PhD THESIS

CORPORATE GOVERNANCE AND THE RELATIONSHIP BETWEEN DEFAULT RISK AND THE EARNINGS RESPONSE COEFFICIENT

by

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A thesis

submitted to the Victoria University of Wellington

in fulfilment of the

requirements for the degree of

Doctor of Philosophy in Accounting

Victoria University of Wellington

2012

Acknowledgement

At last...I have made it! What an amazing learning journey it has been. First, I would like to thank my loving family, especially my husband Mohd. Ali who has sacrificed his time and business while I have worked on my PhD. I am especially grateful for his patience, understanding and for taking care of things when I needed time and space. His constant encouragement, companionship and commitment during this journey have been indispensible to this achievement. My special thanks to all my children Sofea, Adam, and Aidid. Although they have no idea what their mum is always occupied with they never indicate any doubt in the ultimate success of their mum. My profound thanks to my mum Jamilah Nae'mat, and my brothers and sisters for their never ending prayers and encouragement.

My sincere appreciation to my supervisors Professor Tony van Zijl, Dr Wares Karim and Dr. Bhagwan Khanna. To Tony, his excellent direction throughout this research effort has provided me with both guidance and challenge to keep working. His thoughtful scholarship has steered me on the right track to complete my thesis. Wares has provided excellent support for my work and gave me much to think about my topic in wider contexts. I am grateful for his logical, sensible approach and for his challenging questions to stimulate me in the quest for quality. To Bhagwan for his guidance, assistance, patience and especially moral support over the long lonely years of my research that has helped me cope with the challenges and the disappointments along this course. I also acknowledge the support of the School of Accounting and Commercial Law administration staff who have always been positive and generously available. My appreciation also goes to all my fellow PhD students. I am grateful

Declaration on Sources

I hereby confirm that the work presented in this thesis is my own and original that has been carried out through the School of Accounting and Commercial Law, Victoria University of Wellington, during my candidature as a PhD student. I declare that the material of this thesis has not been submitted either in whole or in part for the award of any other degree or diploma at this or any other university. To the best of my knowledge and belief, it contains no material previously published or written by other persons or institutions except where due reference has been made.

(Nor Balkish Zakaria)

This study examines the effect of corporate governance on the relationship between default risk and the earnings response coefficient (ERC). Using a sample of 2,004 firm-years comprising 334 firms listed on the Bursa Malaysia over a six year period from 2002 to 2007, this study tests whether corporate governance mitigates the effect of default risk on ERC while controlling for the established determinants of ERC — beta, growth, earnings persistence and size.

Using reverse regression, the study confirms that beta is negatively related to ERC and that growth, earnings persistence and size are positively related to ERC. Default risk is found to be negatively related to ERC thus confirming that beta is only a partial measure of risk relevant to ERC. Corporate governance — as indicated by audit quality, audit committee expertise and independence, and board independence and board shareholding — mitigates the negative effect of default risk on ERC.

The results of the study hold both for the pooled sample of 2,004 firm-year observations and on a year by year basis for the 334 firms in the sample. The results are also found to be robust to various sensitivity tests including to alternative measures of the variables. The study thus provides systematic and comprehensive additional evidence on the determinants of ERC. Of itself this is an important contribution to the literature but especially so given that the evidence comes from Malaysia — an emerging economy — whereas the existing empirical literature relates mainly to developed countries.

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