FINANCIAL REPORTING QUALITY OF MALAYSIAN FAMILY FIRMS

Kamarul Bahrain Abdul-Manaf[1]
Noor Afza Amran[2]
Ayoib Che-Ahmad[3]

ABSTRACT

This study examines the quality of financial reporting for family firms in Malaysia. We use earnings informativeness as our measure for financial reporting quality. According to the entrenchment effect, firms with concentrated ownership are more likely to produce low quality financial reporting. In family firms, ownership is concentrated. Therefore, based on entrenchment effect, family firms are expected to produce low quality financial reporting. However, our result shows otherwise. Using a sample of Malaysian public listed firms for the period 2000-2007, we find that earnings informativeness is higher for family firms than for non-family firms. As far as earnings informativeness is concerned, the result provides evidence that family firms produce high quality financial reporting.

Keywords: *Earnings informativeness, ownership structure, family firms, Malaysia.*

[1]School of Accountancy, Universiti Utara Malaysia, 06010 UUM Sintok, Kedah, Malaysia, Email: kama1183@uum.edu.my
[2]School of Accountancy, Universiti Utara Malaysia, 06010 UUM Sintok, Kedah, Malaysia, Email: afza@uum.edu.my
[3]School of Accountancy, Universiti Utara Malaysia, 06010 UUM Sintok, Kedah, Malaysia, Email: ayoib@uum.edu.my

INTRODUCTION

Ownership structure determines the distribution of power between managers and shareholders. According to Jensen and Meckling (1976), management and external shareholder interests diverge when management owns a lower number of shares in firms. Therefore, it is necessary to reduce the separation of power and ownership to increase shareholders' values (Morck, Shleifer, & Vishny, 1988). Many studies focus on ownership structure to determine its effect on financial reporting quality. It is an area of research that remains unsettled. For example, Fan and Wong (2002) and Ball, Robin and Wu (2003) examine financial reporting quality for Malaysian firms. In Malaysia, ownership structure of many firms is concentrated. The majority of shares are held either by the state, families or individuals (Zhuang, Edwards & Capulong, 2001; Hui, 1981; La Porta et al., 1998). Fan and Wong (2002) and Ball et al. (2003) find that Malaysian firms produce low quality financial reporting. They posit that this is due to concentrated ownership. However, this contradicts with recent studies indicating that concentrated ownership is associated with high quality financial reporting. Wang (2006) reports that family firms are inclined to report high quality financial information. They are not likely to engage in opportunistic behaviour in reporting earnings as it could damage the families' reputation. This result is supported by Ali, Chen and Radhakrishnan (2007) who too, find that family firms report higher earnings quality than non-family firms. Similarly, Wan Nordin (2009) finds that family firms are associated with high corporate transparency.

The objective of this paper is to examine financial reporting quality for family firms in Malaysia. In family firms, ownership is concentrated. The operations of the firms are controlled by family members. According to the entrenchment effect, owners have the incentive to engage in transactions that would increase their own wealth. This is possible as owners control the operations of the firms as well as firms' financial reporting. They are more likely to manage financial reporting for self-interest purpose. Therefore, it is expected that family firms produce low quality financial reporting. However, recent studies (Ali et al., 2007; Wan Nordin, 2009; Wang, 2006) indicate that the quality of financial reporting for family firms is higher than for non-family firms.

We use earnings informativeness as our measure for financial reporting quality. Earnings informativeness refers to earnings and stock returns relationship. A strong earnings and stock returns relationship is regarded as high quality financial reporting (Vafeas, 2000; Bushman et al., 2004). As recent studies indicate that family firms are associated with high quality financial reporting, we expect that earnings informativeness is greater for family firms than for non-family firms. Using a sample of Malaysian firms for the period 2000-2007, we find that earnings informativeness is greater for family firms than for non-family firms. Our results support recent studies that show family firms produce high quality financial reporting.

The rest of the paper proceeds as follows. Section 2 reviews prior studies and develops the hypothesis. Section 3 discusses the research method and Section 4 presents the results and discussions. Section 5 is the conclusion.

PRIOR STUDIES AND HYPOTHESIS DEVELOPMENT

OWNERSHIP STRUCTURE

In East Asian countries, firms are usually controlled by families or the state. Controlling shareholders have power, primarily, through the use of pyramids and participation in management (La Porta et al., 1998). A study by Claessens, Djankov and Lang (2000) in nine East Asian countries (Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Thailand and Taiwan) reveals that more than two-thirds of the firms are controlled by a single shareholder. About 60% of concentrated firms' top management is related to the family of the controlling shareholder and there is extensive family control in more than half of East Asian firms. Yammeesri and Lodh (2004) study 243 non-financial firms listed on the Stock Exchange of Thailand for the years 1993 to 1996. They find that firms with controlling ownership have higher performance than those with non-controlling ownership. Results also show that family-controlling ownership has a positive and significant relationship to firm performance.

The ownership structure in many Malaysian firms is concentrated, whereby the shares are held mostly by the state, families or individuals. Reports on the Observance of Standards and Codes (ROSC) by the World Bank indicate that 67.2% of the shares in Malaysia are held by family members. A study by Hui (1981) finds that 0.8 % of shareholders own 69% of all shares in the 62 largest Malaysian firms between 1974 and 1976. La Porta et al. (1998) evidence that 54% of ownership is owned by the three largest owners who are from the ten largest Malaysian non-financial listed companies. A survey conducted by PricewaterhouseCoopers (1998) shows that almost 97% of Malaysian Public Listed Companies (PLCs) are substantial shareholders[1] with 33% of them involve in management. Abdullah (2001) finds that the single largest shareholder holds 36% of the firm's shares. Ahmad, Abdul Manaf and Ishak (2003) study 236 PLCs and find that the block-holders hold 60.75% of company ownership. A study by Abdullah and Mohd-Nasir (2004) determines that the average shareholding by the top 20 shareholders is 73%. Tam and Tan (2007) claim that concentrated ownership affects firm performance. Firm characteristics such as firm age, size and sector also influence firm performance. A study by Zainal Abidin, Mustaffa Kamal and Jusoff (2009) also shows that directors in Malaysia have sizeable ownership stakes in the firm compared to their counterparts in Western countries such as Sweden and the UK.

Family Firms

Family firms have special characteristics that distinct themselves from non-family firms. In family firms, ownership is concentrated and managerial ownership is high. The management mainly consists of family members and board of director is less open to outsider (Corbetta & Montemerlo, 1999). Family spirit is strong in family firms whereby, it serves as a monitoring and controlling mechanism (Fama & Jenssen, 1983). Moreover, family traits influence the governance of family firms (Mishra, Randoy & Jenssen, 2001). The involvement of family members in the management allows them to have extensive knowledge in the operations of the firms. Consequently, family members are able to make flexible, timely and efficient decision makings (James, 1999). In addition, the presence of family members in the management benefits family firms in term of lower cost of debt, and therefore, family firms are more likely to maximize shareholders' values (Anderson, Mansi & Reeb, 2003).

Agency cost is expected to be less severe for family firms compared to non-family firms. Agency cost arises due to the separation of ownership and control. However, as family members control the operations of the firms, they become dominant and entrenched. According to entrenchment effect, owners are more likely to engage in transactions that benefit themselves. As owners have control on firms' financial reporting, they have the incentives and the opportunities to manage accounting numbers for self-interest purpose. Consequently, investors do not trust reported earnings as they expect owners manipulate earnings, and hence, this undermines the credibility of earnings and lowers earnings informativeness (Fan & Wong, 2002). It is also argued that family firm structure produces low quality financial reporting. This is due to the fact that debt tends to be private for family firms. Capital requirement is usually financed by bank loans. Information asymmetry is more likely resolved by private communication. Therefore, there is no demand for high quality financial reporting (Ball et al., 2003).

Nevertheless, recent studies document that family firms are associated with high quality financial reporting. Wang (2006) argues that due to the entrenchment effect, users of financial statements demand family firms to produce high quality earnings. Family firms are concerned with families' reputation. Therefore, they have the incentives to report earnings of high quality in order to protect the families' reputation. Wang examines the quality of earnings for S&P 500 firms and finds that earnings are more informative for family firms. Ali et al. (2007) contend that family firms acknowledge that market aware of their activities and therefore, they are not inclined to engage in activities that benefit themselves. They are concerned that market might penalize their rent seeking activities in the form of lower equity value. Accordingly, family firms have the incentive to produce high quality earnings. Ali et al. find that earnings of family firms are of higher quality than that of non-family firms. In a related study, Wan Nordin (2009) examines whether family firms are associated with greater corporate transparency. He reports that corporate transparency is higher for family firms than it is for non-family firms.

[1] A substantial shareholder is defined as having at least 5% (direct or indirectly) of the aggregate of nominal amounts of all the voting shares in the firm as defined in Section 69D, Companies Act 1965.

Earnings Informativeness

Earnings informativeness refers to the extent earnings recognize information that is incorporated in stock prices (Vafeas, 2000; Fan & Wong, 2002). A strong relationship between earnings and stock returns is regarded as high quality financial reporting. Many previous studies measure earnings informativeness to assess the quality of financial reporting. Lev and Zarowin (1999) examine the quality of financial reporting in the U.S over the twenty years period from 1977 to 1996. They report that over the period, earnings informativeness has declined suggesting a deteriorating in the quality of financial reporting.

Ball, Kothari and Robin (2000) adopt the same measure to examine the quality of financial reporting between common-law countries and code-law countries. They find that financial reporting in common-law countries is of higher quality. Teoh and Wong (1993) report that the market perception of the quality of accounting earnings positively affects the informativeness of earnings. Vafeas (2000) documents earnings informativeness is high for firms with good corporate governance mechanisms. Earnings are more informative for firms with effective board structure. The results indicate that earnings and stock returns relationship is greater for firms with small board of directors, which is regarded as more effective than large board of directors. Bushnan et al. (2004) show that boards tend to adopt stronger corporate governance mechanism when earnings informativeness is low. Fan and Wang (2002) find that concentrated ownership is associated with low earnings informativeness as ownership concentration prevents leakage of proprietary information about the firms' rent-seeking activities.

Based on the findings of Wang (2006), Ali et al. (2006) and Wan Nordin (2009) that show financial reporting of family firms is of higher quality than that of non-family firms, we hypothesize that:

H_1: Earnings informativeness is higher for family firms than it is for non-family firms.

RESEARCH METHOD

SAMPLE SELECTION

We obtain data from the company annual reports and financial database. The annual reports are retrieved from the Bursa Malaysia website (www.bursamalaysia.com). The financial data is retrieved from the Thomson Advance Database. We define a family firm as a firm that meets the following criteria: (1) CEO is the founder or the successor who is related by blood or marriage, (2) at least two family members hold management position in the company, and (3) family directors have a minimum of 20% interest (direct and indirect shareholding) in the company. The sample in this study is public firms listed on the Main Board of Bursa Malaysia.[2] Firms classified under the finance sector, unit trusts and REITS are excluded because of their unique features and business activities as well as differences in compliance and regulatory requirements. Our sample consists of 2,856 firm-years over the period 2000-2007.

MEASUREMENT MODEL

Following Vafeas (2000) and Fan and Wong (2002), earnings informativeness is measured by earnings and stock returns relationship. We include the dummy variable for family firms to examine the difference in earnings informativeness between family firms and non-family firms. The estimating equation is as follow:

$$RET_t = \beta_0 + \beta_1 FAMILY_t + \beta_2 EARN_t + \beta_3 FAMILY_t.EARN_t + \varepsilon_t$$

where RET_t is a twelve-month stock return, $FAMILY_t$ is a dummy variable that equals one for family firm and equals zero otherwise, $EARN_t$ is annual earnings deflated by the beginning of period market value, and ε_t is the residual term. β_2 measures the sensitivity of stock returns to earnings for non-family firms, while β_3 measures the marginal sensitivity of stock returns to earnings for family firms. We predict earnings informativeness to be higher for family firms than for non-family firms. Therefore, it is expected that β_3 to be positive and significant.

RESULTS AND DISCUSSIONS

Table 1 reports descriptive statistics for regression variables. The minimum value and the maximum value of earnings are -25.32 and 22.17, respectively. Earnings are left-skewed to where mean value of 0.03 is. The mean value of stock returns is 0.09. The minimum value and the maximum value of stock returns are -0.90 and 5.26, respectively.

Table 1: Descriptive statistics for regression variables

[2] In August 2009, the Main Board and the Second Board of Bursa Malaysia were merged, and known as the Main Market of Bursa Malaysia.

	Mean	Std.Dev.	Upper Quartile	Lower Quartile	Minimum	Maximum
EARNINGS	0.03	1.02	0.15	0.01	-25.32	22.17
STOCK RETURNS	0.09	0.58	0.27	-0.25	-0.90	5.26

Table 2 reports regression results for stock returns on earnings. β_2 measures the sensitivity of stock returns to earnings for non-family firms, while β_3 measures the marginal sensitivity of stock returns to earnings for family firms. The slope coefficient on β_2 is 0.04 and statistically significant at a 1 percent level. The differential slope coefficient on β_3 is 0.09 and statistically significant at a 10 percent level. The results indicate that the sensitivity of stock returns to earnings is greater for family firms. Stock returns for family firms are 3.25 {(0.04 + 0.09) / 0.04} more sensitive to earnings than it is for non-family firms. The results confirm our expectation that earnings informativeness is higher for family firms than it is for non-family firms. The results provide evidence that the quality of financial reporting for family firms is of higher quality than it is for non-family firms.

Table 2: Regression results for stock returns on earnings

Variable	β	Coefficient
CONSTANT	B_0	0.08*** (0.000)
FAMILY	B_1	0.02 (0.427)
EARN	B_2	0.04*** (0.000)
FAMILY*EARN	B_3	0.09* (0.087)

***Significant at 1% level, **Significant at 5%, *Significant at 10%.
(Figures in the parentheses are the p-values)

Fan and Wong (2002) and Ball et al. (2003) posit that it is due to concentrated ownership that Malaysian firms produce low quality financial reporting. However, our results suggest that the quality of financial reporting for family firms is of high quality although the ownership is concentrated. It appears that Malaysian family firms are concerned with their reputation and they acknowledge that investors demand them to produce high quality financial reporting. Family firms believe that if they produce low quality financial reporting, investors might penalize them in the form of lower equity value. Hence, family firms are motivated to produce high quality financial reporting. Accordingly, investors regard the financial information provided by family firms is of higher quality than that provided by non-family firms. Our results are consistent with the earlier studies (Wang, 2006; Ali et al., 2006; Wan Nordin, 2009) that show family firms produce high quality financial reporting.

We believe that there should be other explanation for the results obtained in Fan and Wong (2002) and Ball et al. (2003). Both of these studies are conducted during the period before the enactment of Financial Reporting Act in 1997. During this period, Malaysia lacks of regulation that could regulate firms to prepare financial statements in accordance with specific accounting standards. Furthermore, during this period, Malaysian Accounting Standards Board has not been established yet. There is no accounting standards board to oversee the development of and to issue accounting standards in Malaysia. The condition of financial reporting environment during the period is weak and it could be the contributing factor for the results obtained in Fan and Wong (2002) and Ball et al. (2003). Further study on this issue would enhance our understanding.

CONCLUSION

In this paper, we examine the quality of financial reporting for family firms. We use earnings informativeness as our measure for financial reporting quality. Using a sample of Malaysian public listed firms during the period 2000-2007, we find that earnings informativeness is higher for family firms than it is for non-family firms. The empirical result suggests that investors value earnings reported by family firms higher than earnings reported by non-family firms. Interestingly, our study provides evidence to support recent studies (Wang, 2006; Ali et al., 2007; Wan Nordin, 2009) that document family firms are associated with high quality financial reporting.

REFERENCES

Abdullah, S.N. 2001. Characteristics of board of directors and audit committees. *Akauntan Nasional,* 14 (10), pp.18-21.

Abdullah, S.N., & Mohd-Nasir, N. 2004. Accrual management and the roles of board of directors and audit committees among Malaysian listed companies: Evidence during the Asian financial crisis. *IIUM Journal of Management and Economics,* 12 (1), pp.49-80.

Ahmad, C.A., Abdul Manaf, N.A., & Ishak, Z. 2003. Corporate governance, ownership structure and corporate diversification: Evidence from the Malaysian listed Companies. *Asian Academy of Management Journal,* 8 (2), pp.67-89.

Ali, A., Chen, T., & Radhakrishnan, S. 2007. Corporate disclosures by family firms. *Journal of Accounting and Economics,* 44, pp.238-286.

Anderson, R.C., Mansi, S., & Reeb, D.M. 2003. Founding family ownership and the agency cost of debt. *Journal of Financial Economics,* 68, pp.263-285.

Ball, R., Kothari, S.P., & Robin, A. 2000. The effect of international institutional factors on properties of accounting earnings. *Journal of Accounting and Economics,* 29, pp.1-51.

Ball, R., Robin, A., & Wu, J. S. 2003. Incentives versus standards: properties of accounting income in four East Asian countries. *Journal of Accounting and Economics*, 36, pp.235-270.

Bushman, R., Chen, Q., Engel, E., & Smith, A. 2004. Financial accounting information organizational complexity and corporate governance systems. *Journal of Accounting and Economics,* 37, pp.167-203.

Claessens S., Djankov, S., & Lang, L.H.P. 2000. The separation of ownership and control in East Asian corporation. *Journal of Financial Economics,* 58 (1/2), pp.81-112.

Corbetta, G., & Montemerlo, D. 1999. Ownership, governance and management issues in small and medium-size family businesses: A comparison of Italy and the United States. *Family Business Review,* 12 (4), pp.361-374.

Fama, E., & Jensen, M. 1983. Separation of ownership and control. *Journal of Law and Economics*, 26, pp.301-325.

Fan, J.P., & Wong, T.J. 2002. Corporate ownership structure and the infromativeness of earnings in East Asia. *Journal of Accounting and Economics*, pp.401-425.

Hui, L.M. 1981. *Ownership and control of the one hundred largest corporations in Malaysia.* Kuala Lumpur: Oxford University Press.

James, H.S. Jr. 1999. Owner as manager, extended horizons and the family business. *International Journal of Economics of Business,* 6 (1), pp.41-55.

Jensen, M.C., & Meckling, W.H. 1976. Theory of the business: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 13, pp.305-360.

La Porta, R., Lopez-De-Silanes, F., Shleifer, A., & Vishny, R. 1998. Law and finance. *Journal of Political Economy,* 106 (6), pp.1113-1155.

Lev, B., & Zarowin, P. 1999. The boundaries of financial reporting and how to extend them. *Journal of Accounting Research,* 37 (2), pp.353-385.

Mishra, C.S., Randoy, T., & Jenssen, J.I. 2001. The effect of family influence on firm value and corporate governance. *Journal of International Financial Management and Accounting*, 12 (3), pp.235-259.

Morck, R., Shleifer, A., & Vishny, R.W. 1988. Management ownership and market valuation: An empirical analysis. *Journal of Financial Economics,* 20, pp.293-315.

PricewaterhouseCoopers. 1998. *Corporate Governance: 1998 Survey of public listed companies.* PricewaterhouseCoopers. Kuala Lumpur.

Tam, O.K., & Tan, M.G.S. 2007. Ownership, governance and firm performance in Malaysia. *Corporate Governance: an International Review,* 15 (2), pp.208-222.

Teoh, S.H., & Wong, T.J. 1993. Perceived auditor quality and the earnings response coefficients. *The Accounting Review,* 68, pp.346-367.

Vafeas, N. 2000. Board structure and the informativeness of earnings. *Journal of Accounting and Public Policy,* 19, pp.139-160.

Wan Nordin, W.H. 2009. The impact of family-firm stucture and board composition on corporate transparency: Evidence based on segment disclosures in Malaysia. *The International Journal of Accounting,* 44, pp.313-333.

Wang, D. 2006. Founding family ownership and earnings quality. *Journal of Accounting Research,* 44, pp.619-656.

Yammeesri, J., & Lodh, S.C. 2004. *Influence of ownership structure and corporate performance: Evidence from Thailand.* Paper presented at the meeting of 5th Asia-Pacific Journal of Accounting and Economics, Kuala Lumpur.

Zainal Abidin, Z., Mustaffa Kamal, N., & Jusoff, K. 2009. Board structure and corporate performance in Malaysia. *International Journal of Economics and Finance,* 1 (1), pp.150-164.

Zhuang, J., Edwards, D., & Capulong, M.A.A. 2001. Corporate governance and finance in East Asia: A study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand. Asian Development Bank, Manila, Philippines, pp.1-179.