Pertanika J. Soc. Sci. & Hum. 25 (S): 227 - 236 (2017)

SOCIAL SCIENCES & HUMANITIES

Journal homepage: http://www.pertanika.upm.edu.my/

# Ownership Structure and Financial Restatement in Malaysia

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## ABSTRACT

This study is on the ownership structure of companies in Kuala Lumpur Stock Exchange (KLSE) aims at strengthening corporate governance. The authors investigate the relationship between ownership structure and financial restatement of listed companies for the period from 2005 to 2013. Using five types of ownership, managerial, government, institutional, family and foreign ownership, findings reveal that financial restatement is negatively and significantly associated with managerial ownership and foreign ownership.

*Keywords:* : Corporate governance, financial restatement, ownership

## INTRODUCTION

The issue of financial restatements continues to received attention as the number of restatement continue to be discovered and made known to public. In Malaysia, cases of financial restatements like CSM Corporation Bhd., OilCorp Bhd., Goh Ban Huat Bhd. and Transmile Group that are frequently reported in the business section has received considerable attention from the regulators (Abdullah, Yusof, & Nor, 2010). In addition to misstatement of revenue, restatements which due from correction of errors indicate a poor auditing and corporate governance and it has to be addressed as it effects investor's confidence in Malaysian companies (Agrawal & Chadha, 2005). Reasons for financial restatements, especially when frauds are involved, have raised our significant concerns about the adequacy of financial disclosure oversight and corporate governance practices like ownership. Prior Previous research shows the presence of a link between corporate governance and financial restatement. Coffee (2005) argues that differences in the

ARTICLE INFO

*Article history:*
Received: 15 September 2016
Accepted: 30 December 2016

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ISSN: 0128-7702 

structure of ownership lead to differences in the nature of corporate scandals and incidents of restatements.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

We focus on material financial restatements, which by definition are defined as a function of significant accounting problems with the firm. These restatements identified by the General Accounting Office (GAO) as resulting from "aggressive" accounting practices, misuse of facts, oversight or misinterpretation of accounting rules, and fraud (U.S. General Accounting Office, 2003, p. 4). A material misstatement has passed undetected by internal control mechanisms as well as the external auditors. Only later is the misstatement discovered, and the revised financial released (Abbott, Parker, & Peters, 2004). In short, the restatements of interest in this study are relatively rare occurrences that signal severe shortcomings in both internal like ownership structure and external governance mechanisms.

There is limited empirical evidence on variable of ownership structure and consequences towards financial restatement and those existing studies provide ambiguous results. The early work by Zhang (2012) described ownership to be managerial ownership, family ownership, government ownership, institutional ownership, CEO ownership. There are various studies assumed that ownership structure types of governance could prevent or restrain financial restatements since they could play their role on monitoring the preparation of financial statements. Different countries have different corporate ownership structure. In Korea, ownership structure is classified in terms of the role played by the largest shareholder (Jung & Kwon, 2002). In Malaysia Claessens, Djankov and Lang (2000), state that 50% of shares are owned by institutional shareholders or blockholders. Bursa Malaysia Listing Requirement (2013) state that each listed company must ensure that at least 25% of its total listed shares are in the hands of public shareholders or unit holders.

Ownership concentration in determination of ownership structure has been widely used by other researcher since free-riding problem and accounting errors problem could be solved with the existence of large shareholder (Zhizhong et al., 2011). According to Chu and Cheah (2004), they had used the first single largest substantial shareholder as the proxy of ownership concentration to classify ownership structure in Malaysia due to certain parties are controlling Malaysian companies via nominee names to remain anonymous (Chu & Cheah, 2006). On the other hand, some researcher used top ten largest shareholders as the proxy of the ownership to classify ownership structure (Chen et al., 2006). Other studies identified ownership identities to be either family controlled, conglomerate, others institution, state, foreign and dispersed firms. In this study, we focus on the relationship between five types of ownership structure: managerial ownership, government ownership, institutional ownership, family ownership and foreign ownership and their relationship with financial restatement.

La Porta, Lopez-De-Silanes and Sheilfer, (1999) investigate the ownership of large companies in 27 countries and noted that despite the existence of large shareholders helps to overcome the "free-riding problem" of outside shareholders, they would also expropriate from the company at the cost of small shareholders' interests. This happened while large shareholders act as monitoring managers for all shareholders. Theoretically (Jenses & Meckling, 1976), the higher holding percentage large shareholders have, the weaker the intention, they have to transfer profit form the company. With the high ownership concentration, the company performance is highly associated with large shareholder's interests. Large shareholders intend to set up strong and valid accounting control program to prevent and discover accounting errors. In addition, the interference of large shareholders also strikes the profligacy of management and the board, and the intention of opportunism (Zhizhong et. al., 2011).

Our research is underpinned by the theory of agency and signalling. This research referred the agency theory in relating to the agents who are top managers with the principles who are shareholders. While for the signalling theory, present study referred to the existence of information asymmetry between the two parties which is between owners of the companies and managers. The most frequently referred research, Junrui and Ma (2011) examined the relationship between concentration ownership, managerial ownership, government ownership, corporate ownership, institutional ownership, tradable shares and incidence of financial restatement in China. We argued that even if some of the corporate scandals and failures occurred as a result of the financial market bubbles burst in 1997, the extensive corporate misconduct and misreporting reveals also a failure of the auditing and corporate governance system which one of this is ownership structure (Keune & Johnstone, 2012; Price, Sharp, & Wood, 2011; Romanus, Maher, & Fleming, 2008). Hence, we choose to investigate the type of ownership variables in predicting restatement. We will contribute to the existing literature gap by providing additional evidence on the situation in emerging market like Malaysia which is often thin, riddled with information gaps and weakly supported by enforcement institutions such as courts. It is possible that different ownership structure can influence accounting restatements.

This study expects the incidence of financial restatement to be negatively related to managerial ownership at lower levels. Our first hypothesis is as follows:

H1: There is significant negative relationship between lower level managerial ownership and financial restatement.

Our second hypothesis is as follows:

H2: There is significant positive relationship between government ownership and financial restatements.

The third hypothesis is as follows:

H3: There is significant negative relationship between institutional ownership and financial restatements.

The fourth hypothesis is:

H4: There is significant negative relationship between family ownership and financial restatement.

The fifth hypothesis is as follows:

H5: There is significant negative relationship between foreign ownership and financial restatement.

## METHODS

### Sample

We select all publicly listed companies in Kuala Lumpur Stock Exchange (KLSE) over the entire duration of the estimation time period (2005-2013) as initial samples. Of these initial samples, companies involved in real estate investment trusts industry, finance industry, close-end funds and exchange traded funds were excluded, since their accounting and reporting environments differ from those in other industries. This gives a final sample of 853 firm-year observations from fiscal years 2005 to 2013. We collect the ownership structure and financial data of sample companies in the year of accounting errors, match them with those of the companies in control samples, and examine it by logistic regression.

### Variables Measurement

**Dependent variable.** The proxies we use to measure financial restatement, as the dependent variables is supported by Abdullah, Yusof and Nor (2010). The keywords of "restate", "restatement", "restated", or "prior year adjustment" were identified from each annual report. The year when accounting errors occurred are presented as previous year where we regard the period of occurring accounting errors as the most recent years before restatements. Restatement financial year is dummy variable with a value of 1 if the company restated its statements, 0 otherwise. (Junrui & Ma, 2011).

**Independent variables.** Five ownership structures were used in this study; management ownership, government ownership, institutional ownership, family ownership and foreign ownership. The measurement for these ownership is taken from the concentration of ownership based on the top ten largest shareholders. The management ownership (ManOWn) is measured as the total percentage of executives who hold shares directly or indirectly. Government ownership (GovOwn) is measured as the total percentage of government held shares. Institutional shareholding (InsOwn) is measured as the total percentage of top five institutional investors in Malaysia. Family ownership (FamOwn) is measured as the aggregate percentage of shares held by family members. Finally, foreign ownership (ForeOwn) is measured as the total percentage shares held by foreign corporate or individuals.

**Control variable.** Consistent with prior empirical research on the relationship between corporate governance and financial restatement (Junrui & Ma, 2011), we controlled variables such as : return on assets (ROA), computed as the ratio of earnings before interest and taxes to total assets and leverage (LEV), defined as the total liabilities to total assets.

**Regression model.** This study uses ordinary logistic regression as the main statistical technique to test the hypothesis. To test the relationship between the ownership structure and financial restatements, the following logistic regression models was used as follow:

$$FinRest = \beta0 + \beta1ManOwn(t\text{-}1) + \beta2GovtOwn(t\text{-}1) + \beta3InstOwn(t\text{-}1) + \beta4FamOwn(t\text{-}1) + \beta5ForeOwn(t\text{-}1) + \beta c1\ ROA(t\text{-}1) + \beta c2LEV(t\text{-}1) + \varepsilon(t\text{-}1)$$

where:

Fin Rest = the incidence of financial restatements

ManOwn = percentage of managerial ownership

GovtOwn = percentage of government ownership

InstOwn = percentage of institutional ownership

FamOwn = percentage of family ownership

ForeOwn = percentage of foreign ownership

ROA = the book value of earning before tax and interest divided by total asset

LEV = the book value of total liabilities divided by total assets.

## RESULTS

### Descriptive Statistics

Table 1
*Descriptive statistics of the sample variables (2005-2013)*

| | Min. | Max. | Mean | Std. Dev | t-value | Min. | Max. | Mean | Std. Dev |
|---|---|---|---|---|---|---|---|---|---|
| | Restate (n=59) | | | | | Non-Restate (n=126) | | | |
| ManOwn | 0 | 11.450 | 0.857 | 2.195 | -3.998* | 0 | 51.750 | 5.112 | 11.506 |
| GovtOwn | 0 | 46.910 | 2.550 | 7.820 | 0.075 | 0 | 72.740 | 2.435 | 10.427 |
| InstOwn | 0 | 15.290 | 2.189 | 3.972 | -0.812 | 0 | 31.500 | 2.801 | 5.109 |
| FamOwn | 0 | 75.890 | 4.399 | 10.873 | -1.009 | 0 | 60.750 | 6.266 | 13.375 |
| ForeOwn | 0 | 23.100 | 2.332 | 4.779 | -2.977* | 0 | 92.889 | 6.862 | 15.587 |
| ROA | -0.209 | 0.313 | 0.060 | 0.079 | 0.278 | -2.750 | 1.501 | 0.048 | 0.324 |
| LEV | 0 | 0.834 | 0.433 | 0.224 | -0.699 | 0.006 | 1.734 | 0.460 | 0.252 |

*Correlation is significant at the 0.05 level (2-tailed)

The descriptive statistics of variables used in the sample are shown in Table 1 for restated companies and Table 2 for non-restate companies. Managerial ownership is found to be significantly lower for the companies that restated their accounts (0.857) than non-restate companies (5.112). One explanation for this finding is managerial ownership could play as internal monitoring device that can align managerial and shareholder interest (Dimmoct, Gerken, & Marietta-Westberg, 2015). Similarly, the mean value for restated (non-restated companies), institutional 2.189(2.801), family 4.399 (6.266) and foreign ownership 2.332 (6.862). Foreign ownership role could resemble institutional and family investors, in monitoring the management from involving in non- maximizing activities and improve the governance structure (Dahlquist & Robertsson, 2011). The percentage of government ownership is higher for companies that restated their accounts, supporting the assumption of Zhang (2012) that government ownership has difficulty in restraining management in the incident of financial restatement.

## Regression Results

Table 3
*Logistic regression of the variables*

| | Predicted Sign | Model 1 (without control variable) | Model 2 (with control variable) |
|---|---|---|---|
| Constant | ? | -0.005 | 0.484 |
| ManOwn | - | -0.151* | -0.155* |
| GovtOwn | + | -0.008 | -0.008 |
| InstOwn | - | -0.031 | -0.040 |
| FamOwn | - | -0.022 | -0.026 |
| ForeOwn | - | -0.064* | -0.065* |
| ROA | - | | 0.405 |
| LEV | + | | 0.164 |
| $R^2$ | | 0.178 | 0.199 |

*Notes:* *p<0.05, two-tailed tests

Result in Table 3 show that H1 and H5 are supported. Thus, the extension of shares owned by management and foreign investors is associated significant negatively with restatement. The evidence indicates that managerial ownership does mitigate agency costs and is effective in controlling management's opportunistic behaviours, supporting previous evidence (Dimmoct et. al, 2015).

For H5, the evidence suggests that although foreign ownership is a minority types of shareholders, they are actively involved in monitoring the company's reporting process. This is consistent with the study done by Ben-Nasr, Boubakri and

Cosset (2015), where foreign ownership minimizes abnormal accruals, privileged earnings informativeness and report more stable earnings. Thus, foreign ownership plays an important monitoring role thus preventing financial restatement.

The other 3 hypotheses are not supported. The directions of the associations are as predicted except for foreign ownership. The result of this study is not consistent with the study done Junrui and Ma (2011) and Peng (2007) who found out that government ownership significantly influences the incident of financial restatement due to the absence of absolute controlling shareholders. Our findings reveal that the higher degree of government ownership in companies could create value and is powerful to restrain management in the incidence of financial restatement in Malaysia.

Institutional ownership is also not found to have a significant link with financial restatement. Institutional owners mainly focused on short term financial results and tend to engage in earning management by giving managerial incentives. Apart from that, the reason for the insignificant finding might due to the fact that these block holders are motivated in their personal profit rather than considering the interest of the minority shareholders

Another variable that does not have a significant association with financial restatement is family ownership, which is consistent with the evidence in Malaysia. According to Munir et al. (2013), at lower level of ownership (0% to 15%), the family managers are likely to report high earning quality. However, at higher level, the objectives of family directors dispersed with company's performance. One explanation for these mixed findings could be due to the existence of entrenchment effects. Higher ownership lead to higher information asymmetry between family ownership and outside shareholders that lead to poor earnings quality.

## CONCLUSION

This study highlighted the structure of ownership in public listed companies in Malaysia. Our objective was to examine the relationship between ownership structure and the incidence of financial restatement. From the statistical test, we found out that managerial ownership and foreign ownership significantly influence the occurrence of financial restatement. Both of these ownerships are associated with less likelihood of financial restatement. This indicates that managerial shareholders are effective in monitoring and disciplining managers in order to ensure the accounts prepared are not misstated. These findings support the good job of controlling managers done by managerial shareholders (Junrui & Ma, 2011; Dimmock et. al., 2015). We also found out that foreign ownership is effective in guaranteeing the quality of accounting information. The existence and the supervision of foreign ownership could reduce the opportunism of the management especially from long-term foreign investors. The long-term relationship involved commitment and responsibility to ensure a good company future prospect. Thus, foreign investors will be stricter to make sure the management did not involve in non-value maximizing activities. We concluded that Hypothesis 1 and Hypothesis 5 are supported by this result.

Meanwhile, institutional ownership, government ownership and family ownership have an insignificant effect on financial restatement. From the result, government ownership found to reduce the likelihood of restatement, adverse from the predicted influence. The reason for this might due to the nature of Malaysia Government Link Companies where government play a good role to maintain companies' performance. Part of the companies' return will be used to generate the country's development and becoming an important source to the country.

This study hopes to assist regulatory bodies, such as Bursa Malaysia, the Malaysian Institute of Corporate Governance, the Securities Commission of Malaysia, in formulating new policies or regulations to deter financial restatements. Besides that, for the internal control, this study hopefully will assist the companies in formulating the best systems to prevent any financial restatement incidence by concerning on ownership structure in their company.

## ACKNOWLEDGMENTS

This work was supported by Research Alculturation Grants Scheme (RAGS) from Ministry of Higher Leaning, Malaysia.

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