



***EFFECT OF MODERATING FACTORS ON VALUE RELEVANCE OF  
EARNINGS INFORMATION AMONG PYRAMID STRUCTURE FIRMS IN  
SELECTED ASEAN COUNTRIES***

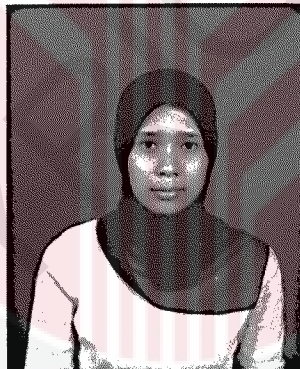
**NAZRATUL AINA BINTI MOHAMAD ANWAR**

**GSM 2010 8**

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COUNTRIES**

By

**NAZRATUL AINA BINTI MOHAMAD ANWAR**



**Thesis submitted to the Graduate School of Management,  
Universiti Putra Malaysia, in Partial Fulfillment of the  
Requirement for the Degree of Master of Science**

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Abstract of thesis presented to the Senate of Universiti Putra  
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Master of Science

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**September 2010**

**Chair: Professor Dr Mohamad Ali Abdul Hamid, PhD**

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The objective of this study is to ascertain if the presence of institutional owner as second largest owner, the absence of CEO duality and the higher level of cash flow rights in the hand of ultimate owner, hereby referred to as moderating factors, help to improve the value relevance of earnings information in pyramid structure firms. The separation of cash flow rights and control rights in pyramid structure firms has entrenched the ultimate owner and provide them with opportunities to manipulate earnings information, which in turn reduce the value relevance of the earnings information reported.

This study hypothesizes that the moderating factors identified will help to reduce the agency problem between ultimate owner and minority shareholder by reducing the opportunity of ultimate owner to manipulate earnings information, which in turn will

increase the value relevance of earnings information in pyramid structure firms.

The sample in this study consists of 153 pyramid structure firms from Malaysia, Indonesia, Thailand and Philippines, where the identity of the ultimate owner is family ownership and the firms were originally assembled by Claessens et al. (2002) from 1992 to 1997.

Earnings-return model with the interaction between earnings information reported by pyramid structure firms and moderating factors is provided to show the effect of the factors on the earnings-return relationship in an attempt to measure the value relevance of earnings information reported. Positive earnings-return relationship and higher  $R^2$  indicate that the earnings information is value relevant and vice versa.

Using panel data regression, the results show that the presence of all proposed moderating factors is significant to minimize and mitigate the negative effects of the structure based on higher  $R^2$  reported with positive earnings-return relationship. Thus, the moderating factors moderate the negative effects of pyramid structure firms and help to increase the low value relevance of earnings information among pyramid structure firms.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra  
Malaysia untuk memenuhi sebahagian daripada keperluan untuk ijazah  
Sarjana Sains

**KESAN FAKTOR-FAKTOR PEYEDERHANA KE ATAS KERELEVANAN  
NILAI MAKLUMAT PENDAPATAN DI KALANGAN FIRMA-FIRMA  
BERSTRUKTUR PIRAMID DI NEGARA-NEGARA ASEAN TERPILIH**

Oleh

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Objektif kajian ini adalah untuk menentukan samada dengan kehadiran pemilik institusi sebagai pemilik kedua terbesar, ketidakhadiran kedua dalam jawatan ketua pegawai eksekutif (*CEO*) dan tahap hak aliran tunai pemilik utama yang lebih tinggi, (dengan ini dirujuk sebagai faktor-faktor penyederhana), dapat membantu meningkatkan kerelevanan nilai maklumat pendapatan di dalam firma-firma berstruktur piramid. Pemisahan hak aliran tunai dan hak kawalan di dalam firma-firma berstruktur piramid telah mengukuhkan kedudukan pemilik utama dan memberi peluang kepada mereka untuk memanipulasi maklumat pendapatan dan seterusnya mengakibatkan kurangnya kerelevanan nilai maklumat pendapatan yang telah dilaporkan.

Kajian ini mengutarakan hipotesis iaitu faktor penyederhana yang dikenalpasti akan

dapat membantu mengurangkan masalah agensi di antara pemilik utama dan pemegang saham minoriti dengan cara mengurangkan peluang pemilik utama memanipulasi maklumat pendapatan, yang mana akan meningkatkan kerelevanan nilai maklumat pendapatan dalam firma-firma berstruktur piramid.

Sampel kajian ini melibatkan 153 buah firma-firma berstruktur piramid dari Malaysia, Indonesia, Thailand dan Filipina, di mana identiti pemilik utama adalah pemilikan keluarga dan pada asalnya telah dihimpun oleh Claessens et al. (2000) dari tahun 1992 hingga 1997.

Model pendapatan-pulangan bersama interaksi antara maklumat pendapatan yang dilaporkan oleh firma-firma berstruktur piramid dengan faktor-faktor penyederhana telah dimasukkan untuk menunjukkan kesan faktor-faktor tersebut ke atas hubungan pendapatan-pulangan dalam usaha mengukur kerelevanan nilai maklumat pendapatan yang dilaporkan. Hubungan pendapatan-pulangan yang positif dan  $R^2$  yang lebih tinggi menandakan bahawa maklumat pendapatan tersebut mempunyai nilai kerelevanan dan begitu juga sebaliknya

Dengan menggunakan regresi data panel, hasil keputusan telah menunjukkan iaitu kehadiran semua faktor penyederhana yang dicadangkan adalah penting untuk meminimumkan kesan negatif struktur piramid tersebut, berasaskan kepada laporan  $R^2$  yang lebih tinggi serta hubungan pendapatan-pulangan yang positif. Oleh itu, faktor penyederhana tersebut telah pun dapat menyederhanakan kesan-kesan negatif firma-

firma berstruktur piramid tersebut dan membantu meningkatkan kerelevanan nilai maklumat pendapatan di kalangan firma-firma berstruktur piramid.



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In the name of Allah, the most Gracious, most Merciful. With his blessing and will, I can complete this thesis.

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My many thanks to my friends; Fakarudin, Afrah, Linda, Suhaida and Irwan, the lecturers and staff members of Graduate School of Management, Universiti Putra Malaysia and those whose directly or indirectly contributed in many ways to the realization of this thesis.



I certify that an Examination Committee met on **1<sup>st</sup> June 2010** to conduct the final examination of **Nazratul Aina Binti Mohamad Anwar** on her **Master of Science** thesis entitled **“Effect of Moderating Factors On Value Relevance of Earnings Information among Pyramid Structure Firms in Selected ASEAN Countries”** in accordance with Universiti Pertanian Malaysia (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulations 1981. The Committee recommends that the candidate be awarded the relevant degree. Members of the Examination Committee are as follows:

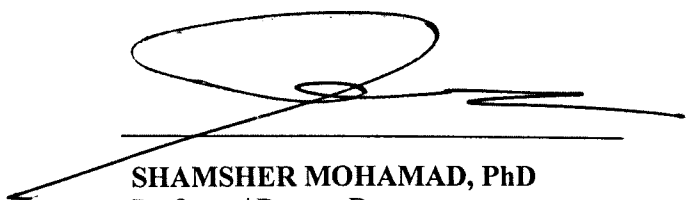
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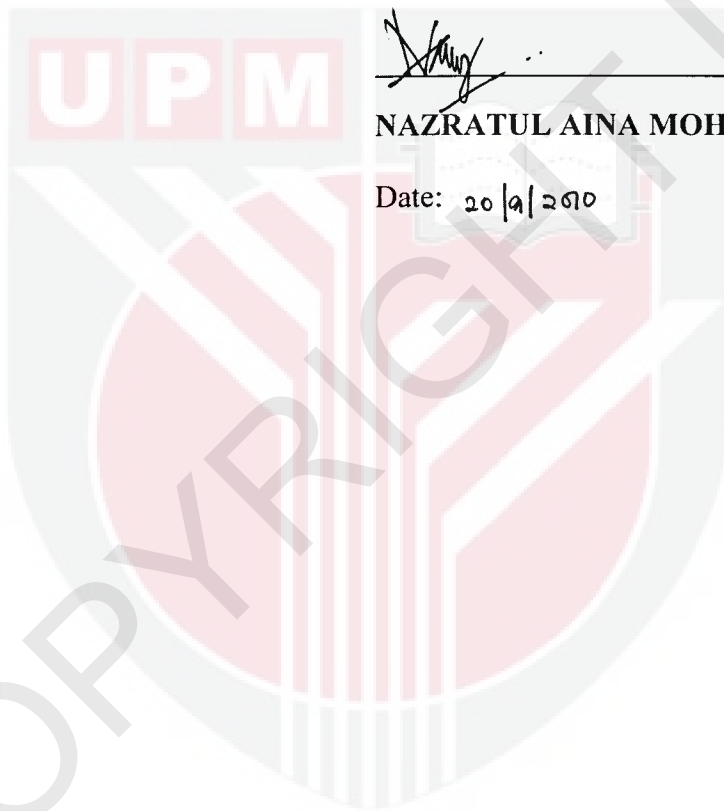


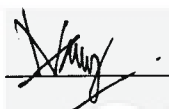
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## DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.





NAZRATUL AINA MOHAMAD ANWAR

Date: 20/9/2020



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## LIST OF ABBREVIATIONS

AR	ANNUAL RETURN
CEO	CHIEF EXECUTIVE OFFICER
CFR	CASH FLOW RIGHTS
CR	CONTROL RIGHTS
EPS	EARNINGS PER SHARE
FASB	FINANCIAL ACCOUNTING STANDARD BOARD
FERC	FUTURE EARNINGS RESPONSE COEFFICIENT
GLS	GENERALIZED LEAST SQUARE
IASB	INTERNATIONAL ACCOUNTING STANDARD BOARD
OLS	ORDINARY LEAST SQUARE
SFAC	STATEMENTS OF FINANCIAL ACCOUNTING CONCEPTS
UEM	UNITED ENGINEERS MALAYSIA
UO	ULTIMATE OWNER

# CHAPTER I

## INTRODUCTION

This chapter contains six sections. Section one describes the background of the study, section two outlines the problem statement, section three explains the objectives of the study and section four outlines the contribution of this study. This is followed by section five which gives the research framework and section six concludes the chapter with an explanation on the organization of this study.

### 1.1 Background Of The Study

Accounting information is essential for investors to undertake investment activities and they rely on accounting information, including earnings information to make investment decisions since it provides a better insight of a corporation. According to Scott (1997), relevant information is information that is able to affect investors' belief about future returns. Reliable information also affects belief of the investors on what it claims to measure by presenting it truthfully. In general, before investors make any investment decisions, they need relevant information which they can rely on in order to decide on further steps in their investment activities. It also implies that value relevance of accounting information is important; especially earnings information, since earnings reported is one of the important criteria that investors look at in investment activities to give a better picture of a firm.

Despite the importance of value relevance on accounting information for investment activities, Fan and Wong (2002) found that the value relevance of earnings information of seven East Asian countries is low. Findings by Fan and Wong are also supported by Yeo et al. (2002) and Francis et al. (2005).

Fan and Wong (2002), Yeo et al. (2002) and Francis et al. (2005) conclude that the value relevance of earnings information in East Asian firms is typically low due to the common and significant presence of pyramidal ownership structure in East Asian firms.<sup>1</sup> Jaggi et al. (2009), Andres (2008), Faccio and Lang (2002), Claessens et al. (2000) and La Porta et al. (1999) support the significant presence of pyramid firms in East Asian, where they find that more than half of East Asian corporations and economies, as measured in terms of total corporate assets are controlled by pyramid firms. It is postulated by Fan and Wong (2002) that the value relevance of earnings information in pyramid firms of the seven East Asian countries is low because of entrenchment and information effects arguments.<sup>2</sup>

Based on information effect hypothesis (Fan and Wong, 2002), it is argued that concentrating ownership avoid leak of proprietary information when decision rights given to specific knowledgeable person. This strategy can prevent their competitors in assessing proprietary information of their rent seeking activities where the benefit of

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<sup>1</sup> Attig et al. (2004) defined pyramid structure as an entity or group of companies whose ownership structure present a top down series of control, where an ultimate owner is located at the top of the structure with following layers of firm below it. The structure itself actually creates a separation of actual ownership and control, especially to the ultimate owner and firm at the lower part of the structure.

<sup>2</sup> Prior studies investigated the value relevance of earnings information in pyramid structure firms and found that the value relevance of earnings information in this type of firm is low (Fan and Wong, 2002; Yeo et al., 2002; Francis et al., 2005)

this strategy works in East Asia environment which is common with political lobbying activities and pyramid ownership structure. In other words, this strategy works in ownership concentration environment by restraining the information flow to the public and reduce the possible competition of the political rent-seekers or social authorize. Consequently, the value relevance of earnings reported by pyramid structure firms was affected as the information reported is limited and not fully.

In entrenchment effects argument, they argued that the separation in control right (herewith will be referred to as CR) and cash flow right (herewith will be referred to as CFR)<sup>3</sup> caused the ultimate owner (herewith will be referred to as UO) to be entrenched by their high levels of control even though their ownership level is low. This separation leads to low degree of alignment between UO and minority shareholders. Since control is not aligned with actual ownership, outside investors predict that the UO maybe involved in manipulation and may report the earnings information for self-interest purposes, rather than presenting the actual condition of the firm. As a result, investors pay less attention on the earnings information reported and cause the value relevance of the earnings information to be reduced. In other words, value relevance of the report decreases because of entrenchment effect of the UO, which will lead to agency problems between UO and minority shareholders. Thus, this will reduce the value relevance of earnings information of pyramid firms.

However, this study will only focus on the entrenchment effect argument as one way

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<sup>3</sup> La Porta et al. (1999) and Claessens et al. (2000) define CR as the weakest relation in the line of control and CFR as the actual investment that the ultimate owner have in the firm at the lower chain in the pyramidal group.

to solve the value destruction issue among pyramid structure firms is by reducing the entrenchment effect of the ultimate owner in order to limit their effective power and reduce agency problem between them and minority shareholder.

This study will extend Fan and Wong's (2002) study by proposing and testing three moderating factors that perhaps, will moderate the negative influence of the pyramid structure on value relevance of earnings information reported among four developing countries in South East Asia. The proposed moderating factors are the presence of institutional owner as second largest UO, separation of CEO and Chairperson position, and lastly, reducing the separation between CFR and CR by increasing the level of CFR of the UO. These factors are treated as a moderator instead of predictor because it is hypothesized that these factors will reduce the negative effect of entrenchment effect and agency problem between UO and minority shareholders on the value relevance of earnings information reported by pyramid structure firms. When these factors reduce the entrenchment effect and agency problem between UO and minority shareholders, it may change the negative perception of investors toward earnings reported to positive. Consequently, the earnings reported is said to have value relevant when investors positively react to it.

The three factors are chosen because prior studies have indicated that these factors can reduce the entrenchment effect and agency problems pertaining to ownership structure in general. (Jung and Kwon, 2002; Yeo et al., 2002; Fan and Wong, 2002; Rajgopal et al., 1999; El- Gazzar, 1998; Jensen, 1993; Lipton and Lorsch, 1992; Jensen and

Meckling, 1976) Perhaps preventive features, these factors would also work in pyramid structure firms as it is one of the ownership structures existed. Entrenchment effect, agency problem and value relevance of earnings information are closely associated. Thus, reducing the entrenchment effect will solve the agency problem between UO and minority shareholders and this consequently will increase the value relevance of earnings information among pyramid firms.

Generally, in a pyramid structure firm, the structure causes the separation between CFR and CR and this allows the UO to act in their self-interest, which then decreases the value relevance of the earnings information. The relevant argument for this phenomenon is the entrenchment hypothesis (Fan and Wong, 2002). The hypothesis explains that the UO supervises the accounting information and he or she has strong opportunistic incentive to snag minority shareholders because the UO has more control than the equity ownership of minority shareholders.

In order to monitor such abusive behavior of the UO, the presence of the second largest UO can moderate the negative effect of the pyramid structure by its role of collecting information and monitoring the activities of the UO. Prior studies prove that the presence of institutional owner has a significant role in increasing the value relevance of earnings information towards market perception, especially to the investors (Yeo et al., 2002; Jung and Kwon, 2002; Rajgopal et al., 1999). Institutional owners will not only play their role to monitor activities of the UO, but they can also influence other investors using their significant right as the second largest UO in the

corporation even though their control is not as effective as the UO.

Rajgopal et al. (1999) argue that the existence of external unrelated shareholders lead to closer monitoring and inspection of management which then will reduce the opportunity of the UO to manipulate earnings. Yeo et al. (2002) support this view by showing that institutional ownership decreases the absolute value of discretionary accruals because institutional owners are better educated than individual investors, yet can reduce the apparent benefit of managing accruals. Both studies indicate that the presence of institutional owner plays a significant monitoring role and consequently can mitigate the agency conflicts between UO and minority shareholders.

Separation of CEO and Chairperson position, who at the same time may be the UO in the pyramid firms, can help to reduce the agency problem in pyramid firms by allowing the board of directors to monitor and control management actions. Latham (1999) said that the pyramid firm's CEO often controls the board of directors when he is also the Chairperson of the board in real practice. As a Chairperson, the person is in a powerful position to influence the decision made by the board. If the Chairperson is at the same time also the CEO, the ability of the board to monitor is questionable. This situation has actually exaggerated the actual function of the Chairperson, who is supposed to monitor and control the management effectively. For this reason, Lipton and Lorsch (1992) and Jensen (1993) recommended separating the position of CEO and Chairperson.

When there is no separation of the positions, there are no monitoring activities by the Chairperson over the CEO and conflict of interest may occur. This situation leads to agency problem between the minority shareholders and the UO, who is the CEO and the Chairperson at the same time. If the position of CEO and Chairperson of the board is separated, the minority shareholders may believe that the monitoring role by the Chairperson of the board strengthens the firms' internal control thus reducing agency problems between them.

Apart from the presence of institutional owner as second largest UO and the absence of CEO duality in the pyramid firms, higher level of CFR of the UO can be the other option to mitigate the negative effect of pyramid firms on value relevance (Fan and Wong, 2002; Jung and Kwon 2002; Gomes, 2000).

A study by Fan and Wong (2002) proves that value relevance of earnings information in pyramid firms that has large separation of ownership and control is low to outside investors in East Asian countries. Implicitly, this indicates that the higher separation between CFR and CR in pyramid firms, the less will be the value relevance of the earnings information. Fan and Wong (2002) suggest that, one way to mitigate the problem of UO entrenchment is by increasing their CFR. Once the CFR increases, it will cost the UO to switch or manipulate the firm's cash flows for private gain even though they have effective control over the firm. Consistent with this idea, Jung and Kwon (2002) in their study found that earnings are more informative as the CFR of the UO increase.



These findings support the convergence of interest hypothesis for the owner-manager structure proposed in Jensen and Meckling (1976). Specifically, Jensen and Meckling (1976) suggest that convergence of interest between owner and manager could occur when the CFR of the UO increase, thus reducing the agency costs.

Based on prior studies discussed above, the three moderating factors proposed can help to minimize the agency problems, which are common in pyramid structure firms. Since agency problems are closely associated with value relevance, reducing agency problems by reducing entrenchment effect of the UO shall in turn improve the value relevance of earnings information in pyramid firms.

## **1.2 Problem Statement**

As stated before, earnings reported should be relevant and reliable based on two major characteristics stated by Scott (1997). In order to achieve the characteristics, closer devotion to international disclosure rules and the adoption of international accounting standards seems to be vital to improve corporate transparency in the region (World Bank, 1998). Despite the fact that efforts to enforce stricter reporting rules and standards had been done, the common belief is that corporate transparency especially among Asian countries has been declining (Asian Wall Street Journal, 1999) because it is said that the new accounting rules may only increase the quantity, not the quality of accounting information. This clearly shows that increasing the compulsory or voluntary items to be disclosed in the financial report and adoption of accounting

standard alone cannot be the only solution towards this problem. Evidently in East Asia, investors' perception towards earnings information seems to be affected by the presence of pyramid ownership structure firms. Prior studies by Francis et al. (2005), Fan and Wong (2002) and Yeo et al. (2002) show that the value relevance of earnings reported in pyramid firms are low. Fan and Wong (2002) found that value relevance of earnings reported is low due to the entrenchment and information effect argument. Yeo et al. (2002) supported Fan and Wong (2002) based on entrenchment effect argument, where the findings show that the value relevance of earnings does not always increase as the managerial ownership increase suggesting that the entrenchment effect might set in.

All prior literature provides evidence that the pyramid structure causes deterioration of earnings informativeness. However, very few have suggested solution to this problem. Furthermore, we have to find other alternatives that might help to overcome the agency problem arising from the separation of CFR and CR instead of just focusing on role of accounting disclosure and adoption of accounting standards in increasing the value relevance of earnings information among pyramid firms. Since it is important for us to minimize the problems, this study will propose and test three moderating factors, namely the presence of institutional owner as second UO, the absence of CEO duality and lastly, the higher level of CFR of the UO. These three proposed moderating factors have been empirically proven by prior literature to help increase the value relevance of earnings information in normal firms by reducing the agency problems between UO and minority shareholders. Perhaps, these moderating factors

might work in pyramid structure firms to mitigate or reduce the negative impact of pyramid structure itself, thus increasing the value relevance of earnings reported by pyramid firms.

### 1.3 Objectives Of The Study

Based on the shortfalls of these previous studies, the objectives of this study are:

- 1) To ascertain if the presence of institutional owner as second largest UO will help to improve value relevance of earnings information in pyramid firms.
- 2) To ascertain if the absence of CEO duality, who at the same time is also the UO, will help to improve value relevance of earnings information in pyramid firms.
- 3) To ascertain if reducing the separation between ownership and control by increasing the level of CFR of the UO will help to improve value relevance of earnings information in pyramid firms.

#### 1.4 Contribution Of This Study

This study, which is based on pyramid firms in four South East Asia developing countries provide a useful and significant contribution to the existing value relevance and pyramid ownership literature in the following ways:

First, this study extends the empirical work in pyramid ownership structure by giving specific moderating factors, which may help increase value relevance of earnings information among pyramid firms in South East Asia. Ascertaining this moderating factor is crucial as viable investment activities by investors require relevant and reliable information. Furthermore, we need to bring back investors' confidence toward information provided by pyramid firms since their presence in the economies of South East Asia are significant.

Second, this study will give ideas on finding other solutions to mitigate the negative impact of pyramid structure firms, instead of just focusing on imposing stricter disclosure rules and accounting standards in South East Asia countries.

Finally, this study may also contribute to the existing accounting literature by providing a new data set pertaining to value relevance studies on pyramid structure firms for Malaysia, Indonesia, Thailand and Philippines. This new data set could be incorporated into future accounting studies.

## 1.5 Research Framework

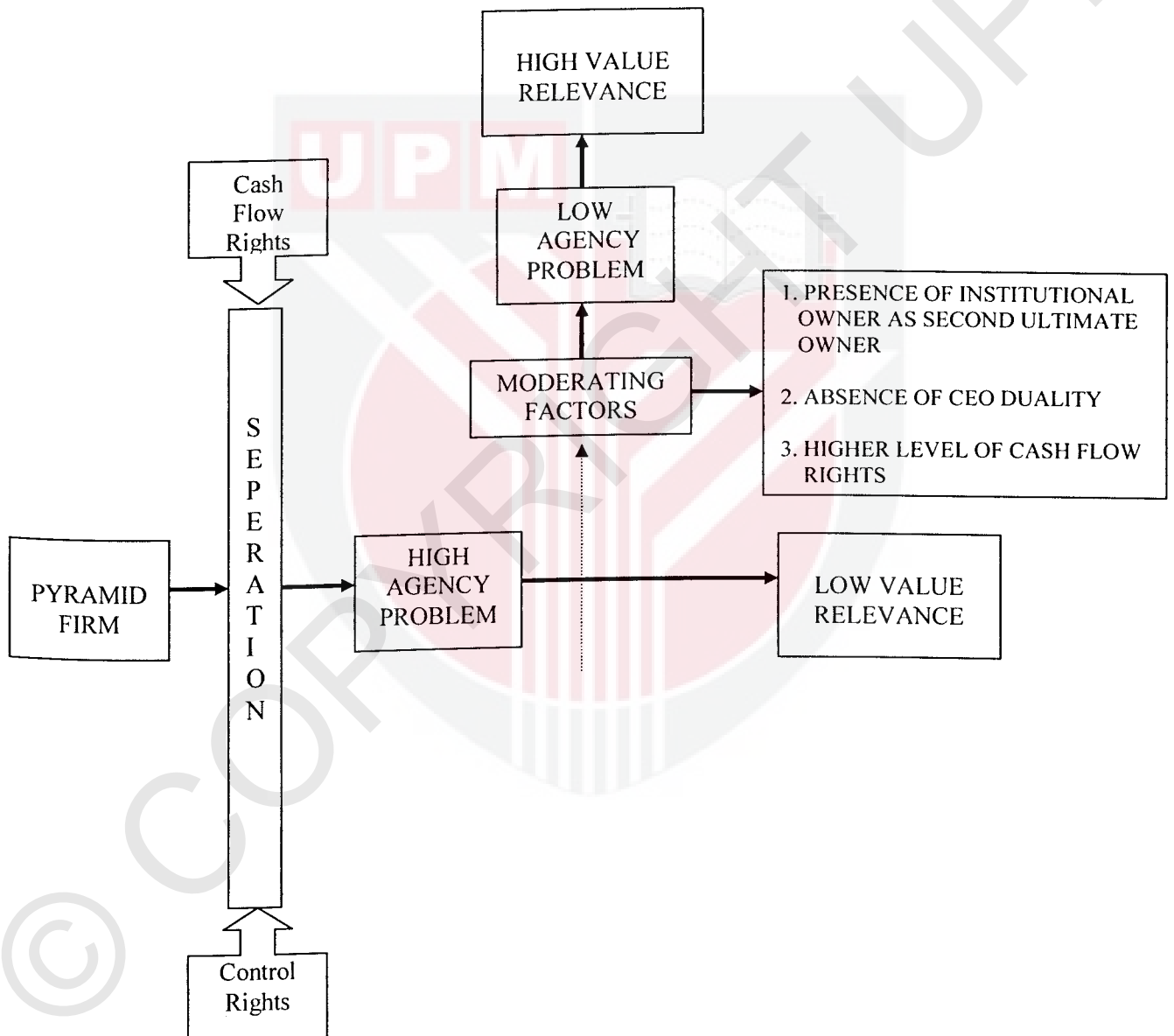


Figure 1.1: Research Framework

## 1.6 Organization Of The Research

This research is divided into two main parts. The first part of the study investigates the influence of pyramid firms on the value relevance of earnings information in South East Asia. The second part of the study investigates the influence of three moderating factors on the value relevance of earnings information in pyramid firms, which is expected to have some bearing over the value relevance in these firms.

This dissertation is divided into five chapters. Chapter 1 provides the background of the study, problem statements, objectives of the study, possible contributions, research framework and organization of this study. Chapter 2 gives related theories and literature reviews on pyramidal structure firms, value relevance, the three moderating factors and development of hypothesis. Chapter 3 explains the methods of data collection and research design. Chapter 4 discusses the findings and Chapter 5 summarizes important conclusions, limitation of the study and suggestions for future research.

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