is in contrast to the results of a rule based mechanism, audit committee. None of the characteristics of audit committee (independence and competence) is significantly associated with all measures of earnings quality and neither are they priced. This has an important implication on the relative spending of resources by regulators on market and rule based mechanisms. The finding that substantial shareholding is priced is a significant contribution as it suggests that substantial shareholding is a mechanism that increases proprietary information flow
to the public and hence reduces information risk. This study, however has not found any evidence that relates cash flow/voting rights and the type of controlling party (family, government, institution, company and management) with earnings quality and the cost of equity. This study contributes new evidence in Malaysia that earnings quality influences cost of equity. The results for accruals quality and predictability are consistent across the two measures of cost of equity. Discretionary accruals are significantly associated with one measure of cost of equity. An important implication is that companies may achieve their objectives by engaging in activities that lead to lower earnings quality, but they stand to pay a higher price in the form of higher cost of equity.
CHAPTER 1
INTRODUCTION

1.1 Motivation of research

The Asian financial crisis has been claimed to be the wake-up call for corporate governance (CG) reform in the Asian region. In response to the crisis, the Malaysian regulators have taken a different approach to regulation by placing the responsibility of valuing the companies in the hands of market players. Under the market based valuation where the disclosure based regime operates, the regulator no longer assesses the merits and worth of corporate proposal namely in security offerings and issuance (Securities Commission 1999).

This market-based approach calls for the need for high quality disclosures/ financial reporting and high standard of corporate governance (Securities Commission 1999, Securities Commission Annual Report 2002). The role of regulators is to set standards to meet this need. Figure 1.1 depicts this market based approach.

Whilst certain structural elements of CG such as corporate ownership and control are the product of the socio-economic development and government policies, in this reformed environment with high quality of information market players are expected to be able to discern good governance in form and substance and make assessment accordingly. In the words of Emeritus Professor Mohamed Ariff,

‘Good corporate governance is more than a check list of dos and don’ts.

It is essentially an infrastructure of built-in checks and balances. Good
governance is not confined to the top layer of the corporate hierarchy, as governance and processes are intricately linked.’ (Emeritus Professor Mohamed Ariff at http://www.mier.org.my/mierscan/ -‘Banking on Corporate Governance’ 25 March 2005)

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Figure 1.1 Market-based regulatory environment

The fact that market penalizes and rewards, or assesses companies for poor or good governance, the market consequences of governance, is part of this checks and balances. This research is motivated by this development into market based approach to regulation which is although new but has been evolving.
1.1.1 High standard of corporate governance (CG) and quality of information imperatives for effective market-based regulation

Substantial effort to improve reporting and CG practices is evidenced from the many guidelines and rules for best practices established (for example Malaysian Code of Corporate Governance (MCCG) (2000)), and laws enacted (Financial Reporting Act 1997, amendments to securities and companies law (2000)). A number of CG mechanisms has long been adopted such as the rules governing independent directors (1987) and audit committees (1993) (SC web page). These rules were subsequently enhanced by the revamping of Exchange Listing Requirements in 2001. This major revamp among others includes disclosure of the extent to which companies comply with the MCCG.

Rules to protect investors and to promote transparency in ownership were also enhanced to include for example rules regarding market manipulation, false and misleading information, prohibition from hiding behind nominees (Securities Law) and one-share-one-vote (s55 Companies act 1965).

In the area of financial reporting, both securities law and companies act have incorporated requirements to comply with standards produced by Malaysian Accounting Standards Board. Since August 1999, the exchange listing requirements provide for companies to report financial information (which include income and cash flow statements, balance sheet and explanatory notes) every quarter. The Bursa Malaysia regularly investigates variances between these unaudited reported results and the year end audited results.
These requirements together supposedly ensure that those who are in control of companies act in the interest of all shareholders and that information that are made available to the market actually reflect the economic performance of the companies. The market players act accordingly through the pricing mechanism and thus ensure efficient resource allocation. In other words, market players use disclosed information to assess companies by requiring high return for high risk companies. Thus poor quality information distort this risk assessment and market players may make wrong investment decisions.

1.1.2 Standard of corporate governance and quality of information in substance

Mere compliance to disclosure requirements and corporate governance practices guidelines, that is compliance in form, does not necessarily ensure that those who are in control of corporate decisions do not in substance, subvert the intent and spirit of those rules and guidelines. There are still practices that are not covered by the rules and especially in financial reporting there is still room for managerial discretion. It has been reported that each of the companies in the United States that was involved in fraudulent scandals such as Enron, Tyco and Disney was in full compliance with the standards for corporate governance related to the board of directors (BOD) and audit committee set by the subsequently enacted Sarbanes Oxley Act (Pergola 2005). Most of them were audited by one of the Big 4 (or 5 then) auditors.

Although not to the same scale as the scandals in the US market, the Malaysian market is not short of improper practices even with the strengthening of the regulations
described above and with increased surveillance. The SC Annual Report 2003 for example cited incidences of assets acquisitions and disposals at questionable prices. It is also reported that companies create debts to offset contractual obligation. There are also questionable transactions detected by the SC such as the acquisition for cash of a private company that was subsequently disposed as a settlement of fictitious debt, the use of money-lending licenses for what was purportedly in the ‘ordinary course of business’, and the creation of a liability for a company that originated from private loan arrangement between individuals. The findings reported in the SC annual report emerged from targeted surveillance, where the SC focused on certain activities and reporting standards. How widespread such activities among the listed companies is an important empirical question. And of equal importance is the question of how pervasive the practices that are although legal, not in pursuance of shareholders wealth maximization.

The incidences of improper and unethical practices possibly signal a failure of the various CG mechanisms to reduce information asymmetry and align interest of those in control with other shareholders. Some of the mechanisms are to enforce independence of BOD and audit committee. However independence in form does not necessarily ensure independence in substance. This is so as independent directors could be associated with the company or the chief executive officer in ways that are too subtle to be captured by the rules and regulations.

Another possible reason which has not been given sufficient attention by researchers is the ability to expropriate funds at relatively less cost to the perpetrator as the disparity between cash flow rights (associated with ownership) and voting rights (associated with
control) of the perpetrator widens. This happens when concentration of control is
achieved through shareholding of multiple layers of companies, thus the term pyramidal
structure (this is explained in detail in Chapter 3).

To have the controlling votes is important from the perspective of corporate
governance. The owner has an influence over decisions such as dividend payments,
appointment of key management personnel, etc. Thus Mr. Zee needs relatively small
capital outlay to control PQR and could expropriate funds from the company as a
controlling shareholder with relatively small cash consequences as owner.

Samples of companies taken in past studies by Claessens, Djankov and Lang (2000) and
Fan and Wong (2002) indicate the existence of such control. Though s55 of Companies
Act 1965 requires one share to have one vote to prevent such disparity, in substance in
pyramidal structure such disparity exists.

This form of ownership concentration is not so apparent by cursory study of substantial
shareholders disclosure. Unlike in the US where companies are allowed to issue shares
that carry more than one vote, such disparity is transparent. Thus the shareholders who
hold the inferior shares with one vote each can discount the price of shares accordingly
knowing the voting power of the other class of shares (Francis, Schipper & Vincent
2005). However in Malaysia where it is not so transparent, therefore the non-controlling
shareholders not-knowing the existence of such control would not be able to do so,
therefore the pricing mechanism for efficient resource allocation breaks down.
1.1.3 Substantial shareholders

A mechanism that may reduce moral hazard faced by non-controlling shareholders is the existence of substantial shareholders i.e shareholders who own more than 5%. According to Kaplan and Minton (1994), Pound (1988) and Shleifer and Vishney (1986) a substantial shareholder has a role in controlling agency problems by actively monitoring the controlling party who in a widely held company, is the management. Similar role could be played by substantial shareholders in companies with concentrated ownership.

In Malaysia it is common for companies to be held by a few substantial shareholders with shareholdings far higher than the threshold 5%, instead of just one substantial shareholder with the majority controlling rights, even though one may be with the highest shareholding and the apparent controlling party,. The following extracts from annual reports of ACP Industries Berhad and Glomac Berhad illustrate this type of ownership concentration.

Table 1.1 ACP Industries Berhad- Analysis of Shareholdings as at 16 August 2004

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Direct Interest</th>
<th>Indirect Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metacorp Berhad</td>
<td>38,734,790</td>
<td>29.02</td>
</tr>
<tr>
<td>MTD Capital Berhad</td>
<td></td>
<td>38,734,790</td>
</tr>
<tr>
<td>Lambang Simfonisim Sdn Bhd</td>
<td></td>
<td>38,734,790</td>
</tr>
<tr>
<td>Employees Provident Fund Board</td>
<td>20,499,000</td>
<td>15.36</td>
</tr>
</tbody>
</table>
Metacorp Berhad, MTD Capital Berhad and Lambang Simfoni Sdn Bhd are companies under the control of Dato’ Dr Nik Hussain Abdul Rahman and his family members. It is fairly obvious that Dato’ Dr Nik Hussain and family are the controlling shareholder. However, the Employees Provident Fund Board with shareholding of around 15% could play a significant role in monitoring the controlling party actions.

Table 1.2 Glomac Berhad- Analysis of Shareholdings as at 30 June 2004

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Direct Interest</th>
<th>Indirect Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Shares</td>
<td>%</td>
</tr>
<tr>
<td>Dato’ Mohamed Mansor Fateh Din</td>
<td>63,552,183</td>
<td>29.33</td>
</tr>
<tr>
<td>Datuk Fong Loong Tuck</td>
<td>47,404,490</td>
<td>21.88</td>
</tr>
<tr>
<td>Employees Provident Fund Board</td>
<td>14,456,590</td>
<td>6.67</td>
</tr>
<tr>
<td>(Three other foreign companies with lesser shareholdings)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Similarly for Glomac Berhad, the substantial shareholder Datuk Fong may be able to play a role in the checks and balance process assuming as apparent that Dato’ Mohamed Mansor and Datuk Fong are not related.

In the West where aggressive takeovers bids are common, the existence of substantial shareholders may control manager’s behavior as they have the ability to remove non-performing managers by facilitating takeovers. Thus the effectiveness of the other substantial shareholders hinges on whether such ability exists. According to Mak and Li (2001) in economies such as Malaysia, hostile takeovers are rare and conflicts are resolved through non-confrontational methods. Besides it would be easier to remove non-performing managers than the other majority and controlling shareholders.
However the experience of KFC Holdings boardroom tussle in 2004/2005, where it was reported that the move to remove the board executive chairman was initiated by a substantial shareholder, indicated that perhaps the situation is changing (NST Business Times, 20 May 2005, pg 1). Thus the effectiveness of the substantial shareholders in monitoring the controlling party is an open question. The same arguments apply for institutional investors such as the Kumpulan Wang Simpanan Pekerja (KWSP). The fact that institutional investors played a major role in setting up the Minority Shareholders Watchdog, suggests that institutional investors on their own may not serve to be an effective monitoring mechanism.

Another factor which makes the effectiveness of substantial shareholders as a control mechanism questionable in Malaysia is the potential alignment of interest between substantial shareholders and the manager or the controlling party through kinship, social or economic relationship (Lim 1981) and through political or governmental affiliation (Gomez & Jomo 1999, Gomez 2002). Thus a substantial shareholder in a company may share the same objectives as the controlling party resulting in a potentially cohesive control to the detriment of other shareholders.

The role of substantial shareholders is an important and interesting area to consider as the monitoring and governance effect if any is inherently non-legal or not imposed by rules or standards unlike monitoring mechanisms such as audit committee and board of directors. Thus the results would shed light on the relative effectiveness of a rule based mechanism such as the audit committee and the board of directors and a market based mechanism, such as a significant shareholding of a shareholder other than the controlling shareholder. In the Malaysian capital market, in the context of the market
based approach to regulation as described earlier, the relevant regulator has a significant role in setting standards and rules with regards to governance and quality of disclosure. This does not preclude the development of mechanisms through market forces such as the substantial shareholding. The substantial shareholder may play a role in aligning the interest of the controlling party and other shareholders including other non-controlling shareholders.

It is a conjecture at this stage that improper practices by the controlling party which escape the law and other non-legal or market based mechanisms such as the substantial shareholders, potentially undermine the credibility of reported results namely the earnings figure. Even though financial accounting rules are extensive there is still room for the exercise of judgment and discretion. Thus activities related to the expropriation of non-controlling shareholders’ wealth, to management entrenchment and to manipulation of accounts without legitimate underlying economic activity could be hidden behind reported earnings numbers.

1.1.4 Earnings as a useful measure

It is expected that market players use a repertoire of measures and information from various sources. However earnings is a summary measure widely used (Francis, LaFond, Olsson & Schipper 2003, Liu, Nissim & Thomas 2002)). It reflects aggregate effects of accounting policy choice made. A survey by Price Waterhouse (2000) found that majority of chief executive officers believed price/earnings ratio was still relevant for market valuation. In addition, anecdotal evidence indicates that market players respond to earnings figure. It was reported that there were unusual share price
movements and dealings of Goh Bah Huat Berhad when it reported earnings of RM100 million in its 31 December 2004 quarterly results, which was later discovered to be erroneous and turned out to be a loss of RM21 million. Apparently some market players have acted on the erroneous profit. Thus for the proper functioning of the market, the state of earnings quality in Malaysia and whether they reflect undesirable elements described above are important empirical questions.

1.1.5 A discerning market as enforcement agent

In a market-based regulatory environment, market players play an important role in enforcement through the pricing mechanism and thus ensure efficient resource allocation. Investors must be able to reinforce proper conduct in companies by rewarding or punishing appropriately, in technical terms by requiring higher rate of return for high risk companies and vice versa. Certainly the rules and guidelines are substantial enough to ensure high quality information to be available to the market for investors to act accordingly. However for this approach to regulation to be effective, the market players must be able to evaluate beyond the disclosed information.

For example in the case of Goh Ban Huat Bhd cited above, market responded to the huge earnings announced without discerning the error impounded in the figure. It is not that there has not been other indicators to doubt the figure such as past quarterly losses, but the market players did not interpret cautiously the earnings figure. On the other hand Mitton (2000) interpreted market reaction to the purchase of Renong shares by United Engineers Malaysia at an inflated price as a penalty for bailing out the troubled parent company. Market could see through the expropriation of other shareholders interest and
UEM share price dropped by 38% on the day the purchase was announced (NST 19 Nov 1997, pg 62).

Given the contradicting observations, it is therefore important to examine whether market players in the Malaysian capital market appropriately prices, if at all they do, earnings quality by requiring higher return from companies with lower earnings quality and vice versa.

1.2 Problem Statement

Theoretical analyses (Berle & Means 1932, Jensen & Meckling 1976) have established the moral hazard problems associated with information asymmetry when there is a separation between ownership and control. In particular, the controlling party has an incentive to expropriate company’s resources and to take actions that may be in divergent to the interest of the other party, who have no access to information in order to detect and monitor such practice. The separation of control and ownership is particularly aggravated when the controlling party can further enhance control through pyramid ownership structure, when there is concentration of ownership or with the existence of shareholders that could exercise control by virtue of these shareholders relationship with the controlling party.

Since rules and regulations, and other non-legal monitoring mechanism cannot firewall completely improper practices as described in preceding paragraph, it is reasonable to expect the higher the degree of separation of ownership and control, the greater the likelihood of such improper practices. The improper practices are potentially manifested
in earnings which then result in low earnings quality. Unlike in a clinical and case by case study, in an empirical study such improper practices are not easily observable. Thus earnings quality is a proxy to the likelihood of improper practices.

Given the considerable amount of effort and resources that have been spent on putting in place rules and standards for good corporate governance, it is not only important to examine if good governance characteristics are associated with high earnings quality and vice versa, it is also important to examine if the capital market is pricing correctly the companies based on the earnings quality.

Thus the purpose of this research is to examine the relationship between the extent of separation of ownership and control in Malaysian listed companies, together with the rule based and market based mechanisms, and earnings quality. Further, drawing from a theoretical assertion that information risk is priced, this study will determine if the capital market rewards or penalizes companies for the companies’ quality of earnings through required return or cost of equity. In essence this is a departure from traditional theory that only systematic risk is priced. Any idiosyncratic such as information risk arises from each company unique circumstances or company specific and can therefore be diversified away. As in previous researches, this study characterizes earnings quality as information risk. Low earnings quality poses a risk as investors cannot rely on earnings information to make investments decision and accordingly affects cost of equity.

The characteristics associated with the separation of ownership and control poses information risk as the controlling party is privy to more information. Drawing parallel
to the original work that characterizes information asymmetry between informed and uninformed investors as information risk, it is here characterized that information asymmetry between the controlling party and other investors as information risk. Thus this study examines if capital market rewards or penalizes companies, assesses companies with characteristics associated with separation of ownership and control. The association between the monitoring mechanisms, audit committee and substantial shareholders, with market assessment is also examined to see if these monitoring mechanisms is priced and therefore perceived as effective in reducing the information risk.

1.3 Research Questions

Against such background, this study seeks answers to the following questions:

a) What is the nature of the separation of control and ownership amongst Malaysian listed companies?

b) What is the state of earnings quality amongst Malaysian companies?

c) Does the separation of ownership and control, in the presence of CG mechanisms, and the alleged potential conflict between controlling and non-controlling managers/shareholders manifest itself in earnings quality?

d) Do investors price accordingly the information risk poses by the quality of earnings?

e) Does the separation of ownership, in the presence of CG mechanisms, affect market assessment, i.e. is priced? Does the market assessment in turn affect the separation of ownership and control?
1.4 Objectives of Research

The main objectives of the study are:

a) to determine the extent of separation of control and ownership by examining ownership structures of Malaysian listed companies from simple structure inducing manager-shareholder conflict to a more complicated pyramidal structures that induces controlling-non-controlling shareholders conflict,

b) to determine whether the degree of separation of control and ownership in the presence of CG mechanisms, has an influence over the quality of earnings,

c) to examine whether investors penalize or reward accordingly companies for low or high quality earnings, through the required return measure or cost of equity measure, and

d) to examine whether the degree of separation of control and ownership in the presence of CG mechanisms, affect the required return or cost of equity.

1.5 Significance of Study

This study, as described earlier, is motivated by the development in the Malaysian capital market towards market based regulation where self-regulation by market players is an expected feature together with the active involvement of regulators in terms of setting rules and standards. Thus this study is therefore timely and contributes significantly towards understanding of a self-regulation aspect of the market and that is the market assessment of earnings quality and of the various governance mechanisms. The contribution of this study is towards understanding of the market consequences of
earnings information and governance mechanisms which unlike the contribution from many previous researches that examine the determinants of earnings quality which include the governance mechanisms themselves. The following describes the contribution of study from different aspects.

1.5.1 Practical contribution

1.5.1.1. To the regulators

Regulators’ investigation is ‘clinical’ and targeted at certain area. Since this is a study of market behavior, thus the market wide effect of the conflict of interest between controlling and non-controlling parties on earnings quality, and the market assessment of it could be understood better. Market based study determines the significance of the relationship and extent of the problem.

It is also important that regulators are informed that the public resources spent on rules and regulations are effective and that the market perceived them as such. Otherwise it is best left to market forces and more resources are spent to ensure the market forces are working well.

1.5.1.2. To market players

In the market-based approach as earlier mentioned, market players play a major role in the price discovery. But market players must use the information and must know how. The SC and BM have stressed on the need for investors education. This research increase awareness of the potential conflicts brought about by control achieved through
pyramidal structure, the way earning figures, in substance should be read and the potential mispricing if low quality earnings is not read as such.

1.5.2 Methodological and theoretical contribution

1.5.2.1 By including the different corporate governance mechanisms and not just the ownership structure, this study examines the relative significance of the different corporate governance mechanisms. These different mechanisms is viewed here as rule based or imposed by rules and regulations such as the audit committee and one that emerges from market forces or market based such as substantial shareholding.

1.5.2.2 This study attempt to measure the information risks poses by the CG mechanisms and ownership structure themselves. Whilst previous research characterize information risks as the imprecision in the information as reflected by the quality of earnings, this study attempt to characterize information risk as the relative amount of information that is kept private and made public.

The study contributes to the understanding of whether the capital market penalizes or rewards companies with certain ownership and earnings characteristics by requiring a higher or lower rate of return. The required return or cost of equity is an important input into financing and investment decisions.

1.5.2.3 Previous studies on ownership structure and other variables are carried out mainly in well developed economies or at regional level. Findings that explain well developed economies may not necessarily be applicable in a less developed economies.
Studies at a regional level such as Asia may fail to capture unique characteristics of specific country that explain differences across companies in that country. This study look at cross-company differences of ownership structure, corporate governance mechanisms, earnings quality and cost of equity in Malaysia given the unique characteristics of Malaysian business environment in which ownership is known to be concentrated and where there is a suggestion that there is a weak market for corporate control and the role of the other substantial shareholders is relatively less researched.

1.5.2.4. A significant contribution of this research, in the context of the theory associating information risk and required return, is from the examination of the substantial shareholding. The associations between substantial shareholding and each of earnings quality and required return have never been examined. In this context the results contribute towards the theory by establishing the substantial share holding role in increasing the precision of information and the flow of information from the private to public domain.

1.6 Thesis Outline

The introduction in this chapter is followed by Chapter 2. Chapter 2 reviews literature to derive theoretical justifications for the relationships that are examined in the thesis and to establish the extent of empirical studies that have already been carried out. This chapter ends by laying out the theoretical and research framework, and the hypotheses thus developed.
Chapter 3 lays out the relationships under study and develops hypotheses by drawing from the literature on theoretical and empirical studies reviewed in Chapter 2.

Chapter 4 describes in detail the sample and variables. Where relevant examples are given to illustrate how a particular variable is measured. The justification for a chosen measure from alternatives of measures is also given. Finally the equations representing the relationships examined are laid out.

Chapter 5 presents the results and brief analysis of the descriptive, bivariate and multivariate analysis of each of the relationships examined. Each hypothesis presented is tested. Where appropriate comparisons are made with findings of previous researches.

Chapter 6 discusses the results, provides explanation and where relevant justifications for findings. The discussion draws Important similarities or differences in the findings from previous researches.

Chapter 7 concludes, highlights significant contribution, provides implications of the findings and discusses limitations of the research. This chapter ends with some direction for future research.
Table 1.3 Summary of motivation of study which leads to problem statement, research questions and objectives

<table>
<thead>
<tr>
<th>MOTIVATION OF RESEARCH</th>
<th>PROBLEM STATEMENT</th>
<th>RESEARCH QUESTIONS</th>
<th>RESEARCH OBJECTIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The move towards disclosure/market based regulatory environment – requires high quality of information and corporate governance – requires market to make assessment. 1.1.1 There has been many rules, regulations etc to improve CG and quality of information, 1.1.2 but in substance CG and information may not be reliable due to nature of ownership in Malaysia (pyramidal structure ,etc) that exacerbates the separation of ownership and control conflict. 1.1.3 The substantial shareholder’s ambiguous role, another feature of ownership needs to be examined 1.1.4. Market uses many information but earnings very useful thus a useful measure/ a proxy of information quality in the market based regulation 1.1.5. In the market based environment, also important that market prices accordingly information specifically earnings and elements of governance.</td>
<td>Theoretical analyses establish the relationship between ownership structure (separation of ownership and control) and improper practices even with rules, regulations, etc. Improper practices lead to poor earnings quality, thus need to examine whether ownership structure is associated with earnings quality, and whether market prices earnings quality. Ownership structure poses information risk in terms of the proportion of information in public/private domain. Thus research also examines if market prices ownership structure together with the monitoring mechanisms.</td>
<td>a) What is the nature of the separation of control and ownership amongst Malaysian listed companies? b) What is the state of earnings quality amongst Malaysian companies? c) Does the separation of ownership and control, in the presence of CG mechanisms, and the alleged potential conflict between controlling and non-controlling managers/shareholders manifest itself in earnings quality? d) Do investors price accordingly the information risk poses by the quality of earnings? e) Does the separation of ownership, in the presence of CG mechanisms, affect market assessment, i.e is priced? Does the market assessment in turn affect the separation of ownership and control?</td>
<td>a) To determine the extent of separation of control and ownership by examining ownership structures of Malaysian listed companies from simple structure inducing manager-shareholder conflict to a more complicated pyramidal structures that induces controlling- non-controlling shareholders conflict, b) To determine whether the degree of separation of control and ownership in the presence of CG mechanisms, has an influence over the quality of earnings, c) To examine whether investors penalize or reward accordingly companies for low or high quality earnings, through the required return measure or cost of equity measure, and d) To examine whether the degree of separation of control and ownership in the presence of CG mechanisms, affect the required return or cost of equity.</td>
</tr>
</tbody>
</table>
CHAPTER 2
LITERATURE REVIEW

2.0 Introduction

This chapter reviews literature to derive theoretical justifications for the relationships that are examined in the thesis and to establish the extent of empirical studies that have already been carried out.

Part 2.1 first reviews literature on the nature and measure of earnings quality and provides justification for the chosen measures in view of the relationships that are being examined.

To link the ownership structure and the monitoring mechanisms that are examined to earnings quality, part 2.2 described the literature that constitutes the body of knowledge related to agency theory and the information asymmetry problems when there is a separation of ownership and control. Empirical research is also reviewed to justify the measures used in the separation of ownership and control construct. The measures are the cash flow/ voting rights and the type of controlling party. This section also establishes the theoretical justification for using two measures, independence and competence, for the audit committee and the role of audit committee and substantial shareholders in information asymmetry related problems.

Part 2.2 establishes the expectation of association between cash flow/ voting rights, the type of controlling party, audit committee characteristics and substantial shareholder with earnings quality.
Part 2.3 reviews literature that establishes the theory related to the pricing of information risks. There are two dimensions of information risks. One is with regards to the imprecision of information which provides a link between earnings quality and required return by the market. The other is with regards to the relative amount of information being made public or kept private by companies. This establishes the expectation between ownership structure and the monitoring mechanisms being examined with the required return. This section also reviews the empirical researches that explore those theoretical links, and discusses briefly the endogeneity problem in studies involving ownership structure.

2.1 Earnings quality

In previous research, such as in Francis, LaFond, Olsson and Schipper 2004, earnings quality is associated with characteristics or attributes of earnings figure that are regarded as favorable and desirable or otherwise. It encompasses more than earnings management whether in good faith, such as in situation where well informed manager manages earnings to signal to users, or in bad faith where manager manages earnings to mislead users.

There is a number of attributes for which this concept of earnings quality is assessed. Each attribute incorporates the respective perspective of the role of earnings in users’ decision making framework. Thus there is no single agreed upon measure of earnings quality (Schipper & Vincent 2004). Francis et al 2004, based on past research, categorized these attributes as accounting based and market based. The accounting
based attributes capture the uncertainty of future cash flows or earnings, whilst the
market based attributes capture the market that is investors’ perception of such
uncertainty. The following described these attributes.

2.1.1. Accounting based earnings attributes

Accrual quality

This attribute measures how close is earnings to cash flow. The underlying view is that
high quality earnings is one that is close to cash flow or low in accruals in general.
Unlike cash flow, the incidence and magnitude of accruals is subjected to management
discretionary accounting choice, therefore could be subjected to management
opportunistic action to mislead users, and is also influenced by a company’s individual
and industry characteristics.

In line with this view, two approaches in measuring accruals that lead to low quality
earnings could be identified from past researches. In the first approach, researches
identify the discretionary component of total accruals such as in Jones (1991) and
Dechow, Sloan and Sweeney (1995) studies, or they identify the discretionary
component of specific accruals such as bad debts in McNichols and Wilson (1988) In
both cases the residuals from the regression of total or specific accruals on variables
explaining the non-discretionary components of the respective accruals, are measures of
discretionary accruals. This measure of discretionary accruals is taken as measure of
earnings management that causes low quality earnings.
The second approach, taken in Dechow and Dichev (2002) and Francis et al (2004), focuses on the direct relationship between accruals and earnings without regards to the discretionary/ manipulative and non-discretionary/ unintentional components, as measure of earnings quality. This approach views the role of accruals as to ‘adjust the recognition of cash flows over time so that the adjusted numbers (earnings) better measure firm performance’ (Dechow & Dichev 2002). Thus the measure of earnings or accrual quality is the residual from the regression of changes in working capital on last period, current period and next period cash flows from operations.

Persistence

A desirable attribute of earnings is if it is permanent or recurring. Earnings is of high quality if it is sustainable or in the term used in past research, persistent. This could be interpreted as a source of earnings from a company’s core operations. Earnings that is low in persistence could be interpreted as of low quality in the sense that a significant part of a company’s earnings is generated from sources that is temporary or ‘managed’ and therefore not recurring.

Formally in econometrics term persistence is a measure of how current period earnings shock (unexpected changes) is carried forward or persist in the future. Thus past studies employ time series economics forecasting methods with varying assumptions regarding the earnings process. For example Francis et al (2003) as in previous studies (Lev 1983, Ali & Zarowin 1992) employ autoregressive model of order 1 (AR1) to estimate persistence (slope coefficient estimate). This assumes that current period earnings depend on previous period earnings plus an error term. Other studies as described in