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The Effect of the Largest Shareholders Control Rights and Cash Flow Rights on Accounting Performance

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Abstract: *This paper investigates the effect of largest shareholders Control Rights (CRs) and Cash Flow Rights (CFRs) on accounting performance using a panel data of 1716 company-year observations from non-financial companies listed on the Main Board of Bursa Malaysia over the period of 2000 to 2009. The results of Weighted Least-Squares (WLS) show that the effect of divergence of the largest shareholders CRs divided by their CFRs and the largest shareholders CRs are positive and significant on accounting performance while the effect of the largest shareholder CRs exceeding its CFRs and the ratio of CRs to CFRs of the largest shareholders are insignificant on accounting performance. This paper provides evidence that the divergence of the largest shareholders CRs from their CFRs leads to increase the incentive for expropriation of minority shareholders and decrease accounting performance of Malaysian listed companies. This evidence expands the understanding of the specific roles of investors' protection in shaping corporate finance or governance, by clarifying their role in delivering value to outside shareholders.*

Keywords: *Control rights (CRs), cash flow rights (CFRs), accounting performance, Malaysia*

INTRODUCTION

Control right of ownerships is defined as the ability of an owner to impact the way a company is run. Higher CRs of the controlling owners expand their capacity to get private advantages of control at the expenses of the other shareholders (Barclay & Holderness, 1989; Franks & Mayer, 2001). CFRs of ownerships are defined as the fraction of performance to which an owner is entitled. (Shleifer and Vishny, 1997) claimed that agency problems in corporate governance are not only between dispersed shareholders and managers, but they also extend to the relationship between the largest shareholders CRs and CFRs of the controlling owners. Higher CFRs of the controlling owners causes more alignment of incentives with other owners and lower the incentives to pursue high costly policies. Grossman and Hart (1988) argued that the separation between CRs and their CFRs would lower company performance and would not be socially optimal. (Driffield, Mahambare, and Pal, 2007) provided evidence that the separation of CFRs and CRs may lower firm value, which at an aggregate level may be reversed among owner-managed family firms, thus highlighting the importance of incentive effects in generating value.

(La Porta et al., 1999) provided evidence that the divergence of largest shareholders CRs fromtheir CFRs raises the incentive for expropriation of minority shareholders and reduces firm performance. (Lins, 2003) and (Bennedsen and Nielsen, 2010) also provided evidence that the existence of agency problem associated with the separation between the largest shareholders CRs and their CFRs. They clarified that higher CRs of the controlling shareholders exceeding their CFRs give them incentives to get private benefits at the expense of other shareholders' value. Previous studies reported that there is a large divergence between CRs and CFRs for most listed firms (Claessens, Djankov, & Lang, 2000; Yeh, Lee, &Woidtke, 2001). When controlling shareholders' CRs deviates from their CFRs, the controlling shareholders have more inducements to benefit by expropriating wealth from the minority shareholders or failing to act in the best interests of the company (Claessens et al., 2000; La Porta et al., 1999; Shleifer&Vishny, 1997). Chin and

Chen (2006) argued that firms with a greater divergence between control and cash flow rights engage in fewer innovative activities in Taiwan. (Bertrand, Mehta, and Mullainathan, 2002) and (Lins, 2003) provideed evidence that performance decreases with the increase in the largest shareholders CRs in relation to CFRs of ultimate controlling shareholders. On the other hand, (Faccio and Lang, 2002) reported that the controlling shareholders in European firms have less CRs in excess of CFRs than those of East Asian firms, and thus the controlling shareholders have less incentive to engage in opportunistic behaviour since they hold on average more CFRs in European firms.

There are different ways to examine the effect of CRs and CFRs on firm performance. (La Porta et al., 1999) and (Xiao, 2008) looked at the divergence of CRs divided by CFRs on firm performance. (Claessens et al. 2002) looked at the effect of CRs of the largest shareholder exceeding its CFRs on firm performance. (Edwards, 2003) and (Yeh, Ko, and Su, 2003) looked at CRs of the ultimate shareholder on firm performance. Hamida and Mamoghli, 2009) looked at CFRs of the largest shareholder on firm performance. (Lins, 2003), (Lemmon and Lins, 2003), and (Cai, Hillier, Tian, & Wu, 2009) looked at the effect of CRs of largest shareholders divided by their CFRs on firm performance. However, previous research so far in Malaysia has been focused only on the separation of CRs and CFRs (see for example, Abdullah & Pok, 2015) and CFRs of the largest shareholder on firm performance (see for example, Hamida & Mamoghli, 2009). Given these studies, the effect of divergence of the largest shareholders CRs divided by their CFRs (La Porta et al., 1999), CRs of the largest shareholder exceeding its CFRs (Claessens et al. 2002), CRs of the largest shareholders (Edwards, 2003; Yeh et al., 2003), and the ratio of CRs to CFRs of the largest shareholders (Lins, 2003; Lemmon & Lins, 2003; Cai, Hillier, Tian, & Wu, 2009) on accounting performance have not been studied in Malaysia. Hence, the relationship may be different in different countries (Kongijn, Kraussl, & Lucas, 2011). Therefore, this study is one of the first attempts to investigate in context of Malaysia so far.

Literature Reviews and Hypotheses

Many studies investigated the effect of CRs and CFRs on firm performance in different ways. (La Porta et al., 1999) hypothesized that the divergence of CRs divided by CFRs affects firm performance using a sample of the largest corporations' ownership structures in 27 wealthy economics during a period of 1995. They found that firm performance is positively and significantly related to the divergence of CRs divided by CFRs. This finding suggested that the divergence of CRs divided by CFRs increases the incentive for expropriation of minority shareholders and decreases the value of firms. (Mitton, 2002) also expected that the divergence between CFRs and CRs to influence company performance of 398 companies during the Asian financial crisis of 1997 and 1998. However, he found that the divergence is not associated with the company performance. This result suggested that there is no incremental loss of value during the crisis for firms with this divergence. (Xiao, 2008) tested the relationship between the ultimate owners' divergence between CRs and its CFRs with firm performance for a panel data of 156 Chinese publicly listed company-year observations with private ultimate owners during the period from 2002 to 2007. He reveals that the ultimate owners' divergence between CRs and CFRs is negatively and significantly related to firm performance, indicating that the higher divergence between CRs and CFRs tends to make managers more likely to engage in value destroying connected party transactions. Therefore, it is hypothesized that:

H_1: The divergence of the largest shareholders CRs divided by their CFRs is positively and significantly related to accounting performance in Malaysia.

(Yeh et al., 2003) conducted a study in China on the relationship between CRs of the largest shareholders and firm performance using a panel data of 251 listed company-year observations during a period of 1997 and 1998. They hypothesized that firm performance decreases if the CRs of the largest shareholders increase significantly. They found that higher CRs of largest shareholders reduce the performance of ownership equity, meaning that the largest shareholders are able to obtain private benefits of control at minority shareholders' expense. In contrast, (Silva and Majluf, 2008) found that performance is not related to control rights, which means that control rights do not influence firm performance. However, it is hypothesized that:
H_2: The largest shareholders CRs is positively and significantly related to accounting performance in Malaysia.
(Lins, 2003) also found that the effect of CFRs leverage is negatively on firm performance. This result is consistent with the finding by (Lemmon and Lins, 2003), who supported the view that a negative relation between a separation in management CRs and CFRs and firm performance is more pronounced where

external corporate governance mechanisms are the weakest. (Cai et al. 2009) also found that the effect of the largest shareholders CRs divided by their CFRs is negative on performance of all Chinese listed firms over a period of 2002 to 2004, suggesting that the higher the ratio of CRs to CFRs, the lower is the expropriation of minority shareholders. Thus, it is hypothesized that:

H_3: Ratio of CRs to CFRs of the largest shareholders is negatively and significantly related to accounting performance in Malaysia.

(Lins, 2003) conducted a study in 18 emerging markets using a sample of 1433 firms during the year of 1995 to test the relationship between the largest shareholders' CRs exceeding its CFRs and firm performance. He found that there is a negative relationship between the largest shareholders' CRs exceeding its CFRs and firm performance. This result is in line with that of (Claessens et al., 2002), where they found lower performance for companies in countries with worse protection of minority shareholders' rights. (Cai et al., 2009) expected that performance of all Chinese listed firms for the period of 2002 to 2004 decreases when the government CRs exceed its CFRs. They show that the effect of the government CRs exceed its CFRs is negatively and significantly related to firm performance. This result is in agreement with (Lins, 2003) and (Lemmon and Lins ,2003). (Bennedsen and Nielsen, 2010) used a sample of East Asian and European firms to examine the effect of the largest shareholders' CRs exceeding its CFRs on firm value. They found that the effect of the largest shareholders' CRs exceeding its CFRs is negative on firm value, indicating that the degree of separation of CRs and CFRs declines firm value. (Cronqvist and Nilsson, 2003) showed that the presence of excess CRs declines the values of Swedish publicly-listed firms. Therefore, it is hypothesized that:

H_4: The largest shareholders CRs exceeding its CFRs is negatively and significantly related to accounting performance in Malaysia.

Research Methodology

190 companies are randomly selected (1 of 4) from a total population of 760 nonfinancial companies, and their performance is measured over a period of 10 years which consists 1716 companies-years (2000-2009). For companies that are delisted, their performances are measured up to the year before delisted. One measure of performance which is Return of Assets (ROA)is used as dependent variable, the divergence of CRs of largest shareholders divided by their CFRs, the largest shareholders CRs exceeding its CFRs, the largest shareholders CRs, and the largest shareholders CRs divided by their CFRs, and three control variables including firm size, firm age, and debt ratio (Oxelheim & Randoy, 2003) are used as independent variables. All data on dependent and independent variables were collected from Malaysia listed companies' annual reports and DataStream. Table 1 presents the measurements and data resources of variables:

Table 1: Measurements and Data Resources of Variables

Variables	Measurements	Data Resources
ROA	[(Net income before preferred dividends + interest expense on debt-interest capitalized * (1-tax rate)] / [average of last year's and current year's total assets] * 100.	DataStream
D(CR/CFR_{it})	Divergence of CRs divided by CFRs of largest shareholders in company i in year t.	Annual Reports
CR_{it}	CRs of largest shareholders in company i in year t.	Annual Reports
$R(CR/CFR_{it})$	Ratio of CRs to CFRs of largest shareholders in company i in year t.	Annual Reports
CR-CFR	CRs minus CFRs of largest shareholders in company i in year t.	Annual Reports
Firm Size ($FSIZE_{it}$)	Log (total assets) of company i in year t.	DataStream
Firm Age ($FAGE_{it}$)	Log (firm age) of company i in year t.	DataStream

Debt Ratio ($DEBT_{it}$)	Long term debt divided by total assets of DataStream company i in year t.

WLS method is used in this paper instead of Ordinary Least Squares (OLS) method to estimate the panel data models (Bozec & Laurin, 2008; Gurbuz, Aybars, & Kutlu, 2010; Gurbuz & Aybars, 2010; Thonet & Poensgen, 1979; Slovin & Sushka, 1993). Since OLS method does not meet one of its assumptions that displays heteroskedasticity problem, WLS method is used to correct the data that suffers from heteroskedasticity problem. Thus, the following models are estimated:

$$Accounting\ Performance_{it} = B_0 + B_1\, D(CR/CFR_{it}) + B_2 FSIZE_{it} + B_3 FAGE_{it} + B_4 DEBT_{it} + e_{it} \quad (1)$$

$$Accounting\ Performance_{it} = B_0 + B_1\, CR_{it} + B_2\, FSIZE_{it} + B_3\, FAGE_{it} + B_4\, DEBT_{it} + e_{it} \quad (2)$$

$$Accounting\ Performance_{it} = B_0 + B_1\, R(CR/CFR_{it}) + B_2\, FSIZE_{it} + B_3\, FAGE_{it} + B_4\, DEBT_{it} + e_{it} \quad (3)$$

$$Accounting\ Performance_{it} = B_0 + B_1\, CR\text{-}CFR_{it} + B_2\, FSIZE_{it} + B_3\, FAGE_{it} + B_4\, DEBT_{it} + e_{it} \quad (4)$$

Where the definitions of variables are described in Table 1.

Results and Discussions

Table 2 shows the descriptive analyses in term of minimum, maximum, means, and standard deviations of each variable used in this paper. Overall, the mean value of ROA during the period from 2000 to 2009 is 0.031%. The range of ROA is from -1.058 % to 6.786% with a standard deviation of 0.209%. It also shows in term of CRs and CFRs that the highest mean value is 0.902% reported for the largest shareholders CRs exceeding its CFRs with maximum (standard deviation) values of 9.928% (0.354%). However, the lowers mean value is 0.047% reported for the ratio of CRs to CFRs of largest shareholders with maximum (standard deviation) values of 0.744% (0.134%). Table 2 also shows that the mean value of firm age is 2.349%, where the range of cash holdings is between 0 and 3.611% with a standard deviation of 0.592%. In addition, firm size records an average of 12.837% with the minimum and maximum values of 7.4748% and 18.083%, respectively. For leverage ratio, the mean value is 0.118% with maximum (standard deviation) values of 24.099% (0.765).

Table 2: Descriptive Analyses of the Variables (Total 1716 observations)

Variables	Minimum	Maximum	Mean	Std. Deviation
ROA	-1.058	6.786	0.031	0.209
D(CR/CFR)	0.104	1.000	0.888	0.247
CR	0.037	0.930	0.395	0.182
R(CR/CFR)	-1.000	0.744	0.047	0.134
CR-CFR	-1.00	9.928	0.902	0.354
FAGE	0.000	3.611	2.349	0.592
FSIZE	7.474	18.083	12.837	1.408
DEBT	0.000	24.099	0.118	0.765

This study begins by using OLS to estimate the panel data. Results of OLS based on models on ROA as the accounting performance are summarized in Table 3. The test of heteroscedasticity is performed to test for the suitability of using OLS as an estimation method. OLS method suffers from heteroscedasticity problem based on White test that gives a value of 64.140 from model (1), 66.170 from model (2), 63.240 from model (3), and 63.327 from model (4) with p-values of 0.000 for all models. Thus, this study estimates the model using WLS in order to correct for the heteroskedasticity problem. Since WLS could correct the problem, the following discuss the results based on WLS models only.

Table 4 presents the results of WLS regression models using ROA as the accounting performance. When model (1) in which the divergence of CRs of largest shareholders divided by their CFRs is used to explain the regression model, the reported F-statistics is 17.744 with p-values of 0.000, indicating that all the independent variables jointly are not equal to zero. Meanwhile, the divergence of CRs of largest shareholders divided by their CFRs positively impacts accounting performance. This result is consistent with the proposed H1 and statistically significant. It means that the lower is the divergence of interests

between majority and minority shareholders, the lower is the expropriation of the companies' resources. This result is also consistent with La Porta et al. (1999) while it is not consistent with Xiao (2008). The results also point out that firm age and firm size have positively and statistically significant influence on accounting performance while debt ratio has negatively and statistically significant influence on accounting performance.

Table 3 Regression Results of OLS Models by Using ROA (Total 1716 observations)

Variables	Model (1)	Model (2)	Model (3)	Model (4)
Const	-0.028 (0.820)	-0.035 (0.737)	-0.028 (0.794)	-0.028 (0.798)
D(CR/CFR)	0.001 (0.064)*			
CR		0.028 (0.015)**		
R(CR/CFR)			-0.001 (0.475)	
CR-CFR				-0.004 (0.799)
FAGE	0.008 (0.123)	0.008 (0.227)	0.008 (0.198)	0.008 (0.197)
FSIZE	0.002 (0.7606)	0.002 (0.758)	0.002 (0.733)	0.002 (0.729)
DEBT	-0.002 (0.496)	-0.002 (0.451)	-0.002 (0.995)	-0.002 (0.473)
R^2	0.001	0.001	0.001	0.001
Adjusted R^2	-0.001	-0.001	-0.001	-0.001
F-statistic	0.555	0.815	0.542	0.546
P-value(F)	0.695	0.515	0.704	0.701
DWT F-critical (d_L)	1.8790 (1.863)	2.028 (1.863)	2.027 (1.863)	2.026 (1.863)
WTest	64.140 (0.000)	66.170 (0.000)	63.240 (0.000)	63.327 (0.000)

Notes. * Significant at the 0.1 level; ** Significant at the 0.05 level; *** Significant at 0.01 level.

When the largest shareholders CRs is used in model (2) of Table 4, the reported F-statistics are 18.801 with p-values of 0.000. The result of the impact of the largest shareholders CRs on accounting performance has the result of coefficient consistent with H2. This result is not in line with (Yeh et al., 2003), who show that higher CRs of largest shareholders reduce the performance of ownership equity in China. It is also not in line with Silva and Majluf (2008), who found that the largest shareholders CRs is not associated with firm performance. The possible reason of a positive relationship is that the largest concentrated ownership of companies owned by families in Malaysia. Thus, families have a strong incentive to supervise managers and improve accounting performance. With respect to three control variables, the results report similar results as in model (1).

When the ratio of CRs to CFRs of the largest shareholders is used as reported in model (3) of Table 4, F-statistics is reported 17.951with p-values of 0.000. This finding of the ratio of CRs to CFRs of the largest shareholders on accounting performance is not consistent with H3. This result means that the ratio of CRs to CFRs of the largest shareholders is not associated with accounting performance. This result is not in line with the findings by (Cai et al. 2009), (Lemmon and Lins, 2003), and (Lins, 2003). The findings of the three control variables report similar findings as in model (1) and model (2).

Table 4 Regression Results of WLS Models byUsing ROA (Total 1716 observations)

Variables	Model (1)	Model (2)	Model (3)	Model (4)
Const	-0.079 (0.000)***	-0.081 (0.000)***	-0.081 (0.000)***	-0.077 (0.000)***
D(CR/CFR)	0.002 (0.038)**			
CR		0.014 (0.058)*		
R(CR/CFR)			0.004 (0.388)	
CR-CFR				-0.007 (0.394)
FAGE	0.006 (0.021)**	0.006 (0.016)**	0.006 (0.019)**	0.006 (0.021)**
FSIZE	0.007 (0.000)***	0.007 (0.000)***	0.007 (0.000)***	0.007 (0.000)***
DEBT	-0.0201 (0.003)***	-0.019 (0.004)***	-0.021 (0.004)***	-0.021 (0.003)***
R^2	0.039	0.042	0.041	0.039
Adjusted R^2	0.037	0.039	0.038	0.037
F-statistic	17.744	18.801	17.951	17.812
P-value(F)	0.000	0.000	0.000	0.000

Notes. * Significant at the 0.1 level; ** Significant at the 0.05 level; *** Significant at 0.01 level.

When the largest shareholders CRs exceeding its CFRs is used as reported in model (4) of Table 4, the reported F-statistics is 17.812 with p-values of 0.000. The result of the impact of the largest shareholders CRs exceeding its CFRs on accounting performance does not have the result of coefficient consistent with H4. This result indicates that the largest shareholders CRs exceeding its CFRs is not related to accounting performance. The reason of insignificant relationship in Malaysia is that there is no expropriation of minority interests in Malaysian companies because of better investors or shareholders' protection laws in Malaysia market as compared to other international markets such as Thailand, Philippines, and Indonesia (Abdullah & Pok, 2015). Finally, model (4) of Table 4 reflect the similar results on other variables as reported on as in model (1), model (2), and model (3).

Conclusion

This paper investigated the effect of CRs and CFRs on accounting performance using a panel data consists of 1716 company-year observations from non-financial companies listed on the Main Board of Bursa Malaysia over the period of 2000 to 2009. The result of WLS shows that the largest shareholders CRs divided by their CFRs and the largest shareholders CRs are positive and significantly influenced accounting performance while the largest shareholder CRs exceeding its CFRs and the ratio of CRs to CFRs of the largest shareholders are insignificantly influenced accounting performance. This paper provides evidence that the divergence of the largest shareholders CRs from their CFRs increases the incentive for expropriation of minority shareholders and decreases accounting performance. This evidence can expand the understanding of the specific roles of investors' protection in shaping corporate finance or governance, by clarifying their role in delivering value to outside shareholders (La Porta et al., 1999). Future research that tries to investigate the CRs, CFRs and firm performance may use other firm performance measures i.e., return on investments (ROI), market to book value ratio (MTBVR), and return on sales (ROS). Other control variables can also be used e.g., industry and risk effects to ensure the robustness the results. Then, the results may be compared with this research.

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