

**Weakness in
corporate governance
and lack of
transparency
accounting essay**



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Weakness in corporate governance and lack of transparency are considered causes of the Asian financial crisis. (Wan et al 2010). The corporate scandals happened in the early 2000s urged regulators around the world to suit the medicine to illness of the global financial stability by institute CG reforms. For instance, the Combined Code and the Sarbanes-Oxley Act were then introduced and enacted in UK and US respectively. As an international financial and business hub, Hong Kong is bound to take its share of the sweeping impact of the Asian financial crisis and the scandals. Hong Kong Stock Exchange determined to introduce the code of CG effective from 2005, with similar provisions on financial disclosures in the world. Most of the studies using US and UK data indicated that the quality of corporate governance practices has improved when firms comply with the provisions of the code. A survey conducted by a research team headed by Professor Stephen Cheung in Hong Kong generated a consistent result with those studies; it indicated that the CG standard of Hong Kong listed firms had been improved obviously in 2005.

2. 1. 3. Earning Management

While regulators aware the issues about CG after the scandals, the confidence of investors around the world who rely on the reported earnings on the financial statement to make their investment decisions have been significantly shaken. Earnings is always the most crucial indicator to evaluate how a firm performs. EM refers to manipulation of a firm's earnings through direct or indirect accounting methods to achieve a desired level and that does not reflect the economic reality to mislead FS users about the corporate performance or gaining self-interest. In short, the practices of EM deter the

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credibility of financial reporting. There is tons of empirical researches evidence that good CG improve the transparency of the quality financial reporting which provides more decision-useful information to investors regardless of the geographical location of the listed company. Some of GCG mechanisms include the existence of independent board of directors, audit committee, no CEO duality, no Top Share (controlling shareholder), and shareholder's coalition in order to face controlling shareholder. (Werner R. Murhadi 2009).

2. 1. 4. The unique features of Hong Kong Firms.

A global code of CG should not be applied as a standard among the world attributed to the unique settings of each jurisdiction. It is important for regulators and analysts to understand the unique features and regional conditions affect the incentive of managing earnings and the reporting quality. Therefore, Most of the researches have done to investigate the relationship between the CG practices and EM with US data, only a few of them analyses about the issues in other regions. An assumption that a same result will be concluded when analyzing HK data is doubtful. The widely acknowledged family ownership concentration characteristic of HK listed firms is still considered as the major contributor of the failure of CG even after the introduction of the code. See the “ vote manipulation” done by PCCW and the affair of Citic Pacific in 2009.

2. 2 Literature review

The research paper which examine whether the disclosure of Corporate

Governance Structures affect the market valuation of earnings surprises and <https://assignbuster.com/weakness-in-corporate-governance-and-lack-of-transparency-accounting-essay/>

firms' earnings management, Jui-Chin Chang and Huey-Lian Sun (2010), suggested that the effectiveness of corporate governance in monitoring earnings management is improved after the mandated disclosure. This finding is consistent with the result of the research on CG and earnings forecasts accuracy which supported that it is effective to enhance the quality of financial disclosure by revising the Malaysian Code on Corporate Governance to encourage public companies to implement good governance practices. (Ahmad-Zaluki et al 2010).

However, Davies and Schlitzer (2008) in their paper raised the question about the practicality of an international' one size fits all" corporate governance code of best practice and the result of the paper implied that the acceptance of a global corporate governance code is limited due to the adaptations in the business environment. Ching, M. L. K. et al. (2002) in their research contended that CG mechanisms and monitoring and oversight activities will affect the use of EM, and the importance of these factors varies across firms and national jurisdictions. Because CG, the legal environment, and monitoring activities are far different in Hong Kong than in the U. S., research studies using American data have limited relevance for HK.

A large proportion of HK listed firms are controlled by families. When most of the results of empirical researches supported the positive association between the CG mechanism and firms' earnings quality, the unique features of Hong Kong is not being considered in those researches. A rare research done by Jaggi, B., et al. (2009) used samples before the adoption of code of corporate governance and find that a higher proportion of independent corporate boards of HK firms is associated with more effective monitoring to <https://assignbuster.com/weakness-in-corporate-governance-and-lack-of-transparency-accounting-essay/>

constrain EM by deterring managers from manipulating the reported earnings; thus the earnings quality is expected to be high despite differences in institutional environments. However, it is not the case of which the firms are family-controlled, either through ownership concentration or the presence of family members on corporate boards.

2. 3 Objective

While countless studies have already done with data of regions other than HK about the association between CG and EM, some of them have also emphasized on the identity of family ownership concentration in Asian regions. This study is done for the purpose of evaluating the effectiveness of the Code of Corporate Governance Practices effective from 2005 on reducing EM practices and improving earnings quality of HK Firms. Focus on the uniqueness of the Hong Kong Firms' ownership structure to investigate whether mandatory disclosure of corporate governance structures improves the quality of financial information of Hong Kong family-controlled firms.

2. 4 Statement of hypothesis

2. 4. 1 Identifying Corporate governance

The research generated by Dey, (2008) examined that different countries have different corporate governance structure. She considered twelve variables of corporate governance to measure different corporate governance structure, such as the effectiveness of the audit committee and duality of CEOs and so on. To determine corporate governance, we would use five variables including a majority-independent audit committee, a

majority-independent board, financial professional having sufficient accounting experience on the committee, big 4 auditors and the separation CEO and chair position.

2. 4. 2 Audit committee and earning quality

According to Hong Kong Exchange and clearing limited (HKEX), after the adoption of code of corporate governance effective that is in 2005, it is a must for Hong Kong listed companies to establish an audit committee, comprising non-executive director (NED) and having at least three members. Based on the research of Bedard, and Courteau (2001), the higher the percentage of independent non-executive director that are not managers in other firms, the higher the earning quality is. Thus, the hypothesis we develop should be:

H1: There is positive relationship between the existence of a majority-independent audit committee and earning quality after the code

2. 4. 3. Independent board of director and earning management

According to Liu and Lu (2007), they found that when preparing financial statement, the board of director can help to monitor and prevent controlling shareholder as this act may make damage to the other shareholder. Besides, the Hong Kong boards of director were by code at least three NED members as well.

H2: There is positive relationship between the proportion of Independent non-executive directors on the board and earning quality after the code.

2. 4. 4. CEO duality and earning management

According to R. Murhadi, Werner. Dr (2009), he found that if there is any job duality, it was less effective and strongly influence higher level of discretionary accrual. Anderson et al. (2003) found that earnings informativeness is positively associated with firms having separated CEO and chair positions

H3: The existence of CEO duality positively influences the level of earnings management after the code.

2. 4. 4 Big 4 auditors and earning management

The previous research done by Klein (2003) found that Big 4 auditors may shift some of their responsibility of monitoring financial reporting to firms' audit committees after SOX. Therefore, there may be difference between discretionary accruals and Big 4 auditor in the before period of SOX.

H4: There is a negative relation between earning management and proportion of Big 4 auditors after the code.

2. 4. 5 Experts in audit committee and earning management

The Code in Hong Kong required that among the three members, it should include at least an independent NED with sufficient and appropriate financial experience. Xie, Davison, and DaDalt (2003) use pre-SOX samples to investigate that audit committee members having financial experience/background negatively influence discretionary accruals.

H5: There is a negative relation between discretionary accruals and the existent of financial experts on audit committees after the code.

2. 4. 6. family control and earning management

Due to the different expectations regarding the effect of family control on earnings management, Jaggi-Leung use pre-code sample to show that an increase in the proportion of outside directors to strengthen board monitoring is unlikely to be effective in family-controlled firms. The percentage of NED on the board to a total number of directors is counted 20% as cut-off point.

H6: There is a negative relation between the existent of family ownership control and earnings quality after the code.

3. Methodology

3. 1 Sample collection

It is to search the WiseNews Database and HKEX website to collect the data for all Hong Kong Listed Firms in all industry for years before and after adoption of code which is accounting period of 2004-2005 and 2005-2006 respectively.

3. 2 Research Design

By using the financial data examined from the above database, it is decided to research all firms excluding banks, insurance and trusts companies as they manage earning obtaining different incentives and opportunities.

(Peasnell et al, 2000) For testing earnings management, Dechow et al., 1995 suggested to use modified Jones model to measure discretionary accruals. However, based on Kothari, Leone and Wasley (2005), in addition to the modified model, they use return on assets as one of variable so as to estimate accruals more accurately. It is cross-sectional regression by using two-digit SIC code, then find out the estimated coefficient by the following formula:

$$\text{(Total discretionary accrual) } TACC_{jt} = \mu_0 + \mu_1(1/AT_{it-1}) + \mu_2(DS_{ale}/AT_{it-1}) + \mu_3(PPE/AT_{it-1}) + \mu_4 ROA_{it-1} \text{ --- (1)}$$

$$\text{Then, NON-ACC}_{jt} = \beta_1(1/AT_{jt-1}) + \beta_2(DS_{ales}_{jt} - DREC_{jt})/AT_{jt-1} + \beta_3(PPE/AT_{jt-1}) + \beta_4 ROA_{jt} \text{ --- (2)}$$

Then, calculating the discretionary accrual by using the following formula,

$$DACC_{jt} = TACC_{jt} - \text{NON-ACC}_{jt} \text{ --- (3)}$$

Using the regression model to calculating the data before and after the code of corporate governance,

$$DACC_{it} = p_0 + 1 \text{ Auditindep} + 2 \text{ BdIndep} + 3 \text{ AccExp} + 4 \text{ CEODua} + 5 \text{ Big 4} + \text{FAMOWN} \text{ --- (4)}$$

Where:

ROA = the ratio of net income to total assets

FAMOWN = 1 if proportion of family members divided by total number director is greater than 20%, 0 for other than this case.

BdIndep: The number of independent board directors calculated by the no. of board members

AuditIndep: The number of independent audit committee members calculated by the no. of audit committee members

AccExp: 1 for having financial professional experience and 0 for none and divided by the no. of audit committee members

Big 4: It is an indicator of the Big 4 auditors. It is one if the firm was Big 4 accounting firms' client and it is zero if not.

CEODua: it may be 1 when CEO is the firm's director of the board, 0 when it is not the case.

4. Time schedule

Time

Action

January

Finish the background of the problem and objectives

Research data for methodology

1st - 11th February

Finish Methodology

Collect data by using software i. e. Excel

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12th – 28th February

Solve the problems that will encounter during the process of collecting data, such as, uncertainty about any data

Analyze data and make result of the analysis

March

Write discussions

Interpret the data what we find

Finish recommendations, conclusions, summary of the project

1 – 4th April

Finish the draft to supervisor

5 – 28th April

Finish the reference lists

Review and proofread the grammar, organization, format of project

Amend some parts based on comments of supervisors