ASSESSMENT OF EARNINGS CONSERVATISM IN MALAYSIAN FINANCIAL REPORTING

By

Khairul Anuar Bin Kamarudin

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
2011

*I dedicate this dissertation to
my children,
Najmi, Ainul, and Imran,
who always give me so much joy
and love.*

Research Supervisors

Professor Tony van Zijl
School of Accounting and Commercial Law,
Victoria University of Wellington,
Wellington, New Zealand.

Professor Keitha Dunstan
School of Business, Bond University,
Gold Coast, Australia.

Declaration on Sources

I hereby confirm that the work presented in this thesis is my own and original work 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.

Khairul Anuar Bin Kamarudin

Acknowledgments

I wish to express my deepest gratitude and appreciation to Prof. Tony van Zijl and Prof. Keitha Dunstan, my supervisors, for their invaluable guidance and support during my years in the doctoral programme, especially throughout the development and completion of this thesis. I would also like to thank Prof. Stephen Taylor, Prof. Peter Clarkson, and Prof. Michael Bradbury for their helpful comments and feedback. This thesis has also benefited from the comments of the faculty and participants of the SACL-VUW Doctoral Consortium, the AFAANZ Conference and Doctoral Symposium, the Quantitative Accounting Research Symposium/Auckland University, and the CAAA 2010 Conference.

Special thanks are due to Prof. Ian Eggleton, the Head of School, and to all SACL staff for their support. I also appreciate the friendship, interest, and support of my doctoral colleagues. I also acknowledge the financial grants received from UiTM-MOHE, Victoria University of Wellington, and the New Zealand Institute of Chartered Accountants.

I would like to express my deepest appreciation to my wife, Wan Adibah, for her unwavering support through this entire process. This thesis would not have been possible without her support and patience. To my parents, Kamarudin and Che Nah, and family, I am grateful for the support offered and prayers made to ensure success in my study and in life. Finally, I must acknowledge several friends who have continually provided assistance and support especially to my children, which allowed me to focus a significant amount of my time on research. I acknowledge Niklin, Dar, Dasuki, and Zuryati.

Abstract

This study examines four influences on earnings conservatism of financial reporting in Malaysia. The study employs a sample of 3,126 firm-year observations of Malaysian listed companies over the period 2003 to 2008 and measures conservatism by the asymmetric timeliness of earnings measure due to Basu (1997). First, the study assesses the degree of earnings conservatism in reporting during the period following the institutional reforms which started after the 1997 Asian financial crisis. The results suggest that conservatism has increased with the reforms which contrasts with the findings of Ball et al. (2003) who find no evidence of earnings conservatism in Malaysia. Second, this study investigates the effect of the adoption of IFRS on the level of earnings conservatism. The results show no systematic difference in the level of earnings conservatism for the short period of one to two years before and after the adoption, suggesting that conservatism may not be specific to any particular set of accounting standards. Third, this study examines the effect of ownership structure on earnings conservatism. Reporting by family firms and widely-held firms exhibits earnings conservatism, but this is not the case for state-controlled firms. The analysis also shows no significant difference between the levels of earnings conservatism for family firms and widely-held firms. Additional tests show that family firms that are strategically controlled by a family, that is, where a member of the controlling family acts as CEO and chairman of the corporate board, report significantly higher earnings conservatism than other family firms. Finally, the study examines the link between corporate governance and earnings conservatism. Employing a comprehensive set of corporate governance variables, this study does not find any evidence to link corporate governance and earnings

conservatism. This result is contrary to the evidence from developed markets, such as the United States and the United Kingdom, where firms with good governance are more timely in recognising bad news. This raises the possibility that the different ownership structures in Malaysia make corporate governance reforms less important. However, this suggestion is subject to environmental and cultural issues that have not been addressed in this study.

Table of Contents

Research Supervisors	iii
Declaration of Sources	iv
Acknowledgments	v
Abstract	vi
Table of Contents	viii
List of Tables.....	xiii
List of Figures	xvi
Abbreviations	xvii
Chapter One: Introduction	
1.1 Background and Objectives of the Thesis.....	1
1.2 Significant Contributions of This Thesis	3
1.3 Main Empirical Findings	7
1.4 Thesis Organisation.....	9
Chapter Two: Earnings Conservatism: A Review of Literature	
2.1 Introduction	10
2.2 Concepts of Conservatism	10
2.3 Theoretical Explanations for Conservatism	12
2.3.1 Contracting	13
2.3.2 Litigation	15
2.3.3 Taxation.....	16
2.3.4 Regulation	16
2.4 Development of Earnings Conservatism Measures	17
2.4.1 The Asymmetric Timeliness of Earnings Model – Basu (1997).....	18
2.4.2 The Time-Series Test of Loss Recognition – Basu (1997)	20
2.4.3 Accruals-Based Test of Loss Recognition – Ball and Shivakumar (2005).....	22
2.4.4 Firm-Year Measure – Francis, LaFond, Olsson, and Schipper (2004).....	23
2.4.5 Firm-Year Measure – Khan and Watts (2009)	23

2.5 Institutional Structure and Earnings Conservatism.....	25
2.6 Firm-Specific Factors and Earnings Conservatism.....	29
2.6.1 Firm Ownership.....	29
2.6.2 Auditors	30
2.6.3 Board of Directors	34
2.7 Chapter Summary.....	36

Chapter Three: Malaysian Institutional Background: Corporate Governance, Financial Reporting, and Ownership Structure

3.1 Introduction	37
3.2 The 1997 Asian Economic Crisis and Reforms in Corporate Governance.....	37
3.2.1 Before the Crisis	37
3.2.2 The Crisis.....	39
3.3 Financial Reporting Reforms and Adoption of IFRS	48
3.4 Ownership Structure of Malaysian Firms	59
3.4.1 Family Firms	61
3.4.2 State-Controlled Firms	63
3.5 Chapter Summary.....	73

Chapter Four: Research Objectives and Hypotheses Development

4.1 Introduction	74
4.2 The Proposed Research	74
4.3 Hypotheses Development.....	75
4.3.1 Earnings Conservatism Following Institutional Reforms	76
4.3.2 IFRS Adoption and Earnings Conservatism.....	79
4.3.3 Ownership Structure and Earnings Conservatism.....	83
4.3.3.1 Family Firms and Earnings Conservatism	83
4.3.3.2 State-Controlled Firms and Earnings Conservatism.....	87
4.3.4 Corporate Governance and Earnings Conservatism.....	91
4.4 Conclusions	94

Chapter Five: Research Methodology

5.1 Introduction	95
------------------------	----

5.2 Sample Selection and Data Collection.....	95
5.3 Measure of Earnings Conservatism	98
5.4 Classification For Pre- and Post-IFRS Adoption	100
5.5 Measurement of Ownership Structure	101
5.6 Measurement of Corporate Governance	103
5.7 Regression Models	114
5.7.1 Earnings Conservatism in Malaysia	114
5.7.2 IFRS Adoption and Earnings Conservatism.....	115
5.7.3 Ownership Structure and Earnings Conservatism.....	117
5.7.4 Corporate Governance and Earnings Conservatism.....	117
5.8 Robustness Tests	118
5.8.1 Alternative Measure for Earnings Conservatism	119
5.8.2 Fama and MacBeth (1973) Annual Regression.....	120
5.8.3 Control for Firm-Specific Variables.....	120
5.9 Conclusions	123

Chapter Six: Empirical Analysis

6.1 Introduction	124
6.2 Descriptive Statistics and Correlation Analysis	124
6.2.1 Descriptive Statistics	124
6.2.2 Correlation Analysis.....	128
6.2.3 Econometric Issues.....	131
6.3 Earnings Conservatism Following the Reforms	136
6.3.1 Introduction	136
6.3.2 Main Analysis: Earnings Conservatism in Malaysia.....	136
6.3.3 Sensitivity Analysis	140
6.3.3.1 Fama and MacBeth (1973) Annual Regression	140
6.3.3.2 Industry and Year Effects	141
6.3.3.3 Control for Firm-Specific Variables	143
6.3.3.4 Restricted Sample - Firm Audited by Big Four Auditors	146
6.3.3.5 Market-Adjusted Return	148
6.3.3.6 Inter-Announcement Period Stock Return.....	150
6.3.3.7 Reduced Sample: Stock Price Higher than MYR 1.00	152

6.3.3.8 Time-series Test of Timeliness in Loss Recognition.....	154
6.3.4 Discussion of the Results.....	157
6.4 IFRS Adoption and Earnings Conservatism	158
6.4.1 Introduction	158
6.4.2 Main Analysis: The Effect of IFRS Adoption on Earnings Conservatism.....	158
6.4.3 Sensitivity Tests.....	161
6.4.3.1 Control for Industry and Year Effects.....	162
6.4.3.2 Sample of Firms with Financial Year Ended 31 December	163
6.4.3.3 Firms with Big Four Auditors	165
6.4.3.4 Auditors' Industry Specialization	167
6.4.3.5 Time-Series Test of Timeliness in Loss Recognition	169
6.4.4 Discussion of the Results.....	171
6.5 Ownership Structure and Earnings Conservatism.....	173
6.5.1 Introduction	173
6.5.2 Main Analysis: Ownership Structure and Earnings Conservatism.....	174
6.5.3 Sensitivity Analysis	177
6.5.3.1 Fama and MacBeth (1973).....	177
6.5.3.2 Industry and Year Effects	179
6.5.3.3 Time-Series Test of Timeliness in Loss Recognition	180
6.5.3.4 Alternative Measures for Family Firms	182
6.5.3.5 State-Controlled Firms: Federal and States' Firms.....	185
6.5.4 Additional Analysis	188
6.5.4.1 Difference in Earnings Conservatism between Family Firms and Widely-Held Firms.	189
6.5.4.2 Strategic Control of Controlling Family and Earnings Conservatism	191
6.5.5 Discussion of the Results.....	196
6.6 Corporate Governance and Earnings Conservatism	198
6.6.1 Introduction	198

6.6.2 Corporate Governance Mechanism and Earnings Conservatism	199
6.6.3 Sensitivity Analysis	200
6.6.3.1 Alternative Measure for <i>CGINDEX</i>	200
6.6.3.2 Individual Measures for Corporate Governance	202
6.6.3.3 Time-Series Test of Timeliness in Loss Recognition	205
6.6.4 Discussion of the Results.....	208
6.7 Summary of Results	208
Chapter Seven: Conclusions	
7.1 Introduction	211
7.2 Summary	211
7.3 Limitations	214
References	217
Appendix 1 Summary of studies on earnings conservatism	234
Appendix 2 Main differences between FRS and MASB standards	251

List of Tables

Table 3.1 Corporate governance initiatives and reforms (1997-2002)	42
Table 3.2 List of MASB Standards as at 31 December 2003	52
Table 3.3 Change of name of MASB standards on January 1, 2005	56
Table 3.4 IFRS adoption in Malaysia as at 31 December 2008	58
Table 3.5 Ownership of YTL Corporation and its holding company	62
Table 3.6 Share Issue Privatization in Malaysia (1983–1999)	65
Table 3.7 Government-Linked Companies in Bursa Malaysia	66
Table 3.8 Substantial shareholders of Malayan Banking Berhad	70
Table 3.9 Summary of government-linked companies delisted from Bursa Malaysia	72
Table 4.1 Directors' profiles for Sime Darby Berhad	90
Table 5.1 Sample selection process	96
Table 5.2 List of variables, sources and definitions	97
Table 5.3 IFRS adoption and period classification	100
Table 6.1 Sample characteristics	125
Table 6.2 Descriptive statistics	127
Table 6.3 Correlation matrix	130
Table 6.4 Analysis for unusual observation and normality	132
Table 6.5 Diagnostic tests for Heteroscedasticity assumption	135
Table 6.6 Asymmetric timeliness of earnings	137
Table 6.7 Asymmetric timeliness of earnings: Fama and MacBeth (1973) annual regression	141
Table 6.8 Asymmetric timeliness of earnings: Controlling for industry and year effects	142

Table 6.9 Asymmetric timeliness of earnings: Controlling for firm-specific variables	145
Table 6.10 Asymmetric timeliness of earnings: Firms audited by Big Four auditors	148
Table 6.11 Asymmetric timeliness of earnings: Alternative measure for news (market adjusted return)	150
Table 6.12 Asymmetric timeliness of earnings: Alternative measure for news (inter-announcement date return)	151
Table 6.13 Asymmetric timeliness of earnings: Sample with stock price greater than MYR 1.00	153
Table 6.14 Time-series test of timeliness in loss recognition: Various specifications	156
Table 6.15 IFRS adoption and earnings conservatism	160
Table 6.16 IFRS adoption and earnings conservatism: Controlling the effect of industry and year effects	163
Table 6.17 IFRS Adoption and earnings conservatism: Sample with financial year end dated 31 December	164
Table 6.18 IFRS Adoption and earnings conservatism: Sample of firms with Big 4 auditors	166
Table 6.19 IFRS Adoption and earnings conservatism: Sample of firms audited by industry specialist	168
Table 6.20 Time-series test of timeliness in loss recognition: Pre- and post-IFRS adoption	170
Table 6.21 Ownership structure and earnings conservatism	175
Table 6.22 Ownership structure and earnings conservatism: Fama and MacBeth (1973) annual regression	178
Table 6.23 Ownership structure and earnings conservatism: Estimation controlling for industry and year effects	180

Table 6.24 Ownership structure and time-series test of timeliness in loss recognition	181
Table 6.25(a) Ownership structure and earnings conservatism: Alternative definitions for family firms and various specifications (Board presence or more than 20% shares)	183
Table 6.25(b) Ownership structure and earnings conservatism: Alternative definitions for family firms and various specifications (Board Presence and More than 30% shares)	184
Table 6.26(a) Earnings conservatism in Firms under control of the Federal Government of Malaysia: Various specifications	186
Table 6.26(b) Earnings conservatism in Firms under control of State Governments: Various specifications	187
Table 6.27 Earnings Conservatism: Family firms versus widely-held firms	190
Table 6.28 CEO duality in family firms and earnings conservatism	193
Table 6.29 Time-series test of timeliness in loss recognition: Strategic control of family firms	195
Table 6.30 Corporate governance and earnings conservatism	199
Table 6.31 Corporate governance and earnings conservatism: An alternative measurement	201
Table 6.32 Individual corporate governance mechanisms and earnings conservatism	203
Table 6.33 Corporate governance score and the time-series test of timeliness in loss recognition: Pooled regression, Fama and MacBeth (1973) annual regression, estimation controlling for industry and year effects	207

List of Figures

Figure 3.1 Pyramidal structure of a Malaysian firm (Johor Corporation)	61
Figure 4.1 Relationships examined	75
Figure 5.1 Malaysian listed firms (2002-2008)	96
Figure 6.1 P-P Plots for residuals	134
Figure 6.2 Dotplots of residuals	134
Figure 6.3 Asymmetric timeliness of earnings	139

Abbreviations

FASB	:	Financial Accounting Standards Board
GAAP	:	Generally Accepted Accounting Principles
GLC	:	Government-Linked Company
GLIC	:	Government-Linked Investment Company
IASB	:	International Accounting Standards Board
IASC	:	International Accounting Standards Committee
IAS	:	International Accounting Standards
KLSE	:	Kuala Lumpur Stock Exchange (currently known as Bursa Malaysia)
MACPA	:	Malaysian Association of Certified Public Accountants (currently known as MICPA)
MICPA	:	Malaysian Institute of Certified Public Accountants
MASB	:	Malaysian Accounting Standards Board
MAS	:	Malaysian Accounting Standard
NYSE	:	New York Stock Exchange
PNB	:	Perbadanan Nasional Berhad
PCG	:	Putrajaya Committee on GLC High Performance
FRF	:	Financial Reporting Foundation
S&P 500	:	Standard & Poor's 500 Index
SEDC	:	State Economic Development Corporation
SOX	:	Sarbanes-Oxley Act

CHAPTER ONE

INTRODUCTION

1.1 Background and Objectives of the Thesis

The purpose of this study is to examine the influences on earnings conservatism in Malaysia. The importance of this topic is highlighted because Ball, Robin, and Wu (2003) find no evidence of conservatism in financial statements of Malaysian listed firms, despite the importance of conservatism as key concept underlying accounting practice (Sterling, 1967). Malaysian accounting standards are perceived as being of high quality, because they are derived from UK and IAS standards, however, the weak institutional structures present in earlier years gave little incentive for preparers of financial statements to produce high-quality financial reports, i.e. to follow conservatism (Ball, et al., 2003). After the 1997 Asian financial crisis, the regulatory bodies in Malaysia undertook major reforms in corporate governance and financial reporting to redress the institutional weaknesses. It is therefore appropriate to examine the degree of earnings conservatism following the reforms.

Another major event in the development of financial reporting in Malaysia has been the adoption of International Financial Reporting Standards (IFRS), effective from 1 January 2006. As IFRS tends towards fair value accounting, the degree of

conservatism (prudence) may be weakened.¹ This raises the possibility that IFRS could be detrimental if conservatism reduces managers' incentives and ability to manipulate earnings and thus reduces information asymmetry of investors as suggested by LaFond and Watts (2008). Using short-term horizons of one and two years before and after the adoption of IFRS, this thesis examines the impact of IFRS on earnings conservatism in Malaysia.

This study also examines whether firm ownership structure has an influence on earnings conservatism. Given that family firms and state-controlled firms play pivotal economic roles in Malaysia and other East Asian countries, they are likely to also have a unique effect on financial reporting incentives. Different types of firms (family, state-controlled, and widely-held firms) have different stakeholders who face different types of information asymmetry and agency costs, and their managers also have different incentives to report earnings conservatively. It is thus appropriate to examine how the degree of earnings conservatism varies across reporting by different types of firms.

Finally, this study examines the influence of corporate governance on earnings conservatism. Though several studies in developed countries have examined this issue, for example, Beekes, Pope, and Young (2004), García Lara, García Osma,

¹ In a handout for both the FASB's July 27, 2005 and the IASB's July 20, 2005 meetings on the conceptual framework (FASB, 2005, p. 24), the FASB responds to questions on "What is the role of conservatism? Does it conflict with neutrality? If not, why not? Why keep it?" with:

"Financial information needs to be neutral – free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty."

and Penalva (2007), and García Lara, García Osma, and Penalva (2009), the literature on the impact of corporate governance on earnings conservatism in Malaysia and other emerging markets remains sparse. While Malaysia introduced the Code on Corporate Governance in March 2000 to improve the quality of governance, no studies have specifically addressed the impact of change in corporate governance practice on earnings conservatism.

1.2 Significant Contributions of This Thesis

Basu (1997) introduced the first and most widely used measure of conservatism described as the asymmetric timeliness of earnings measure. It is based on the premise that the practice of conservatism will cause earnings to reflect bad news more quickly than good news. Using the Basu (1997) model, many studies try to provide explanations for differences in conservatism with respect to country-specific and firm-specific factors. Pope and Walker (1999), for example, find differences in earnings conservatism between the United States and the United Kingdom, while Ball, Kothari, and Robin (2000) compare earnings conservatism between code-law (France, Germany, and Japan) and common-law countries (the United States, the United Kingdom, Canada, and Australia), and find higher earnings conservatism in common-law countries. Extending these studies, this study aims to provide insight on earnings conservatism in an emerging market, i.e. Malaysia. By focusing on a single country, this study avoids several concerns relating to cross-country studies such as the possibility of endogeneity between the variables at the country level, noise in the variables, and severe correlated

omitted variables problems (Miller, 2004).²

More importantly, this approach enables examination of issues specific to a single country, Malaysia, which is an attractive case study for several reasons. First, Malaysia provides a unique setting to examine whether changes in financial reporting incentives affect earnings conservatism. Ball et al. (2003) find no evidence of earnings conservatism in Malaysia and three other East Asian countries, Hong Kong, Singapore, and Thailand, when examining the period from 1984 to 1996. Though the accounting standards of these countries are perceived as being of high quality³, it appears that the weak institutional features of the countries provided poor incentives for managers and auditors to provide high-quality financial statements.

Extending Ball et al. (2003), this study focuses on the years 2003 to 2008, the period following the reforms of corporate governance and financial reporting. My point of departure is the suggestion that the institutional structure became much stronger following the various initiatives undertaken by the regulators in Malaysia, some of which occurred in direct response to the Asian financial crisis and others which were reinforced by concerns raised after the crisis. These initiatives included: the Financial Reporting Act 1997; amendment of the

² According to Miller, a more focused study permits variables to be designed that more cleanly capture the construct being measured, and also frees researchers from the need for variables to be available across a wide range of countries.

³ Each country has been either substantially influenced in the past by the UK or the US accounting standards, and continues to be influenced by International Accounting Standards (IAS). The accounting standards derived from the United Kingdom, the United States, and the IAS standards are generally viewed as being “high quality” and are associated with timely recognition of economic losses (Ball, et al., 2000).

Securities Law and Bursa Malaysia Listing Requirements; the introduction of the Code of Corporate Governance; and establishment of the Malaysian Accounting Standards Board (MASB), the Malaysian Institute of Corporate Governance (MICG), and the Minority Shareholders Watch Group (MSWG).

Second, this research contributes to a greater understanding of the phenomenon of conservatism, especially the effect of IFRS adoption on earnings conservatism. The implementation of IFRS is expected to reduce earnings conservatism since standard setters perceive conservatism as disturbing the neutrality and relevance of accounting information (Watts, 2003a). In contrast, Watts (2003a) and Ball and Shivakumar (2005) contend that conservatism plays a significant role in contracting, litigation, taxation and regulatory enforcement. In addition, LaFond and Watts (2008) argue that any attempt to eliminate conservatism would increase information asymmetry and hence would reduce the usefulness of accounting information. This study provides evidence as to whether IFRS adoption impacts on earnings conservatism.

Third, this study examines the impact of ownership structure on earnings conservatism. This factor is crucial in the Malaysian business environment, where concentrated ownership structures are the norm (Thillainathan, 1999). Most of the literature on ownership structure focuses on its impact on performance, firm value, and agency cost; but the effect of ownership structure on earnings quality, in the form of earnings conservatism, has received little attention. Given that family firms and state-controlled firms play an important role in the Malaysian economy, it is important to examine the influence of ownership structure on

earnings conservatism. Several Malaysian studies have examined the influence of family ownership and control on various factors such as performance (Abdul Rahman & Haniffa, 2005; Abdullah, 2004; Che Haat, 2006), voluntary disclosure (Abdullah & Mohd Nasir, 2004), and aggressive reporting (Abdul Rahman & Mohamed Ali, 2006; Yatim, Kent, & Clarkson, 2006). For state-controlled firms, empirical evidence is very limited; some focus on the impact of state-controlled firms on firm performance (Ang & Ding, 2006), value (Lau & Tong, 2008), and earnings management (Yen, Chun, Abidin, & Noordin, 2007), but none examine earnings conservatism. This study, by contrast, examines the impact of family ownership and control and state-control on firm performance (Ang & Ding, 2006), value (Lau & Tong, 2008), and earnings conservatism (Yen, et al., 2007), but none examine earnings conservatism.

Finally, this study provides evidence from an emerging market on the relationship between corporate governance and earnings conservatism. Theoretically, conservatism is an outcome of mechanisms to control and monitor managers, thereby enhancing contracting between parties (Watts, 2003a). However, the empirical evidence is limited and focuses primarily on developed countries, such as the United States (Ahmed & Duellman, 2007; García Lara, et al., 2009), the United Kingdom (Beekes, et al., 2004), and Spain (García Lara, et al., 2007). This study examines the relationship between corporate governance and earnings conservatism in the emerging market, Malaysia. This study contributes to the body of knowledge on corporate governance and the growing empirical literature pertaining to earnings conservatism. The results should also be useful to regulators in deliberating policies on issues related to corporate governance.

1.3 Main Empirical Findings

The first objective of this study is to examine earnings conservatism in Malaysia following the reforms in corporate governance and financial reporting. Using a sample of 3,126 firm-year observations from the period 2003-2008, this study finds evidence of earnings conservatism in Malaysia during the period under study. This finding stands in contrast to Ball et al. (2003), who find no evidence of earnings conservatism in Malaysia for reporting during the period 1984 to 1996. The findings of this study are consistent with earnings immediately reflecting ‘bad news’ received from a negative revision of future cash flows, but delaying the recognition of ‘good news’ from a positive revision of future cash. These results support the expectation that the institutional reforms, which started from the year 1997, created strong incentives for Malaysian firms to report earnings conservatively.

Secondly, this study examines the impact of the adoption of IFRS on the level of earnings conservatism. The results show no systematic difference between the levels of earnings conservatism for the short horizon period of one to two years before and after IFRS adoption. This suggests that the change from MASB standards to IFRS standards did not have any significant effect on earnings conservatism. This finding supports the argument of Ball et al. (2003) that accounting standards have less impact on earnings conservatism than do financial reporting incentives.

Thirdly, this study examines how earnings conservatism varies between firms with different types of ownership structure, namely family firms, state-controlled

firms, and widely-held firms. Since different types of ownership generate different key stakeholders who are subject to different levels and types of agency conflicts, the incentives to report earnings conservatively also vary accordingly. For state-controlled firms, the results show no evidence of earnings conservatism. This is consistent with the conclusion that state-controlled firms adopt more aggressive accounting. With regard to family firms and widely-held firms, there is evidence of earnings conservatism in both types of firms, indicating that bad news is recognised in a more timely way in accounting earnings than good news. Further investigation shows no statistical difference between the degree of earnings conservatism for family firms and widely-held firms, suggesting that family firms report earnings just as conservatively as do widely-held firms.

This study also examines whether strong control by the family firm in the management and corporate board is associated with the ‘convergence of interest’ hypothesis, thereby providing stronger incentives to report earnings conservatively. The results support the prediction that strong control by the controlling family of firm management and the board of directors is associated with higher earnings conservatism. This result suggests that family firms have lower agency conflicts and incentives for opportunistic reporting when a member of a controlling family holds the position of both CEO and chairman.

Finally, this study examines the relationship between corporate governance and earnings conservatism. Employing a comprehensive set of corporate governance variables, this study does not find any evidence to link corporate governance and earnings conservatism. This result is contrary to the evidence from developed

markets, such as the United States and the United Kingdom, where firms with good governance are more timely in recognising bad news. This raises the possibility that the different ownership structures in Malaysia make corporate governance reforms less important.

1.4 Thesis Organisation

The remainder of this thesis is organised as follows. Chapter 2 reviews the literature on earnings conservatism, including explanations, constructs, and empirical evidence. An overview of the Malaysian institutional environment with regard to corporate governance, financial reporting, and ownership structure is provided in Chapter 3. Chapter 4 explains the proposed research design and discusses the development of the hypotheses, while Chapter 5 explains the research methodology including the sample, choice of measures for the variables, and the regression models. The descriptive statistics and explanations of the empirical results together with the sensitivity analyses, are presented in Chapter 6. Finally, Chapter 7 summarises the results and acknowledges the limitations inherent in the scope of study and research design.

CHAPTER TWO

EARNINGS CONSERVATISM: A REVIEW OF LITERATURE

2.1 Introduction

This chapter reviews the literature on earnings conservatism, including discussion of the concept, theoretical explanations, constructs, and empirical evidence. The concept of earnings conservatism is discussed in Section 2.2. Section 2.3 outlines theoretical explanations for conservatism from the literature. The development of measures of earnings conservatism is explained in Section 2.4. Section 2.5 discusses the influence of institutional structures on earnings conservatism. Section 2.6 reviews the evidence on firm-specific determinants of earnings conservatism. The chapter is summarised Section 2.7.

2.2 Concepts of Conservatism

Basu (1997) interprets conservatism as “capturing accountants’ tendency to require a higher degree of verification for recognizing good news than bad news in the financial statements” (p.4). To differentiate this interpretation from the general explanation of conservatism, as used in accounting textbooks and standard-setters’ publications, empirical studies refer to this concept as earnings conservatism (García Lara & Mora, 2004), conditional conservatism (Ball, et al., 2000; Ball & Shivakumar, 2005), ex-post conservatism (Richardson & Tinaikar, 2004), and news-dependent conservatism (Chandra, Wasley, & Waymire, 2004). To measure earnings conservatism, the Basu (1997) model regresses accounting earnings on stock returns where stock returns serve as a proxy for economic news.

Given that stock prices efficiently capture all types of economic news, and earnings conservatism results in asymmetric recognition of good news and bad news; the result must be a higher coefficient for negative stock returns (bad news) than for positive stock returns (good news). The difference between the coefficients is the measure of conservatism. Examples of earnings conservatism include the lower of cost or market rule for inventory, impairment accounting for non-current tangible assets, and the write-down (impairment) of goodwill.

Earnings conservatism has several important economic roles. Generally, contractual relations, litigation, regulatory incentives, and the relationship between taxation and financial reporting influence the incentives for conservative reporting (Watts, 2003a). In terms of contracting, earnings conservatism facilitates more efficient contracting by restricting management's opportunistic reporting behaviour (Qiang, 2007; Watts, 2003a). Earnings conservatism helps protect the interest of fund providers. Debtholders, for instance, demand timely information about bad news since the option value for their claims is highly sensitive to a fall in firm value (Basu, 1997). In addition, by reporting earnings conservatively, managers reduce litigation risk (Ball, 2001; Ball & Shivakumar, 2005). Previous studies also find that international differences in earnings conservatism are linked to differences in countries' corporate governance regimes and regulatory infrastructure (Ball, et al., 2000; Bushman & Piotroski, 2006; Giner & Rees, 2001).

The second type of conservatism is referred to as unconditional conservatism (Beaver & Ryan, 2005), news-independent conservatism (Chandra, et al., 2004)

and ex-ante conservatism (Pope & Walker, 2003). Unconditional conservatism arises because of the accounting rules, accounting choices, and procedures that cause an understatement of book value and earnings (Easton & Pae, 2004), and thus yield expected unrecorded goodwill (Beaver & Ryan, 2005). This is consistent with Feltham and Ohlson (1995) who define conservatism as a persistent understatement of shareholders' equity relative to market value. In the extreme form, unconditional conservatism causes investments to trigger expense recognition, but not asset recognition (Pope & Walker, 2003, p. 2). Examples of unconditional conservatism include aggressive depreciation of property, plant, and equipment, immediate expensing of internally developed intangibles, and the use of historical cost accounting for positive net present value projects. Gassen, Fülbier, & Sellhorn (2006), however, argue that the economic functions of unconditional conservatism are far less obvious. Further, Ball and Shivakumar (2005) state that "While unconditional conservatism seems inefficient or at best neutral in contracting, conditional conservatism (timely loss recognition) can enhance contracting efficiency" (p. 91). For instance, the accumulation of cookie-jar reserves from continuous understatement of assets increases discretionary freedom of management, especially to mask negative developments (Gassen, et al., 2006).

2.3 Theoretical Explanations for Conservatism

Watts (2003a) provides four explanations for conservatism: contracting, litigation, taxation and regulation. Of the four explanations, contracting is more extensively discussed in Watts (2003) because it is the earliest source of conservatism recognised in the literature; and the arguments related to it are more fully

developed compared to the others. Discussions on the four explanations for conservatism together with a review of recent evidence are provided in the following sections.

2.3.1 Contracting

The first recognised explanation for conservatism is contracting (Watts, 2003a). Since debtholders have an asymmetric payoff with respect to net assets, they are interested in the lower end of the possible values of earnings and net assets. For example, in the case of liquidation, debtholders would receive less than the contracted sum if the net asset value is below the face value of the debt. The limited liability of shareholders and managers restrains managers from claiming their losses. Thus, to protect their investment, debtholders may request more conservative reporting of earnings and impose a strict debt covenant that includes a dividend covenant and a minimum requirement on net assets. Earnings conservatism thus promotes a more efficient debt covenant, including restricting excessive payment of dividends to shareholders. In addition, the debt contract may set a lower bound measure on net assets to trigger technical default, thereby constraining managers from making decisions that could reduce the value of net assets (Beneish & Press, 1993).

Management compensation and employment contracts also contribute to conservatism. Given that managers have more information than other parties, conservatism is essential to reduce managers' upwardly biased estimate of future cash flows, which can lead to overpayment of compensation to managers. Earnings-based compensation plans, create incentives for managers to report

higher earnings, achieved by delaying the recognition of bad news and accelerating the recognition of good news. Moreover, managers have a higher propensity to opt for negative net present value (NPV) investments with larger positive immediate returns. Further, because of limited tenure and liability of managers, it is almost impossible to recover overpayment of compensation, or secure damages, from a poor investment decision made by managers. Even with a court order, the full cost of the action could well be larger than the manager's wealth (Watts, 2003a). In short, earnings conservatism has a pivotal role in mitigating the managers' opportunistic reporting behaviour and alleviating agency conflicts.

From a corporate governance perspective, earnings conservatism facilitates more effective monitoring of the board of directors, shareholders and debtholders. Given that managers have higher incentives to defer the recognition of future economic losses, conservatism helps to issue an early warning to the board of directors and shareholders by accelerating the recognition of economic losses. As a result, prompt corrective action, including terminating poorly performing managers and discontinuing negative NPV projects, can be undertaken to minimise losses and risks.

Many empirical studies support the contracting explanation on earnings conservatism. Qiang (2007), for example, finds that contracting induces earnings conservatism. Ahmed, Billings, Morton, and Stanford-Harris (2002) find that conservatism mitigates bondholder-shareholder conflicts over dividend policy. Furthermore, they find a lower cost of debt in firms with higher accounting

conservatism. In short, this evidence supports the argument earnings conservatism can facilitate contracting.

2.3.2 Litigation

Watts (2003a) proposes a litigation explanation for conservatism. García Lara et al. (2009) contend that conservatism reduces litigation risk for managers, directors, and auditors. Prior studies on auditor litigation find that lawsuits against auditors often relate to non-conservative reporting such as overstatements of earnings or net assets (Kellogg, 1984; St. Pierre & Anderson, 1984) and high earnings-increasing abnormal accruals (Heninger, 2001). Thus, managers will err on the side of conservative reporting to alleviate litigation risk (Chung, Firth, & Kim, 2003), especially when the courts are more likely to award damages for overstated earnings or assets (Kellogg, 1984). At the same time, auditors also have greater incentives for conservative reporting of earnings as litigation against firms and auditors has become more common and more costly (DeFond & Subramanyam, 1998).

Numerous studies support the effect of litigation on earnings conservatism. Qiang (2007), for example, finds litigation induces both earnings conservatism and unconditional conservatism. In the United Kingdom, Huijgen and Lubberink (2005) find greater earnings conservatism among firms that are cross-listed in a more litigious country (the United States) than among UK firms without a US listing. Al-Sehali and Spear (2004) find no evidence of earnings conservatism in Saudi Arabia, where expected litigation costs are low. In an auditing study, Cahan and Zhang (2006) find that ex-Andersen clients have greater conservatism, which

is consistent with the view that an Andersen's audit is a unique source of litigation risk. Greater conservatism is also observed during periods of higher auditor liability (Basu 1997) and among firms hiring big audit firms (Basu, Hwang, & Jan, 2001).

2.3.3 Taxation

Taxation rules may influence accounting practices. Watts (2003a) argues that “asymmetric recognition of gains and losses enables managers of profitable firms to reduce the present value of taxes and increase the value of firms” (p. 209). As such, firms would report low earnings (by accelerating the recognition of expenses and delaying the recognition of revenues) to minimise current tax obligations. Extant studies show the relationship between taxation and conservatism. Hellman (2008), for instance, finds that the link between accounting and taxation is stronger in code-law countries; hence those countries are linked to higher earnings conservatism (Ball, et al., 2000).

2.3.4 Regulation

The fourth explanation for conservatism is regulation. Regulation has a significant role in influencing the incentives for conservative reporting (Watts, 2003a). Governments, through legislation, and the accounting profession, through accounting standards, set and enforce conservative accounting rules. The rationale for these rules is to protect the interests of investors and creditors, thus ensuring well-functioning share and credit markets (Chung, et al., 2003). For instance, the over valuation of the New York Stock Exchange (NYSE) in 1929 caused the SEC

ban on upward valuation of assets (Walker, 1992; Watts, 2003a). Accounting rules, such as goodwill amortisation, also lead to conservative reporting in the United States.

Many empirical studies support the above arguments. Sivakumar and Waymire (2003) find that enforceable accounting rules induce conservatism, while Qiang (2007) finds that regulation induces conservatism. Recently, Lobo and Zhou (2006) examined earnings conservatism levels following the adoption of the Sarbanes-Oxley Act (SOX), and find higher earnings conservatism following SOX. Bushman and Piotroski (2006) examine the effect of legal and political institutions on financial reporting incentives, and find that both factors significantly influence the level of earnings conservatism.

2.4 Development of Earnings Conservatism Measures

This section explains several measures of earnings conservatism employed in empirical studies. The measures include the Basu (1997) asymmetric timeliness of earnings measure, the time-series test of loss recognition model (Basu, 1997), the accruals-based test of loss recognition model (Ball & Shivakumar, 2005), and the firm-year estimate for conservatism (Francis, LaFond, Olsson, & Schipper, 2004; Khan & Watts, 2009). In addition to the above measures, studies also employ the market to book ratio (Roychowdury & Watts, 2007), hidden reserve measure (Penman & Zhang, 2002), and negative accruals measure (Givoly & Hayn, 2000). However, I exclude the discussion of the last three models from this study since the convergent validity tests conducted by Wang, Ó Hógartaigh, and van Zijl (2009) suggest that these measures are from a different group of conservatism

measures.

2.4.1 The Asymmetric Timeliness of Earnings Model – Basu (1997)

In the Basu (1997) model, conservatism is defined as the extent to which current period accounting earnings asymmetrically incorporate economic losses relative to economic gains. With that notion, the following equation is regressed to test the difference in the timeliness of good news and bad news.

$$E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it} \quad (1.1)$$

where E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

The coefficient β_1 measures the response of earnings to returns when returns are positive, and $\beta_1 + \beta_3$ measures the response of earnings to negative returns. If $\beta_1 + \beta_3 > \beta_1$ or $\beta_3 > 0$, then earnings reflect bad news more quickly than good news, and thus β_3 measures earnings conservatism.

In this model, stock return acts as a proxy for economic income, assuming that stock prices reflect all available information. This is consistent with the evidence that stock prices lead earnings information (Ball & Brown, 1968; Kothari & Sloan, 1992). Accounting earnings, however, employs different verification standards for recognising bad news (negative stock returns) and good news

(positive stock returns), and this generates earnings conservatism. For bad news, lower verification standards are used, which results in immediate recognition of losses. For good news, higher verification standards are imposed which cause delay in recognising economic gains. These asymmetric verification standards lead to more timely reporting of bad news relative to good news.

Basu's (1997) reverse regression model has been the most widely used measure of earnings conservatism in empirical research. Among the studies that have employed this model are Ball et al. (2000), Ball et al. (2003), Ball and Shivakumar (2005), Bushman and Piotroski (2006), Francis et al. (2004) and Roychowdury and Watts (2007). Despite the wide acceptance, this model is subject to some criticisms (Bushman & Piotroski, 2006; Dietrich, Muller, & Riedl, 2007; Gigler & Hemmer, 2001).

First, Bushman and Piotroski (2006) criticise the effectiveness of the model since it places heavy reliance on the assumption that stock prices capture all economic gains and losses. Given that the price formation process is not equally efficient across all markets (Morck, Yeung, & Yu, 2000), the effectiveness of the Basu model can be questioned. Furthermore, Gigler and Hemmer (2001) argue that stock returns might not reflect all non-earnings news, and might also reflect good and bad economic news differentially, possibly as a function of a firm's own disclosure policies. If the equity is mispriced, then the model is likely to have measurement error.

Second, Dietrich et al. (2007) claim that the Basu regression is biased and hold

that the inferences made from this model should not be relied upon. The bias is derived from the choice of deflator for the variables in the regression and the partitioning occurring on the basis of an endogenous variable (i.e. negative or positive stock returns). This endogeneity is allegedly attributable to the fact that accounting income has an effect on stock returns (Lai & Taylor, 2008). Despite all the criticisms, Ryan (2006) concludes that the asymmetric timeliness of earnings model is still the best measure of earnings conservatism available. However, Ryan does encourage the use of multiple measures for earnings conservatism. I use the asymmetric timeliness of earnings measure of conservatism as the primary measure in the test of my hypotheses, outlined in Chapter 6.

2.4.2 The Time-Series Test of Loss Recognition – Basu (1997)

The second measure in Basu's (1997) study examines the time-series behaviour of earnings changes. This model has been used in several studies including Ball et al. (2000), Ball et al. (2003), Ball and Shivakumar (2005), Ruddock, Taylor, and Taylor (2006) and Jenkins and Velury (2008). This measure exploits the transitory nature of economic income (Samuelson 1965; Fama, 1970). Basu (1997) argues that while bad news affects earnings immediately, the effect does not persist. On the other hand, good news takes longer to be reflected in earnings, but the effect is more likely to persist in future periods. Thus, the transitory gain and loss components measure the tendency for increases and decreases in accounting income to reverse (Basu, 1997).

The time-series test of loss recognition model assumes that a decrease in current earnings during a bad news period is likely to reverse in the next period. Thus, it

is expected that the reporting of bad news is associated with an increase in negative autocorrelation between current and future earnings. Good news, however, is recognised over several periods. Thus, an increase in current earnings during a good news period is more persistent, while a decrease in earnings is more transitory in nature. Consistent with conservatism arguments, prior studies (for example Basu, 1997; Brooks & Buckmaster, 1976; Elgers & Lo, 1994) find that negative earnings changes are more likely to reverse in the following period than positive earnings changes. To identify the transitory gain and loss components in earnings, Basu (1997) estimates the following linear regression.

$$\Delta NI_{it} = \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + \varepsilon_{it} \quad (1.2)$$

where ΔNI_{it} is the change in earnings for firm i from year $t-1$ to year t , standardised by total assets at end of year $t-1$; $D\Delta NI_{it-1}$ is a dummy variable equal to 1 if ΔNI_{it-1} is negative, and 0 otherwise; and ε_{it} is the error term.

In equation (1.2), a reversal of transitory gains or losses from the prior period would result in a negative coefficient. If the recognition of economic gains in earnings is deferred until the underlying increases in cash flows are realized, then the gains to be recognised as ‘persistent’ positive components of earnings tend not to reverse. Hence, the implication is $\alpha_1=0$. For economic losses, conservative accounting results in early recognition of economic losses in earnings, hence the transitory income decreases tend to reverse in the future: the implication being $\alpha_2+\alpha_3<0$. If economic losses are recognised in a more timely fashion than are gains, the coefficient α_3 is expected to be negative. I use the time-series test of loss recognition as an alternative means of testing my hypotheses.

2.4.3 Accruals-Based Test of Loss Recognition – Ball and Shivakumar (2005)

Ball and Shivakumar (2005) examine differences in earnings conservatism between public and private firms. Since stock price information is not available for private firms, Ball and Shivakumar (2005) developed an accruals-based test of loss recognition as an alternative measure for earnings conservatism. This model assumes that the asymmetry arises because economic losses are recognised on a timely basis as unrealized (i.e., non-cash) accrued charges against earnings. In contrast, economic gains are recognised only when they are realized. From this argument, Ball and Shivakumar (2005) estimate the following piecewise-linear relation between cash flows and accruals in order to measure earnings conservatism.

$$ACC_{it} = \beta_0 + \beta_1 DCFO_{it} + \beta_2 CFO_{it} + \beta_3 DCFO_{it} * CFO_{it} + \varepsilon_{it} \quad (1.3)$$

where CFO_{it} is measured as earnings before exceptional and extraordinary items less accruals of firm i in fiscal year t ; $DCFO_t$ is a dummy variable that takes value 1 if CFO_t is negative and 0 otherwise; and ε_{it} is the error term. While ACC_{it} is measured as:

$$\begin{aligned} ACC_t = & \Delta Inventory + \Delta Debtors + \Delta Other \text{ current assets} \\ & - \Delta Creditors - \Delta Other \text{ current liabilities} \\ & - Depreciation \end{aligned} \quad (1.4)$$

Both variables, accruals and cash flow from operations, are standardised by total assets at the beginning of the period.

This model predicts a negative coefficient for cash flows β_2 and a positive incremental coefficient β_3 for negative cash flows is consistent with the argument that accrued losses are more likely in periods of negative cash flows.

2.4.4 Firm-Year Measure – Francis, LaFond, Olsson, and Schipper (2004)

Based on Basu's asymmetric timeliness of earnings model, Francis, et al. (2004) introduce the firm-year measure of conservatism by estimating equation (1.5) on a firm- and year-specific basis using rolling ten-year windows.

$$EARN_{j,t} = \alpha_{0,j} + \alpha_{1,t}NEG_{j,t} + \beta_{1,j}RET_{j,t} + \beta_{2,j}NEG_{j,t} * RET_{j,t} + \varepsilon_t \quad (1.5)$$

where $EARN_{j,t}$ is firm income before extraordinary items in year t, scaled by market value at the end of year t-1; $RET_{j,t}$ is firm's 15-month return ending three months after the end of fiscal year t; $NEG_{j,t}$ is 1 if $RET_{j,t}$ is negative and 0 otherwise; and ε_t is the error term.

Consistent with Basu (1997), Pope and Walker (1999), and Givoly and Hayn (2000), Francis et al. (2004) measure conservatism using the negative of the ratio of the coefficient on bad news to the coefficient on good news, $Conservatism = -(\beta_{1,j} + \beta_{2,j})/\beta_{1,j}$. Larger values of *Conservatism* imply lower conservative earnings.

2.4.5 Firm-Year Measure – Khan and Watts (2009)

Khan and Watts (2009) introduce a firm-year measure for earnings conservatism (C_Score) by extending the Basu (1997) reverse regression model. Khan and Watts (2009) estimate equation (1.6), which allows coefficients to vary across

firms and over time. In this model, the timeliness of good news and incremental timeliness of bad news are assumed to be linear functions of time-varying firm-specific characteristics for which Khan and Watts suggest namely *Size*, *MTB*, and *LEV*.

$$\begin{aligned}
X_{it} = & \beta_1 + \beta_2 D_i + R_i (\mu_1 + \mu_2 Size_i + \mu_3 MTB_i + \mu_4 Lev_i) \\
& + D_i R_i (\lambda_1 + \lambda_2 Size_i + \lambda_3 MTB_i + \lambda_4 Lev_i) + \delta_1 Size_i + \delta_2 MTB_i \\
& + \delta_3 Lev_i + \delta_4 D_i Size_i + \delta_5 D_i MTB_i + \delta_6 D_i Lev_i + \varepsilon_{it}
\end{aligned} \tag{1.6}$$

where X is earnings; R is returns; D is a dummy variable that equals 1 if R is negative, and 0 otherwise; $Size$ is the natural log of market value of equity; Lev is the ratio of long-term and short-term debt deflated by market value of equity; MTB is the market to book ratio; i indexes the firm; and ε is the residual.

From the estimation, the timeliness of good news (G_Score) and conservatism (C_Score) are calculated using the following equations:

$$G_Score = \beta_3 = \mu_1 + \mu_2 Size_i + \mu_3 MTB_i + \mu_4 Lev_i \tag{1.7}$$

$$C_Score = \beta_4 = \lambda_1 + \lambda_2 Size_i + \lambda_3 MTB_i + \lambda_4 Lev_i \tag{1.8}$$

where λ_i and μ_i , $i=1$ to 4, are constant across firms, but vary over time.

Khan and Watts (2009) also provide evidence on the empirical properties of C_Score . The result shows that a higher C_Score is associated with higher Basu (1997) earnings conservatism, more negative return on earnings and more variable non-operating accruals, suggesting the validity of the C_Score measure.

Consistent with predictions in prior literature, Khan and Watts (2009) find that firms with a higher *C_Score* have higher information asymmetry, longer investment cycles, greater idiosyncratic uncertainty and greater probability of litigation. Lai and Taylor (2008) estimate and validate Khan and Watts' *C_Score* measure for conservatism (based on the 2007 working paper version) using an Australian sample. They find that the *C_Score* is positively associated with stock return volatility, investment cycle length and prior period conservatism. In addition, they find that the *C_Score* is negatively associated with firm size, firm age, and leverage.

2.5 Institutional Structure and Earnings Conservatism

Since the seminal work of Basu (1997) on earnings conservatism, numerous cross-countries studies have been conducted to examine how institutional structure influences earnings conservatism. The following studies provide evidence that institutional structure, including the legal/judicial system, securities laws, and political economy, create incentives that influence the behaviour of corporate executives, investors, regulators and other market participants, which indirectly shape the properties of accounting numbers, in particular earnings conservatism.

Ball et al. (2000) examine earnings conservatism in code-law and common-law countries that include seven international GAAP regimes (Australia, Canada, United States, United Kingdom, France, Germany and Japan). The study documents substantial variation in asymmetric timeliness of earnings across regimes, where common-law countries exhibit higher earnings conservatism than

code-law countries. This result suggests legal and institutional environments have a significant influence on earnings conservatism in the countries examined. Ball et al. (2000) argue that enhanced common-law disclosure standards reduce the agency costs of monitoring managers, thus countering the advantage of closer shareholder-manager relationships in code-law countries. Another study by Giner and Rees (2001) examines earnings conservatism in three distinct legal traditions: French code (or civil) law, German code-law and English common law. The results show that earnings conservatism is stronger in the United Kingdom than in France or Germany. By concentrating on European countries, Giner and Rees (2001) minimise the impact of other social and economic differences and thereby isolate legal and accounting effects more clearly.

Extending the previous studies, Bushman and Piotroski (2006) examine the influence of legal and political institutions on earnings conservatism using a sample of firms from 38 countries from 1992 to 2001. They find that firms in countries with a high-quality judicial system recognise bad news in a more timely fashion than firms in countries with a low-quality judicial system. In addition, strong public enforcement of securities is positively associated with slowness in the recognition of good news, while private enforcement of securities law has no effect on conservatism. In terms of state involvement in the economy, evidence from common-law countries (civil-law countries) reveals that firms facing high state involvement in the economy report earnings aggressively (conservatively). This evidence suggests that managers adjust their financial reporting in response to legal and political institutions.

In the United States, Lobo and Zhou (2006) examine the effect of the introduction of the Sarbanes-Oxley Act (SOX) on earnings conservatism. Since SOX requires the CEO and CFO of all exchange-listed firms to certify the material accuracy and completeness of their firms' financial statements, SOX increases litigation risk, thereby providing greater incentives to report earnings conservatively. Consistent with the prediction, Lobo and Zhou (2006) find an increase in earnings conservatism in financial reporting following SOX. In addition, post-SOX financial reports have lower discretionary accruals than those in the period preceding SOX.

Raonic, McLeay, and Asimakopoulos (2004) assess the impact of country-level disclosure regimes, legal enforcement, and the importance of equity markets on earnings conservatism of European firms. They find higher earnings conservatism for firms domiciled and listed in different markets, showing a varying level of earnings sensitivity to market news. This is partly due to the interaction between the different institutional factors that drive the demand for accounting earnings recognition. In short, the study concludes that regulatory enforcement is positively associated with the bias towards conservatism while equity market exposure appears to be positively associated with greater timeliness in earnings recognition.

Grambovas, Giner, and Christodoulou (2006) extend Ball et al. (2000) and Raonic et al. (2004) by providing further evidence on earnings conservatism from the United States and from European Union (EU) countries. They find earnings have become more conservative in the EU as well as the United States. However, there is little evidence on differences in earnings conservatism between the two regions.

From the results, they argue that the changes in this property of earnings in both regions are attributable to a common factor that affects firms in both locations and is not limited to the economic convergence process that happened in EU countries.

Numerous studies have documented evidence that accounting standards have a significant impact on earnings conservatism. Accounting standards play a critical role in corporate governance by informing investors and by making contracts more verifiable (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). A study by Pope and Walker (1999), which assesses the differences between conservatism in the United States and the United Kingdom, finds differences in the timeliness of income recognition in the two regimes operating under separate sets of accounting standards. In the United Kingdom, the write-offs of large transitory losses through extraordinary items was tolerated before the introduction of FRS No. 3 in 1993; however, in the United States, those items would be classified as components of ordinary earnings. The results suggest that the incentives facing UK firms to classify bad news earnings components as extraordinary items were strong over the sample period. Barth, Landsman, and Lang (2008) examine whether the application of International Accounting Standards (IAS) in 21 countries is associated with higher accounting quality. They find that firms applying IAS have more timely loss recognition, less earnings management, and more value relevance of accounting information, than firms applying non-US domestic standards.

2.6 Firm-Specific Factors and Earnings Conservatism

Apart from cross-country studies on earnings conservatism, several studies provide explanations on variation in the level of earnings conservatism as results of firm-specific factors. These studies include, among others, factors relating to firm ownership, external auditors, and board of directors.

2.6.1 Firm Ownership

Empirical studies find that firm ownership has a significant effect on earnings conservatism. Ball and Shivakumar (2005), for instance, examine whether public or private firms in the UK have different levels of earnings conservatism. Both types of firms are subject to similar auditing regulation, but the results show that private firms report with less earnings conservatism. Specifically, the results show that the asymmetric timeliness of earnings is lower in private firms than in public firms. Ball and Shivakumar's (2005) study suggests that different market demand affects earnings conservatism even though both types of firms are subject to the same basic rules.

In the United States, Wang (2006) examines the relationship between founding family ownership and earnings quality on data from S&P 500 firms during the period 1994–2002. The findings show that, on average, founding family ownership has higher earnings quality, measured using various proxies including earnings conservatism. In terms of earnings conservatism, founding family firms have lower persistence of transitory loss components in earnings, implying higher earnings conservatism. In addition, founding family firms exhibit lower abnormal

accruals and greater earnings informativeness, implying an effect of family ownership on earnings quality.

Subsequently, Ahmed and Duellman (2007) examine whether outside directors' shareholdings have a significant influence on conservatism. Given that the presence of outside directors is crucial in promoting board independence, holding significant equity stakes would provide additional incentives for the outside directors to monitor (and if necessary confront) managers (Jensen, 1993). Using a sample from the S&P 500 over the fiscal years 1999–2001, Ahmed and Duellman (2007) find a positive relationship between outside directors' shareholdings and conservatism, thus supporting the prediction.

Recently, LaFond and Roychowdury (2008) examine the effect of managerial ownership on earnings conservatism. Given that earnings conservatism is a potential mechanism to address agency conflicts, LaFond and Roychowdury hypothesise that when managerial ownership declines, the severity of agency conflicts increases; and hence increase the demand for conservatism. Consistent with this prediction, the results show that, as managerial ownership declines, earnings become more conservative. This result shows that when managers have increased incentives to overstate gains and understate losses and are less exposed to the consequences of their actions, shareholders would demand more conservative reporting.

2.6.2 Auditors

Some studies argue that auditors could indirectly affect the quality of financial

statements through their influence on clients' accounting choices (Becker, Defond, Jiambolvo, & Subramanyam, 1998; DeFond & Subramanyam, 1998). Given that the courts are more likely to award damages for overstated earnings or assets (Kellogg, 1984), auditors generally have a preference for conservative reporting. Auditors would be expected to place pressure on the client to report earnings conservatively in order to reduce the litigation risk. The extent of auditors' influence over the clients' financial reporting could vary, depending on auditor attributes such as auditor size, audit tenure, industry specialisation, and the provision of non-audit services.

Basu et al. (2001) examine the effect of the size of the audit firm on earnings conservatism. Since Big Eight audit firms have greater exposure to legal liability (Thoman, 1996), Basu et al. (2001) predict that Big Eight auditors are more conservative than auditors who are not members of the Big Eight. The result from the Basu (1997) reverse regression model shows that the difference in the timeliness of earnings to good and bad news is greater for Big Eight audit clients, implying higher earnings conservatism. Further, earnings conservatism in Big Eight audit clients increases more than it does in non-Big Eight audit clients in a period of high liabilities, suggesting that Big Eight auditors are more sensitive to liabilities exposure. The result holds even after matching observations by year, industry and size.

Extending Basu et al. (2001), Chung, Firth, and Kim (2003) examine the role of auditors in influencing a more conservative accounting in their clients' financial reporting. They contend that the economic performance of the client and the size

of audit firms determine the insistence of auditors on conservatism and the ability auditors have to force their clients to comply with their requests. Consistent with the prediction, the results show that Big Six audit clients report more conservative earnings than do non-Big Six audit clients only when the clients' financial performance is worse than expected.

Krishnan (2005a) examines the role of auditor-industry specialisation on earnings conservatism. Previous studies argued that auditor-industry expertise is associated with higher audit quality (O'Keefe, King, & Gaver, 1994). It is argued that industry specialists gain experience and accumulate industry-based knowledge that are precursors to superior audit judgment quality (Bédard & Biggs., 1991; Bonner & Lewis, 1990). Consistent with the prediction, Krishnan finds clients of specialist auditors have higher earnings conservatism than clients of non-specialist auditors. This implies that auditors' industry expertise moderates the clients' tendency to delay the recognition of economic losses.

Johnson, Khurana, and Reynolds (2002) examine the effect of audit-firm tenure on earnings conservatism. Using two proxies for conservatism, they find a positive association between earnings conservatism and the length of the auditor-client relationship. Specifically, they find an increase in conservatism between short audit-firm tenure (one to three years) and medium audit-firm tenure (four to eight years). However, the study finds no evidence of reduced conservatism for longer audit-firm tenures of nine or more years. These results imply lower conservatism for short auditor tenure, and thus provide evidence that mandating auditor rotation may adversely affect the quality of financial reports.

One of the controversial aspects in auditing and financial reporting studies is related to non-audit services. The provision of non-audit services by incumbent auditors is alleged to impair auditor independence. To provide more insight on this issue, Ruddock, Taylor, and Taylor (2006) examine whether high levels of non-audit fees is associated with reduced earnings conservatism. Their findings show that higher-than-expected levels of non-audit services are not associated with reduced conservatism. This result is robust even after using various proxies for economic news and conducting comprehensive sensitivity tests.

Another issue that has attracted researcher attention is the indictment of Arthur Andersen, one of the biggest audit firms in the world. Krishnan (2005b) examines the timely reporting of bad news by Arthur Andersen's Houston-based clients. Using a control group consisting of Houston-based clients audited by other Big Six auditors, this study finds that Arthur Andersen clients are less timely in reporting bad news. This result suggests that the clients of Arthur Andersen's Houston office engaged in aggressive accounting practices i.e. delayed recognition of publicly available bad news.

Subsequently, Cahan and Zhang (2006) examine accounting conservatism of ex-Andersen clients following the demise of Arthur Andersen. The study posits that successor auditors demanded their ex-Andersen clients apply more conservative accounting so as to reduce litigation risk. The analysis shows ex-Andersen clients had larger decreases in abnormal accruals in the year 2002, after Arthur Andersen's demise. This result is consistent with auditor conservatism, in which the successor auditors perceive the Andersen audit as a unique source of litigation

risk. Krishnan (2007) reports a similar finding when examining the level of earnings conservatism of the former Andersen clients when they were forced to switch auditor in 2002. This study finds that, before the switch of auditor, earnings of former Andersen clients were less conservative relative to earnings of non-Andersen clients. However, after the switch of auditor, earnings conservatism increase for the former Andersen clients but not for the control sample clients. These findings suggest that auditors and managers employ earnings conservatism as a risk-management strategy in the post-Andersen era.

2.6.3 Board of Directors

The board of directors is the apex of the monitoring and control system of large firms (Fama & Jensen, 1983). Conservative accounting information assists the board of directors in reducing deadweight losses resulting from agency problems and alleviates agency conflicts between contracting parties (Watts, 2003a). Hence, many studies examine the link between characteristics of the board of directors' and earnings conservatism.

In the United States, Ahmed and Duellman (2007) investigate the relationship between accounting conservatism and characteristics of the board of directors, in particular, board independence and the strength of outside directors' monitoring incentives. The results from S&P 500 firms over the fiscal years 1999–2001 show a negative relationship between conservatism and the proportion of inside directors on the board. In addition, they find a positive relationship between outside directors' shareholdings and conservatism, showing that ownership of shares by outside directors enhances their monitoring incentives. These results

suggest that both factors, board independence and the strength of outside directors' monitoring incentives, facilitate greater monitoring of managers that leads to more conservative reporting.

Beekes et al. (2004) report a similar finding in a UK study. Using listed non-financial firms from 1993 to 1995, they examine the relationship between board composition (in terms of the proportion of outside directors) and earnings quality, measured using earnings timeliness and conservatism. The results show higher earnings conservatism in firms with a relatively high proportion of outside directors. This finding implies that board composition is a crucial factor in determining earnings quality in the United Kingdom.

In Spain, García Lara et al. (2007) investigate whether CEO influence over the board has a significant effect on earnings conservatism. As proxies for the influence of the CEO over the board of directors, this study employs two aggregate indexes incorporating six and eight variables relating to the board of directors and monitoring committees. The variables include board size, non-executive directors, independent directors, executive chairman, board meetings, audit committee, nomination/remuneration committee and an executive committee. The results show that firms with a low level of CEO influence over the board exhibit higher earnings conservatism than firms with higher CEO influence over the board. This implies the importance of board independence in promoting greater earnings conservatism.

Recently, García Lara et al. (2009) examine the relationship between corporate

governance and earnings conservatism in the US from 1992 to 2003. To capture the strength of corporate governance, this study employs a composite measure that includes various internal and external corporate governance components. The results show that firms with strong corporate governance exhibit higher earnings conservatism. Further tests on the endogenous nature of corporate governance find that the direction of causality flows from governance to conservatism, and not vice versa. This implies that governance and conservatism are not substitutes.

2.7 Chapter Summary

This chapter has reviewed the literature on earnings conservatism. This includes discussion of the concept of conservatism and explanations for accounting conservatism. This chapter also includes explanations of various earnings conservatism measures employed in previous studies and reviews the empirical evidence, especially the influence of institutional structures and firm-specific factors on earnings conservatism.

The next chapter provides an overview of the Malaysian institutional environment, including corporate governance, financial reporting, and ownership structure.

CHAPTER THREE

MALAYSIAN INSTITUTIONAL BACKGROUND: CORPORATE GOVERNANCE, FINANCIAL REPORTING, AND OWNERSHIP STRUCTURE

3.1 Introduction

This chapter examines the Malaysian institutional background with particular reference to corporate governance, financial reporting, and ownership structure. Section 3.2 discusses the institutional reforms implemented following the 1997 financial crisis. The reforms in financial reporting in Malaysia, especially following the introduction of the Financial Reporting Act (1997) are outlined in Section 3.3. Section 3.4 explains the ownership structure of Malaysian firms, with particular emphasis on family firms and state-controlled firms. Finally, Section 3.5 summarizes the chapter.

3.2 The 1997 Asian Economic Crisis and Reforms in Corporate Governance

3.2.1 Before the Crisis

Attention to corporate governance emerged in Malaysia with the introduction of the Companies Act 1965 and was subject to progressive development long before the 1997 economic crisis. The 1965 Act describes the roles and responsibilities of directors and managers to keep proper accounting records (Abdullah & Mohd Nasir, 2004). Subsequently, the Securities Industries Act (SIA) 1983 and the Securities Commission Act (SCA) 1993 provided a legislative and regulatory framework for the Malaysian capital market. These last two Acts prohibited

artificial trading and market rigging, thereby effectively regulating the operations of securities dealers (Liew, 2007).

The Securities Commission was established in March 1993 as a watchdog to improve the legal and regulatory framework governing the capital market. In the same year, the Bursa Malaysia Listing Requirements were revised to require all listed firms to set up audit committees of at least three people, comprising a majority of independent directors. This requirement was intended to improve the standards of corporate disclosure in Malaysia (Wan Hussin & Ibrahim, 2003).

To enhance the accountability of directors and to promote good corporate ethics, the Companies Commission of Malaysia, formerly known as the Registrar of Companies, introduced the Code of Ethics for Directors in 1996. In the same year, the Securities Commission moved from a merit-based system to disclosure-based regulation, which ensured high-quality financial reporting by promoting improved standards of disclosure, due diligence, corporate governance and accountability among the directors of public firms. Under the new system, the role of the Securities Commission shifted from evaluating the relative merits of the issuer and its securities to regulating the disclosure of quality information (Che Haat, 2006).⁴ The final implementation phase of disclosure-based regulation would require all listed firms, among other requirements, to: (1) publish financial

⁴ Disclosure-based regulation (DBR) was implemented in three phases: Phase 1 (1996–1999) focuses on a flexible/hybrid merit-based regime which emphasises disclosure, due diligence and corporate governance; Phase 2 (1999–2000) moves to partial DBR which emphasises disclosure, due diligence and corporate governance, and the promotion of accountability and self-regulation; and Phase 3 (2001 onwards), full DBR, was implemented emphasizing high standards of disclosure, due diligence and corporate governance as well as the promotion of self-regulation and responsible conduct.

statements on a quarterly basis within two months of each financial quarter (these statements included an income statement, a balance sheet, a cash flow statement and explanatory notes); (2) furnish annual audited accounts, and auditors' and directors' reports within four months from the end of the financial year; and (3) make immediate public disclosure of all material information of a financial and non-financial nature concerning its affairs (Nathan, Lin, & Fong, 2000).

3.2.2 The Crisis

The Asian economic crisis began in July 1997. The value of the Malaysian currency, Ringgit Malaysia (MYR), dropped from MYR 2.50 per US\$ to, at one point, MYR 4.80 per US\$. The Bursa Malaysia composite index fell from approximately 1300 to nearly 400 points in a few short weeks. Interest rates increased to more than 12% during the crisis. These problems started with the speculative short-selling of Malaysian currency, which was followed by high capital outflows from the country (Abdul Rahman, 2006). In December 1997, to control these problems, the Malaysian government imposed capital controls including pegging the Malaysian Ringgit at 3.80 to the US dollar. Other measures included restricting the trading of Malaysian stocks outside Malaysia, introducing a punitive tax for holding Malaysian stocks for less than one year and making unofficial trading of the ringgit illegal (Poon, 2000).

The origins of the economic crisis are a matter of debate. Prime Minister Dr Mahathir accused currency speculator, George Soros, of causing the problem. Many economists, however, would argue the will of the country to overcome the crisis had been weakened by endemic structural and policy weaknesses (Fischer,

1998; Kawai, Newfarmer, & Schmukler, 2001; Miller & Luangaram, 1998; UNCSO, 2002; Zhuang, 1999). Among the alleged weaknesses were inappropriate exchange rate policies, poor corporate governance and transparency, inadequate prudential banking supervision, excessive short-term unhedged corporate foreign debt, and corporate moral hazard problems due to implicit government guarantees for risky debt-financed investments (Morris, Pham, & Gray, 2011).

The financial crisis also caused a massive loss of foreign investors' confidence in the Malaysian capital market (Abdul Rahman & Haniffa, 2005), and this was exacerbated by poor corporate governance. Rajan and Zingales (1998) argue that investors ignored weaknesses in East Asian firms when the economy was doing well, but quickly pulled out once the crisis began because they believed the region lacked adequate institutional protection for their investments. Further, expropriation of minority shareholders became worse during that period. In addition, Johnson, Boone, Breach, and Friedman (2000) argue that in countries with weak corporate governance, the financial crisis resulted in more expropriation of wealth by managers and thus caused a larger fall in asset prices.

United Engineers Malaysia (UEM), a blue chip firm in Malaysia, provides an example of the expropriation of minority shareholders interests during the financial crisis. In November 1997, UEM acquired 32.6% of Renong, its financially troubled parent. The minority shareholders were horrified and saw this transaction as a bailout of Renong at an inflated price. UEM's stock price fell 38.24% on the day the transaction was announced (Foon, 1997, November 19, p.

62). The controversy surrounding this transaction, which was undertaken without proper disclosure and prior shareholder approval, led to a significant loss in investors' confidence in the Malaysian stock market (Abdul Rahman, 2006).

The impact of the financial crisis, in particular reduced investor confidence in the Malaysian capital market, provided a strong impetus for regulators to introduce reforms to enhance the protection of investors. The reforms targeted two main areas: corporate governance and financial reporting. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000; 1998) contend that corporate governance is an important factor in financial market development and firm value. Johnson et al. (2000), for instance, show that country-specific measures of corporate governance explain the extent of currency depreciation and stock market decline in emerging markets during the crisis better than standard macroeconomic variables. In response to the demand for a stronger capital market, regulators adopted various strategies. These are discussed in the remainder of this section. Matters relating to financial reporting reforms are discussed separately in Section 3.3.

Corporate governance reforms, among others, are crucial to: (1) strengthening the protection of minority shareholders' rights; (2) enhancing the transparency and accountability of directors; (3) strengthening regulatory enforcement; and (4) promoting training and education at all levels in corporations (Finance Committee on Corporate Governance, 1999).

The reforms started with the establishment of the High Level Finance Committee on Corporate Governance by the Ministry of Finance in March 1998, followed by

a series of regulatory changes through the Securities Commission, Bursa Malaysia, and the Companies Commission of Malaysia. This included the establishment of the Malaysian Institute of Corporate Governance, and the Minority Shareholder Watchdog Committee. Table 3.1 summarises the corporate governance and financial reporting initiatives and reforms made by Malaysian authorities after the economic crisis.

Table 3.1
Corporate governance initiatives and reforms (1997–2002)

Year	Initiatives and Reforms
1997	An independent accounting standard-setting board was introduced.
1998	The formation of the High Level Finance Committee to conduct a detailed study on corporate governance and to make recommendations for improvements.
1998	Amendments were made to the Securities Industry Central Depository Act (SICDA) with a view to enhancing transparency in share ownership amidst other improvements.
1998	The Malaysian Institute of Corporate Governance was established.
1998	Regulations for directors and CEOs to disclose interest in the publicly listed companies (PLC) were introduced.
1999	Quarterly reporting was introduced.
1999	A revamp of the takeovers and mergers code was done.
2000	The Malaysian Code on Corporate Governance was introduced.
2000	Amendments were made to the Securities Commission Act 1993 by making the Securities Commission the sole regulator for fund-raising activities and the corporate bond market.
2001	The Audit Committee must have a member who is financially trained.
2001	The Malaysian Capital Market master plan was launched to further streamline and regulate the capital market and to chart the course for the capital market for the next ten years.
2001	The Financial Sector master plan was launched to chart the future direction of the financial system over the next ten years. It outlined strategies to achieve a diversified, effective, efficient and resilient financial system.
2001	The mandatory disclosure of corporate governance code compliance was introduced.
2001	A minority shareholders watchdog group was established.
2001	A mandatory accreditation programme for directors was introduced.
2002	Internal audit guidelines for PLCs were introduced.

Source: Mahmood, (2003); Securities Commission of Malaysia (www.sc.com.my/index.asp; accessed on 02.01.09); Malaysian Institute of Corporate Governance (www.micg.net/home.htm; accessed on 02.01.09)

The High Level Finance Committee on Corporate Governance, comprising government and industry representatives, carried out detailed investigations to identify and address weaknesses relating to the 1997 financial crisis. Bursa Malaysia and PriceWaterhouseCoopers (PWC), on the other hand, conducted a

survey on corporate governance of public listed firms and then made recommendations for corporate governance best practices for Malaysia (Ow-Yong & Kooi Guan, 2000). The result was the Report on Corporate Governance, 1999, which highlighted the importance of boards of directors as corporate governance mechanisms to protect and enhance shareholder wealth. The report aimed to improve corporate disclosure, promote good corporate governance practice in Malaysia, and to re-establish investor confidence in the Malaysian capital market (Finance Committee on Corporate Governance, 1999).

Following the recommendations proposed by the Finance Committee on Corporate Governance (FCCG), the High Level Finance Committee on Corporate Governance introduced the Malaysian Code on Corporate Governance (MCCG) in March 2000. This code which was heavily influenced by the Cadbury Report and the Hampel Report in the United Kingdom (Finance Committee on Corporate Governance, 2000), empowered investors by providing them with information on listed firms' corporate governance practices. In addition to the audit committee, which had been mandatory since 1993, the MCCG recommended the board of directors appoint remuneration and nomination committees. Other committees, such as a risk management committee and corporate governance committee were also recommended (Finance Committee on Corporate Governance, 2000). The MCCG also recommended separation of roles between chief executive officer and chairman of the board of directors, though this was not required by the Listing Requirements of Bursa Malaysia.

Another important aspect of corporate governance is the firm's internal control

system. The MCCG stressed that the board of directors should maintain a sound system of internal control. The Guide for Statement of Internal Control, 2000, noted various key areas that directors must pay attention to before they include the Statement of Internal Control in the annual reports. In reporting the corporate governance principles and best practices in annual corporate reports, all listed firms are required to provide information pertaining to internal control such as identifying principal risks and ensuring implementation of appropriate systems to manage risks.

In January 2001, the MCCG came into full effect when an amendment was made to the Listing Requirements of the Bursa Malaysia. It is important to note that the MCCG is not mandatory for all listed firms, but the revision of the listing requirements creates strong demand for higher standards of conduct and a higher quality of financial reporting by public listed firms. The revision, for example, requires all public listed firms to include in their annual report a statement of corporate governance, a statement of internal control, the composition of the board of directors, the composition of and quorum for the audit committee (Kuala Lumpur Stock Exchange, 2001). Under the revamped listing requirements, all listed firms must include in their annual reports a narrative of the application of the principles and best practices set out in the MCCG. Reasons for areas of non-compliance and alternative practices that were adopted must be justified and disclosed. In addition, directors of publicly listed firms are required to attend a directors' training program, known as the mandatory accreditation programme, which includes topics such as the Companies Act 1965, the Listing Requirements of Bursa Malaysia, risk management and internal control, and relevant securities

laws.

In March 1998, the Malaysian Institute of Corporate Governance (MICG) was established by the High Level Finance Committee on Corporate Governance, with the objective, amongst others, of facilitating the development of corporate governance and strengthening corporate governance principles and compliance efforts. The MICG is a non-profit public firm limited by guarantee, with founding members from various bodies, including the Federation of Public Listed Companies (FPLC), the Malaysian Institute of Accountants (MIA), the Malaysian Association of Certified Public Accountants (MICPA), the Malaysian Institute of Chartered Secretaries and Administrators (MAICSA), and the Malaysian Institute of Directors (MID). The MICG seeks to provide an independent platform for various stakeholders to interact and debate corporate governance issues, in which it promotes continuous improvement in corporate governance best practices.

Following a recommendation in the Report on Corporate Governance, the Minority Shareholder Watchdog Group (MSWG) was established in August 2000. The MSWG is a special governing body set up as a ‘check and balance’ mechanism to protect the interests of minority shareholders from being abused by the majority shareholders. The establishment of the MSWG is one strategy to enhance corporate governance and encourage independent and proactive shareholder participation in the listed firms. The MSWG comprises representatives from the five largest institutional funds in the country, including the Employee Provident Fund (EPF), Permodalan Nasional Berhad (PNB), Social Security Organization (SOCSO), Lembaga Tabung Haji (LTH), and Lembaga

Tabung Angkatan Tentera (LTAT) (Abdul Wahab, How, & Verhoeven, 2007).

In February 2001, the Securities Commission launched the Capital Market Master Plan (CMP) in response to the recommendations contained in the Report on Corporate Governance. The CMP contains 152 recommendations, of which 10 deal with development of the institutional and regulatory framework for the capital market from 2001 to 2010. The focus is mainly on corporate governance issues. Later, in August 2003, the Corporate Law Reform Committee was established to spearhead the corporate law reform programme. This was perceived as another milestone for corporate governance reforms in Malaysia.

Legal provision for whistle blowers was another aspect highlighted in the Report on Corporate Governance prepared by the Finance Committee. To address this matter, the Securities Industry Act 1983 (SIA) was amended by Parliament in September 2003 with effect from 5 January 2004. The SIA introduces provisions governing whistle blowers and enhances enforcement/investor redress mechanisms for breaches of securities laws. This amendment is crucial because it ensures that auditors can disclose information that is material to the regulators, and also deals with internal whistle blowers, usually the key officers dealing with the financial statements of the company.

The efforts to improve corporate governance and protect investors and shareholders continued even after the issuance of the MCCG. Various initiatives to strengthen the existing mechanism were undertaken, including the issuance of the guideline Best Practice in Corporate Disclosure by Bursa Malaysia in August

2004. The objective of the guideline is to ensure compliance of public listed firms with disclosure obligations under the Listing Requirements and securities law. More importantly, the Best Practice guide is intended to inspire trust and confidence between investors and public listed firms by ensuring firms provide equal access to information in a timely, accurate, and complete manner.

In October 2007, the MCCG was revised to strengthen the roles and responsibilities of boards of directors and audit committees. The revision provides guidelines for the appointment of directors, the role of nominating committees, the eligibility criteria for appointment as an audit committee member, the audit committee composition, the frequency of meetings and the need for continuous training. The 2007 Revised MCCG Code requires the audit committee to consist of at least three members (all of whom must be non-executive directors), and a majority of whom must be independent directors. Further, it is recommended that all audit committee members should be financially literate, with at least one member being a member of an accounting association or body. The Revised Code also enhances the role of the nomination committee by requesting that when candidates are recommended for directorships they should have the necessary skills, knowledge, expertise, experience, professionalism, and integrity to strengthen the board and to ensure the board discharges its roles and responsibilities effectively. The Revised Code also provides greater clarity to the board's roles in regard to compensation, monitoring, and replacement of management, and planning the succession of senior management.

3.3 Financial Reporting Reforms and Adoption of IFRS

The introduction of the Financial Reporting Act 1997 (Act 558) (FRA 1997) was the most important development in financial reporting in Malaysia. The Act, which was gazetted on 6 March 1997, introduced and set out the first formal accounting framework for Malaysia in response to the rapid economic development and globalization of the commercial market that demanded a higher quality of financial reporting and accounting practices (Fadzly & Ahmad, 2004). Two bodies, the Malaysian Accounting Standards Board (MASB) and the Financial Reporting Foundation (FRF), were established under FRA 1997.⁵ MASB issued accounting standards for both public and private firms. This made Malaysia the first country in the Southeast Asia region to give legal status to accounting standards. At the same time, the FRA 1997 ended the long conflict between the Malaysia Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants (MICPA) on standards setting.

The development of accounting standards in Malaysia began in the early 1970s. At the time, MICPA played the main role despite the existence of MIA which governed the accounting profession in the country. Standard setting in Malaysia began when the MICPA President received a letter from the governor of the Malaysian Central Bank⁶ highlighting the need for professional standards to guide financial reporting in Malaysia (Selvaraj, 1999). The letter also requested the

⁵ FRF is a trustee body which is responsible for overseeing the MASB's performance, financial and funding arrangements. It acts as a sounding board for the MASB, insofar as the FRF is the first to review MASB's technical pronouncements before it goes out to the public.

⁶ Also known as Bank Negara Malaysia

MICPA to provide a statement of generally accepted accounting principles for its members (Selvaraj, 1999). In response to the letter, the MICPA set up a Technical Committee to review matters raised by the Central Bank. After 1976, the committee started to assess the International Accounting Standards (IAS) for local adoption and to conduct studies on accounting standards relating to industries of particular importance to the Malaysian economy (Selvaraj, 1999). Eventually, Malaysia selectively adopted the International Accounting Standards (IAS) in 1978.

From 1987 until 1992, both professional bodies, the MIA and the MICPA, had jointly developed accounting standards, especially on local issues. Examples of accounting standards developed from this collaboration are MAS 1 on Earnings Per Share, MAS 2 on Mergers and Acquisitions, and MAS 5 on Accounting for Aquaculture. However, the professional bodies failed to reach agreement on MAS 6 on Goodwill, which then led to conflict and the dissolution of their collaboration. In this conflict, the MIA issued an exposure draft for MAS 6⁷, which was based on the controversial UK ED 47. The MICPA, however, decided that adoption of MAS 6 should be deferred until the controversy surrounding the UK's ED 47 was determined or until the International Accounting Standards Committee (IASC) issued a revised standard on goodwill. According to Selvaraj (1999), the disagreement over MAS 6 triggered the dissolution of the Common Working Technical Committee and ended the MIA-MICPA collaboration. The two professional bodies then continues to develop separate accounting standards

⁷ MAS requires goodwill to be amortised over 25 years

(Selvaraj, 1999). This created confusion among accounting practitioners and distorted the development of accounting standards in Malaysia.

By 1997, in addition to eight customised Malaysian Accounting Standards (MAS), twenty-four International Accounting Standards (IAS) had been adopted in Malaysia. The IAS had become the model for Malaysian accounting standards, for several reasons. First, the early accounting professionals in Malaysia were trained overseas, particularly in the United Kingdom and Australia, thus, they gained a certain respect for the international accounting system. Second, the cost of adopting an existing set of accounting standards was lower than developing the standards from scratch. Adoption of international accounting standards requires less time and effort, and allows the local accounting profession to have a structured and strong set of accounting standards. Third, adoption of the IAS is also a strategy to gain international recognition. It would also ensure that financial statements produced by Malaysian companies were comparable and reliable.

Even though the MIA and the MICPA both adopted IAS standards and issued local accounting standards, there was no regulatory body nor any statutory requirement to enforce compliance with accounting standards in Malaysia prior to the introduction of FRA 1997 (Saleh, Iskandar, & Rahmat, 2005). As a result, there were varying degrees of compliance with accounting standards among the Malaysian public listed firms. This scenario suggests a weak financial reporting environment in Malaysia compared to that in the United Kingdom and the United States. The empirical evidence from Ball et al. (2003) supports this notion. Ball et al. (2003) find low earnings quality in Malaysian financial reporting during the

period 1984 to 1996, which was attributed to the weak institutional foundation and legal environment.

From 1997, the standards-setting roles no longer rested with the professional bodies. Under FRA 1997, the Malaysian Accounting Standards Board (MASB), together with the Financial Reporting Foundation (FRF), became the only standard-setting bodies. Standard-setting became more independent and more representative. It had representatives from all relevant parties including preparers, users, regulators, and the accounting profession. Section 7 of the FRA 1997, states the functions of the MASB as follows:

...(a) to issue new accounting standards as approved accounting standards; (b) to review, revise or adopt existing accounting standards as approved accounting standards; (ba) to amend, substitute for, suspend, defer, withdraw or revoke any approved accounting standards in whole or in part; (c) to issue statements of principles for financial reporting; (d) to sponsor or undertake development of possible accounting standards; (e) to conduct such public consultation as may be necessary in order to determine the contents of accounting concepts, principles and standards; (f) to develop a conceptual framework for the purpose of evaluating proposed accounting standards; (g) to make such changes to the form and content of proposed accounting standards as it considers necessary; and (h) to perform such other function as the Minister may prescribe by order published in the Gazette. (p. 9–10)

With the power provided under the Act, the MASB has reviewed, revised and adopted existing accounting standards and issued new standards as approved accounting standards, known collectively as MASB standards. By the end of 2003, the Board had 32 approved accounting standards for publicly listed companies in Malaysia, including 28 standards adopted from the International Accounting Standards and 4 locally developed standards, as shown in Table 3.2.

Table 3.2
List of MASB Standards as at 31 December 2003

Panel A: MASB's standards adopted from the International Accounting Standards

MASB	Title (<i>as in MASB standards</i>)	IAS	Effective Date
MASB 1	Presentation of Financial Statements	IAS 1	1 July 1999
MASB 2	Inventories	IAS 2	1 July 1999
MASB 3	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies	IAS 8	1 July 1999
MASB 4	Research and Development Costs	IAS 9	1 July 1999
MASB 5	Cash Flow Statement	IAS 7	1 July 1999
MASB 6	Effects of Changes on Foreign Exchange Rates	IAS 21	1 July 1999
MASB 7	Construction Contracts	IAS 11	1 July 1999
MASB 8	Related Parties	IAS 24	1 January 2000
MASB 9	Revenue	IAS 18	1 January 2000
MASB 10	Leases	IAS 17	1 January 2000
MASB 11	Consolidated Financial Statements and Investments in Subsidiaries	IAS 27	1 January 2000
MASB 12	Investment in Associates	IAS 28	1 January 2000
MASB 13	Earnings per Share	IAS 33	1 January 2000
MASB 14	Depreciation Accounting	IAS 4	1 July 2000
MASB 15	Plant, Property and Equipment	IAS 16	1 July 2000
MASB 16	Financial Reporting of Interest in Joint Ventures	IAS 31	1 July 2000
MASB 19	Events After the Balance Sheet Date	IAS 10	1 July 2001
MASB 20	Provisions, Contingent Liabilities and Contingent Assets	IAS 37	1 July 2001
MASB 21	Business Combinations	IAS 22	1 July 2001
MASB 22	Segment Reporting	IAS 14	1 January 2002
MASB 23	Impairment of Assets	IAS 36	1 January 2002
MASB 24	Financial Instruments: Disclosure and Presentations	IAS 32	1 January 2002
MASB 25	Income Taxes	IAS 12	1 July 2002
MASB 26	Interim Financial Reporting	IAS 34	1 July 2002
MASB 27	Borrowing Costs	IAS 23	1 July 2002
MASB 28	Discontinuing Operations	IAS 35	1 January 2003
MASB 29	Employee Benefits	IAS 19	1 July 2003
MASB 30	Accounting and Reporting by Retirement Benefits Plans	IAS 26	1 July 2003

Panel B: MASB's locally developed accounting standards

Previously known as	MASB	Title (<i>as in MASB standards</i>)	Effective Date
MAS 3	MASB 17	General Insurance Business	1 July 2000
MAS 4	MASB 18	Life Insurance Business	1 July 2000
MAS 5	MAS 5	Accounting for Aquaculture	1 September 1998
	MASBi-1	Presentation of Financial Statements of Islamic Financial Reporting	1 January 2003

Source: Malaysian Accounting Standards Board

In 1998, a year after the Financial Reporting Act was enacted by the Parliament, the Companies Act 1965 was also amended to include a new provision⁸, which requires companies to comply with the ‘approved accounting standards’ as defined in Section 2 of FRA 1997. This amendment creates legally binding accounting standards, and thus requires compliance with the accounting standards issued by the MASB. To enforce the compliance of MASB standards, a number of regulatory bodies, including the Securities Commission, Bursa Malaysia (formerly known as the Kuala Lumpur Stock Exchange), the Central Bank of Malaysia, and the Companies Commission of Malaysia, are responsible within their respective jurisdictions for ensuring compliance. In the event of non-compliance, the regulators have the power to direct the company to take the necessary rectifying actions, or make necessary announcements with respect to the non-compliance or required corrections. They also have powers to impose penalties for such offences committed by public listed firms.

The Securities Commission (SC) enforces several aspects of compliance with the accounting standards for publicly listed companies through the issuance of its rules and policies. For example, the SC requires all listed firms to meet the terms in its Corporate Disclosure Policy, which demands firms maintain a high level of disclosure. The SC also issued Post Listing Obligations, requiring all submitted annual and interim corporate reports to be prepared in accordance with approved accounting standards. In addition, the SC frequently discusses and reviews issues relating to the minimum compliance with accounting standards and other statutory

⁸ Section 166A of Companies Act 1965 [Act 125]

requirements for publicly listed firms in Malaysia. The SC also requires companies that seek to issue or offer securities to the public to submit the proposed issuance to the SC for approval. Companies that fail to submit the proposal, or that submit false and misleading information to the SC, may incur a fine of RM3 million or, in the case of directors of such companies, 10 years imprisonment.

Bursa Malaysia also enforces the application of approved accounting standards among Malaysian listed firms. For listed firms, compliance with the accounting standards is made mandatory through the Bursa Malaysia listing requirements. The listing requirements require submission of corporate annual reports and the preparation of financial statements must be in accordance with approved accounting standards. Firms that fail to meet this requirement may, among other things, receive letters of caution, receive reprimands, be fined an amount not exceeding RM1 million, be given directions for rectification, face the non-acceptance of applications or submissions, have conditions imposed for approval of submissions, face suspension of trading, and may be delisted by Bursa Malaysia. In the case of a breach of the listing requirements, Bursa Malaysia may also on application to the High Court, seek an order requiring a particular director to be removed from the firm's board and barred from holding directorship in any other listed firm.

The Companies Commission of Malaysia (CCM) is a government agency that is responsible for regulating matters relating to the incorporation of companies and business registration. In addition, CCM promotes good ethical conduct amongst

directors and managers. In terms of financial reporting, CCM is concerned with compliance with accounting standards in the financial statements of private companies. Yet, another agency, the Central Bank of Malaysia, deals with matters relating to banks and financial institutions. Besides ensuring that financial statements of banks and financial institutions comply with approved accounting standards, the Central Bank also provides specimen financial statements and guidelines on financial reporting for banks and financial institutions that deal specifically with non-performing loans and interest.

A further development in financial reporting occurred in 2005. In that year, all listed firms in the European Union started to prepare financial statements using the International Financial Reporting Standards (IFRS). Other countries around the world quickly followed suit. Malaysia adopted IFRS from 1 January 2006. In October 2005 the MASB published a notice of issuance of 18 of the 21 new/revised MASB-approved accounting standards for application in relation to financial statements, including 11 Issues Committee Interpretations. These pronouncements were to be effective for financial periods beginning on or after 1 January 2006. In 2005, MASB standards were renamed to Financial Reporting Standards (FRS), in line with International Financial Reporting Standards (IFRS). In addition, MASB also changed the numbering of the standards to correspond to those of the relevant international standards. This move eliminated an anomaly whereby the numbering of MASB standards differed from their respective international standards. Table 3.3 shows the changes made to MASB standards in the process of IFRS adoption.

Table 3.3
Change of name of MASB standards on January 1, 2005

Standard	New name	Title	Effective Date
MASB 1	FRS 101 ₂₀₀₄	Presentation of Financial Statements	1 July 1999
MASB 2	FRS 102 ₂₀₀₄	Inventories	1 July 1999
MASB 3	FRS 108 ₂₀₀₄	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies	1 July 1999
MASB 4	FRS 109 ₂₀₀₄	Research and Development Costs	1 July 1999
MASB 5	FRS 107 ₂₀₀₄	Cash Flow Statements	1 July 1999
MASB 6	FRS 121 ₂₀₀₄	The Effects of Changes in Foreign Exchange Rates	1 July 1999
MASB 7	FRS 111 ₂₀₀₄	Construction Contracts	1 July 1999
MASB 8	FRS 124 ₂₀₀₄	Related Party Disclosures	1 January 2000
MASB 9	FRS 118 ₂₀₀₄	Revenue	1 January 2000
MASB 10	FRS 117 ₂₀₀₄	Leases	1 January 2000
MASB 11	FRS 127 ₂₀₀₄	Consolidated Financial Statements and Investments in Subsidiaries	1 January 2000
MASB 12	FRS 128 ₂₀₀₄	Investments in Associates	1 January 2000
MASB 13	FRS 133 ₂₀₀₄	Earnings Per Share	1 January 2000
MASB 14	FRS 104 ₂₀₀₄	Depreciation Accounting	1 July 1999
MASB 15	FRS 116 ₂₀₀₄	Property, Plant and Equipment	1 July 2000
MASB 16	FRS 131 ₂₀₀₄	Financial Reporting of Interest on Joint Ventures	1 July 2000
MASB 17	FRS 202 ₂₀₀₄	General Insurance Business	1 July 2001
MASB 18	FRS 230 ₂₀₀₄	Life Insurance Business	1 July 2001
MASB 19	FRS 110 ₂₀₀₄	Events After the Balance Sheet Date	1 July 2001
MASB 20	FRS 137 ₂₀₀₄	Provision, Contingent Liabilities and Contingent Assets	1 July 2001
MASB 21	FRS 122 ₂₀₀₄	Business Combinations	1 July 2001
MASB 22	FRS 114 ₂₀₀₄	Segment Reporting	1 January 2002
MASB 23	FRS 136 ₂₀₀₄	Impairment of Assets	1 January 2002
MASB 24	FRS 132 ₂₀₀₄	Financial Instruments: Disclosure and Presentations	1 January 2002
MASB 25	FRS 112 ₂₀₀₄	Income Taxes	1 July 2002
MASB 26	FRS 134 ₂₀₀₄	Interim Financial Reporting	1 July 2002
MASB 27	FRS 123 ₂₀₀₄	Borrowing Costs	1 July 2002
MASB 28	FRS 135 ₂₀₀₄	Discontinuing Operations	1 January 2003
MASB 29	FRS 119 ₂₀₀₄	Employee Benefits	1 January 2003
MASB 30	FRS 126 ₂₀₀₄	Accounting and Reporting by Retirement Benefit Plans	1 January 2003
MASB 31	FRS 120 ₂₀₀₄	Accounting for Government Grants and Disclosures of Government Assistance	1 January 2004
MASB <i>i-1</i>	FRS <i>i-1</i> ₂₀₀₄	Presentation of Financial Statements of Islamic Financial Institutions	1 January 2003

Source: Malaysian Accounting Standards Board

It is important to note that the change of name from MASB standards to FRS in 2005 did not actually change the content of the standard. The real adoption of IFRS was made effective starting from January 1, 2006. There are a number of significant changes to the country's accounting standards as a result of the

adoption of IFRS, as summarised in Appendix 2. Although standards are named as FRS, as at January 2006 Malaysian FRS are almost word-for-word identical to the corresponding IFRS issued by the IASB, except for some standards that have not yet as at 31 December 2008 been made effective, namely IFRS 7 Financial Instruments: Disclosures and IFRS 8 Operating Segments.

The Financial Reporting Standards (FRS) also include one Islamic accounting standard and four local standards, which deal with matters that are not covered under IFRS or IAS.⁹ These standards have been developed particularly to cater for the Malaysian environment. The local standards are FRS 201₂₀₀₄ Property Development Activities, FRS 202₂₀₀₄ General Insurance Business, FRS 203₂₀₀₄ Life Insurance Business, FRS 204₂₀₀₄ Accounting for Aquaculture. According to the Financial Reporting Act 1997, compliance with these FRS is mandatory. As stated in Section 26D of the Act:

Where financial statements are required to be prepared or lodged under any law administered by the Securities Commission, the Central Bank or the Registrar of Companies, such financial statements shall be deemed not to have complied with the requirements of such law unless they have prepared and are kept in accordance with the approved accounting standards. (p. 18)

Malaysian Accounting Standards Board (MASB) adopted IFRS and made the standards effective from 1 January 2006. Therefore, the earliest financial statements reported by Malaysian companies under the mandated IFRS are dated 31 December 2006. Taking into account the adoption of IFRS, the MASB has

⁹ FRS i-1₂₀₀₄ Presentation of Financial Statements of Islamic Financial Institutions.

currently produced a total of 208 technical pronouncements, comprising 85 Standards (including interpretations), 2 Forewords, 1 Framework, 2 SOPs, 5 Technical Releases, 19 Translations and 94 Exposure Drafts for both private and non-private entities. Appendix 2 summarises the principal differences between IFRS and MASB that have had a significant impact on financial reports after the adoption of IFRS¹⁰.

Table 3.4
IFRS adoption in Malaysia as at 31 December 2008

Standard	Title	Effective Date	Status
IFRS 1	First-time Adoption of FRS Reporting Standards	1 January 2006	Enacted
IFRS 2	Share-based Payment	1 January 2006	Enacted
IFRS 3	Business Combinations	1 January 2006	Enacted
IFRS 4	Insurance Contracts	-	Exposure Draft issued
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	1 January 2006	Enacted
IFRS 6	Exploration for and Evaluation of Mineral Resources	1 January 2007	Enacted
IFRS 7	Financial Instruments: Disclosures	-	Exposure Draft issued
IFRS 8	Operating Segments	-	Exposure Draft issued

Note: The numbering of the FRSs corresponds to the IFRSs issued by the IASB. For example, FRS 1 in Malaysia is equivalent to IFRS 1. FRS with a '100 prefix' corresponds to its equivalent IASs. Thus FRS 101 is equivalent to IAS 1. FRS with a '200 prefix' denotes locally developed Standard with no equivalent International Standard.

As reported in Table 3.4, FRS 4, FRS 7 and FRS 8 have still not been adopted by the MASB. The full merging with the International Financial Reporting Standards is scheduled for 1 January 2012.

In short, the financial reporting framework in Malaysia has experienced

¹⁰ The purpose of the table is to highlight the main changes in accounting standards after the adoption of IFRS. It is highly summarized and does not provide complete requirements of the standards.

significant changes since 1997. The introduction of FRA 1997 led to the establishment of the MASB, which resolved long-standing conflicts between the MIA and MICPA. Since its establishment, the MASB has played a vital role in setting accounting standards, including adoption of IAS standards and the introduction of local standards. Another very important event in the development of financial reporting in Malaysia is the adoption of IFRS starting from 1 January 2006.

3.4 Ownership Structure of Malaysian Firms

Dispersed ownership is common in most developed countries, such as the United States and the United Kingdom, but in Malaysia firms are insider-dominated with highly-concentrated shareholdings. World Bank (1999), based on a study conducted in 1998 of Malaysian firms, shows that the five largest shareholders of the firms in the sample owned 60.4% of the outstanding shares and more than half of the voting shares. Some 67.2% of shares were in family hands, 37.4% had only one dominant shareholder and 13.4% were state-controlled. A similar finding was reported by Capulong, Edwards, Webb, and Zhuang (2001), where the largest shareholder still possessed an average 30.3% of outstanding shares among all listed firms in Malaysia in 1998, with the top five shareholders owning an average 58.8%.

The highly-concentrated shareholdings have evolved historically from family-owned enterprises and foreign firms, mainly from the United Kingdom and other European countries, as a result of British colonisation (Abdul Rahman, 2006). Despite the rapid growth of Malaysia's economy, the concentrated structure has

not been diluted (Tam & Tan, 2007). The introduction of the ‘Look East’ policy in the 1980s attracted many investments from Japanese corporations via joint-ventures with local partners, and also resulted in concentrated ownership. Furthermore, the initial public offerings by family-controlled companies and the privatisation of key state enterprises also led to highly-concentrated shareholdings.

In addition, the pyramidal ownership structure is a common feature of firms in Malaysia and other East Asia countries (Claessens, Djankov, & Lang, 2000). Several factors have led to use of this structure, including: (i) to minimise the controlling stakeholder stake, (ii) to maximise the dilution of outside shareholdings by a reduction in the ratio of voting rights to cash flow rights (Burkart, Gromb, & Panunzi, 1997); and (iii) to use as a means of limiting the liability of the controlling shareholder (Akoi, 1999).

Figure 3.1 illustrates an example of pyramidal structure in a Malaysian firm. Johor Corporation, a wholly owned subsidiary of the State Government of Johor, owns 53.22% of Kulim Berhad, who owned 59.58% of shares in QSR Berhad. QSR Berhad controls of KFC Holdings Berhad, through a 50.25% shareholding. As such, Johor Corporation has established control over KFC Berhad, through their control of Kulim Berhad and QSR Berhad, even with only 15.93% of cash flow rights. The reduction in the ratio of voting rights to cash flow rights in a pyramidal structure allows the holding firm, i.e. family firms and state-controlled firms, to establish control with minimal capital investment by maximizing the dilution of outside shareholdings.

Figure 3.1
Pyramidal structure of a Malaysian firm (Johor Corporation)

Source: Annual reports of relevant firms

To provide greater understanding of the ownership structure of Malaysian listed firms, the following subsections outline the characteristics of family firms and state-controlled firms.

3.4.1 Family Firms

The dominance of family firms in the Malaysian economy, especially those owned by Chinese families, started well before the independence of Malaysia. A survey by the World Bank (1999) found that 85% of the firms surveyed had owner-managers and that the post of CEO, chairman of the board or vice

chairman belonged to a member or nominee of the controlling family. Another study by Claessens et al. (2000) found that around 40% of 238 sample firms in Malaysia were closely held by a single large shareholder, i.e. a family. Further, a joint survey by Shamsir Jasani Grant Thornton and Malaysia Institute of Management (2002) indicated that most of the businesses in Malaysia were managed by their founder (59%), while 30% were managed by the second generation, the majority of whom were the children of the founder.

Table 3.5
Ownership of YTL Corporation and its holding company

Panel A: List of Five Largest Shareholders in YTL Corporation Berhad		
Name of shareholders	Shareholdings	%
Yeoh Tiong Lay & Sons Holdings Sdn Bhd	790,362,611	52.83
Employees Provident Fund Board	181,914,264	12.16
Skim Amanah Saham Bumiputera	43,420,000	2.90
Fidelity Contrafund	20,877,500	1.40
Amanah Saham Wawasan 2020	17,018,600	1.14
Total	1,053,592,975	70.43

Panel B: List of Substantial Shareholders of Yeoh Tiong Lay & Sons Holdings Sdn Bhd		
Name of shareholders	Shareholdings	%
Yeoh Tiong Lay (Founder of YTL Group)	8,220,004	20.18
Francis Yeoh Sock Ping (son–CEO of YTL Group)	5,000,000	12.28
Yeoh Seok Kian	5,000,000	12.28
Yeoh Soo Min	1,250,000	3.07
Yeoh Seok Hong	5,000,000	12.28
Michael Yeoh Sock Siong	5,000,000	12.28
Yeoh Soo Keng	1,250,000	3.07
Mark Yeoh Seok Kah	5,000,000	12.28
Total	35,720,004	87.72

Source: Annual report (2008) of YTL Corporation Berhad

The Yeoh family, the owner of one of the biggest conglomerates in Malaysia, is a

prime example of this.¹¹ Yeoh Tiong Lay founded the YTL Corporation Berhad, together with other listed subsidiaries such as YTL Power International Berhad, YTL Cement Berhad, YTL Land and Development Berhad, YTL E-Solutions Bhd, and YTL Industries Berhad. Using a private holding company, Yeoh Tiong Lay & Sons Holdings Sdn Bhd, the Yeoh family owns and controls 52.83% of shares in YTL Corporation Berhad (as reported in Panel A Table 3.5). Panel B Table 3.5 reports that the Yeoh family owned 35,720,004 shares, equivalent to 87.72% of shares, of the private holding company, Yeoh Tiong Lay & Sons Holdings Sdn Bhd. The details are reported in Panel B Table 3.5.

The growth in the number of family firms in Bursa Malaysia also relates to a change in the Listing Requirements of Bursa Malaysia in 1998, in which the minimum paid-up ordinary share capital was reduced to not less than MYR 40 million (Salleh, 2009). This change led to a substantial number of new listings of small firms, predominantly family firms.¹²

3.4.2 State-Controlled Firms

The government's involvement in listed firms started with the launch of the New Economic Policy in 1969, with the aim of eradicating poverty and reducing social inequality. Among the impacts of the policy was a significant shift of ownership

¹¹ In December 2008, the group record a total market capitalisation of about MYR 36.4 billion.

¹² Bursa Malaysia rules: (1) the company is incorporated in Malaysia, (2) the paid-up ordinary share capital is not less than MYR 40 million, (3) at least 25%, but not more than 50%, of the paid-up capital is in the hands of a minimum of 500 public shareholders holding not less than 1000 shares each, (4) the company has five consecutive years of after-tax profit of at least MYR 1 million and an aggregate after-tax profit of not less than MYR 12 million over the same five years, and (5) the company complies with the corporate disclosure requirements and other rules and by-laws of the Bursa Malaysia.

and control from foreign companies to local entities, e.g. Guthrie, Sime Darby and Golden Hope. The famous 'dawn raid' on the London Stock Exchange was an example of a massive affirmative strategy to regain control of Malaysian assets from British interests. On September 7, 1981, Permodalan Nasional Berhad (PNB) made a successful take-over of 50.41% of shares of Guthrie Corporation, which was listed on the London Stock Exchange. The successful 'Dawn Raid', as it was commonly termed by the London brokers, enabled PNB to control Guthrie Corporation, a large plantation company in Malaysia controlling more than 76,000 hectares of rubber, oil palm and cocoa.

In 1983, the Malaysian government announced a privatization policy with the objectives of relieving the financial and administrative burden of the government and reducing the size of the public sector. In addition, the policy aimed to increase competition, efficiency, productivity, and economic growth through private entrepreneurship and investments (see Economic Planning Unit Prime Minister's Department of Malaysia, 1985, 1991). The privatization strategy resulted in the incorporation and listing of numerous state-controlled listed firms such as Tenaga Nasional Berhad (the national power generator and distributor), Malaysian Airline System Berhad (the national airline), and Telekom Malaysia Berhad (the national telecommunications provider). Several methods of privatization were employed, but the most significant were 'Share Issue Privatizations'. Table 3.6 presents examples of privatized state-owned enterprise through share issue privatization.

Even though the shares of these listed firms are made available to the public for investment, the Malaysian government, through the Ministry of Finance and other

Government-Linked Investment Companies (GLICs), owns substantial amounts of the shares, especially in firms of public importance. For instance, in the utility, plantation, and financial sectors, privatised firms remain in government control. In contrast, the government disposed entirely of its holdings in certain business entities to private investors. For example, Sports Toto Malaysia Sdn Bhd, which ran Toto betting, was privatised in 1985 when its Chief Executive Officer, Vincent Tan Chee Yioun, acquired 70% of the paid-up capital through his private company.

Table 3.6
Share Issue Privatization in Malaysia (1983–1999)

No	Company	Prospectus Date	Listing Date
1.	Bina Darulaman Bhd	23 December 1995	2 February 1996
2.	Cahaya Mata Sarawak Bhd	22 December 1988	2 February 1989
3.	Carpets International Malaysia Bhd	10 June 1992	27 July 1992
4.	Cement Industry of Malaysia Bhd	7 May 1984	26 June 1984
5.	Edaran Otomobil Nasional	8 June 1990	26 July 1990
6.	Far East Holdings Bhd	22 December 1990	31 January 1991
7.	Johore Tenggara Oil Palm Bhd	Privatised in 1994	15 August 1996
8.	Kedah Cement Holdings Bhd	9 December 1991	29 January 1992
9.	Kelang Container Terminal Bhd	25 September 1992	23 November 1992
10.	KPJ Healthcare Bhd	18 October 1994	29 November 1994
11.	Malaysia International Shipping Corp. Bhd	29 December 1986	27 February 1987
12.	Malaysian Airline System Bhd	18 September 1985	16 December 1985
13.	Padiberas Nasional Berhad	12 January 1996	25 August 1997
14.	Pasdec Holdings Bhd	5 September 1997	27 October 1997
15.	Pernas International Hotels & Properties Bhd	8 August 1990	25 September 1990
16.	Perusahaan Otomobil Nasional Bhd	21 January 1992	26 March 1992
17.	Petronas Dagangan Berhad	20 January 1994	8 March 1994
18.	Petronas Gas Bhd	14 July 1995	4 September 1995
19.	SAP Holdings Bhd	30 September 1994	7 November 1994
20.	Sindora Berhad	24 October 1995	7 December 1995
21.	Sports Toto Malaysia Bhd	1 August 1985	Listed in 1987
22.	Tenaga Nasional Berhad	29 February 1992	28 May 1992
23.	Telekom Malaysia Berhad	26 September 1990	7 November 1990
24.	Tradewinds (M) Bhd	28 January 1988	23 March 1988

Note: There are a total of 38 Share Issue Privatizations in Malaysia during 1983–1999 in Malaysia. Source: Sun, Qian, and H. S. Tong Wilson. 'Malaysia Privatization: A Comprehensive Study', *Financial Management* Vol. 31, No. 4, 79–105, 2002.

In certain cases, the government holds golden shares, which enable the holder (government) to outvote or veto all other shares (World Bank, 1999). For

example, certain matters require the express consent of the holder of the share or it may confer special rights in the appointment of the board of directors (World Bank, 1999). As such, the government has a power to appoint board members and senior management, and to make major decisions such as contract awards and restructuring and divestments, though in most cases it is not the ultimate beneficial owner.

Government has significant participation in the economy. It is exercised by holding equity in the private sector; in particular in state-controlled firms, which are also known as Government-Linked Companies (GLC). Though the number of state-controlled firms is relatively small, representing less than 10% of the firms listed on Bursa Malaysia, these firms account for approximately MYR 260 billion in market capitalisation, or approximately 36% of the Bursa Malaysia market capitalisation. Table 3.7 shows the statistics for state-controlled firms in Bursa Malaysia.

Table 3.7
Government-Linked Companies in Bursa Malaysia

Variable	Statistic
No of Companies	57
Market Capitalisation (MYR billion)	261
% Bursa Malaysia Composite Index	54
% of Bursa Malaysia	36
No of Employees –estimate ‘000	400

source: Putrajaya committee, high performance GLC, handbook of transformation plan (as at 26 July 2005)

Government control of public firms is achieved using various agencies and investment entities. Khazanah Nasional (Khazanah) is an investment holding arm of the Government of Malaysia and has investments in over 50 major firms

covering a broad spectrum of industries. Khazanah is responsible for driving shareholder value creation and enhancing corporate governance in firms controlled by the government. Apart from Khazanah, Petroliaam Nasional (Petronas), a national and wholly-owned oil company, has also invested a substantial amount of capital in the equity market.

The Malaysian capital market also has significant investments from other government agencies and fund managers, such as the Employees Provident Fund, Kumpulan Wang Persaraan, Lembaga Tabung Angkatan Tentera, Lembaga Tabung Haji, and Permodalan Nasional Berhad. The Employees Provident Fund (EPF), for example, was established under the Employees Provident Fund Act 1991 (Act 452) to provide retirement benefits for its members. Currently, employees contribute 11% of their pay, while employers contribute 12% to the fund. Kumpulan Wang Persaraan is a fund providing retirement benefits specifically for the public sector. In addition, Lembaga Tabung Angkatan Tentera (LTAT) is a superannuation scheme for serving members of the Armed Forces. For officers, participation is voluntary, but other ranks are required to contribute 10% of their monthly salary to LTAT, while the government, as employer, contributes 15%.¹³ The LTAT fund has invested in several areas, including retail business and cash investments such as bonds, fixed deposits and equities. In addition, Boustead Holdings Berhad, a subsidiary of LTAT, is invested in various businesses including plantations, heavy industries, properties, finance,

¹³ For officers, participation is voluntary and the contributions are a minimum of RM 25 with a maximum of RM750 monthly.

pharmaceuticals, manufacturing, and trading.¹⁴

On 17 March 1978, the Malaysian government established the Permodalan Nasional Berhad (PNB) to encourage share ownership among Bumiputera.¹⁵ Initially, PNB catered for only one ethnic group. The PNB mutual fund, Amanah Saham Nasional, for instance, was entirely for members of the bumiputera ethnic group. Subsequently, the PNB introduced other mutual funds such as Amanah Saham Wawasan 2020, Amanah Saham Malaysia, Amanah Saham 1Malaysia, and Amanah Saham Gemilang, in which all Malaysians are eligible to invest. Currently, the PNB investments involve more than 360 firms in Malaysia. In addition, the PNB has gained control of Malayan Banking Berhad, NCB Holdings Berhad, MNI Holdings Berhad, and Sime Darby Berhad.¹⁶

The Lembaga Tabung Haji (or Future Pilgrims Fund Corporation) was set up in 1963 to help the Malaysian Muslim community in performing Hajj (pilgrimage). Previously, pilgrims from rural areas sold their livestock or properties to cover their hajj (pilgrimage) expenses. The establishment of Lembaga Tabung Haji helps them to plan their savings for the pilgrimage, and provides pilgrimage management services. In 1969, the Pilgrimage Fund Management Board was established under the Pilgrimage Fund and Management Board Act 1969 (Act no 8), which marked significant investment of Lembaga Tabung Haji in the

¹⁴ See Lembaga Tabung Angkatan Tentera's website for more information, available for access at <http://www.ltat.org.my/>

¹⁵ Bumiputera means in Malay "sons of the soil". It refers to Malays and other indigenous people as distinct from Chinese, Indians, and other non-indigenous residents.

¹⁶ See Perbadanan Nasional Berhad's website for more information, available for access at <http://www.pnb.com.my/index.cfm>.

Malaysian capital market. Currently, Lembaga Tabung Haji controls two public listed firms: TH Plantations Berhad and Bank Islam Malaysia Berhad, which is involved in the business of oil palm plantations and Islamic banking respectively.¹⁷

ValueCap and Social Security Organization (SOCSO) also invested funds in Bursa Malaysia. Khazanah Nasional Bhd, Permodalan Nasional Bhd, and Kumpulan Wang Persaraan equally own ValueCap, which invests heavily in high-growth stocks. On the other hand, SOCSO was established in 1971 under the Employees' Social Security Act 1969 (Act 4) and is responsible for social security schemes, namely the Invalidity Pension Scheme and the Employment Injury Insurance Scheme. Through these schemes, SOCSO protects workers against industrial accident, including accidents that occur while working, occupational diseases, becoming an invalid, or death due to any cause. Workers contribute monthly to SOCSO, which then invests in various instruments including the equity market.

Other than the federal government, Malaysia has thirteen state governments. Every state government has established a State Economic Development Corporation (SEDC), which acts as the investment holding arm of the State. For example, Johor Corporation, an investment arm for the Johor State Government, has significant investments in the Malaysian economy, with more than 280 member companies. These include several listed firms (as shown in Figure 3.1)

¹⁷ See Lembaga Tabung Haji's website for more information. Available for access at www.tabunghaji.gov.my

such as KPJ Healthcare Bhd, Kulim Bhd, Damansara Realty Bhd, QSR Brand Bhd, Sindora Bhd, and KFC Holdings Bhd.

Table 3.8 shows how the government has established control of Malayan Banking Berhad (Maybank), one of the biggest financial institutions in Malaysia. The largest shareholder in Maybank is Skim Amanah Saham Bumiputera, a mutual fund under Permodalan Nasional Berhad (PNB), which owns 44.67% of shares. The Employees Provident Fund holds another 10.25% of shares. In addition, PNB itself holds 6.57% of shares, while Kumpulan Wang Persaraan, the pension fund for civil servants, holds another 2.55% of shares. Finally, a government agency involved in development of land, FELDA, owns 124 million shares in Maybank, bringing Malaysian government investment in Maybank to 65.89% of shares.

Table 3.8
Substantial shareholders of Malayan Banking Berhad

Name of shareholders	Shareholdings	%
Skim Amanah Saham Bumiputra	2,180,681,634	44.67
Employees Provident Fund Board	500,281,336	10.25
Permodalan Nasional Berhad	320,776,808	6.57
Kumpulan Wang Persaraan (Diperbadankan)	137,195,625	2.55
Lembaga Kemajuan Tanah Persekutuan (FELDA)	124,622,156	1.85
Total	3,263,557,559	65.89

Source: 2008 Annual report of Maybank Berhad

In January 2005, the government established the Putrajaya Committee on GLC High Performance (PCG) to develop comprehensive national policies and guidelines to transform GLCs into high-performing entities. A report issued by PCG shows that the performance of GLCs is below the market average (PCG, 2005). A substantial number of GLCs were also removed from the official list of Bursa Malaysia because of poor performance. Table 3.9 presents the summary of

GLCs that were delisted from Bursa Malaysia over the period 2005 to 2009. PCG is responsible for implementing and overseeing the implementation of these policies and guidelines to transform GLCs into high-performing firms. To improve the performance of GLCs, several restructuring strategies have been undertaken, including the merger of Kumpulan Guthrie Bhd, Sime Darby Bhd, Golden Hope Plantations Bhd, and the bulk of their subsidiaries.

In terms of corporate governance, PCG has undertaken various initiatives to strengthen the governance of state-controlled firms. On 29 July 2005, PCG introduced the 'Green Book', a framework to guide GLC transformation and upgrade the effectiveness of GLCs' boards of directors. The transformation programme covers comprehensive aspects of firm management, including guidelines and programmes to enhance the effectiveness of the board of directors and reinforce strong corporate governance in state-controlled firms. Section 2 of the Green Book specifies corporate governance aspects such as board composition, separation of the roles of the Chairman and CEO, a cap on the number of directorships, directors' compensation, an annual review of Director and Board performance and many others. In addition, on 23 March 2006, to promote financial transparency fifteen GLCs made public their key performance indicators (KPI) and financial and operational targets in local newspapers (New Straits Times, 23 March 2006).

Table 3.9
Summary of government-linked companies delisted from Bursa Malaysia

No	Company	Main shareholders	Delisting Date
1.	Pelangi Bhd	Perbadanan Nasional Bhd (49.42%) Skim Amanah Saham Bumiputera (25.33%)	15 August 2005
2.	Tractors Malaysia Holdings Bhd	Sime Darby Bhd (71.74%) Employees Provident Fund Board (5.32%)	24 February 2006
3.	MNI Holdings Bhd	Skim Amanah Saham Bumiputera (66.56%) Employees Provident Fund Board (9.19%) Permodalan Nasional Bhd (7.68%)	23 March 2006
4.	CIMB Bank	Commerce Asset-Holding Bhd (61.37%) Commerce Asset-Holding Bhd (9.92%)	6 April 2006
5.	Johan Ceramics Bhd	Lembaga Tabung Angkatan Tentera (59.92%) Lembaga Tabung Haji (11.92 %)	13 April 2007
6.	UDA Holdings Bhd	Khazanah Nasional Bhd (50.01%)	31 May 2007
7.	Island & Peninsular Bhd	Permodalan Nasional Bhd (79.94%) (nominees) Permodalan Nasional Bhd (16.72%)	13 July 2007
8.	Opus Group Bhd	UEM World Bhd (62.37%)	19 October 2007
9.	Malaysian Industrial Development Finance Bhd	Skim Amanah Saham Bumiputera (48.78%) Permodalan Nasional Bhd (20.17%)	30 October 2007
10.	Sime UEP Properties Bhd	Sime Darby Bhd (51.15%) Skim Amanah Saham Bumiputera (23.19%) Employees Provident Fund Board (8.04%)	30 November 2007
11.	Sime Engineering Services Bhd	Sime Darby Bhd (70.03%) Employees Provident Fund Board (6.21%)	30 November 2007
12.	Mentakab Rubber Company (Malaya) Bhd	Chermang Development (Malaya) Sdn. Bhd. (a subsidiary of Golden Hope) (57.17%) Golden Hope Plantations Bhd (12.75%)	30 November 2007
13.	Kumpulan Guthrie Bhd	Permodalan Nasional Bhd (54.29%) Skim Amanah Saham Bumiputera (10.43%) Employees Provident Fund Board (7.08%)	30 November 2007
14.	Golden Hope Plantations Bhd	Skim Amanah Saham Bumiputera (38.35%) Permodalan Nasional Bhd (13.28%) Kumpulan Wang Amanah Pencen (12.08%) Employees Provident Fund Board (5.91%)	30 November 2007
15.	Guthrie Ropel Bhd	Kumpulan Guthrie Bhd (57.85%)	30 November 2007
16.	Highlands and Lowlands Bhd	Kumpulan Guthrie Bhd (Guthrie) (54.53%) Skim Amanah Saham Bumiputera (12.94%) FELDA (6.79%)	30 November 2007
17.	Negara Properties Bhd	Golden Hope Plantations Bhd (56.48%)	6 December 2007
18.	Boustead Properties Bhd	Boustead Holdings Bhd (65.01%) Lembaga Tabung Angkatan Tentera (8.60%) Employees Provident Fund Board (5.18%)	8 August 2008
19.	Cement Industries of Malaysia Bhd	UEM World Bhd (50.56%)	13 November 2008
20.	UEM Builders Bhd	UEM World Bhd (51.70%) Lembaga Tabung Haji (5.56%)	21 November 2008
21.	UEM World Bhd	Khazanah Nasional Bhd (57.90%)	18 February 2009
22.	Vads Bhd	Telekom Malaysia Bhd (64.77%)	19 February 2009

Source: Bloomberg business news retrieved from <http://investing.businessweek.com>, company announcement and annual report of listed firms retrieved from <http://www.klse.com.my>

3.5 Chapter Summary

This chapter has focussed on issues pertaining to institutional reforms, including corporate governance and financial reporting, in Malaysia following the 1997 economic crisis. This chapter provides a brief explanation of the 1997 financial crisis, and a discussion of institutional reforms, in particular corporate governance and financial reporting. Finally, the chapter describes the unique ownership structure of Malaysian firms, in particular, family ownership and state-control. The next chapter sets out the objectives of the research and develops the hypotheses to be tested.

CHAPTER FOUR

RESEARCH OBJECTIVES AND HYPOTHESES DEVELOPMENT

4.1 Introduction

This chapter explains the research objectives and develops the hypotheses of the study. The next subsection, Section 4.2, describes the purpose of this research. The development of the hypotheses is presented in the four subsections of Section 4.3. Section 4.3.1 discusses the hypothesis on the level of earnings conservatism after the reforms; Section 4.3.2 discusses the hypothesis on the effect of the adoption of IFRS on earnings conservatism; Section 4.3.3 reviews the hypothesis on the influence of ownership structure, i.e. family firms and state-controlled firms, on earnings conservatism; and Section 4.3.4 develops the hypothesis on the relationship between corporate governance and earnings conservatism. A summary of this chapter is provided in Section 4.4.

4.2 The Proposed Research

Figure 4.1 presents a diagrammatic representation of the relationship examined in the study. First, this study examines the level of earnings conservatism after the reforms of corporate governance and financial reporting in Malaysia. Second, this study examines whether the adoption of new accounting standards, IFRS, has had any significant impact on the level of earnings conservatism. Third, this study investigates the effect of ownership structure on earnings conservatism. Finally, the relationship between corporate governance and earnings conservatism is

examined, which covers three main aspects, namely: the characteristics of boards of directors; the characteristics of the audit committee; and the quality of external auditors.

Figure 4.1
Relationships Examined

4.3 Hypotheses Development

The development of the hypotheses of the study is presented in the following sections.

4.3.1 Earnings Conservatism Following Institutional Reforms

Despite the importance of earnings conservatism, empirical studies examining this issue in Malaysia remain sparse. The most significant study was carried out by Ball et al. (2003), who examine earnings conservatism in four East Asian countries (Malaysia, Singapore, Thailand and Hong Kong). Using a sample of 2,726 firm-year observations from 1984 to 1996, they find that the four East Asian countries have low levels of earnings conservatism, hence a low quality of financial reporting. From this finding, Ball et al. (2003) argue that incentives appear to dominate accounting standards as a determinant of financial reporting in Hong Kong, Malaysia, Singapore and Thailand. In terms of accounting standards, these countries were substantially influenced in the past by UK or US accounting standards, and continued to be influenced by the International Accounting Standards (IAS), which are perceived as ‘high quality’ standards. However, weak institutional structures appear to provide little incentives to prepare financial reports which report earnings conservatively.

Another study, by Bushman and Piotroski (2006), also includes Malaysian firms in its sample. To examine the effect of country-level institutions, including a country’s legal/judicial system, securities laws, and political economy, on conservative accounting practices, Bushman and Piotroski (2006) examine a final sample of 86,927 observations drawn from 38 countries. Of the total sample, Malaysian firms contribute 2,348 firm-year observations from 1992 to 2001. Bushman and Piotroski find that of country-level institutions, those such as judicial systems, strong public enforcement aspects of securities law, and lower state involvement in the economy, significantly influenced the financial reporting

incentives for conservative accounting. From the results reported in Bushman and Piotroski (2006), Malaysian firms recognise bad news in a more timely fashion than they recognise good news, which is in conflict with Ball et al.'s (2003) findings. However, while the study periods overlap, the Bushman and Piotroski's (2006) study period extends to a later date which includes the early post reform years.

To complement both studies, this study examines the current state of earnings conservatism following the institutional reforms discussed earlier in this study. The sample covers the period 2003–2008 and is thus different from Ball et al. (2003), who examine the period prior to the 1997 Asian financial crisis, and also later than Bushman and Piotroski (2006) whose sample extends only to the year 2001. Importantly, the results from this study will give better insight as to whether the period following the institutional reforms exhibits the presence of earnings conservatism.

This study predicts that earnings conservatism is a pervasive feature of Malaysian financial reporting following reforms to corporate governance and financial reporting. There are several reasons for this prediction.

First, after the 1997 Asian financial crisis, there were major reforms in the institutional structure governing Malaysian firms, including matters relating to corporate governance, securities laws, and financial reporting. Amongst the initiatives were (1) the introduction of the Financial Reporting Act (1997) in 1997; (2) the establishment of the Malaysian Accounting Standards Board

(MASB) in 1997; (3) the establishment of the Malaysian Institute of Corporate Governance (MICG) in March 1998; (4) amendments to the Securities Industry Act (1983) in September 2003; (5) revision of the Malaysian Code of Takeovers and Mergers in 1999; (6) the issuance the Malaysian Code on Corporate Governance (MCCG) in March 2000; (7) the establishment of the Minority Shareholder Watchdog Group (MSWG) in August 2000; (8) the amendment of the listing requirements of the Bursa Malaysia to enable full effect to be given to the MCCG in January 2001; (9) the launch of Capital Market Master Plan (CMP) by Securities Commission in February 2001; (10) the issuance of the Best Practice in Corporate Disclosure by Bursa Malaysia in August 2004; (11) the adoption of IFRS in January 2006; (12) the introduction of the Green Book (Initiative on Board Effectiveness) by the Putrajaya Committee on GLC High Performance (PCG) to guide GLC transformation and upgrade the effectiveness of GLC Boards in April 2006; and (13) the revision of MCCG in 2007. These concerted initiatives by the regulators were undertaken to enhance public confidence in the Malaysian capital market and to strengthen the protection of investors.

Secondly, the period examined in this study is associated with high demand for conservative reporting due to several high-profile corporate scandals, which include the alleged failure of auditors to detect and persuade their clients to make timely recognition of economic losses. The high-profile corporate scandals in US firms such as Enron and WorldCom eroded investors' confidence in the securities markets and caused a credibility crisis in the accounting profession (Wall Street Journal, 2002 February 6). The share prices of the affected firms plummeted and this cost investors billions of dollars, hence exerting greater demand for earnings

conservatism. Evidence from Lobo and Zhou (2006) shows an increase in conservatism in US firms' financial reports after the introduction of the Sarbanes-Oxley Act, a regulatory measure introduced after the Enron scandal. In the Malaysian context, the failure of local firms such as Perwaja Steel, Technology Resources Industries, and Malaysian Airlines System, to name but a few, also eroded the confidence of the public in financial statements and thus created a strong demand for reporting that was more conservative.

From the above arguments, it is predicted that the period following the institutional reforms will exhibit earnings conservatism, as shown by the timelier recognition of bad news as opposed to good news. I conjecture that reforms in institutional structure, especially in corporate governance and financial reporting, create strong incentives for corporate managers, account preparers, auditors and investors to favour reporting earnings conservatively. The hypothesis is stated as follows (stated in the null form):

H₀₁: Ceteris paribus, accounting earnings reported after the institutional reforms incorporate bad news (negative returns) and good news (positive returns) in the same way.

4.3.2 IFRS Adoption and Earnings Conservatism

Malaysia adopted the International Financial Reporting Standards (IFRS) from 1 January 2006 and the process is planned to reach full convergence by 1 January 2012. Since the adoption of IFRS represents a profound change in Malaysian financial reporting, it is appropriate to investigate whether the adoption of IFRS

has had a significant impact on the quality of accounting information, i.e. earnings conservatism.

The adoption of IFRS could be expected to affect earnings conservatism in many ways. First, under IFRS, conservatism is no longer a desirable quality of financial statements. Previously, the need for conservatism was often linked to reliable reporting of past events, consistent with stewardship and the feedback function of accounting. Over time, international accounting standards have become increasingly future-oriented: their decision making function has assumed greater and greater importance (IASB, 2010), while conservatism as a governing principle has slipped in significance (Hellman, 2008). In the IASB (2010) Conceptual Framework, prudence (conservatism), which was one of the aspects of reliability in Concepts Statement 2 or the Framework (IASB, 1989), is not considered as an aspect of faithful representation. Prudence (conservatism) was removed because it is inconsistent with neutrality. This is a changed view compared with the prevailing IASB framework, but the change is not surprising given the de-emphasis of conservatism in a number of standards issued by the International Accounting Standards Committee (IASC) and the IASB during the past decades.

Second, IFRS is increasingly permitting or requiring use of fair value accounting, while in the previous standards MASB employed principally historical cost accounting. On this basis, it is expected that the financial statements prepared under MASB standards could report more conservative earnings than those prepared under the IFRS standards. Historical cost accounting is associated with the concept of prudence, where appropriate provisions must be made for any

potential losses; while for gains, only gains that meet the recognition criteria can be recorded, otherwise they are deferred until they are realisable. As such, the value of an asset would be impaired when its market value has fallen significantly; but the asset's value cannot be appreciated when the market value is higher than the purchase price. However, certain exceptions, such as the revaluation of assets, are permissible in Malaysia, thus allowing an increase in the value of property, plant, and equipment.

One example of the changes made by IFRS standards relates to accounting for goodwill (or, indeed, all indefinite life intangibles). Prior to IFRS, goodwill was normally capitalised and amortised over a number of years.¹⁸ In IFRS standards, no amortisation of goodwill is permissible. FRS 3 requires goodwill to be “tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired” (para 55). This rule prevents excessive understatement of assets caused by goodwill amortisation, thereby reducing unconditional and overall conservatism. In contrast, the impairment testing rule ensures timely recognition of economic losses associated with goodwill, though it does not permit recognition of an increase in the value of goodwill.

Contrary to the above arguments, several studies argue that changes in accounting standards would not affect earnings conservatism. LaFond and Watts (2008) find that information asymmetry is positively related to conservatism. From the finding, LaFond and Watts (2008) argue that “... if the FASB was successful in

¹⁸ There is no specific standard on goodwill in Malaysia prior to IFRS.

meeting its stated goal of eliminating conservatism, then it would increase information asymmetry between investors, not reduce it. This outcome is inconsistent with the objectives of the Securities Acts” (p. 447). This argument is consistent with Watts’ (2003a) explanation that conservatism arises not only from regulation, but also from contracting, litigation and taxation. Changes in one explanation may produce a minimal impact on overall earnings conservatism.

Consistent with this argument, several studies find that accounting standards have no influence on earnings conservatism. Ball and Shivakumar (2005), for example, find public and private firms in the United Kingdom have different levels of earnings conservatism, though subjected to similar accounting standards. Furthermore, Ball et al. (2003) find low earnings conservatism in Malaysia, Singapore, Thailand, and Hong Kong, although these countries adopted International Accounting Standards which were considered to be high-quality accounting standards.

This study aims to provide insight as to whether IFRS adoption has had any impact on earnings conservatism by resolving these conflicting arguments on the effect of accounting standards. To this end, this study tests the following hypothesis (stated in the null form):

Ho2: Ceteris paribus, there is no significant difference in the earnings conservatism level between pre- and post-IFRS adoption periods.

4.3.3 Ownership Structure and Earnings Conservatism

The third objective of this study is to examine whether earnings conservatism varies across different types of ownership structure. In contrast to developed countries where firms are typically widely-held, the ownership structure of Malaysian firms is highly concentrated, with control of many firms vested in either a family or government. The following section discusses the influence of family firms and state-controlled firms on earnings conservatism.

4.3.3.1 Family Firms and Earnings Conservatism

The relationship between family influence and earnings conservatism is closely related to the management entrenchment hypothesis and the convergence-of-interest hypothesis (Morck, Shleifer, & Vishny, 1988). The two hypotheses offer different predictions on the impact of owner-manager ownership of shares on agency conflicts, and expectations about firm financial performance and corporate reporting behaviour.

The management entrenchment hypothesis holds that higher levels of owner-manager ownership lead to entrenchment of management (Fan & Wong, 2002; Morck, et al., 1988). The controlling shareholder, who has sufficient control over the board of directors, would pursue his own objectives without fear of disciplinary actions from other ownership interests; hence greater agency conflict between the controlling owner and minority shareholders (also known as Type II agency costs) is generated. That is, controlling shareholders are more likely to make decisions that maximise their wealth through expropriation of minority

shareholders (Fan & Wong, 2002). In term of earnings' reporting, the controlling shareholder has greater incentives to report earnings aggressively, as a means of channelling out the firm's wealth, i.e. via dividends, at the expense of other suppliers of funds.

The convergence-of-interest hypothesis posits that agency conflicts (Type I) decrease as an owner-manager's ownership interest increases. In addition, outside investors also perceive that managers have greater incentive to maximise firm value when their shareholding is high (Abbott, Parker, & Peters, 2004; Fan & Wong, 2002). A higher level of owner-manager ownership stake in the firm results in lesser divergence of interests, and therefore monitoring is less necessary (Menon & Williams, 1994). In short, convergence of interest between the owner-manager and outside investors occurs (Feldmann & Schwarzkopf, 2003).

With regard to this study, it is predicted that that the convergence-of-interest hypothesis provides better grounds for predicting the relationship between family firms and earnings conservatism. The prediction is based on several premises.

First, the interests of managers, who are members of the controlling family, are more aligned to the interests of the shareholders (Wang, 2006). For instance, they would forgo short-term benefits from manipulating earnings that can damage the firm's reputation (Wang, 2006), thereby alleviating agency costs. It is suggested that managers in family firms are also less likely to delay the recognition of bad news because this could damage the firm's long-term performance, the family reputation and the firms' stock value. This argument is consistent with several

studies that find family firms produce higher quality earnings than widely-held firms (Ali, Chen, & Radhakrishnan, 2007; Claessens, et al., 2000; Wang, 2006).

Second, managers in family firms have less incentive to report earnings aggressively because their compensation plan is not closely tied to reported earnings (Chen, 2005). In general, management compensation plans may trigger managers to performing aggressive reporting to maximise their benefits (Gaver, Gaver, & Austin, 1995; Guidry, Leone, & Rock, 1999; Healy, 1985), but this phenomenon is less prominent in family firms. With regards to family firms, the close relationship between managers and the controlling family leads to manager compensation that is less sensitive to changes in reported earnings because manager performance is more directly observable by the family (Brunello, Graziano, & Parigi, 2003; Miller & Le Breton-Miller, 2006). In addition, the appointment of managers in family firms is based on kinship ties; and in the area of employer-employee relationships, paternalism and unconditional loyalty take precedence over merit, experience, and educational qualifications (Yen, et al., 2007). These factors provide less incentive for managers to manipulate earnings or delay the recognition of bad news.

Third, I conjecture that family firms will report earnings conservatively to attract other investors and to maintain good relationships with lenders. Given that founders of family firms are long-term shareholders who view the firm as an asset to be passed along to heirs (Casson, 1999), they are less likely to issue new shares, since it might dilute their control. To finance new projects, family firms have to rely on banks or lenders as a source of capital. Thus, it is critical to have a good

long-term relationship with these parties. Based on this argument, I expect family firms would report earnings conservatively as demanded by the debtholders.

Finally, large shareholdings in family firms leads to greater monitoring of managers by family members (Demsetz & Lehn, 1985; Villalonga & Amit, 2006), hence reducing the likelihood of aggressive reporting. Given that the controlling family has a long investment horizon (Anderson & Reeb, 2003a), this helps mitigate myopic investment decisions by managers (James, 1999). The longer investment horizon of the controlling family (Anderson, Mansi, & Reeb, 2003; Miller & Le Breton-Miller, 2006) drives managers to pursue positive net present value projects even if doing so reduces short-term earnings. Given that the controlling shareholder has a long experience with the firm, they acquire firm-specific knowledge and industry-specific knowledge that enhances their monitoring effectiveness, especially in restraining opportunistic reporting by managers.

My prediction is also consistent with evidence from empirical studies of family firms and their earnings quality. For instance, Wang (2006) finds that family firms report better-quality earnings in terms of lower absolute abnormal accruals, a larger earnings response coefficient and less persistence of transitory loss components in earnings. Further, Ali, Chen, and Radhakrishnan (2007) find that family firms have higher earnings response coefficients, lower discretionary accruals, greater predictability of cash flows, and provide more voluntary disclosure of bad news. There are also studies that have opposite findings. Fan and Wong (2002), who examine 977 companies in seven East Asian countries,

find that concentrated ownership and the associated pyramidal and cross-holding structures create agency conflicts between controlling owners and outside investors, and are hence associated with low earnings informativeness. Furthermore, Francis et al. (2005) predict and find that earnings are generally less informative, and dividends are at least as (if not more) informative for dual class firms (from with two classes of stock with equal cash flow rights but different voting rights).

In sum, based on the theoretical arguments and empirical evidence, it is predicted that family firms have greater incentives to report earnings conservatively. The hypothesis is stated as follows (stated in the null form):

H_{03a}: Ceteris paribus, in family firms, accounting earnings incorporate bad news and good news in the same way.

4.3.3.2 State-Controlled Firms and Earnings Conservatism

In this section, I conjecture that state-controlled firms have unique incentives and demand for conservative reporting of earnings compared to both family firms and widely-held firms.

First, it is posited that state-controlled firms have poor monitoring mechanisms to curb aggressive earnings reporting. Compared to family firms and widely-held firms, the board of directors in state-controlled firms can be considered as weak and ineffective since the directors tend to be appointed from the set of persons who have a close relationship to the governing political party or who have served

as senior government officers. For example, in Sime Darby Berhad, a state-controlled firm, six out of the twelve directors have political connections or have served as senior government officers. The detailed profiles are reported in Table 4.1. Since the directors lack business experience, the board becomes ineffective and unable to monitor managers, especially when the business's operations are complex and diversified. Anecdotal evidence shows that state-controlled firms underperformed the broader Malaysian market in respect of all key financial indicators except for firm size (PCG, 2005). Recently, Sime Darby Berhad, Malaysia's second largest company by market value, lost MYR 964 million (US\$ 296m/EUR 240m) on four projects because of poor management decisions and control¹⁹. This shows poor performance by directors in overseeing the business operation; and this is exacerbated when the firm size is large and the firm has diversified business operations.

Second, managers of state-controlled firms have a greater tendency to report aggressive earnings as a compensation maximisation strategy. Unlike in family firms, managers in state-controlled firms have greater incentives to delay the recognition of bad news to achieve higher reported earnings since their annual compensation is tied to the firm's financial performance. However, the difference in behaviour from other firms may not be significant. Anecdotal evidence shows that high-performance managers of state-controlled firms have greater opportunities for career development. For example, Tan Sri Amirsham Abdul

¹⁹ Source: The Star Online News Portal (a Press company in Malaysia) <http://biz.thestar.com.my/news/story.asp?file=/2010/5/21/business/6307079&sec=business> retrieved on 30 May 2010.

Aziz, a former CEO of Malayan Banking Berhad, was appointed as the Minister in charge of the Economic Planning Unit on March 18, 2008, while Dato' Sri Idris Jala, a former CEO of Malaysian Airlines System Berhad, was also appointed as a minister without portfolio in the Prime Minister's Department and the CEO of the Performance Management and Delivery Unit. Great opportunities for job promotion in state-controlled firms, including being appointed to a ministerial position, gives managers incentives to report higher reported earnings, in particular by delaying the recognition of bad news and accelerating the recognition of good news.

Third, state-controlled firms have complex ownership structures and more severe agency problems may occur (Shleifer & Vishny, 1994) than in other firms. This prediction is based on the nature of GLCs, where the principal-agent relationship is broken down into two other agency relationships since the government acts simultaneously as the principal and agent. In relation to the managers of a government-owned company, the government is a principal, thus it must assign goals (Rodriguez, Espejo, & Cabrera, 2007). The government is also the agent in its relationship with the public, the ultimate owners of the resources invested in by the government-owned company (Ernst, 2004). It is thus posited that the boards of directors of state-controlled firms are weak and ineffective compared to family firms and widely-held firms because board members are appointed by and accountable to the government, which is also the agent for the public. Since the government and the board of directors are also the agent, they themselves have private incentives.

Table 4.1
Directors' profiles for Sime Darby Berhad

No	Name	Position	Connection	Note
1.	Tun Musa Hitam	Chairman and Independent non-executive director	Yes	Former Deputy Prime Minister/ Politician
2.	Tun Dato' Seri Ahmad Sarji Abdul Hamid	Deputy Chairman and Non-independent non-executive director	Yes	Former Top Government Officer
3.	Dr. Arifin Mohamad Siregar	Independent non-executive director	Yes	Former Indonesian ambassador to the United States.
4.	Tan Sri Dato' Dr. Wan Mohd. Zahid Mohd. Noordin	Non-independent non-executive director	Yes	Former Director General of Education.
5.	Tan Sri Datuk Dr. Ahmad Tajuddin Ali	Independent non-executive director	Yes	Chairman of the Energy Commission of Malaysia.
6.	Datuk Seri Panglima Sheng Len Tao	Independent non-executive director	Yes	Chief Adviser to the China Banking Regulatory Commission
7.	Raja Dato' Seri Arshad Raja Tun Uda	Senior independent non-executive director	No	
8.	Dato' Henry Sackville Barlow	Independent non-executive director	No	
9.	Dato' Mohamed Sulaiman	Non-independent non-executive director	No	
10.	Dato' Dr. Abdul Halim Ismail	Non-independent non-executive director	No	
11.	Datin Paduka Zaitoon Dato' Othman	Non-independent non-executive Director	No	
12.	Dato' Seri Ahmad Zubair Murshid	President & Group Chief Executive	No	

Connection refers to the political connection or ex-government top officer

Source: Annual report of Sime Darby Berhad for year 2008

According to Downs's (1957) model of government, in the decision-making process government considers not only the interests of the public as voters, but also the plans or agendas of the opposition parties that compete for votes. Therefore, the government wants to control or monitor managers and managerial decisions so that the decisions are in line with its political interests.

From the above arguments, it is posited that the managers and directors of state-controlled firms have incentives to opportunistically report higher earnings, achieved by delaying the recognition of bad news. This study tests the following hypothesis, stated in the null form:

H_{03b}: Ceteris paribus, in state-controlled firms, accounting earnings incorporate bad news and good news in the same way.

4.3.4 Corporate Governance and Earnings Conservatism

Corporate governance has a crucial role in monitoring and controlling the behaviour of senior managers and protecting the interests of different parties in the firm (Fama, 1980; Fama & Jensen, 1983). Strong corporate governance is able to: (i) promote financial statement transparency; (ii) reduce accounting manipulation; (iii) limit the ability of managers to conceal bad news for a long period; (iv) enhance greater independence of the committees destined to monitor management; and (v) provide strong support to the expected bias of the auditor towards conservative reporting (García Lara, et al., 2007).

It is posited that strong corporate governance has a significant role in enhancing

earnings conservatism. This assertion is made on the basis of several premises, as discussed below.

First, a strong board of directors demands higher earnings conservatism because it provides an early warning signal, which triggers a prompt investigation of the origin of bad news (García Lara, et al., 2007). Earnings conservatism is a mechanism that facilitates good governance, in that it ensures that assets are invested and used efficiently and prevents the inappropriate distribution of assets to managers or other parties. Timely recognition of bad news, for example, prevents managers from hiding less favourable information, thereby reducing the agency costs of the monitoring of contracts. For this reason firms with good corporate governance opt for high earnings conservatism.

Second, strong boards will force greater conservatism in order to reduce agency costs arising from asymmetric information between managers and other parties related to the firm, asymmetric payoff and limited liability (Watts, 2003a). In addition, stronger boards are likely to demand more conservative accounting since they are more proficient at efficient contracting and understand the benefits of conservatism (Ahmed & Duellman, 2007). Consistent with this argument, García Lara et al. (2007) find that firms with a strong board, where the CEO has limited influence over the functioning of the board, exhibit a greater degree of earnings conservatism.

Third, conservative reporting of earnings in the financial statements helps the board of directors in evaluating managers' investment decisions and strategies.

Conservatism ensures any decrease in the future cash flow from a negative NPV investment is reported in a timely fashion, thus allowing immediate corrective measures to be made by the board of directors. Furthermore, conservatism is an essential characteristic of a firm's accounting system that can help directors in reducing deadweight losses and moderating other sources of information, thereby increasing firm and equity values (Watts, 2003a).

Finally, conservatism reduces the litigation risk to the auditor and board of directors. Since the shareholders and debtholders prefer a downward bias in earnings in order to constrain management from aggressive accounting, directors and auditors reduce the litigation risk when exerting greater earnings conservatism. Furthermore, courts are more likely to award damages for overstated earnings or assets (Kellogg, 1984). Thus, firms with strong corporate governance would demand greater earnings conservatism.

In short, firms with good corporate governance will favour earnings conservatism. This is triggered by the roles and benefits of earnings conservatism, the demand of providers of funds to constrain aggressive accounting choices and practices, and the need of directors and auditors to reduce litigation risk. Based on the above arguments, A positive association is predicted between strong corporate governance and earnings conservatism. Thus, the fourth hypothesis is set as follows (stated in the null form):

H₀₄: Ceteris paribus, the degree of earnings conservatism is not related to the quality of corporate governance.

4.4 Conclusions

This chapter has discussed the research objectives of the study and the development of four hypotheses. The first hypothesis tests whether bad news is recognised in earnings in a more timely fashion than is good news, following the institutional reforms. The second hypothesis tests whether there is a significant change in earnings conservatism as a result of IFRS adoption. The third hypothesis tests whether earnings conservatism varies according to ownership structure, in particular, family firms and state-controlled firms. The final hypothesis tests the relationship between corporate governance and earnings conservatism.

The next chapter describes the research design and method, the sample used for the study, measurement of conservatism and other relevant variables, and the regression models to test the hypotheses.

CHAPTER FIVE

RESEARCH METHODOLOGY

5.1 Introduction

The present chapter concentrates on the research design and research method. Section 5.2 discusses the sample selection process. The measure for earnings conservatism is discussed in Section 5.3. Section 5.4 describes the process used for classifying the financial statements into pre- and post-IFRS periods. The measures of ownership structure are outlined in Section 5.5. Section 5.6 explains the measures for corporate governance. Section 5.7 describes the regression models used in this study, while Section 5.8 discusses the robustness tests employed in the analyses. The chapter concludes with Section 5.9.

5.2 Sample Selection and Data Collection

This study examines earnings conservatism issues in Malaysian listed firms following the institutional reforms discussed in Chapter 3. Basically this study focuses on a sample from 2003 to 2008, but the calculation of certain variables such as earnings yield and stock returns requires one-year lag data. Figure 5.1 presents the statistics for listed firms in Bursa Malaysia from 2002 to 2008.

The sample selection process involves a number of steps. First, I identified all firms listed on Bursa Malaysia as at 31 December 2008. From the Worldscope database, I found a total of 977 listed firms as at that date. Second, I identified newly-listed firms from the years 2002 to 2008. These 349 firms were then

excluded from the sample. Third, I excluded 37 firms listed in the financial sector in Bursa Malaysia. Fourth, I excluded 36 inactive firms, including all firms suspended from trading. Finally, I excluded 34 firms with missing and incomplete data. This process results in a final sample of 521 firms for the six-year period. The sample selection process is summarised in Table 5.1.

Figure 5.1
Malaysian listed firms (2002–2008)

Source: Bursa Malaysia

Table 5.1
Sample selection process

Selection criteria	Number
Initial sample (as at 31 December 2008)	977
Excludes:	
(i) Newly listed firms (2002 to 2008)	(349)
(ii) Financial sector	(37)
(iii) Inactive/suspended from trading	(36)
(iv) Missing and incomplete data	(34)
Final sample (per year)	521
Total firm-year observations (521 firms x 6 years)	3,126

Table 5.2
List of variables, sources and definitions

Variable	Symbol	Source	Definition/Formula
Total assets	<i>TASSETS</i>	Worldscope	Total current assets and noncurrent assets.
Total liabilities	<i>TLIAB</i>	Worldscope	Total short and long term liabilities.
Earnings before interest and taxes	<i>EBIT</i>	Worldscope	The earnings of a firm before interest expense and income taxes.
Stock price	<i>PRICE</i>	Worldscope	The closing price of the security.
Earnings per share	<i>EPS</i>	Worldscope	Earnings per share earnings as reported by the firms.
Cash flow from operations	<i>CFO</i>	Worldscope	The net cash receipts and disbursements resulting from the operations of the firm.
Industry classification	<i>INDUSTRY</i>	Bursa Malaysia	Dummy variables for industry, including construction, consumer product, hotel, IPC, industrial product, plantation, property, technology, and trading/services.
Board size	<i>#BODSIZE</i>	Annual Report	Total number of directors in the board of directors at financial year end.
Non-executive directors	<i>#NONEXEC</i>	Annual Report	Total number of non-executive directors at financial year end.
Independent directors	<i>#BODINDP</i>	Annual Report	Total number of independent directors at financial year end.
Independent chairman	<i>INDCHRM</i>	Annual Report	Dummy variable that takes value 1 if the chairman of board of directors is a non-executive independent director, otherwise 0.
Board meeting	<i>#BODMEET</i>	Annual Report	Total number of meetings held by the board of directors for the financial year.
Audit committee size	<i>#ACSIZE</i>	Annual Report	Total number of directors in the audit committee as at financial year end.
Audit committee independence	<i>#ACINDP</i>	Annual Report	Total number of independent directors on the audit committee.
Audit committee financial expertise	<i>#ACEXPERT</i>	Annual Report	Total number of directors in audit committee that have accounting or finance degree or professional qualification, or members of accounting professional bodies, or have experience working as chief financial officer.
Audit committee meeting	<i>#ACMEET</i>	Annual Report	Total number of meetings held by audit committee for the financial year.
Size of Audit Firm	<i>BIG4</i>	Annual Report	Dummy variable that takes value 1 if the firms audited by Big Four auditors, otherwise 0.
Number of Family Directors on Board of Directors	<i>FAMDIR</i>	Annual Report	Total number of directors with family relationship with each other and/or major shareholders of the company.
Family Ownership	<i>FAMOWN</i>	Annual Report	Total percentage of shares owned by the controlling family.
Government Ownership	<i>GOVOWN</i>	Annual Report	Total percentage of shares owned by GLCs and GLICs.

For the data collection process, I extracted data from two sources: Worldscope electronic database and corporate reports.²⁰ Firstly, I identified all variables required, as summarised in Table 5.2, and then performed a search in Worldscope. From the search, I found that financial and stock price data are downloadable from Worldscope, while corporate governance and ownership data are not available. As a solution, I downloaded 3,126 corporate reports from Bursa Malaysia website for all 521 firms for the six-year period. I then hand collected the corporate governance and ownership data from corporate reports. Description of the variables collected for this study are summarised in Table 5.2.

For industry classification, I classified the industry based on Bursa Malaysia's industry classification. I collected this information from Bursa Malaysia's official website. In addition, I also gathered information from various businesses' and organisations' websites, including the Khazanah Nasional and State Economic Development Corporation corporate websites.

5.3 Measure of Earnings Conservatism

Following the research design of Basu (1997), I use the asymmetric timeliness of earnings model as the primary measure for earnings conservatism. This measure has been widely used in many studies, for example Ball et al. (2000), Ball et al. (2003), Ball and Shivakumar (2005), Bushman and Piotroski (2006), Francis et al. (2004) and Roychowdury and Watts (2007). In this model, conservatism is

²⁰ Annual financial reports for Malaysian listed companies are available from Bursa Malaysia's website (http://www.bursamalaysia.com/website/bm/listed_companies/company_announcements/annual_reports/index.jsp)

defined as the extent to which current period accounting earnings asymmetrically incorporate economic losses relative to economic gain. Stock return is used as a proxy for economic income as it is assumed that stock prices reflect all available information, consistent with the evidence that stock prices lead earnings information (Ball & Brown, 1968; Beaver, Lambert, & Morse, 1980; Kothari & Sloan, 1992). Following Ball, et al. (2000), Ball, et al. (2003), Bushman and Piotroski (2006), and Grambovas, et al. (2006), I use fiscal year return as a proxy for economic news. Accounting earnings imposes different verification standards for recognition of different types of economic news. For bad news (negative stock returns), lower verification standards are used, which results in the immediate recognition of losses. However, for good news (positive stock return), higher verification standards are imposed for gains to be recognised in accounting earnings. This approach results in a stronger positive association between bad news and earnings, which suggests the timelier reporting of bad news relative to that of good news.

Following Basu (1997), I estimate a linear regression of accounting earnings on stock returns as follows:

$$E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it} \quad (5.1)$$

where E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

In equation (5.1), β_1 measures the response of earnings to returns when returns are positive, and $\beta_1 + \beta_3$ measures the response of earnings to negative returns. If $\beta_1 + \beta_3 > \beta_1$ or $\beta_3 > 0$ then earnings reflect bad news more quickly than they reflect good news, that is, earnings conservatism.

5.4 Classification For Pre- and Post-IFRS Adoption

Since this study aims to compare earnings conservatism before and after adoption of International Financial Reporting Standards (IFRS), it is crucial to determine the cut-off point for the date of IFRS adoption. The IFRS became effective and mandatory in Malaysia starting from 1 January 2006; hence the earliest published annual reports using these standards are financial statements dated 31 December 2006. Table 5.3 presents the breakdown of the observations based on the accounting standards.

Table 5.3
IFRS adoption and period classification

Year	Financial Year End	N	IFRS Period
2004	1 January 2004 to 30 December 2004	227	Two-year prior to IFRS adoption
	31 December 2004	294	
2005	1 January 2005 to 30 December 2005	227	
	31 December 2005	294	
2006	1 January 2006 to 30 December 2006	227	One-year prior to IFRS adoption
	31 December 2006	294	
2007	1 January 2007 to 30 December 2007	227	First year of IFRS adoption
	31 December 2007	294	
2008	1 January 2008 to 30 December 2008	227	Second year of IFRS adoption
	31 December 2008	294	

I compare earnings conservatism for the short-horizon periods of one year and two years before and after IFRS adoption. For the main analysis, I examine two samples: (i) 1,042 firm-year observations for one year pre- and post-IFRS adoption for all firms; and (ii) 2,084 firm-year observations for two year pre- and post-IFRS adoption for all firms. I also conducted additional tests by limiting the sample to firms with a financial year end dated 31 December, which involve a sample of (i) 588 firm-year observations for one year pre- and post-IFRS adoption; and (ii) 1,176 firm-year observations for two year pre- and post-adoption of IFRS.

5.5 Measurement of Ownership Structure

Previous studies refer to ownership structure as the distribution of equity and also the identity of the equity owners (Claessens, et al., 2000; Francis, Schipper, & Vincent, 2005; Wang, 2006). Most of the studies of ownership structure focus on immediate ownership, such as equity directly owned by individuals or institutions. However, Fan and Wong (2002) argue that immediate ownership is not sufficient for characterising the ownership and control structure of East Asian firms, as these firms are generally associated with complicated indirect ownership. This study therefore focuses on ultimate ownership. I used data from various sources, including annual reports, corporate websites, and business magazines to identify the ultimate owners of Malaysian listed firms.

Following La Porta, Lopez-de-Silanes, and Shleifer (1999), I defined an ultimate owner as the shareholder who has the determining voting rights of the firm and who is not controlled by anybody else. This definition suits the pyramidal

ownership structure which is a common feature of firms in Malaysia and other East Asia countries (Claessens, et al., 2000). If a firm does not have an ultimate owner, it is classified as widely held. For firms with an ultimate owner, I divide those firms into family or state-controlled firms

Identification of state-controlled firms was made on the basis of two sources. First, I used the list of firms announced by the Putrajaya Committee on GLC High Performance as being government-linked companies (GLCs), or their subsidiaries or affiliates, or government-linked investment companies (GLICs). This list includes firms in which the Federal Government of Malaysia has a direct or indirect controlling stake.²¹ This definition includes subsidiaries and affiliates of GLCs or GLICs.²² Second, I broadened the scope of state-controlled firms to include firms which are under direct or indirect control of any of the thirteen State Governments.²³ For instance, Kumpulan Perangsang Selangor Berhad is a firm over which the State Government of Selangor has direct control; hence I classified this firm as a state-controlled firm. In Section 3.5.2, I discussed various examples of state-controlled firms, including firms which are controlled by state governments.

I followed Jaggi et al. (2009), Ho and Wong (2001) and Anderson and Reeb

²¹ In addition to share ownership, 'direct controlling stake' also refers to the government's ability to appoint board members, senior management and make strategic decisions (e.g. award contract, strategy, restructuring and financing, acquisitions and divestments etc.).

²² There are seven GLICs in Malaysia, namely Employees Provident Fund, Khazanah Nasional Bhd, Kumpulan Wang Amanah Pencen, Lembaga Tabung Angkatan Tentera, Lembaga Tabung Haji, Menteri Kewangan Diperbadankan, and Permodalan Nasional Bhd.

²³ Apart from the federal government, Malaysia has thirteen state governments: Perlis, Kedah, Pulau Pinang, Perak, Selangor, Melaka, Negeri Sembilan, Johor, Pahang, Terengganu, Kelantan, Sabah, and Sarawak.

(2003b), where family firms were identified based on the presence of family members on the board of directors. If two or more members of the controlling family are present on the board, the firm would be classified as a family firm.²⁴ A family relationship includes: father/mother, son/daughter, husband and wife, father/mother-in-law, son/daughter-in-law, brothers and sisters, nieces and nephews. However, I noticed one weakness when using this definition of family firms in relation to Malaysia. Certain firms in Malaysia have only one member of the controlling family sitting on the board of directors. Genting Berhad, for example, is a business controlled by the family of the late Lim Goh Tong through a private firm (Kien Huat Realty Sdn Berhad). His son, Lim Kok Thay, is the only member of Lim's family on the board of directors, but he also acts as the CEO and Chairman of the board. To reduce the classification bias, I also classified a firm as a family firm when a member of the controlling family (largest shareholder) holds the top executive position, either chief executive officer, managing director, president, or chairman of the board of directors.

5.6 Measurement of Corporate Governance

Corporate governance encompasses the various mechanisms available to constrain the opportunistic behaviour of management and, consequently, results in more credible and relevant accounting information for users. Extending previous studies (for example Ahmed & Duellman, 2007; Beekes, et al., 2004; García Lara, et al.,

²⁴ I identified the family relationship from the disclosure of director's relationships with other directors and major shareholders that were disclosed in the directors' profile in the corporate annual reports. This information was publicly available since Bursa Malaysia requires all public firms to disclose the profile of all directors, including their family relationship with other directors and major shareholders.

2007, 2009), I used various aspects of corporate governance including the board of directors, audit committee, and external auditor as indicators of corporate governance quality. Gompers, Ishii, and Metrick (2003) and Davila and Penalva (2006) argue that the use of indexes which aggregate several governance measures allow better classification of firms in accordance with the strength of their governance. This is consistent with the concept of corporate governance as a set of mechanisms that work together.

Following the approach of García Lara et al. (2007), who developed *Gov6* and *Gov8* scores from six and eight corporate governance variables respectively, I constructed a corporate governance index (*CGINDEX*) by using an unweighted aggregate of measurement on 11 corporate governance variables. In addition, I categorised the observations into three groups: (i) good governance sample (if *CGINDEX* is in the top third of the pooled sample), (ii) poor governance sample (if *CGINDEX* is in the bottom third of the pooled sample), and (iii) average governance sample (if *CGINDEX* is in the middle group of the pooled sample). The use of a broader set of variables enables each variable to complement the others and provide a better means to discriminate between strong and weak governance structures (García Lara, et al., 2007). The corporate governance variables employed in this study are as follows:

(i) Board Size

Board size is an important mechanism in ensuring board effectiveness. Prior studies, for example Yermack (1996), Conyon and Peck (1998), and

Eisenberg, Sundgren, and Wells (1998), suggest that larger boards negatively impact on firm value and performance. In a report about corporate governance issued by the Finance Committee on Corporate Governance (FCCG) in 1999, Malaysian listed firms are reported to have an average of eight directors (Finance Committee on Corporate Governance, 1999). The Malaysian Code of Corporate Governance (2000, 2007) made no recommendation in respect to board size, but the Code suggests that every board should examine its size, with a view to determining the impact of the number of directors upon effectiveness. Jensen (1993) suggests that the optimal board size is between seven and eight members.

However, a recent study by Coles, Daniel, and Naveen (2008) argues that board size is a more complicated issue and find that the relationship between board size and Tobin's Q is U-shaped. Furthermore, Linck, Netter, and Yang (2008) find that firms choose board structure on the basis of the costs and benefits of monitoring and advising. Nevertheless, this study has followed Jensen's (1993) recommendation. I use eight as the optimal point for board size. Thus, *BODSIZE* takes the value of 1 (good governance) if the number of directors is eight or fewer; 0 otherwise.

(ii) Non-Executive Directors

The role of non-executive directors may be crucial for the resolution of agency problems between managers and shareholders (Fama, 1980; Fama & Jensen, 1983). Having a high proportion of non-executive directors on the board is

linked to a lower influence by the CEO and other executive directors. The careers of executive directors are primarily related to allegiance to the CEO, but non-executive directors include independent directors and other directors representing institutional investors. Thus, the presence of non-executive directors may be vital to enforcing strong monitoring of managers (Beekes, et al., 2004). The Cadbury Committee (1992) suggests that there should be at least three non-executive directors on the board, of which a majority should be independent. On the other hand, the Hampel Committee (1998) on corporate governance was of the opinion that if non-executive directors are to be effective on the board, they should make up not less than one third of the board, again a majority of which should be independent.

Byrd and Hickman (1992) and Rosenstein and Wyatt (1990) argue that outside directors play an important part in protecting shareholders' wealth in situations where the interests of managers and outside owners diverge. In most cases, outside directors hold senior management positions in other large firms and they are familiar with the financial reporting process (Fama & Jensen, 1983). This enables them to exert greater monitoring on firm financial reporting. Consistent with this argument, several studies find that firms with a high proportion of outside directors report more conservative earnings than firms with a low proportion of outside directors (Ahmed & Duellman, 2007; Beekes, et al., 2004). To measure the influence and strength of non-executive directors, *NONEXEC* takes the value of 1 (good governance) if non-executive directors constitute more than half of the board, otherwise 0.

(iii) Board Independence

The importance of board independence in strengthening corporate governance has been advanced in the previous literature for at least two reasons. First, the existence of independent directors exerts a better monitoring of managers' decisions and activities by corporate boards (Fama, 1980). This is crucial to avoid an abuse of power by managers in order to maximise their own wealth (Roe, 1991). Fama and Jensen (1983) argue that a higher proportion of independent directors on corporate boards would result in more effective monitoring of boards and would limit managerial opportunism. Second, independent directors provide advice to corporate boards on strategic decisions, which may improve the firm's economic and financial performance (Fama, 1980). Realising the importance of independent directors in strengthening corporate governance, MCCG (2000, 2007) recommends that independent directors comprise at least one third of the corporate board.

With regard to earnings conservatism, independent directors have greater incentives to restrict managers' opportunistic actions, such as accelerating the recognition of good news in earnings or delaying the recognition of bad news. Given that independent directors do not share the benefits of opportunistic reporting, they risk their reputation in the professional labour market without gain from permitting opportunistic reporting (Fama, 1980). Therefore, in this study, board independence (*BODIND*) takes value 1 if the proportion of independent directors to the total number of directors is more than the median value, otherwise 0.

(iv) Independent Chairman

MCCG (2000, 2007) recommends separation of roles between the CEO and the chairman of the board of directors as such separation improves the board's monitoring function. According to Hermalin and Weisbach (2003), a board's effectiveness is heavily determined by board independence from the CEO. When a CEO has excessive power over board matters, reported earnings could easily be manipulated (Abdul Rahman & Mohamed Ali, 2006). If the Chairman is appointed from among the independent directors, the CEO has no influence on director nomination and election, thus giving greater independence to the board (Jensen, 1993).

Chau and Gray (2010) argue that a chairman who is not independent has the freedom to manage a firm without constraint as he possesses a great amount of power and authority. According to Jensen (1993), the presence of chairman that is also the chief executive of the firm could override the advantage of having independent directors on the board and weaken the function of the board of directors. Since an independent chairman enhances the functions of the board with improved monitoring of the CEO and firm management, thus mitigating any tendency to delay the recognition of bad news. In this study, I assign a value 1 to *INDCHRM* if the chairman is an independent director, and 0 otherwise.

(v) Board Meetings

The number of board meetings held during the financial year is used as a

proxy for the level of real monitoring and control exerted by directors (Vafeas, 1999). More frequent board meetings should indicate a more effective board because it suggests more active and close monitoring of managers to enable more timely corrective action if necessary. In this study, *BODMEET* takes the value 1 if the number of board meetings during the year is more than the median value, otherwise 0.

(vi) Size of Audit Committee

Many empirical studies support the argument that the size of the audit committee positively affects earnings quality. A plausible explanation is that a larger audit committee has greater capacity and resources to perform its duties, including detection and curbing of earnings manipulation; hence having a larger committee results in a higher level of earnings quality. For example, Lin et al. (2006) find a negative association between the size of an audit committee and the occurrence of earnings restatements, implying that the size of an audit committee is a significant factor in mitigating earnings manipulation. In the Malaysian context, MCCG (2007) suggests that an audit committee should comprise at least three members. Following this recommendation, *ACSIZE* takes value 1 if the size of the audit committee is more than three, otherwise 0.

(vii) Audit Committee Independence

Given that audit committee independence is crucial to exert effective monitoring of managers and to promote high standards of financial reporting,

MCCG (2007) recommends that independent directors should dominate, that is, constitute more than half, of the audit committee. This recommendation is consistent with much of the empirical evidence of a positive association between audit committee independence and earnings quality. For example, Abbott et al. (2004) report that firms with an independent audit committee that meets at least four times a year have a lower number of financial restatements. In addition, Carcello and Neal (2000) find that financially distressed firms with independent audit committees are more likely to receive a going-concern qualification and are less likely to terminate their external auditors. This evidence implies that audit committee independence implies effective control over managers' financial reporting, by reducing opportunistic reporting by management. Hence, I predict that having an independent audit committee would result in more timely recognition of bad news. To measure audit committee independence, *ACINDP* takes the value 1 if all members of the audit committee are independent directors, otherwise 0.

(viii) Number of Audit Committee Meetings

MCCG (2007) suggests that the audit committee should meet regularly. The code recommends that the meeting should be attended by the finance director, the head of internal audit, and the firm external auditor. Other board members may only attend the meeting upon invitation. The code states that the audit committee should have a meeting with the external auditor at least twice a year without the presence of executive directors as to promote more independent discussions.

Given that the frequency of the audit committee meetings represents the time devoted by the audit committee in monitoring firm management and financial affairs, prior studies use this variable to measure firm governance. Abbot et al. (2004) used a binary variable that takes value 1 if the audit committee held more than four meetings a year, otherwise 0. Other studies, for example Bédard, Chtourou, and Courteau (2004) and David, Scott, and Irem (2007), measure the frequency of audit committee meetings based on the total number of meetings held in a year. In this study, *ACMEET* takes value 1 if the number of the audit committee meetings is more than the median value of the sample, and 0 otherwise.

(ix) Financial Expertise of Audit Committee

The appointment of audit committee members with a finance and/or accounting background helps to strengthen the functioning of the audit committee, particularly in monitoring and enhancing the quality of financial reporting. I identify the financial expertise of the audit committee based on the number of members of the audit committees with prior education and working experience in accounting, auditing, or finance, and holding a membership of any professional accounting body. The revised MCCG Code 2007 requires at least one audit committee member to be a member of an accounting association or body. The presence of a financial expert on the audit committee is expected to facilitate better monitoring of managers and to ensure a high quality of financial reporting. Thus, I assign value 1 for *ACEXPERT* if the audit committee has two or more members with financial expertise, and 0 otherwise.

(x) Size of Audit Firm

In general, big audit firms are expected to provide superior audit quality relative to small audit firms, for a number of reasons. Dopuch and Simunic (1980), for example, argue that investors associate Big Six (currently known as Big Four) auditors with higher quality audits because of observable characteristics such as specialized training, greater resources, and peer review. In addition, Big Four auditors have more invested in their reputation and face substantially higher litigation costs (Chung, et al., 2003).

These arguments are supported by significant empirical evidence. For instance, previous studies find that big audit firms have lesser earnings management (Becker, et al., 1998; Francis, Maydew, & Sparks, 1999) and a higher earnings response coefficient (Teoh & Wong, 1993). Furthermore, Gul, Tsui, and Dhaliwal (2006) find big audit firms are more effective in mitigating the adverse effect of non-audit services on the value relevance of earnings. With regard to earnings conservatism, Chung et al. (2003) find that Big Six auditors have stronger influence than do non-Big Six auditors in persuading their clients to adopt more conservative accounting, particularly where the clients' financial performance is worse than expected.

In term of size of audit firms in Malaysia, big firms constitute only around 1.1% of the total number of firms (Abu-Bakar & Ahmad, 2009), but they audit around 60% of the listed firms (Arens, Loebbecke, Iskandar, Susela, & Isa, 1999). Around 91.4% of Malaysian audit firms are small, with one to two

partners; while medium-size audit firms, with three to eight partners, constitute 7.5% of audit firms (Abu-Bakar & Ahmad, 2009). To measure the size of audit firms, I use a dummy variable of *BIG4* that takes value 1 if the observation is audited by a Big Four audit firm, otherwise 0.

(xi) Auditor Industry Specialization

Auditor industry specialization is also argued playing a significant role in promoting earnings conservatism. Krishnan (2005a) find that industry specialists report more conservative earnings than non-specialists, suggesting that auditors' industry specialization moderates the tendency of the client to delay the recognition of economic losses in earnings. Furthermore, clients of industry specialists have significantly lower discretionary accruals than clients of non-specialist auditors (Krishnan, 2003). Consistent with prior literature (for e.g. Balsam, Krishnan, & Yang, 2003; Krishnan, 2003), I identify industry specialists (*SPECIALIST*) using an industry leader approach. Under this approach, an industry specialist is the audit firm with the largest market share (based on the total sales of the companies audited) in the industry. I calculate industry market shares as follows:

$$Market\ Shares_{ik} = \frac{\sum_{j=1}^{jik} Sales_{ijk}}{\sum_{i=1}^{ik} \sum_{j=1}^{jik} Sales_{ijk}}$$

where *Sales* is total sales/revenues, and the numerator is the total sales of all *Jik* clients of audit firm *i* in industry *k*. The value of *i* represents the audit firms. I use four-digit GICS codes to identify industry categories. The

denominator in the above model is the total sales for all clients of audit firm i summed over all k industries. To measure auditor industry specialisation, I use a dummy variable for *SPECIALIST* that takes value 1 if the observation is audited by an industry specialist and 0 otherwise.

5.7 Regression Models

This study employs ordinary least squares regression (OLS) to estimate the model used to examine the relationship between earnings conservatism and other variables such as a change in accounting standards, corporate governance and different types of ownership structure. The detailed applications of the model are discussed in the next subsections.

5.7.1 Earnings Conservatism in Malaysia

The first objective of this study is to examine the extent of earnings conservatism in Malaysia in 2003 to 2008. To test whether earnings are more timely in recognising bad news compared to good news, I employed Basu's (1997) asymmetric timeliness of earnings model, as stated below.

$$E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it} \quad (5.1)$$

where E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

The coefficient for the interaction variable of $RET*RD$, β_3 , captures the incremental response to negative news relative to positive news. If a firm adopts conservative accounting practices, β_3 is expected to be positive. The ratio $(\beta_1+\beta_3)/\beta_1$ ratio measures the sensitivity of earnings to bad news relative to their sensitivity to good news. If a firm practices conservative accounting, $(\beta_1 + \beta_3)/\beta_1$ is expected to be greater than one.

To ensure the robustness of the results, I employed various sensitivity tests including (1) Fama and MacBeth (1973) annual regression estimation; (2) control for industry and year effects; (3) control for firm specific factors; (4) restricting the observation to firms with Big Four auditors; (5) controlling for market return; (6) using announcement date returns; and (7) excluding firms with share price less than one Ringit (MYR). I also used the Basu time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism. Detailed discussions of the robustness tests are provided.

5.7.2 IFRS Adoption and Earnings Conservatism

The second objective of this study is to examine whether there is a significant change in earnings conservatism after the adoption of IFRS in Malaysia. To conduct the test, I estimate equation (5.2), which tests the significance of the difference in earnings conservatism between pre- and post-IFRS adoption periods. For the main analysis, I examine two samples: (i) 1,042 firm-year observations for one-year pre- and post-IFRS adoption; and (ii) 2,084 firm-year observations for two-year pre- and post-IFRS adoption. For the additional tests, I limit the sample to firms with financial year-end dated 31 December. This test involves a sample

of (i) 588 firm-year observations for one year pre- and post-IFRS adoption for firms with financial year end 31 December; and (ii) 1,176 firm-year observations for two year pre- and post-IFRS adoption.

$$\begin{aligned}
 E_{it}/P_{it-1} = & \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 IFRS_{it} \\
 & + \beta_5 IFRS_{it} * RET_{it} + \beta_6 IFRS_{it} * RD_{it} + \beta_7 IFRS_{it} * RET_{it} * RD_{it} \\
 & + \varepsilon_{it}
 \end{aligned} \tag{5.2}$$

where *IFRS* is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0 otherwise; and the other variables are as defined above.

Equation (5.2) is an adaptation of the Basu (1997) model. I estimate this equation to allow the coefficients β_3 to differ across pre- and post-IFRS periods. This modification enables this study to test for differences in conservatism across these two periods. The coefficient β_3 measures the level of conservatism in the pre-IFRS period. The corresponding measure in the post-IFRS period is $\beta_3 + \beta_7$. Therefore, the difference in conservatism between the pre- and post-IFRS periods is given by β_7 . If the coefficient is positive (negative), it would indicate that financial statements prepared under the new accounting standards (IFRS) are more (less) conservative than under the old standards (MASB standards). The coefficient β_1 measures how quickly good news is reflected in reported earnings in the pre-IFRS period. The corresponding measure in the post-IFRS period is $\beta_1 + \beta_5$. Therefore, the difference between the pre- and post-IFRS periods with regard to earnings incorporating good news is given by β_5 .

To ensure the robustness of the results, various sensitivity analyses are conducted including (1) using different samples and time frames; (2) Fama and MacBeth (1973) annual regression estimation; (3) controlling for industry and year effects; (4) restricting the observation to firms with Big Four auditors; (5) concentrating on firms audited by an industry specialist; and (6) using the Basu (1997) time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism. Detailed discussions of the robustness tests are provided.

5.7.3 Ownership Structure and Earnings Conservatism

The third objective of this study is to examine whether earnings conservatism is influenced by ownership structure, in particular, family firms and state-controlled firms. I also include widely-held firms to enable comparison. In doing so, I estimate equation (5.1) for different types of firms. For robustness analysis, I employ various sensitivity tests including (1) Fama and MacBeth (1973) annual regression estimation; (2) controlling for industry and year effects; (3) alternative definition for family firms and government-linked companies; (4) employing a time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism.

5.7.4 Corporate Governance and Earnings Conservatism

The fourth objective of this study is to examine the relationship between earnings conservatism and corporate governance. I estimate equations (5.3a) and (5.3b) to test the relationship between corporate governance and earnings conservatism.

$$\begin{aligned}
E_{it}/P_{it-1} = & \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 CGINDEX_{it} \\
& + \beta_5 CGINDEX_{it} * RET_{it} + \beta_6 CGINDEX_{it} * RD_{it} \\
& + \beta_7 CGINDEX_{it} * RET_{it} * RD_{it} + \varepsilon_{it}
\end{aligned} \tag{5.3a}$$

$$\begin{aligned}
E_{it}/P_{it-1} = & \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 DUMCG_{it} \\
& + \beta_5 DUMCG_{it} * RET_{it} + \beta_6 DUMCG_{it} * RD_{it} \\
& + \beta_7 DUMCG_{it} * RET_{it} * RD_{it} + \varepsilon_{it}
\end{aligned} \tag{5.3b}$$

where *CGINDEX* is an unweighted aggregate of 11 corporate governance variables; and *DUMCG* is a dummy variable that takes value 1 if *CGINDEX* is in the top third of the pooled sample, and 0 if *CGINDEX* is in the bottom third. The other variables are as defined above.

To ensure the robustness of the result, I perform several sensitivity tests such as (1) estimating the Fama and MacBeth (1973) annual regression; (2) controlling for industry and year effects; (3) using continuous variables rather than dummy variables; (4) employing a time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism. Detailed discussions of the robustness tests are provided in the relevant section.

5.8 Robustness Tests

This study includes various robustness tests for every hypothesis. In this section, I provide the general sensitivity tests that were conducted for all the hypotheses. Sensitivity analyses which are unique to a particular hypothesis are discussed separately in the data analysis section.

5.8.1 Alternative Measure for Earnings Conservatism

As noted in Section 2.4.1, the Basu asymmetric timeliness of earnings measure is subject to a number of criticisms. However, as also noted, Ryan (2006) concludes that asymmetric timeliness of earnings is still the best measure of earnings conservatism. Nevertheless, Ryan encourages the use of multiple measures. To ameliorate the above concerns, I also employed the time-series test of timeliness in loss recognition, equation (1.2), as described in Section 2.4.2.

Khan and Watts (2009) estimate a firm-year measure for earnings conservatism (*C_Score*) by allowing the coefficient for $RET*RD$ in the Basu (1997) asymmetric timeliness of earnings model to vary across firms and over time. An explanation of this model is provided in Section 2.4.5 above. Despite the robust estimation of *C_Score* in the United States, Khan and Watts (2009) suggest several caveats on the application of this model. First, the development of *C_Score* is motivated from the four Watts (2003a) determinants of conservatism in the US. Hence, for non-US samples, this may not be an appropriate measure since the institutional features differ from those in the United States. In certain countries, there are weak legal enforcement regimes, in which contracts are more easily vitiated and litigation (and litigation liabilities) more easily circumvented. Second, the *C_Score* has not been developed by solving for equilibrium conditions in an analytical model, thus it is not necessarily the optimal measure of conservatism. Finally, there are possibilities of a correlated omitted variable problem if *C_Score* is used as an independent variable in a multiple regression. Considering the caveats made by Khan and Watts (2009), I do not employ the firm-year measure.

5.8.2 Fama and MacBeth (1973) Annual Regression

I use the Fama and MacBeth (1973) annual regression estimate technique to cope with potential cross-sectional dependence problems, particularly since the data are concentrated over a small number of years. OLS standard errors from pooled regressions are biased and result in incorrect inferences in the presence of cross-sectional dependence (Bernard, 1989). This problem is especially acute in regressions using annual stock returns because the common time-series variation in observations drawn from the same year induces cross-sectional dependence, and biases the pooled cross-sectional standard errors (Basu, 1997). Estimating the regression separately for each year partially controls this problem. The coefficients for the parameters are obtained as the simple average from the cross-sectional regression. The t-statistics are the ratios of the mean estimated coefficients to the standard deviation of the distribution of the annual estimated slope coefficients, divided by the square root of the number of years.

5.8.3 Control for Firm-Specific Variables

To ascertain the validity of the results, this study controls for firm-specific variables, particularly firm size, leverage and market to book ratio. These variables influence Watts' explanations for conservatism, including contracting, litigation, taxation and regulation (Khan & Watts, 2009). Thus, in this study I include these variables as controls.

(i) Firm Size

This study controls for firm size (*SIZE*) as it affects the demand for conservatism. Given that larger firms are more mature and have richer information environments, the information asymmetry and the overall uncertainty of the business is low, which causes lower contracting demands for conservatism (Khan & Watts, 2009). Large firms also have lower information asymmetry than small firms, though their business operations are more complex, with many segments (Easley, Hvidkjaer, & O'Hara, 2002). On the other hand, larger firms have higher litigation demand for conservatism because these firms attract more litigation due to higher expected recovery costs. Khan and Watts (2009) argue that larger firms have lower taxation demand for conservatism since they have more divisions and segments, which permit the aggregation of gains with losses across divisions, and greater flexibility to smooth (or defer) high earnings, hence reducing the present value of their tax liability. The study measures size as the natural logarithm of a firm's assets.

(ii) Leverage

This study controls for firm leverage (*LEV*) because firms with higher leverage have higher contracting, litigation, and taxation demands for conservatism (Khan & Watts, 2009). Furthermore, the potential for agency conflicts between shareholders and debtholders is high when leverage is high (Barclay & Smith, 1995; Jensen & Meckling, 1976; Myers, 1977). In addition, high-leverage firms have a higher likelihood of financial distress and a higher

likelihood of being sued, thus generating greater demand for conservatism. High-leveraged firms are more likely to be mature firms with higher taxable earnings thereby generating a higher taxation demand for conservatism (Khan & Watts, 2009). In short, high-leverage firms are more likely to have a higher demand for conservatism as conservatism triggers debt covenant violations in a timely fashion and constrains opportunistic diversion of resources (Khan & Watts, 2009). The study measures leverage as the ratio of total debt to total assets.

(iii) Market to Book Ratio

Finally, the study controls for the market to book ratio (*MTB*), a proxy for growth options. This is crucial because firms with high growth options are more likely to have a higher probability of litigation, lower taxable earnings, and be free of regulation (Khan & Watts, 2009). Given that growth options are positively linked to agency costs (Smith & Watts, 1992), firms with a high levels of growth options (high *MTB*) would demand higher conservatism. Furthermore, high *MTB* firms have a higher litigation demand for conservatism because their stock returns are more volatile, since a large proportion of their market value is due to risky growth options (Khan & Watts, 2009). However, firms with high *MTB* are less likely to be regulated, and thus have a lower regulation demand for conservatism (Khan & Watts, 2009).

Application of earnings conservatism, or the asymmetric verification

requirements for gains versus losses, generates cumulative understatement of net assets relative to market values; hence it results in higher *MTB*. Roychowdury and Watts (2007), however, state that the positive relationship between conservatism and *MTB* is not observed empirically due to the ‘buffer problem’. They argue that in a short-horizon period, beginning *MTB* is negatively correlated with conservatism flows due to prior unrecognised increases in asset values reducing the necessity to recognise asset value losses. Given that ending *MTB* is a function of beginning *MTB*, this induces a negative relation between ending *MTB* and conservatism at the annual horizon (Roychowdury & Watts, 2007). However, for longer horizons (three years or more), Roychowdhury and Watts (2007) find the effect of the beginning *MTB* is minimised and ending *MTB* is positively correlated with conservatism.

5.9 Conclusions

The present chapter has described the research design and method adopted for the study. The sample is described, and the chapter then discussed the measures for the variables used in the study. Finally, the chapter explains the regression models employed in testing the hypotheses. The next chapter presents the data analysis and findings of the study.

CHAPTER SIX EMPIRICAL ANALYSIS

6.1 Introduction

This chapter presents and discusses the findings of this study. The chapter is organised as follows. Section 6.2 presents the descriptive statistics for the continuous and dichotomous variables, and the correlation matrix. It also provides a review of the econometric issues. The results for the test of Hypothesis 1 on earnings conservatism following the institutional reforms discussed in Chapter 3 are reported in Section 6.3. Section 6.4 presents the results for the test of Hypothesis 2 on the effect of IFRS adoption on earnings conservatism. The results for the test of Hypothesis 3 on how the level of earnings conservatism varies across different types of ownership structure are reported in Section 6.5. Section 6.6 presents the findings for the test of hypothesis 4 on the relationship between corporate governance and earnings conservatism. Each section includes the relevant sensitivity analyses. Finally, Section 6.7 summarises the findings.

6.2 Descriptive Statistics and Correlation Analysis

6.2.1 Descriptive Statistics

Table 6.1 provides the characteristics of the sample. Panel A shows the breakdown of the sample according to the financial year end. More than half (56.46%) of the sample has a financial year end of 31 December, while 12.35% and 13.63% of the sample have a financial year end of 31 March and 30 June,

respectively. Only a few firms close their accounts on months other than December, March and June.

Table 6.1
Sample characteristics

Panel A: Sample according to financial year end

Month	N	Pct (%)
January	124	3.97
February	12	0.38
March	386	12.35
April	90	2.88
May	73	2.34
June	426	13.63
July	53	1.70
August	54	1.73
September	72	2.30
October	53	1.70
November	18	0.58
December	1,765	56.46
Total	3,126	100.00

Panel B: Sample according to industry classifications

Sector	Symbol	N	Pct (%)
Construction	<i>CSTRUCT</i>	33	6.33
Consumer Product	<i>CONS</i>	87	16.70
Hotel	<i>HOTEL</i>	4	0.77
IPC	<i>IPC</i>	5	0.96
Industrial Product	<i>IPROD</i>	169	32.44
Plantation	<i>PLANT</i>	33	6.33
Property	<i>PROP</i>	67	12.86
Technology	<i>TECH</i>	17	3.26
Trading/Services	<i>TDG</i>	106	20.35
Total		521	100.00

Panel C: Sample according to ownership structure

Ownership	N	Pct (%)
Family firms	1,770	56.62
State-controlled firms	234	7.49
Widely-held firms	1,122	35.89
Total	3,126	100.00

Panel D: Sample according to auditor size

Auditor	N	Pct (%)
Big Four	2063	65.99
Non-Big Four	1063	34.01
Total	3,126	100.00

Panel E: Sample according to auditor industry specialisation

Auditor	N	Pct (%)
Industry specialist	854	27.32
Non-industry specialist	2272	72.68
Total	3,126	100.00

Panel B of Table 6.1 shows the classification of the sample according to industry. Almost one third of the sample (32.44%) comes from the industrial product sector, while the consumer product sector provides 16.70% of the sample. This is consistent with the general economy of Malaysia, where manufacturing sectors dominate the economy. The trading/services and property sectors are also significant in the sample, with 106 firms (20.35%) and 67 firms (12.86%) respectively. Thirty-three firms (6.33%) in the sample come from the construction sector. The plantation sector has only 33 firms (6.33%) in the total sample, which is quite a small proportion compared to the economic contribution of that sector and its importance to the Malaysian economy. This phenomenon is due to the large number of mergers among plantation firms, including firms under the control of the Malaysian government.

Panel C provides a breakdown of the ownership structure of the firms in the sample. More than half of the sample (56.62%) are family firms, followed by widely-held firms (35.89%) and state-controlled firms (7.49%). Even though the number of state-controlled firms is small, state-controlled firms constitute around

36% of the total market capitalisation (PCG, 2005), indicating there is significant influence by state-controlled firms in the Malaysian economy. Panel D and Panel E denote firm classification according to auditor size and specialisation. The Big Four auditors audited almost two-thirds (65.99%) of the sample, while the remaining firm-year observations (34.01%) were audited by non-Big Four auditors. An industry specialist audited more than a quarter (27.32%) of the total population, while the remaining firm-year observations (72.68%) were audited by non-specialist auditors.

Table 6.2
Descriptive statistics

<i>Variable</i>	Mean	SD	Min	Q1	Median	Q3	Max
<i>E/P</i>	0.044	0.286	-1.655	0.007	0.070	0.135	1.197
<i>RET</i>	0.179	0.824	-0.746	-0.250	-0.005	0.305	5.370
<i>SIZE</i>	8.561	0.580	7.465	8.132	8.485	8.900	10.313
<i>LEV</i>	0.411	0.209	0.043	0.249	0.405	0.560	0.899
<i>MTB</i>	1.025	0.822	0.152	0.495	0.771	1.253	4.205
<i>BODSIZE</i>	7.444	1.841	3.000	6.000	7.000	9.000	15.000
<i>NONEXEC</i>	0.621	0.172	0.200	0.500	0.600	0.750	1.000
<i>BODIND</i>	0.420	0.108	0.143	0.333	0.400	0.500	0.857
<i>BODMEET</i>	5.341	2.067	0.000	4.000	5.000	6.000	30.000
<i>ACSIZE</i>	3.457	0.677	2.000	3.000	3.000	4.000	10.000
<i>ACIND</i>	0.741	0.122	0.250	0.670	0.670	0.750	1.000
<i>ACMEET</i>	4.841	1.187	1.000	4.000	5.000	5.000	21.000
<i>ACEEXPERT</i>	0.370	0.182	0.000	0.250	0.333	0.400	1.000
<i>CGINDEX</i>	0.452	0.154	0.000	0.364	0.455	0.545	1.000

Note: All variables are truncated at 1% level (upper and bottom).

Table 6.2 summarises the descriptive statistics for the variables included in this study. For earnings yield (*E/P*), the mean is 0.044 with a maximum (minimum) value of 1.197 (-1.655). The stock return (*RET*) has a mean of 0.179, while the maximum (minimum) value is 5.370 (-0.746). Firm size (*SIZE*), measured using the natural logarithm of total assets, ranges between 7.465 and 10.313, with a

mean of 8.561. For leverage (*LEV*), the ratio of total debt to total assets is between 0.043 and 0.899, with a mean value of 0.411. The *MTB* ratio ranges between 0.152 and 4.205 with a mean value of 1.025. The mean value for board size (*BODSIZE*) is 7.444; board size ranges between 3 to 15 directors. For board composition, on average 62.1% of board members are non-executive directors (*NONEXEC*) and 42.0% are independent non-executive directors (*BODIND*), showing a high degree of compliance with the MCCG (2000) recommendations. For board meetings (*BODMEET*), on average five meetings were held every financial year, with a range between 0 and 30 meetings. In terms of the audit committee's characteristics, the committee has on average 3.457 members (*ACSIZE*), of whom 74.1% are independent non-executive directors (*ACIND*); the committee held an average of 4.841 meetings per financial year (*ACMEET*), and 37% of the audit committee members have an accounting and/or finance background and are members of professional accounting bodies (*ACEXPERT*). Finally, the unweighted corporate governance index (*CGINDEX*) is on average 0.452, with a range between 0.00 and 1.00.

6.2.2 Correlation Analysis

A correlation analysis was performed to test the strength of the relationships among the variables used in this study. Table 6.3 provides Pearson and Spearman correlations among all variables. In general, the analysis shows no suggestion of collinearity between the variables.

As reported in Table 6.3, earnings yield (*E/P*) and stock returns (*RET*) is positively correlated at the 1% level (Pearson = 0.305; Spearman = 0.405), which

is consistent with the theory on earnings-return relationship. Board size (*BODSIZE*) and audit committee size (*ACSIZE*) are positively correlated with earnings yield (*E/P*), while board independence (*BODIND*), board meeting (*BODMEET*), and audit committee meeting (*ACMEET*) are negatively correlated with earnings yield (*E/P*). The correlation between stock returns (*RET*) and other variables is low, with a Spearman correlation value between -0.050 and 0.073 and a Pearson correlation value between -0.038 and 0.043.

All variables other than earnings yield (*E/P*) and (*RET*) are significantly correlated with the corporate governance index (*CGINDEX*). This is consistent with the fact that the variables are used to develop the corporate governance score. The proportion of non-executive directors (*NONEXEC*) and board independence (*BODIND*) have moderate correlation with the corporate governance score. The Pearson (Spearman) correlation between the proportion of non-executive directors (*NONEXEC*) and corporate governance index (*CGINDEX*) is 0.523 (0.523), while the Pearson (Spearman) correlation between board independence (*BODIND*) and corporate governance index is 0.477 (0.497). The correlations for other variables fall between 0.368 and 0.114.

Overall, all variables have a correlation of less than 0.50, except for the correlation between *CGINDEX* and *NONEXEC*. The results from Table 6.3 suggest there is no serious multi-collinearity among the independent variables, since none of the correlations exceed 0.7 (Pallant, 2007).

Table 6.3
Correlation matrix

<i>E/P</i>	<i>RET</i>	<i>BODSIZE</i>	<i>NONEXEC</i>	<i>BODIND</i>	<i>BODMEET</i>	<i>ACSIZE</i>	<i>ACIND</i>	<i>ACMEET</i>	<i>ACEXPERT</i>	<i>CGINDEX</i>
<i>E/P</i>	0.305*	0.117*	0.023	-0.059*	-0.039**	0.033***	-0.008	-0.022	0.059*	0.009
<i>RET</i>	0.405*	0.043**	0.011	-0.026	-0.008	0.004	-0.038**	-0.015	-0.012	-0.005
<i>BODSIZE</i>	0.125*	0.073*	-0.005	-0.260*	0.031***	0.383*	0.095*	0.034***	-0.101*	-0.191*
<i>NONEXEC</i>	0.014	0.018		0.332*	0.146*	0.088*	0.048*	0.119*	-0.046*	0.523*
<i>BODIND</i>	-0.060*	-0.050*	0.304*		0.026	0.073*	0.293*	0.050*	-0.051*	0.477*
<i>BODMEET</i>	-0.035***	0.018	0.100*	0.043		0.027	0.009	0.461*	0.046	0.313*
<i>ACSIZE</i>	0.052*	0.382*	0.091*	0.111*	0.043		-0.094*	0.033***	-0.296*	0.040
<i>ACIND</i>	-0.001	0.171*	0.048*	0.274*	0.070*	0.220*		0.012	0.046**	0.308*
<i>ACMEET</i>	-0.068*	0.021	0.086*	0.059*	0.476*	0.038**	0.005		-0.001	0.307*
<i>ACEXPERT</i>	0.014	-0.177*	-0.045**	-0.050*	0.045**	-0.480*	-0.063*	-0.032***		0.114*
<i>CGINDEX</i>	-0.013	-0.171*	0.523*	0.497*	0.368*	0.063*	0.284*	0.269*	0.136*	

*, **, and *** Significant at $p < 0.01$, $p < 0.05$, and $p < 0.10$ (2-tailed).

Pearson – upper triangle; Spearman – lower triangle

6.2.3 Econometric Issues

This section discusses several potential econometric issues associated with the estimation of the earnings conservatism model. The issues include outliers, normality, heteroscedasticity and multicollinearity assumptions. These issues are related to the procedure for the estimation of the parameters of the ordinary least squares (OLS) regression. To ensure that the interpretation of the regression estimates is valid, the assumptions about the variables and the error term of OLS must be satisfied.

Firstly, I examined the issue of outliers or unusual observations. It is crucial to consider the undue influence of outliers because outliers can distort the interpretation of data and may lead to incorrect inferences. Some studies delete outliers (e.g. Ball & Shivakumar, 2006; Basu, 1997), while other studies truncate the outliers (e.g. García Lara & Mora, 2004). In this study, I truncated the upper and lower 1% of extreme value.

Table 6.4 summarises the basic statistics for stock return (*RET*) and earnings yield (*E/P*) truncated at 0% and 1%. The 0% truncation represents the unadjusted data that is, no truncation. The truncation at the 1% level indicates that the upper and lower 1% of extreme values are not eliminated but drawn at the tail of the distribution. For example, in the 1% level of truncation of stock return (*RET*), 98% of the values range from -0.746 to 5.370. Furthermore the extreme lower 1% of the value range is from -0.937 to -0.746 and the extreme upper 1% of the value range is from 5.370 to 37.775. Truncation at the 1% level forces the extreme lower firm-year observations to assume the value of -0.746 (at 1% lower) and the

extreme upper firm-year observations to assume the value of 5.370 (at 1% upper). Thus, the extreme values are drawn with the upper and lower tails of the distribution.

Table 6.4
Analysis for unusual observation and normality

Variable Truncation Level	Stock Return (<i>RET</i>)		Earnings Yield (<i>E/P</i>)	
	0 Percent	1 Percent	0 Percent	1 Percent
<i>Min</i>	-0.937	-0.746	-14.315	-1.655
<i>Maximum</i>	37.775	5.370	10.123	1.197
<i>Mean</i>	0.245	0.179	0.037	0.044
<i>Standard Deviation</i>	1.550	0.824	0.600	0.286
<i>Skewness</i>	12.442	3.522	-7.437	-1.887
<i>Kurtosis</i>	223.054	19.494	244.910	15.483
<i>Kolmogorov-Smirnov test</i> <i>(p-value)</i>	(p<0.01)	(p<0.01)	(p<0.01)	(p<0.01)
<i>Skewness/Kurtosis tests for</i> <i>Normality (p-value)</i>	(p<0.01)	(p<0.01)	(p<0.01)	(p<0.01)

The measure of skewness indicates the symmetry in the data. As reported in Table 6.4, I find that the measure of skewness decreases as the level of truncation increases. For example, the level of skewness at the 0% truncation level for stock returns equals (*RET*) 12.442, but it decreases to 3.522 at the 1% truncation level. For earnings yield (*E/P*), the skewness at the 0% truncation level is -7.437, decreases to -1.887 at the 1% truncation level. These results of the skewness of earnings yield and stock returns are consistent with evidence of conservatism. As reported in previous studies, for example Kwon, Yin and Han (2006), negative skewness of earnings is evidence of earnings conservatism.

Kurtosis statistics indicate the extent to which the distribution departs from a bell shape or normal curve due to fat tails. I find that the measure of kurtosis is very

high at the 0% truncation level but decreases at the higher truncation level. The analysis presented in Table 6.4 shows that the level of kurtosis for stock return is 223.054 at the 0% truncation level, and decreases substantially to 19.494 at the 1% truncation level. The level of kurtosis for the earnings yield variable acts in similar fashion. At the 0% truncation level, the kurtosis statistic for earnings yield is equal to 244.910 and then decreases to 15.483 at the 1% truncation level.

Secondly, I tested the assumption of normality for the dependent and independent variables by conducting a Kolmogorov-Smirnov test and Skewness/Kurtosis tests for normality. In addition, I drew the P-P Plots for Residuals and Dotplots of Residuals. Testing for normality (i.e., skewness and kurtosis) is important because it tells the researcher about the distribution of the sample data used for statistical inference. Non-normal data may lead to incorrect conclusions in inferential statistical analyses or may have a bias effect on correlation coefficients (Schroeder, Sjoquist, & Stephan, 1986).

The results in Table 6.4 show that the p-values for the Kolmogorov-Smirnov test and Skewness/Kurtosis tests for normality are less than 0.01 for both variables, showing a non-normally distributed population. Figure 6.1 and Figure 6.2 also depict the problem of normality. However, this problem is common in most market-based accounting studies. These studies find that earnings and stock returns data are skewed to the right, which indicates larger positive values than negative values. Hair, Black, Babin, Anderson, and Tatham (2006) contend that researchers can be less concerned with non-normal variables as the sample size become larger. In this study, the sample, with more than 3,100 observations, can

be considered large.

Figure 6.1
P-P Plots for residuals

Figure 6.2
Dotplots of residuals

Thirdly, I tested for heteroscedasticity when estimating the regression model by OLS. The problem of heteroscedastic disturbances arises from the fact that large (small) firms tend to produce large (small) disturbances. Gujarati (2004) argued that if heteroscedasticity is present, then the OLS estimators no longer exhibit minimum variance among all linear unbiased estimators.

I conducted a Breusch-Pagan/Cook-Weisberg test and White's test on various samples to test the heteroscedasticity assumption. The results for both diagnostic tests are presented in Table 6.5. The results show that the p-values for the Breusch-Pagan/Cook-Weisberg test and White's test for heteroscedasticity are less than 0.01 for both variables, indicating a problem of heteroscedasticity. To overcome this problem, all regression estimates were reported using t-statistics with White (1980) adjustment to correct for the possibility of heteroscedasticity.

Table 6.5
Diagnostic tests for Heteroscedasticity assumption

Sample	Breusch-Pagan/ Cook-Weisberg test		White's test	
	CHSQ	p-value	CHSQ	p-value
<i>Pooled sample</i>	242.73	0.000	65.2	0.000
<i>Family Firms</i>	117.09	0.000	72.14	0.000
<i>State-Controlled firms</i>	8.65	0.000	9.5	0.000
<i>Widely-Held firms</i>	50.68	0.000	32.61	0.000

Finally, I did not find any suggestion of multicollinearity among the regressors included in the regression model. Gujarati (2004) states that the term 'multicollinearity' is used where the variables are intercorrelated (perfect or non-perfect). This issue was discussed in the previous section. The Spearman and Pearson correlation reported in Table 6.3 do not indicate any serious collinearity

issues between the variables.

6.3 Earnings Conservatism Following the Reforms

6.3.1 Introduction

As noted earlier, the first objective of this study is to examine earnings conservatism in Malaysian financial reporting following the institutional reforms discussed in Chapter 3, particularly in respect of corporate governance and financial reporting. The following section (Section 6.3.2) presents the main empirical results, while Section 6.3.3 reports the results from the robustness analyses. Section 6.3.4 discusses the overall results for the first objective.

6.3.2 Main Analysis: Earnings Conservatism in Malaysia

This study employs the Basu (1997) reverse earnings-return regression to examine earnings conservatism, by the asymmetric timeliness of earnings measure. To provide greater insight into the differences in timeliness of earnings between good news and bad news samples, I partitioned the sample into good news and bad news subsamples, and then estimated the basic earnings-return regression to capture the timeliness of earnings in both samples. The regression estimates are reported in Column 1 and Column 2 of Table 6.6. I then estimated equation (5.1), the Basu (1997) reverse earnings-return regression, to test for significant difference between the asymmetric timeliness of earnings for the two subsamples. The regression estimates are summarised in Column 3. In Column 4, the regression estimates of Ball et al. (2003) on earnings conservatism in Malaysia

prior to the 1997 financial crisis are presented for comparison purposes.

The results reported in Column 1 and Column 2 of Table 6.6 show that the coefficients for *RET* in both good news and bad news subsamples are positive and significant at a 1% level. These results show evidence of the timeliness of earnings in response to economic news. The coefficient for *RET* in the good news sample is 0.071, which is lower than the coefficient for *RET* in the bad news sample, which is 0.260. These results indicate a higher timeliness of earnings in relation to bad news relative to good news.

Table 6.6
Asymmetric timeliness of earnings

Sample	Good News		Bad News		Pooled		Ball et al. (2003)	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.052*	(5.900)	0.062*	(5.234)	0.052*	(5.900)	Not reported	
<i>RET</i>	0.071*	(5.010)	0.260*	(7.387)	0.071*	(5.010)	Not reported	
<i>RD</i>					0.009	(0.637)	0.01**	(2.44)
<i>RET*RD</i>					0.189*	(4.975)	0.00	(0.20)
<i>Adj.R</i> ²	0.05		0.03		0.08		0.09	
<i>N</i>	1558		1568		3126		768	
<i>F</i> -stat	25.100		54.575		59.249		Not reported	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

Column 3 reports the regression estimates from the Basu (1997) model, which tests whether there is significant difference between the timeliness of earnings for the good news and bad news subsamples as reported in Column 1 and Column 2. The result shows that the coefficient for *RET*RD*, β_3 , is positive (0.189) and significant at the 1% level, implying that earnings reflect bad news in a more

timely manner than they reflect good news. The estimation results also show that $\beta_1 + \beta_3 > \beta_1$, equivalent to $(0.071 + 0.189) > 0.071$, indicates evidence of earnings conservatism. The value of $(\beta_1 + \beta_3)/\beta_1$ is 3.66, showing that earnings are three times more sensitive to bad news than to good news. With respect to the validity of the models, all F -statistics are significant at the 1% level, while the *adjusted-R*² for equation (5.1) is 8%, but is slightly lower than the result in Ball et al. (2003). For the good news and bad news subsamples, the *adjusted-R*²s are 5% and 3%.

To illustrate the evidence of earnings conservatism, I exhibit the relationship between stock returns and accounting earnings in Figure 6.3. This figure depicts all observations in the sample, with separate regression lines for good news and bad news samples. The slope directions for both lines show a positive relationship between stock return and earnings. As predicted, the slope for bad news in the second (Q2) and third quadrants (Q3) are higher than the slope coefficient for good news in the first quadrant (Q1), showing earnings are more sensitive to bad news relative to good news. This figure depicts evidence of earnings conservatism, in which earnings anticipate economic losses more quickly than economic gains, so that stock prices reflect bad news in the form of contemporaneous market losses earlier than good news in the form of market gains.

The findings as reported in Table 6.6 and illustrated in Figure 6.3 document evidence on earnings conservatism in Malaysia. Regression estimates for 3,126 firm-year observations, in the period following the institutional reforms, show that negative news is registered in earnings more promptly than positive news; hence

providing evidence to reject the first null hypothesis.

Figure 6.3
Asymmetric timeliness of earnings

This result differs from the result documented by Ball et al. (2003) for 768 firm-year observations from 1984 to 1996. Ball et al. Find that the coefficient for $RET*RD$ is 0.00 and not significant ($p>0.10$), showing no evidence for earnings conservatism, or no significant difference in the timeliness of earnings between good news and bad news. In an environment of weak institutional structure, Ball et al. (2003) suggest that preparers of financial reports have less incentive to report high quality earnings, even though the accounting standards are of high quality. Complementing Ball et al. (2003) and Bushman and Piotroski (2006), this study shows evidence of earnings conservatism in the period following the institutional reforms, implying that managers and preparers of financial reports

have higher expectations to meet in reporting and thus report earnings conservatively. In short, our results suggest that the strong institutional factors give greater incentives for managers to report earnings conservatively.

6.3.3 Sensitivity Analysis

This section reports the results from sensitivity tests on the findings in Section 6.3.2. Eight sensitivity analyses were conducted: Fama and MacBeth (1973) annual regression estimation (Section 6.3.3.1), controlling for industry and year effects (Section 6.3.3.2), controlling for firm-specific variables (Section 6.3.3.3), restricting the sample to firms with Big Four auditors (Section 6.3.3.4), controlling for market return (Section 6.3.3.5), employing an alternative measure of economic news using inter-announcement period stock returns (Section 6.3.3.6), excluding observation with share prices less than MYR 1.00 (Section 6.3.3.7), and employing the time-series test of timeliness in loss recognition model as an alternative measure of earnings conservatism (Section 6.3.3.8).

6.3.3.1 Fama and MacBeth (1973) Annual Regression

I estimated a Fama and MacBeth (1973) annual regression to address the possibility of the earlier results being influenced by cross-sectional dependence problems.²⁵ The regression estimates for a good news sample, a bad news sample and a pooled sample using Fama and MacBeth (1973) are reported in Table 6.7.

²⁵ The results obtained from estimating the Fama and MacBeth (1973) annual regression should be interpreted with caution since it assumes that the relationship between variables is stationary over time. Basu et al. (2001) raises concern about the results from this analysis when applied in capital-market-based accounting research.

Table 6.7**Asymmetric timeliness of earnings: Fama and MacBeth (1973) annual regression**

Sample	Good News		Bad News		Pooled	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.068**	(3.845)	0.074**	(3.954)	0.068**	(3.845)
<i>RET</i>	0.054**	(2.649)	0.373*	(5.609)	0.054**	(2.649)
<i>RD</i>					0.006	(0.616)
<i>RET*RD</i>					0.319**	(3.973)
<i>Adj.R</i> ²	0.06		0.06		0.11	
<i>N</i>	1558		1568		3126	
<i>F</i> -stat	7.016		31.458		33.088	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. I use the Fama and MacBeth (1973) methodology to cope with the possible cross-sectional dependence problems. The coefficients of the parameters have been obtained as the simple average from the cross-sectional regression. The *t*-statistics are the ratios of the mean estimated Coefficients to the standard deviation of the distribution of the annual estimated slope Coefficients, divided by the square root of the number of years. Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

Table 6.7 shows the coefficients for RET , β_1 , in all samples are significant, showing evidence of the timeliness of earnings. The coefficient for RET in the bad news sample is 0.373 and significant at the 1% level. This is substantially higher than the good news sample, where the coefficient for RET is only 0.054 ($p < 0.05$). The coefficient for $RET * RD$, which measures the asymmetric timeliness of earnings between the two samples, is positive (0.319) and significant at the 5% level, implying that bad news is recognised significantly faster than good news. In essence, the results in Table 6.7 are consistent with the earlier findings that earnings conservatism is a pervasive feature of Malaysian financial reporting in the period following the institutional reforms.

6.3.3.2 Industry and Year Effects

In this section, I control for the serial correlation problems of the residuals of

panel data by incorporating industry and year dummies in the regression model. Using the Bursa Malaysia industry classifications, I created eight industry dummies: consumer (*CONS*); hotel (*HOTEL*); infrastructure project company (*IPC*); industrial product (*IPROD*); plantation (*PLANT*); property (*PROP*); technology (*TECH*); and trading and services (*TDG*).²⁶

Table 6.8
Asymmetric timeliness of earnings: Controlling for industry and year effects

Statistics	Industry Effect		Year Effect		Industry & Year Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.027	(1.109)	0.027**	(2.015)	0.001	(0.052)
<i>RET</i>	0.071*	(4.946)	0.068*	(4.769)	0.068*	(4.703)
<i>RD</i>	0.009	(0.601)	0.003	(0.192)	0.002	(0.142)
<i>RET*RD</i>	0.191*	(4.983)	0.265*	(6.724)	0.269*	(6.747)
<i>CONS</i>	0.023	(0.879)			0.021	(0.830)
<i>HOTEL</i>	-0.034	(-0.632)			-0.038	(-0.702)
<i>IPC</i>	0.024	(0.697)			0.022	(0.628)
<i>IPROD</i>	0.039	(1.566)			0.041***	(1.661)
<i>PLANT</i>	0.033	(1.069)			0.027	(0.909)
<i>PROP</i>	0.009	(0.320)			0.011	(0.399)
<i>TECH</i>	0.034	(0.919)			0.038	(1.047)
<i>TDG</i>	0.028	(1.087)			0.028	(1.123)
<i>Y2004</i>			0.014	(0.798)	0.014	(0.805)
<i>Y2005</i>			0.067*	(3.944)	0.068*	(3.982)
<i>Y2006</i>			-0.008	(-0.448)	-0.008	(-0.448)
<i>Y2007</i>			0.049*	(3.096)	0.049*	(3.099)
<i>Y2008</i>			0.115*	(6.587)	0.116*	(6.564)
<i>Adj.R</i> ²	0.08		0.09		0.09	
<i>N</i>	3126		3126		3126	
<i>F</i> -stat	16.901		27.355		14.056	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

²⁶ The Construction sector is not included in the model to avoid the perfect multi-collinearity problem.

For year variables, I created five dummy variables from 2004 to 2008, while year 2003 was used as a base variable. I then re-estimated equation (5.2) with industry and year effects. Table 6.8 summarises the regression estimates including: industry effect (column 1), year effect (column 2), and both industry and year effects (column 3).

The result reported in table 6.8 shows that earnings conservatism is a strong feature of Malaysian financial reporting even after controlling for industry and year effects. The coefficient values for $RET*RD$ after controlling for industry effect, year effect, and both industry and year effects, are 0.191, 0.265, and 0.269 respectively, which are all significant at the 1% level. These results imply robust evidence of earnings conservatism in Malaysia in the period following the institutional reforms. At the same time, the results in Table 6.8 show that the coefficients for RET are positive and significant at the 1% level, suggesting that earnings are timely in the recognition of good news.

6.3.3.3 Control for Firm-Specific Variables

This section examines whether the main result is robust after controlling for firm-specific variables such as firm size ($SIZE$), firm leverage (LEV), and growth (MTB). Khan and Watts (2009) find these variables have significant influence on earnings conservatism. Discussion of these factors was provided in Section 5.8.3. Following LaFond and Watts (2008), I included the interaction variables of $SIZE$, LEV , and MTB with RET , RD and $RET*RD$ in equation (5.1). I then estimated the modified equation using pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression. The results are presented in Table 6.9.

The regression estimates reported in Table 6.9 show qualitatively similar results to those reported in the main analysis. The coefficients for $RET*RD$ are positive and significant ($p<0.01$) in all models, implying a more timely recognition of economic losses than economic gains in Malaysia even after controlling the effect of $SIZE$, LEV , and MTB .

For the control variables, the results in Table 6.9 show that all the control variables have significant influence on earnings conservatism. Firm size ($SIZE$) has a negative relationship with earnings conservatism, where the coefficients for $SIZE*RET*RD$ are negative and significant ($p<0.10$). These results provide support for the argument that large firms have lower information asymmetry, thus reducing the contracting demands for conservatism (Khan and Watts, 2009).

For firm leverage (LEV), the results show a positive relationship between LEV and earnings conservatism. The coefficient for $LEV*RET*RD$ for the pooled regression and the Fama and MacBeth (1973) annual regression are positive and significant ($p<0.10$), suggesting that high-leverage firms have higher agency costs and higher financial distress costs, hence creating greater demand for conservatism to alleviate the problems. However, the regression estimates that control for industry effect and year effects do not find any significant association between LEV and conservatism. A plausible explanation is that the risks associated with a specific industry and time period have been captured by the fixed-effect variables.

Table 6.9

Asymmetric timeliness of earnings: Controlling for firm-specific variables

Model Statistics	Pooled		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	-0.355*	(-3.064)	-0.396**	(-3.741)	-0.475*	(-3.881)
<i>RET</i>	-0.230	(-1.481)	-0.257	(-1.296)	-0.206	(-1.283)
<i>RD</i>	0.223	(1.212)	0.258	(1.240)	0.253	(1.355)
<i>RET*RD</i>	1.071**	(2.298)	1.073***	(2.251)	1.062**	(2.180)
<i>SIZE</i>	0.060*	(4.251)	0.064*	(5.009)	0.073*	(4.966)
<i>SIZE*RET</i>	0.033***	(1.823)	0.040	(1.610)	0.029	(1.573)
<i>SIZE*RD</i>	-0.026	(-1.169)	-0.029	(-1.136)	-0.032	(-1.384)
<i>SIZE*RET*RD</i>	-0.124**	(-2.241)	-0.117***	(-2.024)	-0.110***	(-1.906)
<i>LEV</i>	-0.294*	(-5.081)	-0.213**	(-3.856)	-0.311*	(-5.123)
<i>LEV*RET</i>	0.064	(0.869)	-0.035	(-0.300)	0.066	(0.902)
<i>LEV*RD</i>	0.031	(0.313)	-0.009	(-0.165)	0.035	(0.354)
<i>LEV*RET*RD</i>	0.421***	(1.803)	0.694**	(3.398)	0.360	(1.548)
<i>MTB</i>	0.002	(0.163)	-0.016	(-0.826)	-0.005	(-0.486)
<i>MTB*RET</i>	-0.002	(-0.128)	0.018	(0.886)	0.001	(0.076)
<i>MTB*RD</i>	-0.003	(-0.166)	0.005	(0.381)	0.002	(0.109)
<i>MTB*RET*RD</i>	-0.126*	(-2.866)	-0.238**	(-3.383)	-0.143*	(-3.150)
<i>CONS</i>					0.008	(0.333)
<i>HOTEL</i>					-0.091***	(-1.829)
<i>IPC</i>					-0.042	(-1.078)
<i>IPROD</i>					0.028	(1.210)
<i>PLANT</i>					-0.052***	(-1.732)
<i>PROP</i>					-0.032	(-1.247)
<i>TECH</i>					0.022	(0.623)
<i>TDG</i>					0.002	(0.102)
<i>Y2004</i>					0.007	(0.420)
<i>Y2005</i>					0.058*	(3.625)
<i>Y2006</i>					-0.012	(-0.704)
<i>Y2007</i>					0.034**	(2.169)
<i>Y2008</i>					0.092*	(5.506)
<i>Adj.R</i> ²	0.15		0.18		0.16	
<i>N</i>	3126		3126		3126	
<i>F</i> -stat	28.366		19.538		17.124	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 SIZE_{it} + \beta_5 SIZE_{it} * RET_{it} + \beta_6 SIZE_{it} * RD_{it} + \beta_7 SIZE_{it} * RET_{it} * RD_{it} + \beta_8 LEV_{it} + \beta_9 LEV_{it} * RET_{it} + \beta_{10} LEV_{it} * RD_{it} + \beta_{11} LEV_{it} * RET_{it} * RD_{it} + \beta_{12} MTB_{it} + \beta_{13} MTB_{it} * RET_{it} + \beta_{14} MTB_{it} * RD_{it} + \beta_{15} MTB_{it} * RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; $SIZE_{it}$ is the natural logarithm of total assets for firm *i* in fiscal year *t*; LEV_{it} is the ratio of total debts to total

assets for firm i in fiscal year t ; MTB_{it} is the market to book ratio for firm i in fiscal year t ; and ε_{it} is the error term.

For growth (MTB), the results show a strong negative relationship between MTB and earnings conservatism. The coefficients of $MTB*RET*RD$ are negative and significant in all models, indicating that high-growth firms report more conservative earnings. This finding is consistent with the explanation given by Roychowdhury and Watts (2007) that the short horizon MTB is negatively correlated with conservatism flows due to prior unrecognised increases in asset values reducing the necessity to recognise asset value losses.

In short, the estimation results after controlling for firm-specific variables provide support for the main finding that earnings conservatism is a pervasive feature of Malaysian financial reporting following the institutional reforms. In addition, the analysis also provides evidence that $SIZE$, LEV and MTB have significant influence on earnings conservatism.

6.3.3.4 Restricted Sample - Firm Audited by Big Four Auditors

In this section, I control for the difference in audit quality of the Big Four and non-Big Four auditors. Previous studies assert that Big Four auditors (previously known as Big Five/Six/Eight) have a higher audit quality than non-Big Four auditors (DeAngelo, 1981; Francis & Simon, 1987; Palmrose, 1988). Becker et al. (1998) and Francis et al. (1999) find that the clients of Big Six auditors report low discretionary accruals compared to the clients of non-Big Six auditors, even though clients of Big Six auditors have high levels of total accruals. These results show that Big Four auditors have a greater ability to constrain their clients'

aggressive accounting, thus increasing the quality of earnings. Jeong and Rho (2004) state that the Big Four interpret GAAP conservatively and take a strong negotiating stance with clients who require more adjustments to the financial statements. Chung et al. (2003) find that Big Six auditors influence their clients to adopt more conservative accounting when the clients' financial performance is worse than expected.

To control for the differential quality of audit, I reduced the sample to firms audited by Big Four firms. I then re-estimated equation (5.1) using basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression controlling for industry and year effects. The results are presented in Table 6.10.

Table 6.10 shows that the regression estimates for equation (5.1) denote a qualitatively similar result as results in the main analysis. The coefficients for *RET* are positive and significant in all three models, suggesting that earnings are timely in recognition of good news. The coefficients for *RET*RD*, which measure earnings conservatism, are positive and significant at the 1% level. Specifically, the coefficient values for pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression are 0.196, 0.284, and 0.251 respectively; implying negative news is registered in earnings more promptly than positive news. All *F*-statistics are significant at the 1% level, indicating the validity of the models.

Table 6.10

Asymmetric timeliness of earnings: Firms audited by Big Four auditors

Model Statistics	Pooled		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.067*	(6.435)	0.079*	(5.207)	0.073*	(3.395)
<i>RET</i>	0.070*	(4.097)	0.053***	(2.307)	0.066*	(3.859)
<i>RD</i>	0.012	(0.845)	0.007	(0.932)	0.007	(0.436)
<i>RET*RD</i>	0.196*	(4.949)	0.284*	(4.429)	0.251*	(6.044)
<i>CONS</i>					-0.027	(-1.400)
<i>HOTEL</i>					-0.100***	(-1.914)
<i>IPC</i>					-0.044	(-1.214)
<i>IPROD</i>					-0.011	(-0.598)
<i>PLANT</i>					-0.024	(-0.836)
<i>PROP</i>					-0.031	(-1.425)
<i>TECH</i>					-0.005	(-0.118)
<i>TDG</i>					-0.029	(-1.491)
<i>Y2004</i>					0.004	(0.227)
<i>Y2005</i>					0.047*	(2.782)
<i>Y2006</i>					-0.015	(-0.762)
<i>Y2007</i>					0.051*	(3.191)
<i>Y2008</i>					0.078*	(4.443)
<i>Adj.R</i> ²	0.10		0.13		0.11	
<i>N</i>	2063		2063		2063	
<i>F</i> -stat	46.084		54.078		12.539	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

6.3.3.5 Market-Adjusted Return

A study by Morck et al. (2000) reported that the systematic component of returns variation is larger in emerging markets compared to the United States and other developed countries. In Malaysia, and other developing countries, the stock returns variation appears unrelated to fundamentals' co-movement, while in the United States, high firm-specific returns variation was documented. To control for

this problem, time-series non-stationarity in the returns processes, I employed market-adjusted returns as an alternative proxy for economic news. In addition, the use of market-adjusted returns provides a useful robustness check because it can be argued that market-adjusted returns may provide a more reliable indicator for good versus bad news (Pope & Walker, 1999).

To calculate the market-adjusted return, $RET(MKT)$, I used the Bursa Malaysia Composite Index as a proxy for market return. I then calculated a dummy variable $RD(MKT)$, and $RET(MKT)*RD(MKT)$ before re-estimating equation (5.1) using the basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression. The results are summarised in Table 6.11.

The results reported in Table 6.11 show qualitatively similar results to those reported in the main results, in which earnings conservatism is a strong feature of Malaysian financial reporting. The coefficients for $RET(MKT)*RD(MKT)$ are positive and significant ($p<0.01$) in all models, implying a more timely recognition of economic losses than economic gains in Malaysia.

Specifically, the estimated value for $(\beta_1 + \beta_3)/\beta_1$ in the pooled regression is 4.03, implying that earnings are four times more sensitive to bad news than to good news. In other estimation models, higher estimated values for $(\beta_1 + \beta_3)/\beta_1$ were found, showing qualitatively similar results. With respect to the validity of the models, all F -statistics are significant at the 1% level, while the values for $adjusted-R^2$ are between 8% and 10%, consistent with other studies on earnings conservatism.

Table 6.11
Asymmetric timeliness of earnings: Alternative measure for news (market adjusted return)

Model Statistics	Pooled		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.071*	(6.999)	0.079*	(5.149)	0.006	(0.228)
<i>RET(MKT)</i>	0.069*	(4.348)	0.053***	(2.490)	0.065*	(4.058)
<i>RD(MKT)</i>	0.003	(0.216)	0.010	(0.798)	0.010	(0.717)
<i>RET(MKT)*RD(MKT)</i>	0.209*	(6.021)	0.306**	(3.727)	0.271*	(7.317)
<i>CONS</i>					0.029	(1.118)
<i>HOTEL</i>					-0.044	(-0.813)
<i>IPC</i>					0.020	(0.548)
<i>IPROD</i>					0.044***	(1.787)
<i>PLANT</i>					0.025	(0.822)
<i>PROP</i>					0.008	(0.300)
<i>TECH</i>					0.043	(1.188)
<i>TDG</i>					0.031	(1.202)
<i>Y2004</i>					0.039**	(2.216)
<i>Y2005</i>					0.059*	(3.592)
<i>Y2006</i>					0.007	(0.379)
<i>Y2007</i>					0.104*	(6.202)
<i>Y2008</i>					0.042*	(2.707)
$\beta_1 + \beta_3 > \beta_1$	4.03		6.77		5.17	
<i>Adj.R</i> ²	0.08		0.10		0.09	
<i>N</i>	3126		3126		3126	
<i>F</i> -stat	65.942		27.964		15.013	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 \text{RET(MKT)}_{it} + \beta_2 \text{RD(MKT)}_{it} + \beta_3 \text{RET(MKT)}_{it} * \text{RD(MKT)}_{it} + \text{Industry} + \text{Year} + \varepsilon_{it}$$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET(MKT)_{it} is the market adjusted return of firm *i* in fiscal year *t*; RD(MKT)_{it} is a dummy variable that equals 1 if RET(MKT)_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

6.3.3.6 Inter-Announcement Period Stock Return

In this section, I use inter-announcement period stock returns, RET(ANC) , as an alternative measure for economic news. RET(ANC) is calculated based on the period of three months after the end of the previous fiscal year to three months

after the current fiscal year. I re-estimated equation (5.1) using the pooled regression model, Fama and Macbeth (1973) estimation, and the estimation controlling for industry and year effects. The results are reported in Table 6.12.

Table 6.12
Asymmetric timeliness of earnings: Alternative measure for news (inter-
announcement date return)

Model Statistics	Pooled		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.067*	(6.828)	0.072*	(4.112)	0.001	(0.044)
<i>RET(ANC)</i>	0.050*	(2.762)	0.070**	(3.280)	0.059*	(3.199)
<i>RD(ANC)</i>	0.015	(0.989)	0.016	(1.438)	0.003	(0.168)
<i>RET(ANC)*RD(ANC)</i>	0.242*	(5.512)	0.325*	(5.779)	0.311*	(6.851)
<i>CONS</i>					0.009	(0.334)
<i>HOTEL</i>					-0.042	(-0.749)
<i>IPC</i>					0.004	(0.112)
<i>IPROD</i>					0.034	(1.335)
<i>PLANT</i>					0.031	(1.001)
<i>PROP</i>					0.000	(0.017)
<i>TECH</i>					0.037	(1.023)
<i>TDG</i>					0.021	(0.811)
<i>Y2004</i>					0.066*	(3.556)
<i>Y2005</i>					0.074*	(4.194)
<i>Y2006</i>					-0.004	(-0.232)
<i>Y2007</i>					0.093*	(5.397)
<i>Y2008</i>					0.142*	(7.730)
<i>Adj.R</i> ²	0.04		0.07		0.07	
<i>N</i>	3124		3124		3124	
<i>F</i> -stat	37.886		106.921		12.186	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET(ANC)_{it} + \beta_2 RD(ANC)_{it} + \beta_3 RET(ANC)_{it} * RD(ANC)_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; $RET(ANC)_{it}$ is the announcement date return of firm *i* in fiscal year *t*; $RD(ANC)_{it}$ is a dummy variable that equals 1 if $RET(ANC)_{it}$ is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

With regard to earnings conservatism, the results reported in Table 6.12 show that the coefficients for $RET(ANC)*RD(ANC)$ are positive and significant at the 1%

level in all models, implying that bad news is recognised in a more timely fashion than is good news. In short, the results support the prediction managers and preparers of financial reports have higher incentives to report earnings conservatively in order to meet higher market demand for quality accounting information following the institutional reforms.

6.3.3.7 Reduced Sample: Stock Price Higher than MYR 1.00

In this section, I reduce my set of firm-year observations to include only firms with stock prices higher than MYR 1.00. This procedure was undertaken to avoid the creation of artificial scale problems that could lead to the nonlinearity of the model (Kothari & Zimmerman, 1995). In addition, smaller firms have, on average, less liquid stocks, greater information asymmetry and higher idiosyncratic uncertainty (Khan & Watts, 2009). For this reason many studies do not include those observations where the deflator (price at the beginning of the period) is smaller than one dollar. For example, García Lara and Mora (2004) exclude observations with stock prices less than one Euro, while Lobo and Zhou (2006) and Khan and Watts (2009) exclude observations with stock prices below US\$ 1.00.

As a result of excluding all observation with stock price less than MYR 1.00., the number of sample reduces to 1,312 firm-year observations. I then re-estimated equation (5.1) using basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression controlling for industry and year effects. The regression estimates are summarised in Table 6.13.

Table 6.13
Asymmetric timeliness of earnings: Sample with stock price greater than MYR 1.00

Sample Statistics	Pooled		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.075*	(8.834)	0.083*	(8.999)	0.019	(0.730)
<i>RET</i>	0.070*	(5.714)	0.057*	(4.713)	0.067*	(5.567)
<i>RD</i>	0.016	(1.073)	0.027***	(2.036)	0.011	(0.746)
<i>RET*RD</i>	0.185*	(2.969)	0.361**	(3.536)	0.249*	(3.778)
<i>CONS</i>					0.028	(1.114)
<i>HOTEL</i>					0.026	(0.925)
<i>IPC</i>					0.041	(1.345)
<i>IPROD</i>					0.028	(1.094)
<i>PLANT</i>					0.000	(0.003)
<i>PROP</i>					0.030	(1.080)
<i>TECH</i>					0.042	(1.515)
<i>TDG</i>					0.010	(0.362)
<i>Y2004</i>					0.013	(0.664)
<i>Y2005</i>					0.052**	(2.506)
<i>Y2006</i>					0.011	(0.470)
<i>Y2007</i>					0.080*	(4.714)
<i>Y2008</i>					0.115*	(5.098)
<i>Adj.R</i> ²	0.10		0.14		0.14	
<i>N</i>	1312		1312		1312	
<i>F</i> -stat	24.331		70.483		7.715	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 1,312 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

Consistent with the earlier results, I find robust evidence for earnings conservatism in Malaysia. The coefficients for $RET*RD$, which measure earnings conservatism, are positive and significant at the 1% level, hence providing evidence of earnings conservatism in Malaysia following the institutional reforms. Specifically, the coefficient values for pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression are 0.185, 0.361, and 0.249

respectively. These results imply that earnings reflect bad news in a more timely manner than they reflect good news. All F -statistics are significant at the 1% level, while *adjusted-R*²s are between 10% and 14%, indicating the validity of the models.

6.3.3.8 Time-series Test of Timeliness in Loss Recognition

Several studies, for example Dietrich et al. (2007), criticise the application of Basu (1997) reverse regression as a measure for earnings conservatism. The detailed criticisms have been provided in Section 5.8.4. To overcome these criticisms, I followed the suggestion made by Ryan (2006) on the use of multiple measures for earnings conservatism. Similar to Basu (1997) and Ball et al. (2000), I use the time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism.

In the time-series test of timeliness in loss recognition model, I examine the persistence of changes in earnings, a function of the sign of the past-period change, as an alternative measure for earnings conservatism. Economic income is assumed to be completely transitory or independent across time. When earnings reflect economic gains and losses in a timely manner, it will incorporate transitory components. To the extent that earnings smoothes economic income over time, primarily by awaiting the realization of changes in cash flows, it will exhibit persistence. If earnings are asymmetrically conservative in the Basu (1997) sense, primarily by anticipating decreases but not increases in expected future cash flows, it will exhibit larger transitory decreases than increases.

To examine the persistence of changes in earnings, I re-estimated equation (1.2) using basic pooled regression, a Fama and MacBeth (1973) annual regression, and fixed-effects regression. The results are reported in Table 6.14. Consistent with the results reported in Basu's reverse regression, the regression estimates show evidence of earnings conservatism in Malaysia following the institutional reforms. The results from the time-series test of timeliness in loss recognition show that earnings decreases are much less persistent (more transitory) than earnings increases. The coefficient for $\Delta NI_{it-1} * D\Delta NI_{it-1}$, α_3 , is -0.701 ($p < 0.01$) which is incremental with respect to the α_1 with coefficient of -0.116 ($p < 0.05$). This result implies accounting income reflects economic losses more quickly than economic profits in the period after the corporate governance and financial reporting reforms in Malaysia.

The regression estimates from the Fama and MacBeth (1973) annual regression and estimation controlling for industry and year effects shows similar results. For the Fama and MacBeth (1973) annual regression, the coefficient for ΔNI_{it-1} , α_1 , -0.104 ($p > 0.10$), shows no evidence of reversal of prior earnings increase, while the coefficient for $\Delta NI_{it-1} * D\Delta NI_{it-1}$ is -0.741 ($p < 0.01$), indicating significant evidence that earnings decreases are more transitory than earnings increases. The evidence from the estimation results after controlling for industry effects and year effects also reaches a similar conclusion: the coefficient for $\Delta NI_{it-1} * D\Delta NI_{it-1}$ is -0.704 ($p < 0.01$), suggesting that Malaysian firms report earnings conservatively.

Table 6.14

Time-series test of timeliness in loss recognition: Various specifications

Sample Statistics	Pooled		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.006*	(-2.674)	0.006	(-1.983)	0.003	(-0.417)
ΔNI_{t-1}	-0.116**	(-2.184)	-0.104	(-1.312)	-0.115*	(-5.710)
$D\Delta NI_{t-1}$	-0.017*	(-4.259)	-0.018**	(-2.981)	-0.017*	(-4.596)
$\Delta NI_{t-1} * D\Delta NI_{t-1}$	-0.701*	(-6.707)	-0.741*	(-6.185)	-0.704*	(-15.555)
<i>CONS</i>					-0.002	(-0.282)
<i>HOTEL</i>					0.001	(-0.048)
<i>IPC</i>					-0.005	(-0.344)
<i>IPROD</i>					0.001	(-0.080)
<i>PLANT</i>					0.014***	(-1.671)
<i>PROP</i>					-0.002	(-0.342)
<i>TECH</i>					-0.006	(-0.625)
<i>TDG</i>					0.000	(-0.065)
<i>Y2004</i>					0.002	(-0.357)
<i>Y2005</i>					0.000	(-0.081)
<i>Y2006</i>					0.002	(-0.441)
<i>Y2007</i>					0.016*	(-3.154)
<i>Y2008</i>					-0.001	(-0.264)
<i>Adj.R</i> ²	0.14		0.16		0.15	
<i>N</i>	3105		3105		3105	
<i>F</i> -stat	33.33		47.732		33.131	

Model: $\Delta NI_{it} = \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + industry + year + \varepsilon_{it}$

The sample comprises 3,105 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: ΔNI_{it} is the change in earnings for firm *i* from year *t*-1 to year *t*, standardised by total assets at end of year *t*-1; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

In short, the results from the time-series test of timeliness in the loss recognition model are consistent with those reported in the main results. Earnings reported in Malaysia, following the institutional reforms, is timely in recognising losses compared to gains, and thus provides evidence to reject the first null hypothesis.

6.3.4 Discussion of the Results

In the first hypothesis, I predict that earnings conservatism is pervasive in Malaysia following the institutional reforms because of the high demand and incentives to produce high-quality reporting of earnings. Previously, Ball et al. (2003) found no evidence of earnings conservatism in a sample from 1984 to 1996, and concluded that Malaysian financial reporting is of low quality. In this study, I argue that institutional reforms have provided strong demand and incentives for high-quality reporting.

The results show that there is robust evidence of earnings conservatism following the institutional reforms, in which economic losses are recognised in a more timely way than are economic gains. Specifically, earnings are at least three times more sensitive to negative stock returns than to positive stock returns. These results are also robust to various sensitivity tests, including: (1) estimation of Fama–Macbeth t-statistics; (2) estimation controlling for industry and year effects; (3) estimation controlling for firm size, leverage and market to book ratio; (4) controlling for differential audit quality; (5) controlling the effect of market return; (6) employing inter-announcement stock returns as proxy for economic news; (7) reducing the observation to firms with a share price greater than MYR 1.00; and (8) estimation of the time-series test of timeliness in loss recognition model. All the results support the prediction concerning earnings conservatism (that bad news is recognised in a more timely way than is good news); hence the results provide enough evidence to reject the first null hypothesis.

This finding provides support to the arguments made by Bushman and Piotroski

(2006) and Ball et al. (2003) that country-specific factors and preparers' incentives have significant influence in earnings conservatism. Evidence of earnings conservatism in the post-reform period shows that firms have greater incentives and demands to report high quality earnings, in particular by more timely recognition of bad news compared to good news. Contrary to the period before the economic crisis where the weak institutional structures resulted in less incentive to preparers to report earnings conservatively (Ball, et al., 2003).

6.4 IFRS Adoption and Earnings Conservatism

6.4.1 Introduction

The second objective of this study concentrates on the effect of IFRS adoption on earnings conservatism. The main empirical results are reported in Section 6.4.2, which includes comparison of earnings conservatism levels before and after adoption of IFRS, based on one-year and two-year horizons. Section 6.4.3 presents various sensitivity tests, including control for industry and year effects; restricting the sample to observations with a financial year end dated 31 December; limiting the analysis to firms with Big Four auditors; and restricting the observations to firms audited by an industry specialist. In addition, the sensitivity tests also include the time-series test in loss recognition. Section 6.4.4 summarises the findings.

6.4.2 Main Analysis: The Effect of IFRS Adoption on Earnings Conservatism

To examine the effect of IFRS adoption on earnings conservatism, I estimated the

Basu (1997) reverse earnings-return regression, equation (5.1), for two subsamples: (i) one year before and after IFRS adoption, and (ii) two years before and after IFRS adoption. Panel A Table 6.15 reports the regression estimates for the sample for the one-year period before and after IFRS, while Panel B reports the results based on the sample for two years before and after IFRS adoption.

The result in Column 1 Panel A presents regression estimates for equation (5.1) for a sample of 521 firms before the adoption of IFRS (the MASB accounting standards), while Column 2 Panel A reports the regression estimates for the first year after the adoption (the IFRS accounting standards). The coefficients for $RET*RD$ are positive and significant in both columns, showing evidence of earnings conservatism in both periods.

I further regressed equation (5.2) to test for significant difference between the level of earnings conservatism during the MASB and IFRS financial reporting regimes. The results are summarised in Column 3. In equation (5.2), the coefficient for $IFRS*RET*RD$ measures the incremental earnings conservatism for the post-IFRS period. If the coefficient for $IFRS*RET*RD$ is negative (positive) and significant, the post-IFRS period has lower (higher) earnings conservatism than pre-IFRS period. The results summarised in Column 3 Panel A show that the coefficient for $IFRS*RET*RD$ is not significant ($p>0.10$), suggesting no evidence for any significant difference in the level of earnings conservatism between the two financial regimes.

Given that the effect of IFRS on earnings conservatism may not be clearly

observed in the first year after IFRS adoption, I extended the horizon to two years before and after IFRS adoption. The regression estimates are reported in Panel B.

Table 6.15
IFRS adoption and earnings conservatism

Panel A: One year before and after IFRS adoption

Sample Statistics	Pre-IFRS		Post-IFRS		Pooled	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.083***	(1.704)	0.053**	(2.390)	0.083***	(1.704)
<i>RET</i>	-0.066	(-0.419)	0.056	(1.496)	-0.066	(-0.419)
<i>RD</i>	-0.014	(-0.251)	-0.007	(-0.178)	-0.014	(-0.251)
<i>RET*RD</i>	0.410**	(2.254)	0.505**	(2.251)	0.410**	(2.254)
<i>IFRS</i>					-0.030	(-0.566)
<i>IFRS*RET</i>					0.122	(0.751)
<i>IFRS*RD</i>					0.007	(0.099)
<i>IFRS*RET*RD</i>					0.095	(0.328)
<i>Adj.R</i> ²	0.05		0.07		0.06	
<i>N</i>	521		521		1042	
<i>F</i> -stat	8.399		7.787		8.063	

Panel B: Two years before and after IFRS adoption

Sample Statistics	Pre-IFRS		Post-IFRS		Pooled	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.068*	(3.769)	0.065*	(4.637)	0.068*	(3.769)
<i>RET</i>	0.061***	(1.749)	0.076*	(3.574)	0.061***	(1.749)
<i>RD</i>	0.003	(0.100)	0.006	(0.249)	0.003	(0.100)
<i>RET*RD</i>	0.274*	(3.941)	0.207*	(2.909)	0.274*	(3.941)
<i>IFRS</i>					-0.004	(-0.161)
<i>IFRS*RET</i>					0.015	(0.369)
<i>IFRS*RD</i>					0.003	(0.095)
<i>IFRS*RET*RD</i>					-0.067	(-0.674)
<i>Adj.R</i> ²	0.08		0.09		0.09	
<i>N</i>	1042		1042		2084	
<i>F</i> -stat	25.151		20.807		21.813	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 IFRS_{it} + \beta_5 IFRS_{it} * RET_{it} + \beta_6 IFRS_{it} * RD_{it} + \beta_7 IFRS_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$$

The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $IFRS$ is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0 otherwise; and ε_{it} is the error term.

The results presented in column 1 and column 2 show that earnings conservatism is pervasive in both periods. In the pre-IFRS adoption period, column 1, the coefficient for $RET*RD$ is positive (0.274) and statistically significant ($p<0.01$), while in the period after the adoption of IFRS, column 2, the coefficient for $RET*RD$ is positive (0.207) and significant ($p<0.01$), showing evidence of earnings conservatism in both financial reporting regimes. In column 3, the result shows that the coefficient for $IFRS*RET*RD$ is -0.067 which suggests that the post-IFRS period has lower earnings conservatism than the pre-IFRS period. However, this coefficient is not significant ($p>0.10$) and therefore there is no significant difference in earnings conservatism between the two periods.

Overall, the results presented in Table 6.15 suggest that there is no significant difference in the levels of earnings conservatism between the pre- and post-IFRS adoption period; hence the results fail to provide enough evidence to reject the second hypothesis. This implies that though the new standards (IFRS) are linked to more relevant and less prudent (conservative) financial reports, managers and auditors strongly perceived that earnings conservatism is a financial reporting attribute that should be preserved.

6.4.3 Sensitivity Tests

To test the strength of the main results, several robustness tests were carried out. First, I controlled for industry and year effects. Second, I limited my observations to firms with financial year end dated 31 December. Third, I restricted the sample to firms audited by Big Four auditors. Fourth, I concentrated on firms audited by an industry specialist. Finally, I employed the time-series test in the loss

recognition model as an alternative measure for earnings conservatism.

6.4.3.1 Control for Industry and Year Effects

This section presents the regression estimates for equation (5.2) incorporating the control for industry and year effects. The regression estimates on both samples, one year and two years before and after IFRS adoption, are presented in Table 6.16.

Similarly to the earlier results, the results reported in Table 6.16 show no significant changes in earnings conservatism between pre- and post-IFRS adoption periods even after controlling for industry and year effects. Neither of the regression models has statistically significant coefficients for *IFRS*RET*RD* for both samples, of one year and two years before and after IFRS. I could thus conclude that there is no difference in the degrees of earnings conservatism as a result of IFRS adoption.

Overall, the results imply that managers and preparers of financial reports have a higher tendency to ensure timely recognition of unfavourable economic news than to ensure timely recognition of favourable economic news, though the IFRS standards demands relevance and neutral (unbiased) information. In terms of the validity of the results, all *F*-statistics are significant at the 1% level, while the *adjusted-R*² for the model is between 10% and 11%.

Table 6.16
IFRS adoption and earnings conservatism: Controlling the effect of industry and year effects

Sample Statistics	One Year		Two Years	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.086	(1.011)	-0.016	(-0.277)
<i>RET</i>	-0.108	(-0.641)	0.030	(0.502)
<i>RD</i>	-0.033	(-0.524)	0.002	(0.050)
<i>RET*RD</i>	0.543*	(2.729)	0.354*	(3.645)
<i>IFRS</i>	-0.061	(-1.023)	0.039	(1.011)
<i>IFRS*RET</i>	0.073	(0.411)	0.042	(0.639)
<i>IFRS*RD</i>	0.052	(0.584)	0.002	(0.031)
<i>IFRS*RET*RD</i>	0.643	(1.502)	0.159	(0.809)
<i>CONS</i>	0.038	(0.500)	0.074	(1.372)
<i>HOTEL</i>	0.071	(0.959)	0.084	(1.594)
<i>IPC</i>	0.075	(0.747)	0.048	(0.689)
<i>IPROD</i>	0.105	(1.485)	0.115**	(2.214)
<i>PLANT</i>	0.043	(0.602)	0.096***	(1.713)
<i>PROP</i>	-0.019	(-0.231)	0.006	(0.108)
<i>TECH</i>	0.076	(0.766)	0.118	(1.599)
<i>TDG</i>	0.105	(1.482)	0.119**	(2.325)
<i>Y2005</i>			0.029	(1.192)
<i>Y2006</i>			-0.082*	(-3.210)
<i>Adj.R</i> ²	0.10		0.11	
<i>N</i>	588		1176	
<i>F</i> -stat	4.464		7.994	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 IFRS_{it} + \beta_5 IFRS_{it} * RET_{it} + \beta_6 IFRS_{it} * RD_{it} + \beta_7 IFRS_{it} * RET_{it} * RD_{it} + \text{Industry} + \text{Year} + \varepsilon_{it}$$

The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *IFRS* is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

6.4.3.2 Sample of Firms with Financial Year Ended 31 December

For the testing reported in this section, the observations are restricted to firms with a financial year ended 31 December. This procedure was undertaken to control for time effects that might influence the measurement for economic news. I re-estimated equation (5.1) on the sample of one year and two years before and after

IFRS adoption. For the pooled sample, I re-estimated equation (5.2) to test for significant difference in earnings conservatism between the pre and post-IFRS periods. The results are presented in Table 6.17, which includes the results for: (i) pre-IFRS period (Column 1); post-IFRS period (Column 2); and pooled sample (Column 3).

Table 6.17

IFRS Adoption and earnings conservatism: Sample with financial year end dated 31 December

Panel A: One year before and after IFRS adoption

Sample Statistics	Pre-IFRS		Post-IFRS		Pooled	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.162*	(3.195)	0.093*	(3.070)	0.162*	(3.195)
<i>RET</i>	-0.112	(-0.664)	-0.031	(-0.518)	-0.112	(-0.664)
<i>RD</i>	-0.047	(-0.752)	0.019	(0.284)	-0.047	(-0.752)
<i>RET*RD</i>	0.528*	(2.642)	1.151*	(2.957)	0.528*	(2.642)
<i>IFRS</i>					-0.070	(-1.184)
<i>IFRS*RET</i>					0.081	(0.450)
<i>IFRS*RD</i>					0.066	(0.727)
<i>IFRS*RET*RD</i>					0.624	(1.426)
<i>Adj.R</i> ²	0.10		0.08		0.09	
<i>N</i>	294		294		588	
<i>F</i> -stat	13.272		5.145		7.985	

Panel B: Two years before and after IFRS adoption

Sample Statistics	Pre-IFRS		Post-IFRS		Pooled	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.089*	(3.682)	0.067*	(3.739)	0.089*	(3.682)
<i>RET</i>	0.031	(0.533)	0.072**	(2.452)	0.031	(0.533)
<i>RD</i>	-0.008	(-0.212)	0.002	(0.054)	-0.008	(-0.212)
<i>RET*RD</i>	0.326*	(3.301)	0.428**	(2.401)	0.326*	(3.301)
<i>IFRS</i>					-0.022	(-0.722)
<i>IFRS*RET</i>					0.041	(0.637)
<i>IFRS*RD</i>					0.010	(0.188)
<i>IFRS*RET*RD</i>					0.102	(0.501)
<i>Adj.R</i> ²	0.08		0.09		0.09	
<i>N</i>	588		588		1176	
<i>F</i> -stat	20.066		10.380		14.104	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 IFRS_{it} + \beta_5 IFRS_{it} * RET_{it} + \beta_6 IFRS_{it} * RD_{it} + \beta_7 IFRS_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$

The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively.

Variable definitions: E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $IFRS$ is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0 otherwise; and ε_{it} is the error term.

The results reported in Panel A and Panel B show that the coefficients for $RET*RD$ are positive and significant at the 1% level, indicating evidence of earnings conservatism in Malaysia in both periods. However, the coefficients for $IFRS*RET*RD$ in both samples, one year and two years, are positive but insignificant ($p>0.10$), suggesting that there is no significant difference in earnings conservatism between the MASB and IFRS reporting periods.

Overall, the findings reported in Table 6.17 are qualitatively similar to the main results. The analyses find no evidence of significant difference in the levels of earnings conservatism between the MASB and IFRS reporting periods, and thus fail to provide evidence to reject the second hypothesis.

6.4.3.3 Firms with Big Four Auditors

Given the evidence from prior studies that Big Four auditors have higher audit quality, it is important to control for differential audit quality. Detailed discussion was provided in Section 6.3.3.4.

To control for audit quality, I re-estimated equation (5.2) on a restricted sample of firms with Big Four auditors. The regression estimates for equation (5.2) are reported in Table 6.18, including samples of one year and two years before and after IFRS adoption.

Table 6.18

IFRS Adoption and earnings conservatism: Sample of firms with Big 4 auditors

Sample Statistics	One Year		Two Years	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.096***	(1.825)	0.074*	(3.541)
<i>RET</i>	-0.135	(-0.941)	0.056	(1.498)
<i>RD</i>	0.021	(0.367)	0.023	(0.840)
<i>RET*RD</i>	0.523*	(3.196)	0.303*	(4.309)
<i>IFRS</i>	-0.033	(-0.563)	0.012	(0.439)
<i>IFRS*RET</i>	0.194	(1.289)	0.011	(0.226)
<i>IFRS*RD</i>	-0.001	(-0.016)	-0.039	(-1.051)
<i>IFRS*RET*RD</i>	-0.048	(-0.171)	-0.128	(-1.260)
<i>Adj.R</i> ²	0.08		0.10	
<i>N</i>	694		1381	
<i>F</i> -stat	6.340		16.596	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 IFRS_{it} + \beta_5 IFRS_{it} * RET_{it} \\ + \beta_6 IFRS_{it} * RD_{it} + \beta_7 IFRS_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$$

The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *IFRS* is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0 otherwise; and ε_{it} is the error term.

The results reported in Table 6.18 are qualitatively similar to the main findings.

The coefficients for *RET*RD* are positive and significant ($p < 0.01$) for both samples, showing evidence of earnings conservatism in Malaysia. However, the coefficients for *IFRS*RET*RD* for both samples are insignificant ($p > 0.10$), implying there were no significant changes in the level of earnings conservatism after the adoption of IFRS. All *F*-statistics are significant at the 1% level, indicating the validity of the models, while *adjusted-R*²s are between 8% and 10%, which are identical to the previous analysis. In short, the result fails to provide evidence to infer that the adoption of IFRS reduces or increases the earnings conservatism level, even after reducing the sample to firms with Big Four auditors.

6.4.3.4 Auditors' Industry Specialization

Auditors' industry specialization has been found to have significant influence on the quality of earnings, in particular earnings conservatism. Krishnan (2005a), for example, finds that firms audited by industry specialists report more conservative earnings than do firms with non-specialist auditors, suggesting that auditors' industry specialization moderates the tendency of the client to delay the recognition of economic losses. In addition, Krishnan (2003) finds clients of industry specialists have significantly lower discretionary accruals than clients of non-specialist auditors.

Given that industry specialists have superior knowledge and resources, it is to be expected they would facilitate a smoother transition to IFRS accounting standards. I restricted the observation to firms audited by industry specialists to control the effect of auditor industry specialization on earnings conservatism.²⁷ I re-estimated equation (5.1) on samples of one year and two years before and after IFRS adoption. The results are reported in Table 6.19.

Similar to the main results, the coefficients for $RET*RD$ are positive and significant ($p < 0.01$) for both samples, showing evidence of earnings conservatism in Malaysia. The coefficient for $IFRS*RET*RD$, which measures significant difference in the levels of earnings conservatism between the pre- and post-IFRS periods, shows mixed results. For the sample of observations one year before and

²⁷ Industry specialist was identified using an industry leader approach, which is identified based on the percentage of clients' total sales audited per total sales of the companies that are listed in the industry (Krishnan, 2003).

after IFRS adoption, the coefficient for $IFRS*RET*RD$ is -0.426 but is insignificant ($p>0.10$), showing no significant difference in earnings conservatism between the two periods. However, the sample of observations two years before and after IFRS adoption, the coefficient for $IFRS*RET*RD$ is -0.403 and significant at the 5% level ($p>0.10$). These results show mixed but weak evidence that in firms audited by an industry specialist, earnings conservatism declines after the adoption of IFRS.

Table 6.19
IFRS Adoption and earnings conservatism: Sample of firms audited by industry specialist

Sample Statistics	One Year		Two Years	
	Coeff	t-stat	Coeff	t-stat
<i>Intercept</i>	0.157*	(4.997)	0.093*	(3.494)
<i>RET</i>	-0.310*	(-5.491)	-0.028	(-0.401)
<i>RD</i>	0.008	(0.142)	0.021	(0.448)
<i>RET*RD</i>	0.801*	(4.519)	0.461*	(3.284)
<i>IFRS</i>	-0.110**	(-2.380)	-0.017	(-0.502)
<i>IFRS*RET</i>	0.430*	(6.149)	0.135***	(1.818)
<i>IFRS*RD</i>	0.008	(0.103)	-0.047	(-0.783)
<i>IFRS*RET*RD</i>	-0.426	(-1.543)	-0.403**	(-2.428)
<i>Adj.R²</i>	0.23		0.14	
<i>N</i>	291		575	
<i>F-stat</i>	8.808		10.063	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it}*RD_{it} + \beta_4 IFRS_{it} + \beta_5 IFRS_{it}*RET_{it} + \beta_6 IFRS_{it}*RD_{it} + \beta_7 IFRS_{it}*RET_{it}*RD_{it} + \varepsilon_{it}$

The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $IFRS$ is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0 otherwise; and ε_{it} is the error term.

6.4.3.5 Time-Series Test of Timeliness in Loss Recognition

Following Basu (1997) and Ball et al. (2000), I use the time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism.²⁸ This model focuses on the extent to which earnings changes reverse, and the extent to which the probability of reversal differs according to whether the previous earnings change was positive or negative. To investigate the impact of IFRS adoption on earnings conservatism, I modified the time-series test of timeliness in loss recognition model to allow examination of incremental reversal of earnings changes from previous year changes of earnings due to IFRS. The modified model is as follows:

$$\begin{aligned}\Delta NI_{it} = & \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + \alpha_4 IFRS_{it-1} \\ & + \alpha_5 IFRS_{it-1} * \Delta NI_{it-1} + \alpha_6 IFRS_{it-1} * D\Delta NI_{it-1} \\ & + \alpha_7 IFRS_{it-1} * \Delta NI_{it-1} * D\Delta NI_{it-1} + \varepsilon_{it}\end{aligned}\quad (6.1)$$

where ΔNI_{it} is the change in earnings for firm i from year $t-1$ to year t , standardised by total assets at end of year $t-1$; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; $IFRS$ is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0; and ε_{it} is the error term.

Equation (6.1) is the extension for the time-series test of timeliness in loss recognition employed by Basu (1997), which allows IFRS to interact with all

²⁸ This test was conducted to overcome this criticism towards the Basu (1997) asymmetric timeliness of earnings model, which was discussed in Section 5.8.1.

variables in the basic model. The coefficient for $IFRS*\Delta NI_{it-1}*D\Delta NI_{it-1}$ tests whether there is a significant difference of the coefficient for $\Delta NI_{it-1}*D\Delta NI_{it-1}$, between the pre- and post-adoption of IFRS. The coefficient of $\Delta NI_{it-1}*D\Delta NI_{it-1}$ measures the transitory nature of earnings decreases compared to earnings increases, which is a measure for earnings conservatism.

Table 6.20
Time-series test of timeliness in loss recognition: Pre- and post-IFRS adoption

Sample Statistics	One Year		Two Years	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	-0.000	(-0.079)	0.002	(0.578)
ΔNI_{it-1}	-0.279*	(-3.012)	-0.139**	(-2.199)
$D\Delta NI_{it-1}$	-0.015***	(-1.735)	-0.016**	(-2.528)
$\Delta NI_{it-1}*D\Delta NI_{it-1}$	-0.535**	(-2.048)	-0.583*	(-2.992)
$IFRS_{it-1}$	0.004	(0.703)	0.009	(1.597)
$IFRS_{it-1}*\Delta NI_{it-1}$	0.293**	(2.378)	0.137	(1.104)
$IFRS_{it-1}*D\Delta NI_{it-1}$	0.012	(0.965)	0.002	(0.173)
$IFRS_{it-1}*\Delta NI_{it-1}*D\Delta NI_{it-1}$	-0.321	(-0.977)	-0.376	(-1.494)
<i>Adj.R</i> ²	0.20		0.15	
<i>N</i>	1040		2079	
<i>F</i> -stat	10.611		17.925	

Model: $\Delta NI_{it} = \alpha_0 + \alpha_1\Delta NI_{it-1} + \alpha_2D\Delta NI_{it-1} + \alpha_3\Delta NI_{it-1}*D\Delta NI_{it-1} + \alpha_4IFRS_{it-1} + \alpha_5IFRS_{it-1}*\Delta NI_{it-1} + \alpha_6IFRS_{it-1}*D\Delta NI_{it-1} + \alpha_7IFRS_{it-1}*\Delta NI_{it-1}*D\Delta NI_{it-1} + \varepsilon_{it}$

The sample comprises 2,079 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: ΔNI_{it} is the change in earnings for firm *i* from year *t*-1 to year *t*, standardised by total assets at end of year *t*-1; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; *IFRS* is a dummy variable that takes value 1 if the financial statements are prepared according to IFRS standards, and 0; and ε_{it} is the error term.

The regression estimates of equation (6.1) are presented in Table 6.20. The results show that earnings conservatism is a pervasive feature in Malaysian financial reporting. The coefficients for $\Delta NI_{it-1}*D\Delta NI_{it-1}$ are negative and significant in both samples, suggesting that the overall negative serial correlation in earnings changes is driven by a reversal of negative earnings changes. However, no significant evidence was found on differences between earnings conservatism for the two

samples. The coefficients for $IFRS * \Delta NI_{it-1} * D\Delta NI_{it-1}$ are negative but not significant ($p > 0.10$), implying there are no significant changes in the extent to which positive earnings changes are more persistent than negative earnings changes after the adoption of IFRS. Thus, the results from the alternative measure for earnings conservatism fails to provide support for the prediction that the adoption of IFRS would affect earnings conservatism.

6.4.4 Discussion of the Results

The second objective of this study was to examine the effect of IFRS adoption on earnings conservatism in Malaysia. Given that IFRS standards were made effective from 1 January 2006, this study compares the level of earnings conservatism for one-year and two-year horizons pre- and post-IFRS adoption. Employing the modified Basu (1997) reverse earnings-return regression, I find no significant difference in the level of earnings conservatism between the pre- and post-IFRS adoption periods. To ascertain the sensitivity of the results, various sensitivity analyses were conducted including: (i) controlling for industry and year effects; (ii) reducing the sample to firms with financial year ended 31 December; (iii) restricting the sample to firms with Big Four auditors; (iv) limiting the sample to firms audited by an industry specialist; and (v) employing the time-series test of timeliness in loss recognition model as an alternative measure for earnings conservatism.

This study conjectures that IFRS adoption would affect the level of earnings conservatism since the aims of standards setters' in introducing IFRS is to provide more relevant and neutral information. Given that earnings conservatism, or

application of higher verification standards in recognising economic losses than economic gains, biases reporting, conservatism is no longer a desirable qualitative characteristic of earnings under IFRS. Contrary to this prediction, the results from the main analysis and the various sensitivity tests show no significant difference in the level of earnings conservatism between pre- and post-IFRS adoption periods.

However, these results provide support for explanations for conservatism such as contracting, litigation, taxation, and regulation factors (Watts, 2003a, 2003b). Any attempt to reduce earnings conservatism would increase the agency cost and the litigation risk, thus market-based mechanisms would require firms to exercise higher verification standards in recognising economic gains than economic losses. Furthermore, these results may be due to the feature of IFRS that limits managers' discretion in choosing accounting alternatives (Devalle, Onali, & Magarini, 2010). The lack of flexibility in the range of available accounting alternatives may impair the ability of managers to report accounting measures that reflect the underlying economic conditions of a firm (Barth, et al., 2008). Therefore, a priori, it is difficult to determine the effect of IFRS adoption on earnings conservatism.

Overall, this study does not find evidence that IFRS adoption has a significant impact on earnings conservatism. A plausible explanation is that earnings conservatism plays important roles in debt-contracting, minimizing the litigation risk, and enhancing greater monitoring; hence managers, preparers of financial reports, and auditors have greater incentives to report earnings conservatively though the accounting standards warranted unbiased information. As such, this

study provides evidence for debates on the roles of conservatism, and whether it should indeed be eliminated from financial reporting.

6.5 Ownership Structure and Earnings Conservatism

6.5.1 Introduction

This section discusses the results of my tests to investigate whether earnings conservatism is influenced by ownership structure. Ownership structure is classified into family firms, state-controlled firms, and widely-held firms. Section 6.5.2 examines differences in earnings conservatism for each type of ownership structure, measured using the timeliness of earnings in recognising good news and bad news. Section 6.5.3 reports the sensitivity analyses such as Fama and MacBeth (1973) estimation, fixed-effects regression, and time-series test of timeliness in loss recognition. In addition, the sensitivity tests include alternative measures for family ownership/control and classification of state-controlled firms into firms under control of the Federal Government of Malaysia and those under the control of States' Governments. Section 6.5.4 reports two additional tests. First, Section 6.5.4.1 reports the test for difference between the earnings conservatism levels of family and widely-held firms. Second, Section 6.5.4.2 reports tests of the relation between strategic control of a family of a firm's management and corporate board influences earnings conservatism. Finally, the overall results for the third hypothesis are summarised in Section 6.5.5

6.5.2 Main Analysis: Ownership Structure and Earnings Conservatism

To examine differences between earnings conservatism for firms with different ownership structure, I estimated equation (5.1) on three samples: family firms, state-controlled firms and widely-held firms. The regression estimates are reported in Table 6.21. Panel A (Panel B) presents the regression estimates for the timeliness of good news (bad news), while Panel C reports the asymmetric timeliness of earnings between the good news and bad news samples.

The results reported in Panel A show that the coefficients for *RET* in family firms and state-controlled firms are positive and significant at the 1% level, implying that both types of firms recognise good news in a timely manner. For widely-held firms, the coefficient for *RET* is not significant ($p > 0.10$), showing no evidence of timeliness of earnings in recognising good news in those firms.

For the bad news sample, the results reported in Panel B show that bad news is recognised in a timely fashion in family firms and widely-held samples, but not in state-controlled firms. The coefficient values for *RET* in family firms and widely-held firms are 0.292 and 0.213, both significant at the 1% level, implying evidence of timely recognition of bad news. However, the coefficient for *RET* in state-controlled firms is not significant ($p > 0.10$), suggesting that state-controlled firms delay the recognition of bad news. From both Panel A and Panel B, the results show that family firms are timely in recognising both types of economic news, while widely-held firms are timely in recognition of bad news but not good news. Contrary to family firms and widely-held firms, good news appears to be recognised in a more timely fashion than is bad news in state-controlled firms,

showing no evidence of conservatism.

Table 6.21
Ownership structure and earnings conservatism

Panel A: Timeliness of earnings in good news sample						
Sample	Family		State-Controlled		Widely-Held	
Statistics	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.059*	(5.232)	0.086*	(7.230)	0.040**	(2.358)
<i>RET</i>	0.091*	(6.053)	0.074*	(3.918)	0.028	(0.933)
<i>Adj.R</i> ²	0.09		0.10		0.01	
<i>N</i>	854		136		568	
<i>F</i> -stat	36.636		15.354		0.870	
Panel B: Timeliness of earnings in bad news sample						
Sample	Family		State-Controlled		Widely-Held	
Statistics	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.074*	(4.485)	0.081*	(3.167)	0.034***	(1.770)
<i>RET</i>	0.292*	(5.678)	0.163	(1.538)	0.213*	(4.097)
<i>Adj.R</i> ²	0.03		0.03		0.02	
<i>N</i>	916		98		554	
<i>F</i> -stat	32.241		2.364		16.786	
Panel C: The asymmetric timeliness of earnings						
Sample	Family		State-Controlled		Widely-Held	
Statistics	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.059*	(5.232)	0.086*	(7.221)	0.040**	(2.357)
<i>RET</i>	0.091*	(6.053)	0.074*	(3.914)	0.028	(0.933)
<i>RD</i>	0.014	(0.724)	-0.005	(-0.166)	-0.006	(-0.247)
<i>RET*RD</i>	0.201*	(3.747)	0.089	(0.826)	0.185*	(3.093)
<i>Adj.R</i> ²	0.10		0.14		0.04	
<i>N</i>	1770		234		1122	
<i>F</i> -stat	43.233		11.749		15.240	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

The results for difference between the timeliness of earnings in recognition of

good news and bad news are reported in Panel C. The regression estimates, from the Basu (1997) reverse earnings-return regression, contain evidence of earnings conservatism in family firms and widely-held firms. The coefficient for $RET*RD$, which measures the difference or the increment in the timeliness of earnings in recognising bad news compared to good news, are 0.201 and 0.185 in family firms and widely-held firms respectively, and significant at the 1% level. These results imply evidence of earnings conservatism in family firms and wide-held firms. For state-controlled firms, the coefficient for $RET*RD$ is not significant ($p>0.10$), and no evidence of earnings conservatism was found.

Overall, the results show that ownership structure has a significant influence on the level of earnings conservatism. A plausible explanation is that the incentives and demands for conservative reporting vary due to the different levels of agency costs and information asymmetry applicable to each type of ownership structure. With regard to family firms, the findings support the proposition that significant family control of a firm exerts greater monitoring and provides greater incentive to produce high-quality earnings, i.e. earnings conservatism. The evidence is consistent with Wang (2006), who documents that founding family ownership in the United States is associated with higher earnings quality, in particular lower abnormal accruals, greater earnings informativeness, and less persistence of transitory loss components in earnings. Indirectly, this study provides evidence of alignment effects in family firms. For state-controlled firms, the evidence from this study is consistent with Bushman and Piotroski (2006), where in common-law countries firms facing high state involvement in the economy tend to speed the recognition of good news and slow the recognition of bad news relative to firms in

countries with less state involvement. The plausible explanation is that the government might intervene in poorly-performing state-controlled firms, and managers are inclined to avoid such interference by exploiting reporting discretion to portray an optimistic outlook (Bushman & Piotroski, 2006). Furthermore, state-controlled firms were pressured by the government to upwardly tilt their reporting decisions (Bushman & Piotroski, 2006).

6.5.3 Sensitivity Analysis

I performed various robustness tests to test the robustness of the main results. First, in Section 6.5.3.1, I use the Fama and MacBeth estimation. Second, I control for industry and year effects in Section 6.5.3.2. Third, I employed time-series test of loss recognition, the results of which are reported in Section 6.5.3.3. Fourth, I use different definitions for family firms; and the regression estimates are reported in Section 6.5.3.4. Finally, in Section 6.5.3.5, I partition the state-controlled firms into Federal-Government-controlled firms and non-Federal-Government-controlled firms.

6.5.3.1 Fama and MacBeth (1973)

I re-estimated the Basu (1997) reverse earnings-return regression using Fama and MacBeth's (1973) procedure on family firms, state-controlled firms, and widely-held firms to control for cross-sectional dependence problems. The estimation results are presented in Table 6.22.

Consistent with the main results, regression estimates in Table 6.22 show

evidence of earnings conservatism in family firms and widely-held firms. The coefficient for $RET*RD$ in family firms is 0.313 and significant at the 1% level, implying more timely recognition of economic losses and economic gains. The coefficient for RET is also positive and significant ($p<0.01$), suggesting timely recognition of good news. These results show that in family firms, both bad news and good news are recognised in a timely way in earnings, but the recognition speed is faster in the case of bad news.

Table 6.22
Ownership structure and earnings conservatism: Fama and MacBeth (1973)
annual regression

Sample Statistics	Family		State-Controlled		Widely-Held	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.077*	(4.057)	0.085*	(7.993)	0.047***	(2.185)
<i>RET</i>	0.075*	(4.306)	0.082***	(2.422)	0.026	(0.914)
<i>RD</i>	0.008	(0.428)	-0.008	(-0.152)	0.006	(0.304)
<i>RET*RD</i>	0.313*	(4.971)	0.116	(0.649)	0.343***	(2.464)
<i>Adj.R</i> ²	0.14		0.21		0.08	
<i>N</i>	1770		234		1122	
<i>F</i> -stat	56.592		36.999		10.253	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. I use the Fama and MacBeth (1973) methodology to cope with the possible cross-sectional dependence problems. The coefficients of the parameters have been obtained as the simple average from the cross-sectional regression. The *t*-statistics are the ratios of the mean estimated Coefficients to the standard deviation of the distribution of the annual estimated slope Coefficients, divided by the square root of the number of years. Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; and ε_{it} is the error term.

With regard to the widely-held sample, the results show a qualitatively similar result to the earlier analysis. The coefficient for $RET*RD$ is positive (0.343) and significant at the 10% level, showing little evidence of earnings conservatism in widely-held firms. However, the coefficient for RET is not significant, implying no evidence of the timeliness of earnings towards good news. For state-controlled

firms, the results from Fama and MacBeth estimation show that the coefficient for *RET* is positive and significant ($p < 0.10$), implying timely recognition of good news; however, the coefficient of *RET*RD* is not significant, indicating lack of evidence to assert the presence of earnings conservatism in state-controlled firms. In short, the results reported in Table 6.22, based on Fama and MacBeth (1973), support the main results.

6.5.3.2 Industry and Year Effects

In this section, I re-estimated equation (5.1) using fixed-effects regression that incorporated industry and year dummies. This procedure was undertaken to control the serial correlation problem of the residual of panel data in the Basu (1997) reverse earnings-return regression. The regression estimates for family firms, state-controlled firms, and widely-held firms are summarised in Table 6.23.

The results show that the coefficients for *RET* for all types of firms are positive and significant, implying timely recognition of good news. However, the incremental timeliness of bad news, earnings conservatism, is found only in family firms and widely-held firms. The coefficients for *RET*RD* in family firms and widely-held firms are 0.285 and 0.264, respectively, and significant at the 1% level, implying evidence for earnings conservatism in both family firms and widely-held firms. For state-controlled firms, no evidence of earnings conservatism is documented since the coefficient for *RET*RD* is not significant ($p > 0.10$). All *F*-statistics are significant at the 1% level, showing the validity of the results. In short, the main findings are robust even after controlling for industry and year effects.

Table 6.23
Ownership structure and earnings conservatism: Estimation controlling for industry and year effects

Sample Statistics	Family		State-Controlled		Widely-Held	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.029	(0.960)	0.167*	(4.912)	-0.049	(-1.240)
<i>RET</i>	0.088*	(9.427)	0.057*	(2.794)	0.025***	(1.864)
<i>RD</i>	0.005	(0.247)	-0.009	(-0.370)	-0.011	(-0.408)
<i>RET*RD</i>	0.285*	(5.171)	0.106	(1.365)	0.264*	(4.166)
<i>CONS</i>	-0.001	(-0.031)	-0.104*	(-3.039)	0.055	(1.369)
<i>HOTEL</i>	-0.145***	(-1.698)			0.109	(1.267)
<i>IPC</i>	0.067	(0.788)	-0.351*	(-6.473)	0.116	(1.349)
<i>IPROD</i>	0.027	(1.002)	-0.100*	(-3.053)	0.077**	(2.116)
<i>PLANT</i>	-0.027	(-0.739)			0.100**	(2.110)
<i>PROP</i>	-0.034	(-1.122)	-0.094*	(-2.746)	0.086**	(2.027)
<i>TECH</i>	0.043	(0.935)			0.060	(1.161)
<i>TDG</i>	-0.023	(-0.770)	-0.089*	(-3.053)	0.103*	(2.738)
<i>Y2004</i>	0.021	(0.902)	-0.007	(-0.274)	0.002	(0.059)
<i>Y2005</i>	0.091*	(3.808)	0.021	(0.770)	0.037	(1.275)
<i>Y2006</i>	0.003	(0.121)	0.024	(0.921)	-0.032	(-1.119)
<i>Y2007</i>	0.051**	(2.178)	0.028	(1.099)	0.043	(1.512)
<i>Y2008</i>	0.123*	(5.035)	0.042	(1.432)	0.107*	(3.545)
<i>Adj.R</i> ²	0.13		0.26		0.05	
<i>N</i>	1770		234		1122	
<i>F</i> -stat	16.898		7.425		5.077	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

6.5.3.3 Time-Series Test of Timeliness in Loss Recognition

In this section, I estimated the time-series test of timeliness in loss recognition as an alternative measure for earnings conservatism, in order to ascertain the

robustness of the earlier results.²⁹ Table 6.24 presents the regression estimates from the time-series test of timeliness in loss recognition for family firms, state-controlled firms, and widely-held firms.

Table 6.24

Ownership structure and time-series test of timeliness in loss recognition

Sample	Family		State-Controlled		Widely-Held	
Statistics	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.008*	(2.822)	0.005	(0.669)	0.005	(1.130)
ΔNI_{it-1}	-0.166*	(-2.783)	-0.254	(-1.084)	-0.042	(-0.439)
$D\Delta NI_{it-1}$	-0.016*	(-3.238)	-0.008	(-0.737)	-0.020*	(-2.808)
$\Delta NI_{it-1} * D\Delta NI_{it-1}$	-0.608*	(-4.506)	-0.578	(-1.484)	-0.836*	(-4.781)
<i>Adj.R</i> ²	0.14		0.20		0.13	
<i>N</i>	1762		229		1114	
<i>F</i> -stat	19.098		4.254		12.631	

Model: $\Delta NI_{it} = \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + industry + year + \varepsilon_{it}$

The sample comprises 3,105 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: ΔNI_{it} is the change in earnings for firm *i* from year *t*-1 to year *t*, standardised by total assets at end of year *t*-1; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; and ε_{it} is the error term.

The regression estimates for family firms and widely-held firms denote that earnings decreases are much less persistent (more transitory) than their increases.

The coefficients for $\Delta NI_{it-1} * D\Delta NI_{it-1}$ for family firms and widely-held firms are -0.608 and -0.836 respectively, and both are significant at the 1% level. This shows that earnings reflect economic losses more quickly than it reflects economic profits in family firms and widely-held firms. For state-controlled firms, no evidence of earnings conservatism was found as the coefficient for $\Delta NI_{it-1} * D\Delta NI_{it-1}$ is not significant, suggesting that earnings decreases are much less persistent

²⁹ The sample sizes are reduced because of the additional data requirements to calculate income changes in two consecutive years.

(more transitory) than earnings increases. These results are also consistent with the main result based on the asymmetric timeliness of earnings model. Furthermore, the *F*-statistics in all sub-samples are significant at the 1% level, showing the validity of the model.

6.5.3.4 Alternative Measures for Family Firms

In this section, I employ two alternative measures for family firms to test whether the evidence of earnings conservatism in family firms in the analysis above is sensitive to alternative definitions. For the first measure, family firms can be either (i) firms with at least two members of the controlling family on the board of directors; or (ii) firms in which the largest shareholder, either an individual, a family, or a private firm, owns more than 20% of the shares. This definition is based on Faccio and Lang (2002), Arosa, Iturralde, and Maseda (2010), La Porta et al. (1999) and Villalonga and Amit (2006).

For the second measure, I employed a stricter definition for family firms by increasing the minimum threshold for the largest shareholder, whether an individual, a family, or a private firm, to 30. In addition, the board of directors must comprise at least two members from the controlling family. In terms of sample size, the number of observations increases from 1,770 in the main sample to 2,310 firm-year observations in the first alternative measure for family firms; while for the second measure, the number of firm-year observations in the sample decreases to 1,176 firm-year observations.

I re-estimated equation (5.1) using the basic pooled regression, Fama and

MacBeth (1973) annual regression, and fixed-effects regression. The results are summarised in Table 6.25(a) and 6.25(b).

Table 6.25(a)

Ownership structure and earnings conservatism: Alternative definitions for family firms and various specifications (Board presence or more than 20% shares)

Model Statistics	Basic		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.051*	(6.321)	0.066**	(3.830)	0.009	(0.453)
<i>RET</i>	0.081*	(5.958)	0.066**	(2.848)	0.078*	(8.183)
<i>RD</i>	0.018	(1.408)	0.010	(0.821)	0.012	(0.925)
<i>RET*RD</i>	0.168*	(4.879)	0.259*	(5.026)	0.231*	(6.562)
<i>CONS</i>					0.007	(0.361)
<i>HOTEL</i>					-0.062	(-1.254)
<i>IPC</i>					0.088	(1.478)
<i>IPROD</i>					0.026	(1.523)
<i>PLANT</i>					0.032	(1.408)
<i>PROP</i>					0.007	(0.393)
<i>TECH</i>					0.008	(0.312)
<i>TDG</i>					0.012	(0.653)
<i>Y2004</i>					0.026***	(1.814)
<i>Y2005</i>					0.067*	(4.479)
<i>Y2006</i>					0.002	(0.130)
<i>Y2007</i>					0.044*	(3.052)
<i>Y2008</i>					0.097*	(6.342)
<i>Adj.R</i> ²	0.10		0.13		0.12	
<i>N</i>	2310		2310		2310	
<i>F</i> -stat	61.076		59.950		20.469	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 2,310 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

Table 6.25(b)

Ownership structure and earnings conservatism: Alternative definitions for family firms and various specifications (Board Presence and More than 30% shares)

Model	Basic		Fama-MacBeth		Fixed Effects	
Statistics	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.076*	(8.052)	0.084*	(5.675)	0.013	(0.519)
<i>RET</i>	0.093*	(5.441)	0.095*	(7.280)	0.095*	(7.974)
<i>RD</i>	0.017	(1.078)	0.015	(1.097)	0.009	(0.550)
<i>RET*RD</i>	0.175*	(3.470)	0.238**	(3.545)	0.215*	(4.689)
<i>CONS</i>					0.038	(1.561)
<i>HOTEL</i>					0.027	(0.351)
<i>IPC</i>					0.071	(0.944)
<i>IPROD</i>					0.056**	(2.369)
<i>PLANT</i>					0.011	(0.353)
<i>PROP</i>					0.027	(1.049)
<i>TECH</i>					-0.008	(-0.165)
<i>TDG</i>					0.003	(0.113)
<i>Y2004</i>					0.021	(1.163)
<i>Y2005</i>					0.066*	(3.588)
<i>Y2006</i>					0.024	(1.329)
<i>Y2007</i>					0.033***	(1.846)
<i>Y2008</i>					0.086*	(4.596)
<i>Adj.R</i> ²	0.14		0.17		0.16	
<i>N</i>	1176		1176		1176	
<i>F</i> -stat	39.414		24.616		14.972	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 1,176 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

Table 6.25(a) presents regression estimates on the sample derived from the first alternative measure of family firms. The results denote qualitatively similar results to those in the main analysis. The coefficients for *RET* are positively significant in all three models, suggesting that earnings are timely in the recognition of good news. The coefficients for *RET*RD* for the basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects

regression are 0.168, 0.259, and 0.231, respectively, and significant at the 1% level, implying earnings reflect bad news in a more timely manner than good news.

The results reported in Table 6.25(b) also show qualitatively similar results to those reported in the main analysis, in which earnings conservatism is a pervasive feature in family firms. The coefficients for $RET*RD$ are positive and significant ($p<0.01$) in all models, implying a more timely recognition of economic losses than economic gains in family firms.

6.5.3.5 State-Controlled Firms: Federal and States' Firms

In the main results, I find no evidence of earnings conservatism in state-controlled firms. Specifically, state-controlled firms are timely in the recognition of good news but not in the recognition of bad news; hence the results do not provide evidence of earnings conservatism in state-controlled firms. In this section, I further examine whether the main results differ when the sample is divided into firms under control of the Federal Government of Malaysia on the one hand and State Governments on the other. I employed this classification because the monitoring mechanisms for state-controlled firms vary according to firm ownership. For firms under the control of the Federal Government, Khazanah Nasional monitors and assesses the performance of directors. In addition, the Putrajaya Committee on GLC High Performance (PCG) conducts the transformation plan to enhance the performance of these firms. Firms under the control of State Governments are managed and controlled through the State Economic Development Corporation (SEDC), which has limited resources

compared to the Khazanah Nasional.

Table 6.26(a)
Earnings conservatism in Firms under control of the Federal Government of
Malaysia: Various specifications

Variable	Basic		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.075*	(6.940)	0.074*	(6.028)	-0.213*	(-4.578)
<i>RET</i>	0.098*	(3.307)	0.099**	(3.518)	0.086*	(3.380)
<i>RD</i>	-0.005	(-0.130)	-0.014	(-0.272)	-0.017	(-0.656)
<i>RET*RD</i>	0.100	(0.513)	0.085	(0.300)	-0.022	(-0.233)
<i>CONS</i>					0.276*	(6.167)
<i>HOTEL</i>						
<i>IPC</i>						
<i>IPROD</i>					0.257*	(5.903)
<i>PLANT</i>					0.383*	(6.828)
<i>PROP</i>						
<i>TECH</i>						
<i>TDG</i>					0.268*	(6.297)
<i>Y2004</i>					0.027	(0.957)
<i>Y2005</i>					0.042	(1.468)
<i>Y2006</i>					0.038	(1.318)
<i>Y2007</i>					0.017	(0.596)
<i>Y2008</i>					0.020	(0.687)
<i>Adj.R</i> ²	0.19		0.37		0.41	
<i>N</i>	132		132		132	
<i>F</i> -stat	7.314		5.243		8.479	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 132 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

Table 6.26(b)
Earnings conservatism in Firms under control of State Governments: Various specifications

Variable	Basic		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.099*	(3.822)	0.062	(1.846)	0.028	(0.447)
<i>RET</i>	0.053**	(2.035)	0.143	(1.740)	0.021	(0.631)
<i>RD</i>	0.014	(0.383)	0.085	(1.735)	0.040	(0.760)
<i>RET*RD</i>	0.143	(1.223)	0.233	(1.120)	0.278**	(2.014)
<i>CONS</i>						
<i>HOTEL</i>						
<i>IPC</i>						
<i>IPROD</i>					0.088	(1.327)
<i>PLANT</i>					0.160**	(2.383)
<i>PROP</i>					0.077	(1.300)
<i>TECH</i>						
<i>TDG</i>					0.083	(1.420)
<i>Y2004</i>					-0.073	(-1.459)
<i>Y2005</i>					-0.037	(-0.621)
<i>Y2006</i>					-0.004	(-0.084)
<i>Y2007</i>					0.044	(0.953)
<i>Y2008</i>					0.053	(0.823)
<i>Adj.R²</i>	0.09		0.13		0.15	
<i>N</i>	102		102		102	
<i>F</i> -stat	4.864		5.212		2.473	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + Industry + Year + \varepsilon_{it}$

The sample comprises 102 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

To examine whether reporting of earnings conservatism varies between different types of state-controlled firms, I estimated the basic pooled regression, the Fama and MacBeth (1973) annual regression, and fixed-effects regression. Table 6.26(a) reports regression estimates for firms under the control of the Federal Government of Malaysia, while Table 6.26(b) reports the results for firms under the control of State Governments. In Table 6.26(a), the coefficients for $RET*RD$ in all

estimation models are not significant, implying that firms under the control of the Federal Government do not report earnings conservatively. For Table 6.26(b), the coefficients for $RET*RD$ are not significant in the basic and Fama and MacBeth (1973) regressions but the coefficient is weakly significant in the fixed-effects regression. These results show that, in general, state-controlled firms do not report earnings conservatively.

The situation might result from the complex principal-agent relationship and poor monitoring mechanisms in state-controlled firms. As discussed in Section 6.5.2, the government has a higher tendency to intervene in poorly-performing state-controlled firms, the managers of these firms are more likely to avoid such interference, that is by exploiting reporting discretion in order to portray an optimistic outlook (Bushman & Piotroski, 2006). Furthermore, state-controlled firms were pressured by the government to upwardly tilt their reporting decisions (Bushman & Piotroski, 2006).

6.5.4 Additional Analysis

This section extends the analysis of the relationship between ownership structure and earnings conservatism in two ways. First, this study examines whether there is a significant difference between the levels of earnings conservatism of family firms and widely-held firms. Second, this study examines whether strategic control by a family of the board of directors, that is by holding the positions of both CEO and chairman of the board, influences earnings conservatism.

6.5.4.1 Difference in Earnings Conservatism between Family Firms and Widely-Held Firms.

This section further examines systematic differences between the level of earnings conservatism of family firms and widely-held firms. A new variable, named *FAMILY*, which takes value 1 for family firms and 0 for widely-held firms, was established. Other interaction variables, *FAMILY*RET*, *FAMILY*RD* and *FAMILY*RET*RD*, were also introduced and included in the equation below.

$$\begin{aligned} E_{it}/P_{it-1} = & \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it}*RD_{it} + \beta_4 FAMILY_{it} \\ & + \beta_5 FAMILY_{it}*RET_{it} + \beta_6 FAMILY_{it}*RD_{it} \\ & + \beta_7 FAMILY_{it}*RET_{it}*RD_{it} + \varepsilon_{it} \end{aligned} \quad (6.2)$$

where E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; *FAMILY* is a dummy variable that takes value 1 if the observation is family firm, 0 if widely-held firms; and ε_{it} is the error term.

I estimated equation (6.2) using the basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression. The results are presented in Table 6.27. The regression estimates for all models show no significant difference between earnings conservatism for family firms and widely-held firms. The coefficients for *FAMILY*RET*RD* in all models are not significant ($p > 0.10$), suggesting no evidence that family firms have higher or lower earnings conservatism compared to widely-held firms. The F -statistics are significant at the

1% level in all models, while *adjusted-R*²s are between 8% and 10%, indicating the validity of the models.

Table 6.27
Earnings Conservatism: Family firms versus widely-held firms

Variable	Pooled Regression		Fama-MacBeth		Fixed Effects	
	Coeff	t-stat	Coeff	t-stat	Coeff	t-stat
<i>Intercept</i>	0.040**	(2.370)	0.047***	(2.191)	-0.009	(-0.331)
<i>RET</i>	0.028	(0.932)	0.026	(0.913)	0.026***	(1.916)
<i>RD</i>	-0.006	(-0.252)	0.005	(0.289)	-0.018	(-0.705)
<i>RET*RD</i>	0.185*	(3.102)	0.342***	(2.469)	0.259*	(4.111)
<i>FAMILY</i>	0.019	(0.914)	0.030***	(2.131)	0.018	(1.005)
<i>FAMILY*RET</i>	0.063***	(1.906)	0.049	(1.838)	0.062*	(3.804)
<i>FAMILY*RD</i>	0.021	(0.647)	0.003	(0.101)	0.028	(0.859)
<i>FAMILY*RET*RD</i>	0.016	(0.197)	-0.029	(-0.256)	0.028	(0.340)
<i>CONS</i>					0.018	(0.758)
<i>HOTEL</i>					-0.032	(-0.524)
<i>IPC</i>					0.078	(1.289)
<i>IPROD</i>					0.042***	(1.925)
<i>PLANT</i>					0.018	(0.613)
<i>PROP</i>					0.005	(0.198)
<i>TECH</i>					0.041	(1.196)
<i>TDG</i>					0.026	(1.130)
<i>Y2004</i>					0.014	(0.759)
<i>Y2005</i>					0.071*	(3.791)
<i>Y2006</i>					-0.011	(-0.597)
<i>Y2007</i>					0.048*	(2.655)
<i>Y2008</i>					0.117*	(6.150)
<i>Adj.R</i> ²	0.08		0.12		0.10	
<i>N</i>	2892		2892		2892	
<i>F-stat</i>	26.723		39.807		17.578	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 FAMILY_{it} + \beta_5 FAMILY_{it} * RET_{it} + \beta_6 FAMILY_{it} * RD_{it} + \beta_7 FAMILY_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$$

The sample comprises 2,892 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: *E_{it}* is the earnings per share for firm *i* in fiscal year *t*; *P_{it-1}* is the price per share at the beginning of the fiscal year; *RET_{it}* is the annual return of firm *i* in fiscal year *t*; *RD_{it}* is a dummy variable that equals 1 if *RET_{it}* is negative, and 0 otherwise; *FAMILY* is a dummy variable that takes value 1 if the observation is family firm, 0 if widely-held firms; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and *ε_{it}* is the error term.

6.5.4.2 Strategic Control of Controlling Family and Earnings Conservatism

Prior studies of the separation of the roles of CEO and chairman have focused on managerial compensation (Boyd, 1994), earnings restatement (Abbott, et al., 2004), fraudulent financial reporting (Beasley, Carcello, Hermanson, & Lapedes, 2000), and audit committees in the UK/US setting (Collier, 1993; Pincus, Rusbarsky, & Wong, 1989; Turpin & DeZoort, 1998), but no study has considered how CEO duality in family firms influences earnings conservatism.

Hence, I include in this study an examination of this issue. I posit that when a controlling shareholder has strong control over the management and the corporate board, these firms have lower agency costs and less incentive for opportunistic reporting; hence these firms report more conservative earnings than other family firms. I assume that a family firm is under the strong influence of the controlling family when the CEO is appointed from that family and he also acts as the chairman of the corporate board.

To conduct the test, firstly, I restricted the sample to family firms. Secondly, I created a dummy variable, *DUALITY*, that takes the value of 1 when a member of the controlling family holds both the positions of CEO and chairman of the board of directors, otherwise 0. Thirdly, I estimated equation (6.3), modified from the Basu (1997) asymmetric timeliness of earnings model, to test for significant differences in the earnings conservatism level between family firms with strong family influence and family firms with less or no influence of a controlling family.

$$\begin{aligned}
E_{it}/P_{it-1} = & \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 DUALITY_{it} \\
& + \beta_5 DUALITY_{it} * RET_{it} + \beta_6 DUALITY_{it} * RD_{it} \\
& + \beta_7 DUALITY_{it} * RET_{it} * RD_{it} + \varepsilon_{it}
\end{aligned} \tag{6.3}$$

where E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $DUALITY$ is a dummy variable that takes value 1 if the family firm's CEO also acts as the chairman for the board of directors, and 0 otherwise; and ε_{it} is the error term.

I predict that the dual roles of CEO and chairman in a family firm would result in less incentive to manipulate earnings, hence leading to reporting of more conservative earnings. The argument is that the CEO's duality in family firms alleviates the agency cost, because the CEO's compensation is less likely to be influenced by earnings numbers. My prediction is that family firms in which the CEO also acts as the chairman of the board are more likely to report more conservative earnings than other family firms.

The estimation results based on the basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression controlling for industry and year effects are presented in Table 6.28. The results show higher earnings conservatism if a member of the controlling family acts as CEO and chairman of the board of directors. The coefficient for $DUALITY * RET * RD$ in the pooled regression is 0.434 and significant at the 5% level. Similar results are found when using Fama and MacBeth (1973) annual regression and fixed-effects regression,

in which the coefficient for $DUALITY * RET * RD$ is 0.376 and 0.387, and significant at the 10% and 5% levels respectively.

Table 6.28
CEO duality in family firms and earnings conservatism

Sample/ Variable	Pooled regression		Fama-MacBeth		Fixed Effects	
	Coeff	t-stat	Coeff	t-stat	Coeff	t-stat
<i>Intercept</i>	0.051*	(4.081)	0.071**	(3.632)	0.024	(0.789)
<i>RET</i>	0.101*	(6.998)	0.087*	(7.282)	0.097*	(9.700)
<i>RD</i>	0.008	(0.367)	-0.000	(-0.002)	-0.001	(-0.067)
<i>RET*RD</i>	0.145*	(2.672)	0.261*	(4.650)	0.234*	(3.976)
<i>DUALITY</i>	0.061***	(1.857)	0.041	(1.008)	0.046	(1.425)
<i>DUALITY*RET</i>	-0.072	(-1.097)	-0.068	(-0.650)	-0.068**	(-2.484)
<i>DUALITY*RD</i>	0.059	(1.011)	0.073	(1.458)	0.058	(0.987)
<i>DUALITY*RET*RD</i>	0.434**	(2.240)	0.376***	(2.419)	0.387**	(2.474)
<i>CONS</i>					-0.004	(-0.122)
<i>HOTEL</i>					-0.143***	(-1.676)
<i>IPC</i>					0.069	(0.816)
<i>IPROD</i>					0.024	(0.874)
<i>PLANT</i>					-0.028	(-0.761)
<i>PROP</i>					-0.034	(-1.137)
<i>TECH</i>					0.044	(0.953)
<i>TDG</i>					-0.022	(-0.741)
<i>Y2004</i>					0.021	(0.913)
<i>Y2005</i>					0.091*	(3.784)
<i>Y2006</i>					0.003	(0.122)
<i>Y2007</i>					0.052**	(2.228)
<i>Y2008</i>					0.121*	(4.959)
<i>Adj.R²</i>	0.11		0.16		0.13	
<i>N</i>	1770		1770		1770	
<i>F-stat</i>	21.994		54.346		14.119	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 DUALITY_{it} + \beta_5 DUALITY_{it} * RET_{it} + \beta_6 DUALITY_{it} * RD_{it} + \beta_7 DUALITY_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$$

The sample comprises 2,892 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $DUALITY$ is a dummy variable that takes value 1 if a member of the controlling family holds both the positions of CEO and chairman of the board of directors, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

These results imply that the strategic control of a family of the positions of CEO and chairman gives greater incentive to the managers to report more conservative earnings so as to minimise the perceived high ‘agency conflict’ between the controlling shareholder and other shareholders. Furthermore managers have lower incentives to opportunistically report earnings because the compensation of family members is not tied to earnings numbers.

To examine the robustness of these results, I estimated the following equation, modified from the time-series test of timeliness in loss recognition model, on the basic pooled model, Fama and MacBeth (1973) annual regression, and fixed-effects regression. The results are presented in Table 6.29.

$$\begin{aligned}\Delta NI_{it} = & \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + \alpha_4 DUALITY_{it-1} \\ & + \alpha_5 DUALITY_{it-1} * \Delta NI_{it-1} + \alpha_6 DUALITY_{it-1} * D\Delta NI_{it-1} \\ & + \alpha_7 DUALITY_{it-1} * \Delta NI_{it-1} * D\Delta NI_{it-1} + \varepsilon_{it}\end{aligned}\quad (6.4)$$

where ΔNI_{it} is the change in earnings for firm i from year $t-1$ to year t , standardised by total assets at end of year $t-1$; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; $DUALITY$ is a dummy variable that takes value 1 if a member of the controlling family holds both the positions of CEO and chairman of the board of directors, and 0 otherwise; and ε_{it} is the error term.

Table 6.29**Time-series test of timeliness in loss recognition: Strategic control of family firms**

Sample	Pooled regression		Fama-MacBeth		Fixed Effects	
	Coeff	t-stat	Coeff	t-stat	Coeff	t-stat
<i>Intercept</i>	0.006**	(2.074)	0.006	(1.205)	-0.001	(-0.075)
ΔNI_{it-1}	-0.150*	(-5.380)	-0.140	(-1.836)	-0.149*	(-5.327)
$D\Delta NI_{it-1}$	-0.013*	(-2.636)	-0.013	(-1.868)	-0.012*	(-2.585)
$\Delta NI_{it-1} * D\Delta NI_{it-1}$	-0.551*	(-8.686)	-0.556*	(-5.653)	-0.558*	(-8.733)
$DUALITY_{it-1}$	0.009	(1.264)	0.008	(1.173)	0.009	(1.242)
$DUALITY_{it-1} * \Delta NI_{it-1}$	-0.117	(-1.516)	-0.065	(-0.335)	-0.121	(-1.568)
$DUALITY_{it-1} * D\Delta NI_{it-1}$	-0.019	(-1.550)	-0.012	(-1.062)	-0.020	(-1.583)
$DUALITY_{it-1} * \Delta NI_{it-1} * D\Delta NI_{it-1}$	-0.297***	(-1.899)	-0.072	(-0.155)	-0.301***	(-1.926)
<i>CONS</i>					-0.002	(-0.302)
<i>HOTEL</i>					-0.002	(-0.074)
<i>IPC</i>					-0.004	(-0.156)
<i>IPROD</i>					0.002	(0.276)
<i>PLANT</i>					0.025*	(2.606)
<i>PROP</i>					-0.001	(-0.141)
<i>TECH</i>					-0.000	(-0.026)
<i>TDG</i>					0.005	(0.626)
<i>Y2004</i>					0.006	(0.997)
<i>Y2005</i>					0.001	(0.212)
<i>Y2006</i>					0.004	(0.614)
<i>Y2007</i>					0.017*	(2.641)
<i>Y2008</i>					-0.004	(-0.616)
<i>Adj.R²</i>	0.15		0.21		0.15	
<i>N</i>	1762		1762		1762	
<i>F-stat</i>	44.935		23.881		17.130	

Model: $\Delta NI_{it} = \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + \alpha_4 DUALITY_{it-1}$
 $+ \alpha_5 DUALITY_{it-1} * \Delta NI_{it-1} + \alpha_6 DUALITY_{it-1} * D\Delta NI_{it-1} + \alpha_7 DUALITY_{it-1} * \Delta NI_{it-1}$
 $+ \alpha_8 DUALITY_{it-1} * D\Delta NI_{it-1} + industry + year + \varepsilon_{it}$

The sample comprises 2,876 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported t-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: ΔNI_{it} is the change in earnings for firm i from year t-1 to year t, standardised by total assets at end of year t-1; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; $DUALITY$ is a dummy variable that takes value 1 if a member of the controlling family holds both the positions of CEO and chairman of the board of directors, and 0 otherwise; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

Given that the prediction is that a family firm in which the CEO also acts as the chairman of the board will have substantially different financial reporting, I am interested in the incremental coefficient α_7 . Consistent with the earlier analysis,

the results in Table 6.29 show weak evidence that the strategic control of a family on the positions of CEO and chairman is associated with higher earnings reversal when incorporating transitory losses in earnings than other family firms, since the coefficients for $DUALITY * \Delta NI_{it-1} * D\Delta NI_{it-1}$ (α_7) are negatively significant at the 10% level in the pooled regression model and estimation controlling for industry and year effects, coefficients of -0.297 and -0.301, respectively. These results show evidence that holding the dual role of CEO and chairman of the board alleviates the agency costs in family firms, and reduces their incentives to report earnings aggressively. However, the coefficient for $DUALITY * \Delta NI_{it-1} * D\Delta NI_{it-1}$ is not significant when estimated using Fama and MacBeth (1973) annual regression. In general, the results show that earnings conservatism is more pervasive in firms in which the CEO also holds the role of chairman of the board.

6.5.5 Discussion of the Results

The third objective of this study was to examine whether ownership structure has significant influence on earnings conservatism. Given that family firms and state-controlled firms are dominant in the Malaysian economy, this provides opportunities for examining how earnings conservatism levels vary according to ownership structure.

Employing the Basu (1997) asymmetric timeliness of earnings model, I find that earnings reflect bad news more quickly than good news in family firms and widely-held firms, indicating evidence of earnings conservatism. With regard to state-controlled firms, the results show that good news is recognised in a timely way but recognition of bad news is delayed, implying evidence of aggressive

accounting. Various sensitivity tests were conducted, including Fama and Macbeth estimation, estimation controlling for industry and year effects, alternative definitions of family firms, classification of state-controlled firms into firms under the control of Federal and State governments. In all the tests, I find robust evidence of earnings conservatism in family firms and widely-held firms, but not in state-controlled firms.

These results suggest that ownership structure has a significant influence on earnings conservatism. The different levels of agency costs and of information asymmetry in each type of firm create varying incentives and demands regarding conservative earnings reporting. In family firms, the results provide support for ‘alignment effects’ theory, in which family firms exert greater monitoring and which provides higher incentives to report earnings conservatively. This is consistent with the evidence provided by Wang (2006), where family firms in the United States have higher earnings quality, in particular lower abnormal accruals, greater earnings informativeness, and less persistence of transitory loss components in earnings.

For state-controlled firms, the result is consistent with Bushman and Piotroski (2006), who find firms in common-law countries that face high state involvement in the economy tend to slow the recognition of bad news and speed the recognition of good news. As such, a high tendency to government intervention in poorly-performing state-controlled firms motivates managers to avoid such interference by reporting aggressive earnings (Bushman & Piotroski, 2006). On the other hand, Bushman and Piotroski (2006) argued that state-controlled firms

were pressured by the government to report higher earnings.

I further examined systematic differences in the level of earnings conservatism between family firms and widely-held firms. The results from the pooled regression, Fama and MacBeth (1973) annual regression, and fixed effect regression show no significant difference of earnings conservatism between family firms and widely-held firms. This result shows no evidence that widely-held firms are different from family firms in respect of earnings conservatism.

I also conducted additional tests of whether strategic control by a controlling family is associated with higher earnings conservatism. The analysis shows that when a member of the controlling family acts as both CEO and chairman of the board of directors, the family firm reports earnings more conservatively than other family firms. This implies that holding the dual role of CEO and chairman of the board alleviates the agency costs in family firms and reduces incentives to report earnings aggressively. Another possible explanation is that these family firms employ earnings conservatism as a strategy to minimise the perceived high agency conflicts between the controlling shareholder and other shareholders.

6.6 Corporate Governance and Earnings Conservatism

6.6.1 Introduction

The final objective of this study is to examine the relationship between corporate governance and earnings conservatism. The following section, Section 6.6.2, presents and discusses the main empirical results, while Section 6.6.3 reports the

sensitivity analyses. Discussions on the overall results are provided in Section 6.6.4.

6.6.2 Corporate Governance Mechanism and Earnings Conservatism

This section reports the regression estimates for equation (5.3a) and (5.3b), which tests the relationship between earnings conservatism and the corporate governance index, developed from 11 corporate governance variables.

Table 6.30
Corporate governance and earnings conservatism

CGINDEX			DUMCG		
Variable	Coeff	t-stat	Variable	Coeff	t-stat
<i>Intercept</i>	0.015	(0.616)	<i>Intercept</i>	0.034**	(2.209)
<i>RET</i>	0.083*	(2.779)	<i>RET</i>	0.087*	(4.280)
<i>RD</i>	0.081***	(1.840)	<i>RD</i>	0.032	(1.161)
<i>RET*RD</i>	0.287**	(2.550)	<i>RET*RD</i>	0.210*	(2.949)
<i>CGINDEX</i>	0.082	(1.636)	<i>DUMCG</i>	0.029	(1.374)
<i>CGINDEX*RET</i>	-0.026	(-0.467)	<i>DUMCG*RET</i>	-0.016	(-0.519)
<i>CGINDEX*RD</i>	-0.159***	(-1.813)	<i>DUMCG*RD</i>	-0.071***	(-1.870)
<i>CGINDEX*RET*RD</i>	-0.214	(-0.976)	<i>DUMCG*RET*RD</i>	-0.124	(-1.349)
<i>Adj.R²</i>	0.08		<i>Adj.R²</i>	0.08	
<i>N</i>	3126		<i>N</i>	2084	
<i>F-stat</i>	26.770		<i>F-stat</i>	21.873	

Model: $E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 CGINDEX_{it} + \beta_5 CGINDEX_{it} * RET_{it} + \beta_6 CGINDEX_{it} * RD_{it} + \beta_7 CGINDEX_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$

$E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 DUMCG_{it} + \beta_5 DUMCG_{it} * RET_{it} + \beta_6 DUMCG_{it} * RD_{it} + \beta_7 DUMCG_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $CGINDEX$ is an unweighted aggregate of 11 corporate governance variables; $DUMCG$ is a dummy variable that takes value 1 if $CGINDEX$ is in the top third of the pooled sample, and 0 if $CGINDEX$ is in the bottom third; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

I employed two measures for corporate governance. First, I used *CGINDEX*,

which is based on an unweighted corporate governance score from 11 corporate governance variables. Second, I used a *DUMCG*, which is a dummy variable that takes value 1 if *CGINDEX* is in the top third of the pooled sample, and 0 if *CGINDEX* is in the bottom third. The regression estimates are reported in Table 6.30.

The results show that the coefficients for *RET*RD* are positively significant in both estimation models, suggesting evidence of earnings conservatism. However, the coefficients for *CGINDEX*RET*RD* and *DUMCG*RET*RD* are not significant, suggesting no link from corporate governance to earnings conservatism.

6.6.3 Sensitivity Analysis

To examine the robustness of the main results discussed in section 6.6.2, I conducted several sensitivity analyses which included (i) the use of an alternative measure for *CGINDEX*; (ii) individual measures for corporate governance variables; and (iii) time-series test of timeliness in loss recognition.

6.6.3.1 Alternative Measure for *CGINDEX*

I re-calculated *CGINDEX* using nine internal corporate governance variables such as board size (*BODSIZE*), non-executive directors (*NONEXEC*), board independence (*BODIND*), independent chairman (*INDCHRM*), board meetings (*BODMEET*), size of audit committee (*ACSIZE*), audit committee independence (*ACINDP*), number of audit committee meetings (*ACMEET*), and financial

expertise of audit committee (*ACEXPERT*). I then re-estimated equation (5.3a) using basic pooled regression, Fama and MacBeth (1973) annual regression, and fixed-effects regression to test the relationship between earnings conservatism and corporate governance. The results are reported in Table 6.31.

Table 6.31
Corporate governance and earnings conservatism: An alternative measurement

Variable	Basic		Fama-MacBeth		Fixed Effects	
	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat	Coeff	<i>t</i> -stat
<i>Intercept</i>	0.041***	(1.726)	0.041	(1.700)	-0.003	(-0.084)
<i>RET</i>	0.075**	(2.477)	0.065	(1.592)	0.069***	(2.263)
<i>RD</i>	0.073***	(1.738)	0.070	(1.168)	0.071***	(1.688)
<i>RET*RD</i>	0.281*	(2.580)	0.186	(1.234)	0.354*	(3.259)
<i>CGINDEX</i>	0.025	(0.536)	0.056	(0.858)	0.004	(0.079)
<i>CGINDEX*RET</i>	-0.009	(-0.158)	-0.025	(-0.316)	-0.004	(-0.063)
<i>CGINDEX*RD</i>	-0.142	(-1.610)	-0.135	(-1.069)	-0.155***	(-1.750)
<i>CGINDEX*RET*RD</i>	-0.207	(-0.926)	0.306	(0.859)	-0.195	(-0.869)
<i>CONS</i>					0.023	(0.909)
<i>HOTEL</i>					-0.040	(-0.743)
<i>IPC</i>					0.020	(0.584)
<i>IPROD</i>					0.042***	(1.734)
<i>PLANT</i>					0.032	(1.049)
<i>PROP</i>					0.015	(0.549)
<i>TECH</i>					0.038	(1.039)
<i>TDG</i>					0.032	(1.269)
<i>Y2004</i>					0.013	(0.779)
<i>Y2005</i>					0.068*	(3.994)
<i>Y2006</i>					-0.009	(-0.483)
<i>Y2007</i>					0.050*	(3.116)
<i>Y2008</i>					0.119*	(6.613)
<i>Adj. R</i> ²	0.08		0.12		0.10	
<i>N</i>	3126		3126		3126	
<i>F</i> -stat	26.084		59.581		11.511	

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 CGINDEX_{it} + \beta_5 CGINDEX_{it} * RET_{it} + \beta_6 CGINDEX_{it} * RD_{it} + \beta_7 CGINDEX_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported *t*-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm *i* in fiscal year *t*; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm *i* in fiscal year *t*; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; $CGINDEX$ is an unweighted aggregate of nine corporate governance variables; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

Table 6.31 shows qualitatively similar results as results reported in the previous section. As in the previous results of the study, the coefficients for $RET*RD$ are positively significant in both estimation models, suggesting evidence of earnings conservatism. However, the coefficients for $CGINDEX*RET*RD$ are not significant ($p>0.10$), suggesting that there is no evidence link corporate governance and earnings conservatism. With respect to the validity of the models, all F -statistics are significant at the 1% level, while the values for $adjusted-R^2$ are 8%, which is similar to the earlier findings.

6.6.3.2 Individual Measures for Corporate Governance

In this section, I report the analyses on the relationship between earnings conservatism and individual corporate governance mechanisms by comparing the levels of earnings conservatism between subsamples of firms with good and bad governance based on 11 proxies. I modified equation (5.3a) by replacing $CGINDEX$ with individual corporate governance variables such as $BODSIZE$, $NONEXEC$, $BODIND$, $INDCHRM$, $BODMEET$, $ACSIZE$, $ACIND$, $ACMEET$, $ACEXP$ ERT, $BIG4$, and $SPECIALIST$. These variables are dummy variables which take value 1 for good governance firms and 0 for poor governance firms. Explanations about the dummy variables were provided in Section 5.6. I then re-estimated the modified equation (5.2) to examine the relationship between individual corporate governance mechanisms and earnings conservatism. The results are presented in Table 6.32.

Table 6.32
Individual corporate governance mechanisms and earnings conservatism

Variable (VAR)	Intercept	RET	RD	RET*RD	VAR	VAR*RET	VAR*RD	VAR*RET*RD	Adj. R ²	Obs	F-stat
<i>BODSIZE</i>	0.049* (4.638)	0.111* (7.172)	0.041* (2.588)	0.098** (2.336)	0.001 (0.069)	-0.042** (-1.994)	-0.032 (-1.534)	0.089 (1.592)	0.11	3126	44.329
<i>NONEXEC</i>	0.046* (4.115)	0.080* (4.836)	0.014 (0.792)	0.175* (3.739)	0.007 (0.484)	0.001 (0.029)	0.006 (0.292)	-0.013 (-0.219)	0.10	3126	38.361
<i>BODIND</i>	0.051* (6.034)	0.083* (5.863)	0.029** (2.080)	0.184* (4.507)	-0.001 (-0.097)	-0.005 (-0.224)	-0.025 (-1.161)	-0.043 (-0.735)	0.10	3126	37.671
<i>INDCHRM</i>	0.045* (4.446)	0.080* (4.164)	0.021 (1.291)	0.150* (3.175)	0.010 (0.759)	0.000 (0.015)	-0.006 (-0.265)	0.030 (0.498)	0.10	3126	37.865
<i>BODMEET</i>	0.056* (6.889)	0.067* (4.539)	0.023*** (1.884)	0.185* (5.267)	-0.018 (-1.314)	0.043** (2.073)	-0.026 (-1.064)	-0.080 (-1.240)	0.11	3126	42.805
<i>ACSIZE</i>	0.056* (6.523)	0.060* (3.947)	0.014 (1.058)	0.206* (5.529)	-0.017 (-1.301)	0.061* (3.007)	0.010 (0.472)	-0.119** (-2.004)	0.11	3126	45.204
<i>ACIND</i>	0.051* (7.261)	0.083* (7.081)	0.021*** (1.871)	0.190* (5.678)	-0.003 (-0.154)	-0.014 (-0.419)	-0.010 (-0.319)	-0.090 (-1.222)	0.10	3126	37.813
<i>ACMEET</i>	0.051* (7.391)	0.086* (7.605)	0.021*** (1.849)	0.163* (5.162)	-0.005 (-0.277)	-0.029 (-0.810)	-0.019 (-0.647)	0.010 (0.125)	0.10	3126	39.303
<i>ACEXPRT</i>	0.048* (3.820)	0.071* (3.135)	0.009 (0.456)	0.183* (3.080)	0.004 (0.302)	0.015 (0.575)	0.014 (0.576)	-0.020 (-0.288)	0.10	3126	38.389
<i>BIG4</i>	0.031** (2.359)	0.072* (3.143)	0.013 (0.606)	0.155* (2.743)	0.029*** (1.956)	0.012 (0.456)	0.007 (0.263)	0.016 (0.239)	0.11	3126	41.963
<i>SPECIALIST</i>	0.044* (5.643)	0.081* (5.991)	0.028** (2.211)	0.175* (5.029)	0.028*** (1.951)	-0.004 (-0.159)	-0.039*** (-1.693)	-0.035 (-0.551)	0.10	3126	40.386

$$\text{Model: } E_{it}/P_{it-1} = \beta_0 + \beta_1 RET_{it} + \beta_2 RD_{it} + \beta_3 RET_{it} * RD_{it} + \beta_4 VAR_{it} + \beta_5 VAR_{it} * RET_{it} + \beta_6 VAR_{it} * RD_{it} + \beta_7 VAR_{it} * RET_{it} * RD_{it} + \varepsilon_{it}$$

The sample comprises 3,126 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported t -statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: E_{it} is the earnings per share for firm i in fiscal year t ; P_{it-1} is the price per share at the beginning of the fiscal year; RET_{it} is the annual return of firm i in fiscal year t ; RD_{it} is a dummy variable that equals 1 if RET_{it} is negative, and 0 otherwise; VAR is a dummy variable either $BODSIZE$, $NONEXEC$, $BODIND$, $INDCHRMN$, $BODMEET$, $ACSIZE$, $ACIND$, $ACMEET$, $ACEXPERT$, $BIG4$, or $SPECIALIST$; $BODSIZE$ equals 1 if the number of directors is less than nine, and 0 otherwise; $NONEXEC$ equals 1 if the proportion of non-executive directors is more than half, 0 and otherwise; $BODIND$ equals 1 if the proportion of independent directors is more than the median value, and 0 otherwise; $INDCHRM$ equals 1 if the chairman is an independent director, and 0 otherwise; $BODMEET$ equals 1 if the number of board meetings during the year is more than the median value, and 0 otherwise; $ACSIZE$ equals 1 if the size of audit committee is more than three, and 0 otherwise; $ACIND$ equals 1 if all members of the audit committee are independent directors, and 0 otherwise. $ACMEET$ equals 1 if the number of the audit committee meetings is more than the median value, and 0 otherwise; $ACEXPERT$ equals 1 if the audit committee has two or more members with financial expertise, and 0 otherwise; $BIG4$ equals 1 if the observation is audited by a Big Four auditor, and 0 otherwise; $SPECIALIST$ equals 1 if the observation is audited by an industry specialist, and 0 otherwise; and ε_{it} is the error term.

Overall results reported in Table 6.32 show that the only case of significant difference between earnings conservatism for firms with good and poor corporate governance is related to audit committee size. The coefficient for $ACSIZE*RET*RD$ is negative (-1.161) and significant at the 5% level, suggesting evidence of lower earnings conservatism in firms with a bigger audit committee.

This result is contrary to prior studies, for example Ahmed and Duellman (2007) and García Lara and Mora (2004), who find evidence that corporate governance measures have significant association with earnings conservatism. For instance, the proportion of outside directors is found to be associated with earnings conservatism in the United Kingdom (Beekes, et al., 2004) and in the United States (Ahmed & Duellman, 2007), where the percentage of outside directors is positively related to conservatism. Furthermore, García Lara et al. (2007) find that firms where the CEO has a low influence over the functioning of the board of directors show a greater degree of accounting conservatism. However, these studies relate to developed markets with fewer family firms. My results for family firms which show a high levels of conservatism regardless of governance quality, suggests that perhaps corporate governance mechanisms that are relevant for firms in developed countries are not relevant for family firms in developing countries.

6.6.3.3 Time-Series Test of Timeliness in Loss Recognition

I modified equation (1.2) in order to investigate further the relationship between corporate governance and earnings conservatism. This modification enables an examination of the incremental reversal of earnings changes from previous year changes of earnings as a result of corporate governance. The modified model is as

follows:

$$\begin{aligned}\Delta NI_{it} = & \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + \alpha_4 CGINDEX_{it-1} \quad (6.5) \\ & + \alpha_5 CGINDEX_{it-1} * \Delta NI_{it-1} + \alpha_6 CGINDEX_{it-1} * D\Delta NI_{it-1} \\ & + \alpha_7 CGINDEX_{it-1} * \Delta NI_{it-1} * D\Delta NI_{it-1} + \varepsilon_{it}\end{aligned}$$

where ΔNI_{it} is the change in earnings for firm i from year $t-1$ to year t , standardised by total assets at end of year $t-1$; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; $CGINDEX$ is an unweighted corporate governance score developed from 11 corporate governance variables; and ε_{it} is the error term.

I estimated the above equation, which tests for significant differences between earnings conservatism for firms with good and poor corporate governance using the unweighted corporate governance index ($CGINDEX$) developed from 11 corporate governance variables. The regression estimates are summarised in Table 6.33.

Consistent with the earlier analysis, the results in Table 6.33 show that firms with good corporate governance are not likely to have higher earnings reversal when incorporating transitory losses in income, compared with firms with poor corporate governance, since the coefficients for $CGINDEX * \Delta NI_{it-1} * D\Delta NI_{it-1}$ (α_6) are not statistically significant ($p > 0.10$) for all estimation models (coefficients of 0.554, 0.265, and 0.557).

Table 6.33

Corporate governance score and the time-series test of timeliness in loss recognition: Pooled regression, Fama and MacBeth (1973) annual regression, estimation controlling for industry and year effects

Sample	Pooled regression		Fama-MacBeth		Fixed Effects	
	Coeff	t-stat	Coeff	t-stat	Coeff	t-stat
<i>Intercept</i>	0.010	(1.626)	0.012	(1.609)	0.007	(0.754)
ΔNI_{it-1}	-0.209	(-1.311)	-0.250	(-1.274)	-0.211	(-1.320)
$D\Delta NI_{it-1}$	-0.025**	(-2.218)	-0.024	(-1.664)	-0.024**	(-2.209)
$\Delta NI_{it-1} * D\Delta NI_{it-1}$	-0.959*	(-3.096)	-0.874*	(-5.290)	-0.964*	(-3.108)
$CGINDEX_{it-1}$	-0.008	(-0.656)	-0.013	(-0.927)	-0.011	(-0.876)
$CGINDEX_{it-1} * \Delta NI_{it-1}$	0.204	(0.676)	0.326	(0.963)	0.212	(0.699)
$CGINDEX_{it-1} * D\Delta NI_{it-1}$	0.017	(0.752)	0.013	(0.505)	0.017	(0.791)
$CGINDEX_{it-1} * \Delta NI_{it-1} * D\Delta NI_{it-1}$	0.554	(0.924)	0.265	(1.445)	0.557	(0.930)
<i>CONS</i>					-0.002	(-0.262)
<i>HOTEL</i>					0.000	(0.022)
<i>IPC</i>					-0.005	(-0.357)
<i>IPROD</i>					0.001	(0.147)
<i>PLANT</i>					0.015***	(1.819)
<i>PROP</i>					-0.002	(-0.234)
<i>TECH</i>					-0.006	(-0.435)
<i>TDG</i>					0.000	(0.016)
<i>Y2004</i>					0.002	(0.407)
<i>Y2005</i>					0.000	(0.034)
<i>Y2006</i>					0.003	(0.502)
<i>Y2007</i>					0.017*	(3.071)
<i>Y2008</i>					-0.001	(-0.096)
<i>Adj.R²</i>	0.14		0.18		0.14	
<i>N</i>	3105		3105		3105	
<i>F-stat</i>	15.040		38.864		7.186	

$$\begin{aligned}
 \text{Model: } \Delta NI_{it} = & \alpha_0 + \alpha_1 \Delta NI_{it-1} + \alpha_2 D\Delta NI_{it-1} + \alpha_3 \Delta NI_{it-1} * D\Delta NI_{it-1} + \alpha_4 CGINDEX_{it-1} \\
 & + \alpha_5 CGINDEX_{it-1} * \Delta NI_{it-1} + \alpha_6 CGINDEX_{it-1} * D\Delta NI_{it-1} \\
 & + \alpha_7 CGINDEX_{it-1} * \Delta NI_{it-1} * D\Delta NI_{it-1} + \text{industry} + \text{year} + \varepsilon_{it}
 \end{aligned}$$

The sample comprises 3,105 firm-year observations from firms in Bursa Malaysia during 2003–2008. The reported t-statistics are in parentheses and adjusted for heteroscedasticity (White, 1980). Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively. Variable definitions: ΔNI_{it} is the change in earnings for firm i from year t-1 to year t, standardised by total assets at end of year t-1; $D\Delta NI_{it-1}$ is a dummy variable that equals 1 if ΔNI_{it-1} is negative, and 0 otherwise; $CGINDEX$ is the unweighted corporate governance score developed from 11 corporate governance variables; *Industry* are dummy variables for Bursa Malaysia industry sectors; *Year* are dummy variables for fiscal years; and ε_{it} is the error term.

6.6.4 Discussion of the Results

The final objective of this study is to examine the relationship between corporate governance and earnings conservatism. Using 11 corporate governance variables, I estimated the modified Basu (1997) reverse regression model, the results of which show no significant evidence linking corporate governance and earnings conservatism. For robustness tests, I employed three procedures: (i) alternative measure for *CGINDEX* and *DUMCG*; (ii) individual measures for corporate governance; and (iii) estimation based on time-series test of timeliness in loss recognition. All these tests failed to find a significant relationship between corporate governance and earnings conservatism.

6.7 Summary of Results

This chapter presents the findings of this study based on various analyses conducted in accordance with the research objectives and hypotheses. Four main findings can be concluded from this study.

Firstly, this study finds robust evidence that earnings conservatism is a strong feature of Malaysian financial reporting following the institutional reforms of corporate governance and financial reporting. Specifically, earnings reflect bad news in a more timely manner than they reflect good news. The plausible explanation from this finding is that firms have greater incentives and demands to report high-quality earnings, in particular by more timely recognition of bad news compared to good news, when the institutional structure is strong. In contrast, the weak institutional structures in the period before the 1997 economic crisis resulted

in less incentive for preparers of financial reports to report earnings conservatively (Ball, et al., 2003). The results of this study provide support for arguments made by Bushman and Piotroski (2006) and Ball et al. (2003) that institutional structures have significant influence on earnings conservatism.

Secondly, this study finds no significant difference between the degree of earnings conservatism in the periods before and after the adoption of IFRS. The main analysis and various sensitivity tests fail to find any evidence showing significantly higher or lower earnings conservatism in the post-IFRS period relative to the pre-IFRS period. The plausible explanation is that managers, preparers of financial reports and auditors have greater incentives to report earnings conservatively, though the accounting standards warranted unbiased information. This provides support to the role of earnings conservatism in improving debt-contracting, minimizing litigation risk, and enhancing greater monitoring. This result is consistent with LaFond and Watts's (2008) prediction, in which any initiatives to reduce earnings conservatism would increase the agency cost and the litigation risk, hence forcing market-based mechanisms to require firms to report more conservative earnings.

Thirdly, this study finds that bad news is recognised in a more timely fashion than good news in family firms and widely-held firms, showing evidence of earnings conservatism. In state-controlled firms, the results show that good news is recognised in a timely way but recognition of bad news is delayed, implying evidence of aggressive accounting. In all tests, I find robust evidence of earnings conservatism in family firms and widely-held firms, but not in state-controlled

firms. These results suggest that ownership structure has a significant influence on earnings conservatism. The levels of agency costs and information asymmetry are varied between ownership structures, thereby creating varying incentives and demands towards conservative earnings reporting. In family firms, the results provide support for ‘alignment effects’ theory, in which family firms exert greater monitoring and provide higher incentives to report earnings conservatively. In addition, the results show evidence that one person holding the dual role of CEO and chairman of the board alleviates agency costs in family firms, and reduces incentives to report earnings aggressively. Another possible explanation is family firms report more conservative earnings in order to minimise the perceived high agency conflict between the controlling shareholder and other shareholders.

Finally, this study fails to find any significant relationship between corporate governance and earnings conservatism. None of the tests show a significant relationship between the corporate governance index and earnings conservatism.

CHAPTER SEVEN CONCLUSIONS

7.1 Introduction

This chapter provides a summary of the study. Section 7.2 discusses the findings and contributions of this study while Section 7.3 highlights several limitations of this study.

7.2 Summary

The purpose of this study was to investigate the issues relating to earnings conservatism in an emerging market. Motivated by the work of Basu (1997), Ball et al. (2003), and Bushman and Piotroski (2006), this study aims to provide empirical evidence on earnings conservatism in Malaysia. Using a sample of 3,126 firm-year observations, this study examines four main hypotheses.

First, this study examines earnings conservatism in Malaysian financial reporting following the corporate governance and financial reporting reforms. Contrary to Ball et al. (2003), who find no evidence of earnings conservatism in a Malaysian sample from 1984 to 1996, this study finds earnings conservatism is a strong feature of Malaysian financial reporting following the corporate governance and financial reporting reforms. The study finds that earnings reflect bad news received contemporaneously, but delay in the recognition of good news. These results imply that the reforms in corporate governance and financial reporting give strong incentives for Malaysian firms to practise conservative earnings reporting.

Second, this study investigates the effect of IFRS adoption on the level of earnings conservatism. The results show no systematic difference in the level of earnings conservatism for the short period of one to two years before and after adoption, suggesting that the change from MASB standards to IFRS standards has had no effect on the level of earnings conservatism in Malaysian financial reporting. This finding supports the argument of Ball et al. (2003) that accounting standards have had limited impact on earnings conservatism in financial reporting. In addition, it is apparent that the attempt to eliminate conservatism from financial statements failed because it increases rather than reduces information asymmetry. According to LaFond and Watts (2008), conservatism reduces managers' incentives and ability to manipulate earnings and thus reduce information asymmetry and the deadweight losses that information asymmetry generates. In short, conservatism is an ineradicable and an indispensable quality of financial reports, even though it is criticised by the standard setters.

Third, this study extends prior studies by examining how the levels of earnings conservatism varies across different types of ownership structures, namely family firms, state-controlled firms, and widely-held firms. Since different types of ownership are subject to different level and types of agency conflict, the incentives to report earnings conservatively may also vary. For state-controlled firms, this study fails to find evidence of earnings conservatism. The results indicate aggressive accounting. For family firms and widely-held firms, bad news is recognised in earnings on a more timely basis than is good news. The test for difference between family firms and widely-held firms reveals no statistical difference in the levels of earnings conservatism of the two groups.

Indirectly, this study provides evidence in support of the convergence of interest hypothesis, in so far it finds no evidence that family firms produce less conservative earnings compared to widely-held firms. This study further tests the effect of the strategic control of the controlling families on earnings conservatism. The results show firms that are strategically controlled by a family, that is, where a member of the controlling family acts as CEO and chairman of the corporate board, report significantly higher earnings conservatism than other family firms. This result implies that managers of firms that are strategically controlled by a family are more likely to have less incentive for opportunistic reporting and are more likely to have greater demand for conservative reporting. Overall, the results show that ownership structure has significant influence on the firms' financial reporting incentives to report earnings conservatively.

Finally, this study examines whether firms with strong corporate governance report more conservative earnings. The analysis fails to find any significant relationship between corporate governance and earnings conservatism, even though a comprehensive set of corporate governance variables was employed. This result is in conflict with evidence from developed markets, such as the United States and the United Kingdom, where firms with good governance are more timely in recognising bad news. A plausible explanation is that the corporate governance model, which is based on an Anglo-Saxon model, is inappropriate to emerging markets with a substantial number of family-firms. For instance, the appointment of 'independent' directors in family firms is likely to be influenced by the management's close relationship with the prospective directors and the likelihood of their support for the management's philosophy and policies (Chen &

Jaggi, 2000). This situation leads to ineffective corporate governance since independent directors are no longer capable of performing their duties independently. Thus family management sets out to ensure conservatism in earnings.

7.3 Limitations

Notwithstanding an extensive set of sensitivity analyses, the results of this study are subject to certain limitations and need to be interpreted with caution.

First, the construction of the sample has consequences for the generalisability of the results. All firms that existed from the year 2002 to 2008 have been included as long as the data concerned was consistent with the requirement of the study. Selecting the sample on this basis might lead to survivorship bias because it excludes newly-listed firms and firms that were delisted from the official list of Bursa Malaysia during the study period.

Second, the primary measure for earnings conservatism, the asymmetric timeliness of earnings, is exposed to potential measurement error and bias (Dietrich, et al., 2007) as a result of incorrect inferences.

Third, with regard to the adoption of IFRS, full convergence is scheduled for 1 January 2012. For the period under study, IFRS 4 Insurance Contracts, IFRS 7 Financial Instruments: Disclosures and IFRS 8 Operating Segments were still not effective. Thus extra caution is necessary when interpreting the effect of IFRS on earnings conservatism. The findings of no systematic difference of earnings

conservatism between the period under the MASB standards and the period under IFRS standards may be a reflection of this overlap.

Fourth, due to the complex ownership structure of Malaysian firms, this study uses a dichotomous variable as the identifier of family firm. The pyramidal and cross-sectional control and the use of nominees make the determination of the ‘real percentage’ of shares owned by the controlling shareholder a daunting task. The use of nominee accounts by Malaysian investors could also create a measurement bias. Likewise, the lack of a continuous measure for family control might also create a bias.

Fifth, although the alternative measure of family firms includes the percentage of shares owned by the controlling family, some families are nevertheless able to exert control with only a minimal shareholdings, while others require a larger stakes for the same level of control due to differences in firm size, industry, business practices, and product placement (Anderson & Reeb, 2003b).

Sixth, this study uses corporate governance metrics to identify whether firms have good or poor governance structure. It is important to highlight the note of caution by Armstrong, Guay, and Weber (2010). The authors assert that when classifying governance structure into good or bad, researchers have to ensure that “what is being called a ‘bad’ structure is not instead a ‘good’ structure for certain firms” (p. 208). They argue that studies, which identify firms with a relatively higher proportion of outside directors as having a ‘good’ governance structure, ignore “the extensive economic arguments and empirical evidence ... as to why some

firms that are labelled as having ‘bad’ governance might, in fact, have appropriately (endogeneously) selected a board with relatively few outside directors” (Armstrong, et al., 2010, p. 208). Future research should look into the potential interrelationships among various corporate governance mechanisms which would render different mixes of corporate governance mechanism equally effective.

Finally, the analysis has not tested for endogeneity in the relationship between corporate governance and earnings conservatism. This may bias the coefficient estimates and the conclusions that are derived therefrom. To address the endogeneity issue, future studies could employ two-stage least squares estimation of the regression equations (e.g., Heckman, 2000; Imbens & Wooldridge, 2009).

References

- Abbott, L. J., Parker, S., & Peters, G. F. (2004). Audit committee characteristics and restatements. *Auditing: A Journal of Practice and Theory*, 23(1), 69–87.
- Abdul Rahman, R. (2006). *Effective corporate governance* (1st ed.). Malaysia: University Publication Centre (UPENA) Universiti Teknologi Mara, Malaysia.
- Abdul Rahman, R., & Haniffa, R. M. (2005). The effect of role duality on corporate performance in Malaysia. *Corporate Ownership and Control*, 2(2), 40–47.
- Abdul Rahman, R., & Mohamed Ali, F. H. (2006). Board, audit committee, culture and earnings management: Malaysian evidence. *Managerial Auditing Journal*, 21(7), 783–804.
- Abdul Wahab, E. A., How, J. C. Y., & Verhoeven, P. (2007). *Institutional investors, corporate governance and firm performance in Malaysia*. Paper presented at the 2nd Journal of Contemporary Accounting and Economic Symposium Proceedings.
- Abdullah, S. N. (2004). Board composition, CEO duality and performance among Malaysian listed companies. *Corporate Governance*, 4(4), 47–61.
- Abdullah, S. N., & Mohd Nasir, N. (2004). Accrual management and the independence of the board of directors and audit committees. *IIUM Journal of Economics and Management*, 12(1), 49–80.
- Abu-Bakar, N. B., & Ahmad, M. (2009). Auditor independence: Malaysian accountants' perceptions. *International Journal of Business Managment*, 4(12), 129–141.
- Ahmed, A. S., Billings, B. K., Morton, R. M., & Stanford-Harris, M. (2002). The role of accounting conservatism in mitigating bondholder-shareholder conflicts over dividend policy and in reducing debt costs. *The Accounting Review*, 77(4), 867–890.
- Ahmed, A. S., & Duellman, S. (2007). Accounting conservatism and board of director characteristics: An empirical analysis. *Journal of Accounting and Economics*, 43(2/3), 411–437.
- Akoi, M. (1999). Controlling insider control: Issues of corporate governance in transition economies. In M. Akoi & H. Kim (Eds.), *Corporate Governance*

in Transitional Economies: Insider Control and The Role of Banks. Washington DC: World Bank.

- Al-Sehali, M., & Spear, N. (2004). The decision relevance and timeliness of accounting earnings in Saudi Arabia. *The International Journal of Accounting*, 39(2), 197–217.
- Ali, A., Chen, T., & Radhakrishnan, S. (2007). Corporate disclosures by family firms. *Journal of Accounting and Economics*, 44(1/2), 238–286.
- Anderson, R. C., Mansi, S. A., & Reeb, D. M. (2003). Founding family ownership and the agency cost of debt. *Journal of Financial Economics*, 68(2), 263–285.
- Anderson, R. C., & Reeb, D. M. (2003a). Family ownership, corporate diversification, and firm leverage. *Journal of Law and Economics*, 46(2), 653–684.
- Anderson, R. C., & Reeb, D. M. (2003b). Founding-family ownership and firm performance: Evidence from the S&P 500. *The Journal of Finance*, 58(3), 1301–1328.
- Ang, J. S., & Ding, D. K. (2006). Government ownership and the performance of government-linked companies: The case of Singapore. *Journal of Multinational Financial Management*, 16(1), 64–88.
- Arens, A. A., Loebbecke, J. K., Iskandar, T. M., Susela, S. D., & Isa, S. (1999). *Auditing in Malaysia: An integrated approach*. Kuala Lumpur, Malaysia: Prentice Hall.
- Armstrong, C. S., Guay, W. R., & Weber, J. P. (2010). The role of information and financial reporting in corporate governance and debt contracting. *Journal of Accounting and Economics*, 50(2/3), 179–234.
- Arosa, B., Iturralde, T., & Maseda, A. (2010). Ownership structure and firm performance in non-listed firms: Evidence from Spain. *Journal of Family Business Strategy*, 1(2), 88–96.
- Ball, R. (2001). Infrastructure requirements for an economically efficient system of public financial reporting and disclosure. *Brookings-Wharton Papers on Financial Services*, 127–169.
- Ball, R., & Brown, P. (1968). An empirical evaluation of accounting income numbers. *Journal of Accounting Research*, 6(2), 159–178.

- Ball, R., Kothari, S. P., & Robin, A. (2000). The effect of international institutional factors on properties of accounting earnings. *Journal of Accounting and Economics*, 29(1), 1–51.
- Ball, R., Robin, A., & Wu, J. S. (2003). Incentives versus standards: Properties of accounting income in four East Asian countries. *Journal of Accounting and Economics*, 36(1/3), 235–270.
- Ball, R., & Shivakumar, L. (2005). Earnings quality in UK private firms: comparative loss recognition timeliness. *Journal of Accounting and Economics*, 39(1), 83–128.
- Ball, R., & Shivakumar, L. (2006). The role of accruals in asymmetrically timely gain and loss recognition. *Journal of Accounting Research*, 44(2), 207–242.
- Balsam, S., Krishnan, J., & Yang, J. S. (2003). Auditor industry specialization and earnings quality. *Auditing: A Journal of Practice and Theory*, 22(2), 71–97.
- Barclay, M., & Smith, C. (1995). The maturity structure of corporate debt. *Journal of Finance*, 50(2), 609–631.
- Barth, M., Landsman, W., & Lang, M. (2008). International Accounting Standards and accounting quality. *Journal of Accounting Research*, 46(3), 467.
- Basu, S. (1995). *Conservatism and the Asymmetric Timeliness of Earnings*. Ph.D dissertation, University of Rochester.
- Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics*, 24(1), 3–37.
- Basu, S., Hwang, L., & Jan, C. (2001). *Differences in conservatism between Big Eight and non-Big Eight auditors*. Working Paper. Baruch College.
- Beasley, M. S., Carcello, J. V., Hermanson, D. R., & Lapides, P. D. (2000). Fraudulent financial reporting: Consideration of industry traits and corporate governance mechanisms. *Accounting Horizons*, 14(4), 441–454.
- Beaver, W. H., Lambert, R. A., & Morse, D. (1980). The information content of security prices. *Journal of Accounting and Economics*, 2(1), 3–28.
- Beaver, W. H., & Ryan, S. G. (2000). Biases and lags in book value and their effect on the ability of the book-to-market ratio to predict book return on equity. *Journal of Accounting Research*, 38(1), 127–148.

- Beaver, W. H., & Ryan, S. G. (2005). Conditional and unconditional conservatism: concepts and modeling. *Review of Accounting Studies*, 10(2/3), 269–276.
- Becker, C. L., Defond, M. L., Jambolvo, J., & Subramanyam, K. R. (1998). The effect of audit quality on earnings management. *Contemporary Accounting Research*, 15(1), 1–24.
- Bédard, J., & Biggs., S. (1991). The effect of domain-specific experience on evaluation of management representation in analytical procedures. *Auditing: A Journal of Practice and Theory*, 10(Supplement), 77–95.
- Bédard, J., Chtourou, S. M., & Courteau, L. (2004). The effect of audit committee expertise, independence, and activity on aggressive earnings management. *Auditing: A Journal of Practice & Theory*, 23(2), 15–37.
- Beekes, W., Pope, P. F., & Young, S. (2004). The link between earnings timeliness, earnings conservatism and board composition: evidence from the UK. *Corporate Governance: An International Review*, 12(1), 47–59.
- Beneish, M. D., & Press, E. (1993). Costs of technical violation of accounting-based debt covenants. *The Accounting Review*, 68(2), 233–257.
- Bernard, V. L. (1989). Capital market research in accounting during the 1980s: A critical review. In T. J. Frecka (Ed.), *The state of accounting research as we enter the 1990's*: University of Illinois at Urbana–Champaign.
- Bonner, S. E., & Lewis, B. L. (1990). Determinants of auditor expertise. *Journal of Accounting Research*, 28(Supplement), 1–20.
- Boyd, B. K. (1994). Board control and CEO compensation. *Strategic Management Journal*, 15(5), 335–344.
- Brooks, L., & Buckmaster, D. (1976). Further evidence of the time series properties of accounting income. *The Journal of Finance*, 31(5), 1359–1373.
- Brunello, G., Graziano, C., & Parigi, B. M. (2003). CEO turnover in insider dominated boards: The Italian case. *Journal of Banking and Finance*, 27, 1027–1051.
- Burkart, M., Gromb, D., & Panunzi, F. (1997). Large shareholders, monitoring, and the value of the firm. *The Quarterly Journal of Economics*, 112(3), 693–728.

- Bushman, R. M., & Piotroski, J. D. (2006). Financial reporting incentives for conservative accounting: The influence of legal and political institutions. *Journal of Accounting and Economics*, 42(1/2), 107–148.
- Byrd, J. W., & Hickman, K. A. (1992). Do outside directors monitor managers? Evidence from tender offer bids. *Journal of Financial Economics*, 32(2), 195–221.
- Cadbury Committee. (1992). Report of the committee on the financial aspects of corporate governance (With the code of best practice). London: Gee Publishing.
- Cahan, S. F., & Zhang, W. (2006). After Enron: Auditor conservatism and ex-Andersen clients. *The Accounting Review*, 81(1), 49–82.
- Callen, J., Segal, D., & Hope, O.-K. (2010). The pricing of conservative accounting and the measurement of conservatism at the firm-year level. *Review of Accounting Studies*, 15(1), 145–178.
- Capulong, M. V., Edwards, D., Webb, D., & Zhuang, J. (2001). Corporate governance and finance in East Asia: A study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand: Volume one. Manila: Asian Development Bank.
- Carcello, J. V., & Neal, T. L. (2000). Audit committee composition and auditor reporting. *The Accounting Review*, 75(4), 453–467.
- Casson, M. C. (1999). The economics of the family firm. *Scandinavian Economic History Review*, 47(1), 10–23.
- Chandra, U., Wasley, C., & Waymire, G. (2004). *Income conservatism in the U.S. technology sector*. Working paper. University of Rochester.
- Chau, G., & Gray, S. J. (2010). Family ownership, board independence and voluntary disclosure: Evidence from Hong Kong. *Journal of International Accounting, Auditing and Taxation*, 19(2), 93–109.
- Che Haat, M. H. (2006). *The effect of corporate governance on transparency and performance of Malaysian companies*. PhD Unpublished Dissertation, Universiti Teknologi Mara, Malaysia.
- Chen, C. J. P., & Jaggi, B. (2000). Association between independent non-executive directors, family control and financial disclosures in Hong Kong. *Journal of Accounting and Public Policy*, 19(4/5), 285–310.

- Chen, T. (2005). *Executive compensation contracts of family firms*. Working paper. Working paper. University of Texas at Dallas.
- Chung, R., Firth, M., & Kim, J.-B. (2003). Auditor conservatism and reported earnings. *Accounting and Business Research*, 33(1), 19–32.
- Claessens, S., Djankov, S., & Lang, L. H. P. (2000). The separation of ownership and control in East Asian corporations. *Journal of Financial Economics*, 58(1/2), 81–112.
- Coles, J. L., Daniel, N. D., & Naveen, L. (2008). Boards: Does one size fit all? *Journal of Financial Economics*, 87(2), 329–356.
- Collier, P. (1993). Factors affecting the formation of audit committees in major UK listed companies. *Accounting and Business Research*, 23(91A), 421–430.
- Canyon, M. J., & Peck, S. I. (1998). Board size and corporate performance: evidence from European countries. *The European Journal of Finance*, 4(3), 291–304.
- Davila, A., & Penalva, F. (2006). Governance structure and the weighting of performance measures in CEO compensation. *Review of Accounting Studies*, 11(4), 463–493.
- DeAngelo, L. E. (1981). Auditor size and audit quality. *Journal of Accounting and Economics*, 3(3), 183–199.
- DeFond, M. L., & Subramanyam, K. R. (1998). Auditor changes and discretionary accruals. *Journal of Accounting and Economics*, 25(1), 35–67.
- Demsetz, H., & Lehn, K. (1985). The structure of corporate ownership: Causes and consequences. *The Journal of Political Economy*, 93(6), 1155–1577.
- Devalle, A., Onali, E., & Magarini, R. (2010). Assessing the value relevance of accounting data after the introduction of IFRS in Europe. *Journal of International Financial Management & Accounting*, 21(2), 85–119.
- Dietrich, J., Muller, K., & Riedl, E. (2007). Asymmetric timeliness tests of accounting conservatism. *Review of Accounting Studies*, 12(1), 95–124.
- Dopuch, N., & D. Simunic. (1980). The nature of competition in the auditing profession: a descriptive and normative view. In J. Buckley & F. Weston (Eds.), *Regulation and the Accounting Profession* (pp. 77–94). Belmont, CA: Lifetime Learning Publications.

- Downs, A. (1957). *An economic theory of democracy*. New York: HarperCollins.
- Easley, D., Hvidkjaer, S., & O'Hara, M. (2002). Is information risk a determinant of asset returns? *The Journal of Finance*, 57(5), 2185–2221.
- Easton, P., & Pae, J. (2004). Accounting conservatism and the relation between returns and accounting data. *Review of Accounting Studies*, 9(4), 495–521.
- Economic Planning Unit Prime Minister's Department of Malaysia. (1985). *Guidelines on Privatization*. Kuala Lumpur: National Printing Department.
- Economic Planning Unit Prime Minister's Department of Malaysia. (1991). *Privatization Master Plan* Kuala Lumpur: National Printing Department.
- Eisenberg, T., Sundgren, S., & Wells, M. T. (1998). Larger board size and decreasing firm value in small firms. *Journal of Financial Economics*, 48(1), 35–54.
- Elgers, P. T., & Lo, M. H. (1994). Reduction in analysts' annual earnings forecast errors using information in prior earnings and security returns. *Journal of Accounting Research*, 32(2), 290–303.
- Ernst, U. F. W. (2004). Methods for resolving problems of responsibility and transparency in the activities of SOEs in market economies: Models and results. *Corporate Ownership and Control*, 1(3), 37–43.
- Faccio, M., & Lang, L. H. P. (2002). The ultimate ownership of Western European corporations. *Journal of Financial Economics*, 65(3), 365–395.
- Fadzly, M. N., & Ahmad, Z. (2004). Audit expectation gap: The case of Malaysia. *Managerial Auditing Journal*, 19 (7), 897–915.
- Fama, E. F. (1980). Agency problems and the theory of the firm. *Journal of Political Economy*, 88(2), 288–307.
- Fama, E. F., & Jensen, M. C. (1983). Separation of ownership and control. *Journal of Law and Economics*, 26(2), 301–325.
- Fama, E. F., & MacBeth, J. (1973). Risk, return, and equilibrium: empirical tests. *Journal of Political Economy*, 81(3), 607–636.
- Fan, J. P. H., & Wong, T. J. (2002). Corporate ownership structure and the informativeness of accounting earnings in East Asia. *Journal of Accounting and Economics*, 33(3), 401–425.

- Feldmann, D. A., & Schwarzkopf, D. L. (2003). The effect of institutional ownership on board and audit committee composition. *Review of Accounting & Finance*, 2(4), 87–109.
- Feltham, G. A., & Ohlson, J. A. (1995). Valuation and clean surplus accounting for operating and financial activities. *Contemporary Accounting Research*, 11(2), 689–731.
- Finance Committee on Corporate Governance. (1999). Report on corporate governance (pp. 1–275). Kuala Lumpur: Securities Commission.
- Finance Committee on Corporate Governance. (2000). Malaysian Code on Corporate Governance (pp. 1–50). Kuala Lumpur, Malaysia: Securities Commission.
- Fischer, S. (1998). The Asian Crisis and the Changing Role of the IMF. *IMF Finance and Development*, 35(2). Retrieved from <http://www.imf.org/external/pubs/ft/fandd/1998/06/fischer.htm>
- Foon, H. W. (1997, November 19). Investors give thumbs down to UEM's Renong purchase, *The Straits Times*, p. 62.
- Francis, J., LaFond, R., Olsson, P., & Schipper, K. (2004). Cost of equity and earnings attributes. *The Accounting Review*, 79, 967–1010.
- Francis, J., Schipper, K., & Vincent, L. (2005). Earnings and dividends informativeness when cash flow rights are separated from voting rights. *Journal of Accounting and Economics*, 39(2), 329–360.
- Francis, J. R., Maydew, E. L., & Sparks, H. C. (1999). The role of big-six auditors in the credible reporting of accruals. *Auditing: A Journal of Practice and Theory*, 18(2), 17–34.
- Francis, J. R., & Simon, D. T. (1987). A test of audit pricing in the small-client segment of the U. S. audit market. *The Accounting Review*, 62(1), 145–157.
- García Lara, J. M., García Osma, B., & Penalva, F. (2007). Board of directors' characteristics and conditional accounting conservatism: Spanish evidence. *European Accounting Review*, 16(4), 727 – 755.
- García Lara, J. M., García Osma, B., & Penalva, F. (2009). Accounting conservatism and corporate governance *Review of Accounting Studies*, 14(1), 161–201.
- García Lara, J. M., & Mora, A. (2004). Balance sheet versus earnings conservatism in Europe. *European Accounting Review*, 13(2), 261–292.

- Gassen, J., Fülbier, R. U., & Sellhorn, T. (2006). International differences in conditional conservatism: The role of unconditional conservatism and income smoothing. *European Accounting Review*, 15(4), 527–564.
- Gaver, J., Gaver, K., & Austin, J. (1995). Additional evidence on bonus plans and income management. *Journal of Accounting and Economics*, 19(1), 3–28.
- Gigler, F. B., & Hemmer, T. (2001). Conservatism, optimal disclosure policy, and the timeliness of financial reports. *The Accounting Review*, 76(4), 471.
- Giner, B., & Rees, W. (2001). On the asymmetric recognition of good and bad news in France, Germany and the United Kingdom. *Journal of Business, Finance and Accounting*, 28(9), 1285–1331.
- Givoly, D., & Hayn, C. (2000). The changing time-series properties of earnings, cash flows and accruals: Has financial reporting become more conservative? *Journal of Accounting and Economics*, 29(3), 287–320.
- Gompers, P. A., Ishii, J. L., & Metrick, A. (2003). Corporate governance and equity prices. *Quarterly Journal of Economics*, 118(1), 107–155.
- Grambovas, C. A., Giner, B., & Christodoulou, D. (2006). Earnings conservatism: panel data evidence from the European Union and the United States. *Abacus*, 42(3/4), 354–378.
- Guidry, F., Leone, A., & Rock, S. (1999). Earnings-based bonus plans and earnings management by business unit managers. *Journal of Accounting and Economics*, 26(1/3), 113–142.
- Gujarati, D. N. (2004). *Basic Econometrics* (Fourth ed.). New York: McGraw–Hill Inc.
- Gul, F. A., Tsui, J. S. L., & Dhaliwal, D. S. (2006). Non-audit services, auditor quality and the value relevance of earnings. *Accounting and Finance*, 46(5), 797–817.
- Hair, J. F., Black, W. C., Babin, R. E., Anderson, R. E., & Tatham, R. L. (2006). *Multivariate data analysis* (6th ed.). New Jersey: Pearson Education Inc.
- Hampel Committee. (1998). Committee on corporate governance: Final report. London: Gee Publishing.
- Healy, P. M. (1985). The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics*, 7(1/3), 85–107.

- Heckman, J. J. (2000). Causal parameters and policy analysis in economics: A twentieth century retrospective. *Quarterly Journal of Economics*, 115(1), 45–97.
- Hellman, N. (2008). Accounting conservatism under IFRS. *Accounting in Europe*, 5(2), 71–100.
- Heninger, W. G. (2001). The association between auditor litigation and abnormal accruals. *The Accounting Review*, 76(1), 111–126.
- Hermalin, B. E., & Weisbach, M. S. (2003). Boards of directors as an endogenously determined institution: A survey of the economic literature. *Economic Policy Review*, 9, 7–26.
- Ho, S. S. M., & Wong, K. S. (2001). A study of the relationship between corporate governance structures and the extent of voluntary disclosure. *Journal of International Accounting, Auditing and Taxation*, 10(2), 139–156.
- Huijgen, C., & Lubberink, M. (2005). Earnings conservatism, litigation and contracting: The case of cross-listed firms. *Journal of Business Finance and Accounting*, 32(7/8), 1275–1309.
- IASB. (2010). The Conceptual Framework for Financial Reporting. In I. A. S. Board (Ed.). London: International Accounting Standards Board.
- IASC. (1989). Framework for the Preparation and Presentation of Financial Statements: International Accounting Standards Committee.
- Imbens, G. W., & Wooldridge, J. M. (2009). Recent developments in the econometrics of program evaluation. *Journal of Economic Literature*, 47(1), 5–86.
- Jaggi, B., Leung, S., & Gul, F. (2009). Family control, board independence and earnings management: Evidence based on Hong Kong firms. *Journal of Accounting and Public Policy*, 28(4), 281–300.
- James, H. (1999). Owner as a manager, extended horizons and the family firm. *International Journal of Economics of Business*, 6(1), 41–56.
- Jenkins, D. S., & Velury, U. (2008). Does auditor tenure influence the reporting of conservative earnings? *Journal of Accounting and Public Policy*, 27(2), 115–132.
- Jensen, M. C. (1993). The modern industrial revolution, exit, and the failure of internal control systems. *The Journal of Finance*, 48(3), 831–880.

- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305–360.
- Jeong, S. W., & Rho, J. (2004). Big Six auditors and audit quality: The Korean evidence. *The International Journal of Accounting*, 39(2), 175–196.
- Johnson, S., Boone, P., Breach, A., & Friedman, E. (2000). Corporate governance in the Asian financial crisis, 1997–98 *Journal of Financial Economics*, 58, 141–186.
- Johnson, V. E., Khurana, I. K., & Reynolds, J. K. (2002). Audit-firm tenure and the quality of financial reports. *Contemporary Accounting Research*, 19(4), 637–660.
- Kawai, M., Newfarmer, R., & Schmukler, S. (2001). Crisis and contagion in East Asia: Nine lessons. *World Bank Policy Research Working Paper*, WPS2610.
- Kellogg, R. L. (1984). Accounting activities, security prices, and class action lawsuits. *Journal of Accounting and Economics*, 6(3), 185–204.
- Khan, M., & Watts, R. L. (2009). Estimation and empirical properties of a firm-year measure of accounting conservatism. *Journal of Accounting and Economics*, 48(2/3), 132–150.
- Kothari, S. P., & Sloan, R. G. (1992). Information in prices about future earnings: Implications for earnings response coefficients. *Journal of Accounting and Economics*, 15(2/3), 143–171.
- Kothari, S. P., & Zimmerman, J. L. (1995). Price and return models. *Journal of Accounting and Economics*, 20(2), 155–192.
- Krishnan, G. V. (2003). Does Big 6 auditor industry expertise constrain earnings management? *Accounting Horizons*, 17(Supplement), 1–16.
- Krishnan, G. V. (2005a). The association between Big 6 auditor industry expertise and the asymmetric timeliness of earnings. *Journal of Accounting, Auditing and Finance*, 20(3), 209–228.
- Krishnan, G. V. (2005b). Did Houston clients of Arthur Andersen recognize publicly available bad news in a timely fashion? *Contemporary Accounting Research*, 22(1), 165–193.
- Krishnan, G. V. (2007). Did earnings conservatism increase for former Andersen clients? *Journal of Accounting, Auditing and Finance*, 22(2), 141–163.

- Kwon, S. S., Yin, Q. J., & Han, J. (2006). The effect of differential accounting conservatism on the “over-valuation” of high-tech firms relative to low-tech firms. *Review of Quantitative Finance and Accounting*, 27(2), 143–173.
- La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (1999). Corporate ownership around the world. *The Journal of Finance*, 54(2), 471–517.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (2000). Investor protection and corporate governance. *Journal of Financial Economics*, 58, 3–27.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. W. (1998). Law and finance. *Journal of Political Economy*, 106(6), 1113–1155.
- LaFond, R., & Watts, R. L. (2008). The information role of conservatism. *The Accounting Review*, 83(2), 447–478.
- Lai, C., & Taylor, S. L. (2008). Estimating and Validating a Firm-Year Specific Measure of Conservatism: Australian Evidence. *Accounting and Finance*, 48, 673–695.
- Lang, M., Raedy, J., & Wilson, W. (2006). Earnings management and cross listing: Are reconciled earnings comparable to US earnings. *Journal of Accounting & Economics*, 42, 255–283.
- Lang, M., Raedy, J., & Yetman, M. (2003). How representative are firms that are cross-listed in the United States? An analysis of accounting quality. *Journal of Accounting Research*, 41(2), 363–386.
- Larcker, D. F., Richardson, S. A., & Tuna, I. (2007). Corporate governance, accounting outcomes, and organizational performance. *The Accounting Review*, 82(4), 963–1008.
- Lau, Y. W., & Tong, C. Q. (2008). Are Malaysian Government-Linked Companies (GLCs) creating value? *International Applied Economics and Management Letters*, 1(1), 9–12.
- Liew, P. K. (2007). Corporate governance reforms in Malaysia: The key leading players’ perspectives. *Corporate Governance*, 15(5), 724–740.
- Lin, J. W., Li, J. F., & Yang, J. S. (2006). The effect of audit committee performance on earnings quality. *Managerial Auditing Journal*, 21(9), 921–933.
- Linck, J. S., Netter, J. M., & Yang, T. (2008). The determinants of board structure. *Journal of Financial Economics*, 87(2), 308–328.

- Lobo, G. J., & Zhou, J. (2006). Did conservatism in financial reporting increase after the Sarbanes-Oxley Act? Initial evidence. *Accounting Horizons*, 20(1), 57–73.
- MCCG. (2000). Malaysian Code on Corporate Governance. Kuala Lumpur, Malaysia: Securities Commission.
- MCCG. (2007). Malaysian Code on Corporate Governance (Revised 2007). Kuala Lumpur, Malaysia: Securities Commission.
- Menon, K., & Williams, J. (1994). The use of audit committees for monitoring. *Journal of Accounting and Public Policy*, 13(2), 121–139.
- Miller, D., & Le Breton-Miller, I. (2006). Family governance and firm performance: Agency, stewardship, and capabilities. *Family Business Review*, 19(1), 73–87.
- Miller, G. S. (2004). Discussion of what determines corporate transparency. *Journal of Accounting Research*, 42(2), 253–268.
- Miller, M. H., & Luangaram, P. (1998). *Financial crisis in East Asia: Bank runs, asset bubbles and antidotes*. CSGR Working Paper. University of Warwick.
- Morck, R., Shleifer, A., & Vishny, R. W. (1988). Management ownership and market valuation: An empirical analysis. *Journal of Financial Economics*, 20, 293–315.
- Morck, R., Yeung, B., & Yu, W. (2000). The information content of stock markets: why do emerging markets have synchronous stock price movements? *Journal of Financial Economics*, 58(1/2), 215–260.
- Morris, R. D., Pham, T. A. M., & Gray, S. J. (2011). The value relevance of transparency and corporate governance in Malaysia before and after the Asian financial crisis. *Abacus*, 47(2), 205–233.
- Myers, S. (1977). Determinants of corporate borrowing. *Journal of Financial Economics*, 5(2), 147–175.
- Nathan, R. S., Lin, C. S., & Fong, S. W. (2000). *Country paper for Malaysia*. Paper presented at the 2nd Asian Roundtable on Corporate Governance, Hong Kong.
- O’Keefe, T. B., King, R. D., & Gaver, K. M. (1994). Audit fees, industry specialization, and compliance with GAAS reporting standards. *Auditing: A Journal of Practice and Theory*, 13(2), 41–55.

- Ow-Yong, K., & Kooi Guan, C. (2000). Corporate governance codes: a comparison between Malaysia and the UK. *Corporate Governance: An International Review*, 8(2), 125–132.
- Pallant, J. (2007). *SPSS survival manual: A step by step guide to data analysis using SPSS for Windows (Version 15)*. NSW: Allen & Unwin.
- Palmrose, Z.-V. (1988). An analysis of auditor litigation and audit service quality. *The Accounting Review*, 63(1), 55–73.
- PCG. (2005). Catalysing GLC Transformation to Advance Malaysia's Development Kuala Lumpur: Putrajaya Committee – GLC High Performance.
- Penman, S. H., & Zhang, X.-J. (2002). Accounting conservatism, the quality of earnings, and stock returns. *The Accounting Review*, 77(2), 237–264.
- Pincus, K., Rusbarsky, M., & Wong, J. (1989). Voluntary formation of corporate audit committees among NASDAQ firms. *Journal of Accounting and Public Policy*, 8(4), 239–265.
- Poon, S. H. (2000). Malaysia and the Asian financial crisis: A view from the finance perspective. *African Finance Journal*, 2(1), 13–24.
- Pope, P. F., & Walker, M. (1999). International differences in the timeliness, conservatism, and classification of earnings. *Journal of Accounting Research*, 37(3), 53–87.
- Pope, P. F., & Walker, M. (2003). *Ex-ante and ex-post accounting conservatism, asset recognition and asymmetric earnings timeliness*. Working Paper. Lancaster University/University of Manchester.
- Qiang, X. (2007). The effects of contracting, litigation, regulation, and tax costs on conditional and unconditional conservatism: Cross-sectional evidence at the firm level. *The Accounting Review*, 82(3), 759–796.
- Rajan, R., & Zingales, L. (1998). Which capitalism? Lessons from the East Asian crisis. *Journal of Applied Corporate Finance*, 11, 40–48.
- Raonic, I., McLeay, S., & Asimakopoulos, I. (2004). The timeliness of income recognition by European companies: An analysis of institutional and market complexity. *Journal of Business, Finance and Accounting*, 31(1/2), 151–165.
- Richardson, G., & Tinaikar, S. (2004). Accounting based valuation models: what have we learned? *Accounting & Finance*, 44(2), 223–255.

- Rodriguez, G. C., Espejo, C. A., & Cabrera, R. V. (2007). Incentives management during privatization: An agency perspective. *Journal of Management Studies*, 44(4), 536–560.
- Roe, J. M. (1991). Political theory of American corporate finance. *Columbia Law Review*, 91(1), 10–67.
- Rosenstein, S., & Wyatt, J. G. (1990). Outside directors, board independence, and shareholder wealth. *Journal of Financial Economics*, 26(2), 175–191.
- Roychowdury, S., & Watts, R. L. (2007). Asymmetric timeliness of earnings, market-to-book and conservatism in financial reporting. *Journal of Accounting and Economics*, 44(1/2), 2–31.
- Ruddock, C., Taylor, S. J., & Taylor, S. L. (2006). Nonaudit services and earnings conservatism: is auditor independence impaired? *Contemporary Accounting Research*, 23(3), 701–746.
- Ryan, S. G. (2006). Identifying conditional conservatism. *European Accounting Review*, 15(4), 511–525.
- Saleh, N. M., Iskandar, T. M., & Rahmat, M. M. (2005). Earnings management and board characteristics: Evidence from Malaysia. *Jurnal Pengurusan*, 24(4), 77-103.
- Salleh, M. F. M. (2009). *Political influence, corporate governance and financial reporting quality: Evidence from companies in Malaysia*. PhD Thesis, Massey University, Wellington.
- Schroeder, L. D., Sjoquist, D. L., & Stephan, P. E. (1986). *Understanding regression analysis: An introductory guide*. California: Sage Publications Inc.
- Selvaraj, D. S. (1999). “Interests” and accounting standard setting in Malaysia. *Accounting, Auditing & Accountability Journal*, 12(3), 358–387.
- Shamsir Jasani Grant Thornton, & Malaysian Institute of Management. (2002). *The family and the business: International survey report*. Kuala Lumpur: Shamsir Jasani Grant Thornton & Malaysian Institute of Management.
- Shleifer, A., & Vishny, R. W. (1994). Politicians and firms. *The Quarterly Journal of Economics*, 109(4), 995–1025.
- Sivakumar, K., & Waymire, G. (2003). Enforceable accounting rules and income measurement by early 20th century railroads. *Journal of Accounting Research*, 41(2), 397–432.

- Smith, C., & Watts, R. L. (1992). The investment opportunity set and corporate financing, dividend and compensation policies. *Journal of financial economics*, 32(3), 263–292.
- St. Pierre, K., & Anderson, J. (1984). An analysis of the factors associated with lawsuits against public accountants. *The Accounting Review*, 59(2), 242–263.
- Sterling, R. R. (1967). Conservatism: The fundamental principle of valuation in traditional accounting. *Abacus*, 3(2), 109–132.
- Tam, O. K., & Tan, M. G. S. (2007). Ownership, governance and firm performance in Malaysia. *Corporate Governance*, 15(2), 208–222.
- Teoh, S. H., & Wong, T. J. (1993). Perceived auditor quality and the earnings response coefficient. *The Accounting Review*, 68(2), 346–366.
- Thillainathan, R. (1999). Corporate governance and restructuring in Malaysia - a review of markets, mechanisms, agents and the legal infrastructure *Joint World Bank/OECD Survey of Corporate Governance Arrangements in a selected number of Asian countries*.
- Thoman, L. (1996). Legal damages and auditor efforts. *Contemporary Accounting Research*, 13(1), 275–306.
- Turpin, R. A., & DeZoort, F. T. (1998). Characteristics of firms that include an audit committee report in their annual report. *International Journal of Auditing*, 2, 35–48.
- UNCSD. (2002). Sustainable development governance. *Working Paper for consideration in the Second Week of Third Session of the Preparatory Committee for World Summit for Sustainable Development 2002*, retrieved from <http://www.johannesburgsummit.org/html/documents/prepcom3docs/governance30.3.rev1.doc>.
- Vafeas, N. (1999). Board meeting frequency and firm performance. *Journal of Financial Economics*, 53(1), 113–143.
- Villalonga, B., & Amit, R. (2006). How do family ownership, control and management affect firm value? *Journal of Financial Economics*, 80(2), 385–417.
- Walker, R. G. (1992). The SEC's ban on upward asset revaluations and the disclosure of current values. *Abacus*, 28(1), 3–35.

- Wall Street Journal. (2002, 6 February). Accounting faces calls for change. *Wall Street Journal*.
- Wan Hussin, W. N., & Ibrahim, M. A. (2003). Striving for quality financial reporting. *Akauntan Nasional, March*, 18–24.
- Wang, D. (2006). Founding family ownership and earnings quality. *Journal of Accounting Research*, 44(3), 619–656.
- Wang, R., Ó Hógartaigh, C., & van Zijl, T. (2009). Measures of accounting conservatism: A construct validity perspective. *Journal of Accounting Literature*, 28, 165–203.
- Watts, R. L. (2003a). Conservatism in accounting part I: Explanations and implications. *Accounting Horizons*, 17(3), 207–221.
- Watts, R. L. (2003b). Conservatism in accounting part II: Evidence and research opportunities. *Accounting Horizons*, 17(4), 287–301.
- White, H. (1980). A heteroskedasticity-consistent covariance matrix estimator and a direct test for heteroskedasticity. *Econometrica*, 48(4), 817–838.
- World Bank. (1999). Report on the Observance of Standards and Codes (ROSC) on Malaysia: World Bank.
- Yatim, P., Kent, P., & Clarkson, P. (2006). Governance structures, ethnicity, and audit fees of Malaysian listed firms. *Managerial Auditing Journal*, 21(7), 757–782.
- Yen, J. W., Chun, L. S., Abidin, S. Z., & Noordin, B. A. A. (2007). Earnings management practices between government linked and Chinese family linked companies. *International Journal of Economics and Management*, 1(3), 387–406.
- Yermack, D. (1996). Higher market valuation of companies with a small board of directors. *Journal of Financial Economics*, 40(2), 185–211.
- Zhang, J. (2008). The contracting benefits of accounting conservatism to lenders and borrowers. *Journal of Accounting and Economics*, 45(1), 27–54.
- Zhuang, J. (1999). Corporate governance in East Asia and some policy implications, EDRC briefing notes number (Vol. 14): Asian Development Bank.

Appendix 1 Summary of studies on earnings conservatism

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Ahmed, Billings, Morton, and Harris (2002)	Examine whether firms with more severe bondholder-shareholder dividend policy conflict adopted more conservative accounting; and whether conservative accounting is associated with lower cost of debts.	US sample (1987–98).	Market-based measure (Beaver & Ryan, 2000); and accruals-based measure (Givoly & Hayn, 2000).	Firms that experience more severe conflict over dividend policy use more conservative accounting. In addition, accounting conservatism is associated with a lower cost of debts even after controlling for other determinants of cost of debts.
Ahmed and Duellman (2007)	Examine the relationship between board of directors' characteristics and earnings conservatism	US sample (1999–2001).	Market-based measure (Beaver & Ryan, 2000); accruals-based measure (Givoly & Hayn, 2000); and asymmetric timeliness of earnings model (Basu, 1997).	The results show that: the percentage of inside directors is negatively related to conservatism; and the percentage of outside directors' shareholdings is positively associated with conservatism. Overall, the evidence suggests that accounting conservatism reduces the agency costs of firms.
Ahmed, Morton, and Schaefer (2000)	Examine the effect of accounting conservatism on: the stock market valuation of operating assets in the context of the Feltham-Ohlson (1996) model; and the weight on operating assets in the Feltham-Ohlson abnormal operating earnings dynamics (LIM conservatism parameter).	US sample (1997).	Modified Feltham and Ohlson (1996) model and accounting-based measures of conservatism (Beaver & Ryan, 2000), which is one minus depreciation and amortisation deflated by opening total assets; R&D per sales and advertising per sales, and a dummy for LIFO.	Accounting based conservatism measures are positively related to the valuation weight of operating assets, and have incremental explanatory power even after controlling for size, growth, and leverage. This study also finds that the sign of LIM conservatism parameter is, on average, negative. The firms with negative values of parameter are significantly smaller, less profitable and have lower growth. The relation between LIM conservatism parameter and accounting-based conservatism proxies is strong for the subsample of firms with high levels of profitability.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Al-Sehali and Spear (2004)	Examine the decision-relevance and timeliness of accounting earnings in Saudi Arabia.	Saudi Arabia (1995–1999).	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds that Saudi managers do not incorporate economic losses into accounting earnings on a timely basis. This finding is consistent with reduced market demand for accounting information, low levels of public debt, low expected litigation costs, and weak monitoring by analysts and other stakeholders in Saudi Arabia.
Ball, Kothari, and Robin (2000)	Examine differences in the properties of accounting earnings, i.e. timeliness and earnings conservatism, between common-law and code-law countries.	Sample from common-law (Australia, Canada, the UK and US) and code-law countries (France, Germany, and Japan) from 1985 to 1995.	Asymmetric timeliness of earnings model (Basu, 1997).	Earnings reported in common-law countries exhibit significantly greater timeliness than earnings reported in code-law countries. This is due entirely to greater sensitivity to economic losses (earnings conservatism).
Ball, Robin, and Wu (2003)	Examine earnings quality, measured using earnings conservatism, in four East Asian countries in which accounting standards predominantly follow the common-law model.	Sample from Hong Kong, Malaysia, Singapore and Thailand from 1984 to 1996.	Asymmetric timeliness of earnings model (Basu, 1997) and time-series test of timeliness in loss recognition (Basu, 1997).	The analyses show a lack of evidence of earnings conservatism on the four East Asian countries. This study concludes that the reporting quality of these countries is not higher than under code law. In essence, this study suggests that financial reporting incentives dominate accounting standards in determining earnings quality.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Ball and Shivakumar (2005)	Examine earnings quality, measured by timely loss recognition, between UK private and public firms.	Sample of UK private and public firms/ period 1989–1999. Source: ‘Financial Analysis Made Easy’ (FAME) database.	Asymmetric timeliness of earnings model (Basu, 1997) and accruals-cash flow model (Ball & Shivakumar, 2005).	The evidence shows that earnings reported by private firms are of lower quality compared to public firms, despite being prepared under the same regulations. The plausible explanation is private firms have lower quality due to different market demand.
Ball and Shivakumar (2006)	Examine the role of accrual accounting in the asymmetrically timely recognition (incorporation in reported earnings) of gains and losses.	International sample as in Ball, Kothari, and Robin (2000) from 1987 to 2003.	Accruals models using market and non-market based proxies for gains and losses (Ball & Shivakumar, 2006).	This study finds that nonlinear accruals models that incorporate the asymmetry in gain and loss recognition offer a substantial specification improvement than equivalent linear specifications. The conventional linear accruals models, which omit the loss recognition asymmetry, exhibit substantial attenuation bias and offer a comparatively poor specification of the accounting accrual process. In addition, linear specifications also understate the ability of current earnings to predict future cash flows.
Balkrishna, Coulton, and Taylor (2007)	Examine the characteristics of losses, the extent of conditional conservatism, and the extent to which losses reflect incrementally greater conditional conservatism.	Australia (1993–2003).	Asymmetric timeliness of earnings model (Basu, 1997) and accruals-cash flow model (Ball & Shivakumar, 2005).	This study finds that loss incidence in Australia is frequent, affecting around 40% of the sample firm-years. The losses are also persistent, and the probability of loss reversal declines monotonically as the history of losses extends. Finally, conservatism is a pervasive aspect of Australian GAAP, and more evident among loss observations.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Basu (1997)	Examine the effect of conservatism principle on the financial statement; develop conservatism measures; and provide empirical evidence based from the developed models.	US sample (1963–1990).	Asymmetric timeliness of earnings model (Basu, 1997) and time-series test of timeliness in loss recognition (Basu, 1997).	The results show that earnings are two to six times more sensitive to negative returns than to positive returns. The negative earnings changes also are less persistent than positive earnings changes. In addition, positive earnings changes have higher earnings response coefficients than negative earnings changes.
Basu, Hwang, and Jan (2001)	Investigate differences in earnings conservatism in earnings reported in Big Eight clients and non-Big Eight clients.	US sample.	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds that the difference in the timeliness of earnings between good news and bad news is greater for Big Eight clients than non-Big Eight clients. The result holds even after matching clients by year, industry, and firm size. This result suggests that Big Eight auditors are more conservative than non-Big Eight auditors.
Barth, Landsman, and Lang (2008)	Examine whether the application of International Accounting Standards (IAS) results in higher accounting quality, measured using earnings management, timely loss recognition, and value-relevance of accounting information.	Sample of firms from 21 countries that adopted IAS from 1994 to 2003.	Frequency of large negative net income (Lang, Raedy, & Wilson, 2006; Lang, Raedy, & Yetman, 2003).	Firms that adopt IAS show an improvement in accounting quality between the pre- and post-adoption periods, in terms of lower earnings management, more timely loss recognition, and more value-relevance of accounting.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Beekes, Pope, and Young (2004)	Examine the relationship between earnings conservatism and the composition of the board of directors.	Sample from UK-listed non-financial firms from 1993 to 1995.	Asymmetric timeliness of earnings model (Basu, 1997).	Firms whose proportion of outside board members are above the sample median have higher earnings timeliness with respect to bad news, relative to firms whose board composition is below the median. This result suggests that the proportion of outside directors is positively associated with accounting quality.
Brown, He, and Teitel (2006)	Investigate whether conditional conservatism affects the value-relevance of accounting earnings.	Sample from 20 countries from 1993 to 2004.	Asymmetric timeliness of earnings model (Basu, 1997) and accruals-cash flow model (Ball & Shivakumar, 2005). Market to book ratio is used to measure unconditional conservatism.	The findings show that the country-specific level of accrual intensity influences the relationship between conditional conservatism and the value-relevance of accounting earnings. In countries with higher accrual intensity, conditional conservatism is positively associated with the value relevance of earnings. The study finds that this effect is incremental to that of shareholder protection on the value-relevance of earnings.
Bushman and Piotroski (2006)	Examine the influence of institutional structure, such as legal/judicial system, securities laws, political economy, tax regime, and domiciled country, on the reporting of earnings.	Sample from 38 countries from 1992 to 2001.	Asymmetric timeliness of earnings model (Basu, 1997) and accruals-cash flow model (Ball & Shivakumar, 2005).	The results document higher earnings conservatism in firms from countries that have high quality judicial systems, weak public enforcement, and high risk of expropriation of assets. In common-law countries, firms facing high state involvement in the economy have higher earnings conservatism.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Cahan and Zhang (2006)	Examine whether successor auditors after the demise of Arthur Andersen required more conservative accounting from their ex-Andersen clients.	US sample (2001–2002).	Unadjusted (Jones, 1991) and performance-adjusted (Francis et al., 2005) measures of abnormal accruals.	The ex-Andersen clients have larger decreases and lower levels of abnormal accruals in 2002 than other firms. This result implies that the successor auditors require more conservative accounting from ex-Andersen clients because they perceive an Andersen audit as a unique source of litigation risk.
Callen, Segal, and Hope (2010)	Examine the relation between equity prices and conditional conservatism; and introduce a new measure of conservatism at the firm-year level.	US sample (1962–2006).	This study developed a conservatism ratio (CR), a ratio of the current earnings shock to earnings news. CR measures the proportion of the total shock to expected current and future earnings recognised in current year earnings.	The results show that firms with high conservatism ratio (CR) have a greater incidence of losses, more leverage, more negative accruals, and increased volatility of returns, earnings, and accruals.
Chandra, Wasley, and Waymire (2004)	Examine whether US technology firms have higher earnings conservatism than other US firms, and whether the results are subject to shareholder litigation risk and conservative accounting standards.	US sample (1982–2001).	Asymmetric timeliness of earnings model (Basu, 1997) and time-series test of timeliness in loss recognition model (Basu, 1997).	The result shows that technology firms exhibit a higher level of earnings conservatism than other US firms. The additional analysis shows that this result is because of the conservative accounting rules for R&D expensing rather than shareholder litigation risk.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Chung, Firth, and Kim (2003)	Examine whether auditors force conservatism on their clients; and whether the level of conservatism is influenced by the firms' performance and the type of audit firm.	US sample (1988–1997).	Asymmetric timeliness of earnings model (Basu, 1997).	The results show that Big Six auditors have stronger influence on their clients to adopt more conservative accounting than non-Big Six auditors when the clients' financial performance is worse than expected.
Ding and Stolowy (2006)	Examine the changes in the properties of earnings. The analysis includes the impact of certain corporate characteristics such as size, international financing, and audit firm, on such changes.	France sample (1990–1999).	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds French firms report earnings conservatively. The result is consistent with the upward trend in the level of earnings conservatism over the period as a whole. In addition, this study finds that small firms show a higher degree of earnings conservatism than large firms.
Easton and Pae (2004)	Identify two forms of conservative accounting by modifying the Easton and Harris (1991) model, and examine differences in conservatism across samples with different market to book ratios, stock return, loss firms, and industry, R&D, advertising, inventory valuation.	US sample (1988–2002).	Modified Easton and Harris (1991) model which includes lagged operating assets, to capture conservatism due to accounting rules (accounting value added), and change in cash investments, to capture conservatism associated with investments in positive net present value projects (economic value added). Another measure is market to book ratio.	This study finds evidence of both forms of conservatism, where the coefficients for the change in cash investments and the change in lagged operating assets are significant. The results also exhibit higher conservatism in firms with higher market to book ratio. In addition, the results show varying degrees of accounting conservatism across industries.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Francis, LaFond, Olsson, Schipper (2004)	Examine the relationship between cost of equity and seven earnings attributes, market- and non-market-based proxies.	U.S sample (1975–1981).	This study developed a firm-year measure for conservatism by rolling firm-specific ten-year windows of Basu asymmetric timeliness of earnings model. For robustness, this study used C-Score measure used in Penman and Zhang (2000).	The results show the relationship between the cost of equity and accrual quality, earnings persistence, smoothness, and value-relevance. Neither conservatism nor timeliness is associated with the cost of equity in the presence of value-relevance.
Francis and Wang (2008)	Examine whether investor protection environment and the choice of auditor jointly affect the quality of earnings, measured using the magnitude of signed abnormal accruals, the likelihood of reporting a loss, and earnings conservatism.	Sample of firms from 42 countries over the period 1994 to 2004.	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds earnings conservatism is high when the investor protection is strong, but only for firms with Big Four auditors. For other proxies, the signed abnormal accruals are smaller and the likelihood of a loss is greater as the investor protection environment becomes stronger; but for firms with non-Big Four auditors, both proxies are unaffected by difference in investor protection.
García Lara and Mora (2004)	Examine balance sheet and earnings conservatism across eight European countries, and assess the statistical significance of the differences among them.	Sample from Italy, Germany, France, Belgium, Spain, Switzerland, the Netherlands and the UK over the period 1987 to 2000.	Asymmetric timeliness of earnings model (Basu, 1997), and balance sheet conservatism model (Feltham & Ohlson, 1995).	The results show evidence of balance sheet and earnings conservatism in all countries under study. Continental countries have higher balance sheet conservatism, but no significant differences in earnings conservatism between the samples are found, except for the UK, which has higher earnings conservatism. Further, balance sheet conservatism is associated with reduced levels of earnings conservatism.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
García Lara, García Osma, and Mora (2005)	Investigate whether earnings management affects the measures of earnings conservatism in France, Germany, and the UK.	Sample from France, German, and the UK over the period 1990 to 2001.	Asymmetric timeliness of earnings model (Basu, 1997).	The results show no significant differences in earnings conservatism levels between the three countries. However, after controlling for earnings management, earnings conservatism levels in Germany and France decrease significantly and the differences in earnings conservatism between the UK (common-law) and France and Germany (code-law) become significant.
García Lara, García Osma, and Penalva (2007)	Examine the relationship between board of directors' characteristics and earnings conservatism in Spain.	Spain sample (1997–2002).	Asymmetric timeliness of earnings model (Basu, 1997) and accruals-cash flow model (Ball & Shivakumar, 2005).	This study finds evidence that Spanish firms with strong boards use conservative accounting as a governance tool, though the litigation risk is low. In addition, firms where the CEO has a low influence over the board of directors show a greater degree of accounting conservatism.
García Lara, García Osma, and Penalva (2009)	Examine the association between corporate governance and the incidence of conditional conservatism.	US sample (1992–2003).	Asymmetric timeliness of earnings model (Basu, 1997), accruals-cash flow model (Ball & Shivakumar, 2005), and three-year average total accruals (Givoly & Hayn, 2000).	This study finds firms with strong corporate governance have significantly higher levels of earnings conservatism. The causality direction is consistent with the prediction that the flow is from governance to conservatism and not vice versa. This implies that governance and conservatism are not substitutes. In addition, the results show that firms with strong governance appear to use discretionary accruals to inform investors about bad news in a more timely manner.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Givoly and Hayn (2000)	Analyse the extent of reporting conservatism in the US over the last four decades.	US sample (1950–1998).	Asymmetric timeliness of earnings model (Basu, 1997), the level and rate of accumulation of negative non-operating accruals, the measures based on the time-series properties of earnings and cash flows (i.e., the skewness of the earnings distribution relative to the cash flows distribution and the variability of earnings relative to cash flows), and the MTB.	This study finds evidence for an increase over time in the degree of reporting conservatism. Specifically, the evidence shows: a more timely recognition of bad news compared to good news; a decline in reported earnings over the last four decades; a massive accumulation of negative non-operating accruals over this period; and a more dispersed and negatively skewed earnings distribution relative to cash flows.
Gassen, Fülbier, and Sellhorn (2006)	Examine the relationship between unconditional conservatism, conditional conservatism, and income smoothing, and investigate determinants of these attributes.	Sample from 23 developed markets (1990–2003).	Trigonometric measure based on the asymmetric timeliness of earnings model (Basu, 1997); MTB; and accumulated accruals over time, excluding contemporaneous accruals.	The findings are as follows: (1) unconditional conservatism and income smoothing are associated with conditional conservatism; (2) income smoothing is only weakly associated with this firm-specific measure of conditional conservatism; (3) conditional conservatism and income smoothing are weakly associated for a broad international sample. Income smoothing explains international differences in conditional conservatism; and (4) unconditional conservatism and income smoothing are driven by different explanatory firm-level factors. Conditional conservatism increases with the importance of debt financing, while income smoothing increases with the importance of dividends.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Giner and Rees (2001)	Investigate differences of earnings conservatism in countries from three distinct legal traditions: French code/civil law, German code-law and English common law.	France, German, and the UK (1990–1998).	Asymmetric timeliness of earnings model (Basu, 1997).	The analysis shows a small difference of earnings conservatism between Germany, France, and the UK. Additional analysis using prior years' earnings and prior years' economic news, however, finds earnings conservatism is higher in the UK (a common-law country) than in France or Germany (code-law countries).
Grambovas, Giner, and Christodoulou (2006)	Examine earnings conservatism in the United States and the European Union countries.	EU countries and a US sample (1989–2004).	Modified asymmetric timeliness of earnings model (Basu, 1997).	The results from the panel data show that earnings have become more conservative in the EU when taken as a whole. This is also the case in the US. Further, there is little evidence of significant differences in earnings conservatism between the two samples.
Huijgen and Lubberink (2005)	Compare earnings conservatism of the UK firms cross-listed in the US with the UK firms without a US listing	UK sample (1993–2002).	Asymmetric timeliness of earnings model (Basu, 1997).	Earnings in the UK cross-listed firms are more conservative than earnings of UK firms without a US listing. The cross-listed firms show a high level of conservatism during the early years of their cross-listing, suggesting that these firms employ earnings conservatism to signal high-quality reporting to investors.
Jindrichovska and McLeay (2005)	Investigates earnings conservatism in the Czech market.	Czech sample (1993 to 1999).	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds no evidence of earnings conservatism in the Czech market, since profits are more persistent than losses. The study argued that the incentives for conservatism in the Czech Republic are low because of the transitional nature of the economy, the restrictive tax regulations, and the regulatory environment, which is close to stakeholder corporatism.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Jenkins and Velury (2008)	Examine the relation between auditor tenure and the reporting of conservative earnings.	US sample (1980–2004).	Asymmetric timeliness of earnings model (Basu, 1997) and time-series test of timeliness in loss recognition model (Basu, 1997).	The results show an increase in conservatism between short and medium tenure and that the extent of conservatism does reduce over long tenure. From these results, this study implies that mandating auditor rotation may have an adverse affect on earnings conservatism.
Khan and Watts (2009)	Develop a firm-year measure of accounting conservatism, and illustrate the applications by testing several hypotheses.	US sample (1962–2005).	This study developed a firm-year measure of earnings conservatism (<i>C_Score</i>) from the Basu (1997) asymmetric timeliness of earnings model.	This study finds the <i>C_Score</i> captures variation in conservatism and is able to predict asymmetric earnings timeliness at horizons of up to three years ahead. The findings show that firms with longer investment cycles, higher idiosyncratic uncertainty, and higher information asymmetry have higher accounting conservatism. These results are consistent with conservatism being a response to information asymmetry and litigation, rather than a factor inducing those attributes.
Krishnan (2005a)	Examine the relationship between auditor industry expertise and the asymmetric timeliness of earnings.	US sample (1989–1998).	Asymmetric timeliness of earnings model (Basu, 1997)	This study finds that the clients of specialist auditors are more timely in reflecting bad news in their earnings than clients of nonspecialist auditors. This result implies that the tendency of clients to delay the recognition of economic losses in earnings is influenced by auditors' industry expertise.
Krishnan (2005b)	Examine whether earnings of Andersen's Houston-based clients are timely in reporting bad news about future cash flows.	US sample (1996–2000).	Asymmetric timeliness of earnings model (Basu, 1997)	The result shows that the clients from Andersen's Houston-based office are less timely in reporting bad news than non-Andersen clients. This study suggests that the clients of Andersen's Houston office engaged in aggressive accounting practices, including delaying the recognition of publicly available bad news.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Krishnan (2007)	Examine whether earnings conservatism has increased for a sample of former Arthur Andersen clients that were forced to switch auditors in 2002.	US sample (2001–2002).	(i) Asymmetric timeliness of earnings model (Basu, 1997); (ii) time-series test of timeliness in loss recognition model (Basu, 1997); (iii) accruals-cash flow model (Ball & Shivakumar, 2005); and (iv) earnings skewness (Basu, 1995).	The study finds an increase of earnings conservatism in former Andersen clients when they switched to a Big Four auditor. Former Andersen clients have a higher level of conservatism in 2002 than the sample of non-Andersen clients that did not switch auditors. These results imply that Big Four auditors employ earnings conservatism as a risk management strategy in the post-Andersen period.
Kwon, Yin, and Han (2006)	Examines systematic differences in the level of earnings conservatism between high-tech and low-tech firms.	US sample (1990–1998).	(i) Asymmetric timeliness of earnings model (Basu, 1997); (ii) cumulative nonoperating accruals (Givoly & Hayn, 2000); (iii) distribution of earnings and discretionary accruals (Givoly & Hayn, 2000).	High-tech firms have significantly higher earnings conservatism compared to low-tech firms. The evidence shows that high-tech firms have more cumulative nonoperating components, higher asymmetric timeliness of earnings, negative skewness of earnings distribution, and an income reducing pattern for earnings management.
Lai and Taylor (2008)	Validate the C-Score measure of Khan & Watts (2007) and several factors associated with variation in conservatism.	Australian sample (1993–2006).	C-Score firm-year measure of conservatism (Khan & Watts, 2009).	This study finds that conservatism is a strong feature of the Australian financial reporting environment. The analysis shows a positive relationship between conservatism and stock return volatility, investment cycle length and prior period conservatism, but is negatively associated with firm age, firm size, and leverage.
LaFond and Roychowdury (2008)	Examine the relationship between managerial ownership and financial reporting conservatism.	US sample (1994–2004).	Asymmetric timeliness of earnings model (Basu, 1997).	The results show a negative relationship between managerial ownership and earnings conservatism, robust to various controls, including investment opportunity set. This study provides evidence of a demand for conservatism from the firm's shareholders.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Lai and Taylor (2008)	Validate the C-Score measure of Khan & Watts (2007) and several factors associated with variation in conservatism.	Australian sample (1993–2006).	C-Score firm-year measure of conservatism (Khan & Watts, 2009).	This study finds that conservatism is a pervasive feature of the Australian financial reporting environment. The analysis shows a positive relationship between conservatism and stock return volatility, investment cycle length and prior period conservatism. In addition conservatism is negatively associated with firm age, firm size, and leverage.
LaFond and Roychowdury (2008)	Examine the relationship between managerial ownership and financial reporting conservatism.	US sample (1994–2004).	Asymmetric timeliness of earnings model (Basu, 1997).	The results show a negative relationship between managerial ownership and earnings conservatism, robust to various controls, including investment opportunity set. This study provides evidence of a demand for conservatism from the firm's shareholders.
LaFond and Watts (2008)	Examine how information asymmetry relates to earnings conservatism.	US sample (1983–2001).	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds a positive relationship between earnings conservatism and the information asymmetry between insider and outsider. Further analysis shows that changes in information asymmetry between equity investors leads to changes in conservatism.
Lin and Chen (1999)	Survey the applicability of the conservatism accounting convention in China.	China sample (1998).	Survey the perception of accountants, management, government officials, bank loan officers, investment analysts, and auditors.	This survey finds that, in general, the respondents held no negative attitudes to the conservatism convention under the changing business environment in the country. There is clear evidence that various interested parties of business accounting would support an expanded adoption of 'conservatism' in Chinese accounting.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Lobo and Zhou (2006)	Examine the change in managerial discretion, measured using earnings conservatism and discretionary accruals, over financial reporting following the Sarbanes-Oxley Act.	US sample over the period of two years pre- and post-SOX.	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds an increase in earnings conservatism in financial reporting following SOX. In the post-SOX period, firms incorporate losses more quickly than gains. Furthermore, firms report lower discretionary accruals after SOX than in the period preceding SOX. These results show that the introduction of SOX altered management's discretionary reporting behaviour toward more conservative reporting.
Mason (2004)	Examine the Feltham and Ohlson's (1995) assertion on the relationship between accounting conservatism and the differential response to operating accruals.	US sample (1975–1996).	Market to book ratio; and accounting-based measures to proxy for conservatism which include unrecorded inventory assets, unrecorded R&D assets, unrecorded advertising, unrecorded gains or losses on pension plan assets, unrecorded account receivable assets, and unrecorded depreciation.	This study finds a positive association between the valuation of multiple on operating assets and aggregate score of conservatism and various components of conservatism scores, including depreciation, advertising, and R&D. The result, from partitioning the firm based on conservatism, is consistent with Feltham and Ohlson's (1995) prediction that the magnitude of the response coefficient on operating accruals is positively associated with conservatism.
Pae, Thornton, and Welker (2005)	Examine the relationship between earnings conservatism and market-to-book ratio (MTB).	US sample (1970–2001).	Asymmetric timeliness of earnings model (Basu, 1997).	Firms with lower MTB ratios have greater earnings conservatism than firms with higher MTB ratios. In addition, the negative association between earnings conservatism and the MTB ratio stems from the accrual component of earnings, not the operating cash flow component of earnings.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Pope and Walker (1999)	Examine differences in the timeliness of income recognition of earnings before and after extraordinary items, between US and UK GAAP firms.	US and UK samples (1976–1996).	Asymmetric timeliness of earnings model (Basu, 1997).	Earnings conservatism, displayed by earnings before extraordinary items, under US GAAP was higher than under UK GAAP. However, the examination of earnings after extraordinary items reveals that the sensitivity of earnings to bad news was higher under UK GAAP than under US GAAP.
Qiang (2007)	Examine whether the explanation for conservatism (contracting, litigation, regulation, and taxation), applies to conditional conservatism, unconditional conservatism, or both.	US sample. (1988–1999).	Book-value-based measures of conservatism (Beaver & Ryan, 2000) and accruals-based measures of conservatism (Givoly & Hayn, 2000).	These findings are as follows: (i) contracting induces conditional conservatism; (ii) litigation induces both forms; and (iii) regulation and taxation induce unconditional conservatism. Overall, the evidence shows that conditional and unconditional conservatism play distinct roles in contracting, regulation, and taxation, as well as in litigation.
Raonic, McLeay, and Asimakopoulou (2004)	Examine the impact of country-level disclosure regimes, legal enforcement and the importance of equity markets on conservatism.	European sample (1987–1999).	Asymmetric timeliness of earnings model (Basu, 1997).	This study finds that firms domiciled and listed in different markets exhibit greater conservatism. Equity market exposure appears to be positively associated with greater timeliness in earnings recognition, while regulatory enforcement is positively associated with the bias towards conservatism.
Ruddock, Taylor, and Taylor (2006)	Examine whether the provision of non-audit services by incumbent auditors is associated with impairment of auditor independence, or a reduction in earnings conservatism.	Australian sample. (1993–2001).	Asymmetric timeliness of earnings model (Basu, 1997) and time-series test of timeliness in loss recognition model (Basu, 1997).	The results consistently show that higher than expected levels of non-audit services are not associated with reduced conservatism.

Appendix 1: Summary of studies on earnings conservatism (continued)

Author(s)	Objective(s)	Sample	Conservatism Measure(s)	Main Empirical Results
Wang (2006)	Examine the relation between founding family ownership and earnings quality using data from the Standard & Poor's 500 companies.	US sample (1994, 2002).	Time-series test of timeliness in loss recognition model (Basu, 1997).	The results show that founding family ownership is positively associated with earnings quality. Specifically, founding family firms have greater earnings informativeness, lower abnormal accruals, and less persistence of transitory loss components in earnings. This study also suggests a nonlinear relation between family ownership and earnings quality.
Zhang (2008)	This paper examines the ex-post and ex-ante benefits of accounting conservatism to lenders and borrowers in the debt contracting process.	US sample (1994–2003).	Asymmetric timeliness of earnings model (Basu, 1997); the accumulated non-operating accruals and the time-series skewness of earnings (Givoly & Hayn, 2000).	This study shows that conservatism benefits lenders ex-post through the timely signalling of default risk, where more conservative borrowers are more likely to violate debt covenants following a negative price shock. Further, conservatism gives benefits to borrowers ex-ante through lower interest rates.

Appendix 2 Main differences between FRS and MASB standards

Category	FRS Standards	MASB Standards
Business combination and goodwill	FRS 3 Business Combinations (effective from January 1, 2006).	MASB 21 Business Combinations, renamed to FRS 122 ²⁰⁰⁴ Business Combinations (effective from July 1, 2000).
Method allowed for business combinations	FRS 3 does not allow the merger method for business combinations. Only the acquisition method is allowed under this standard. This applies from the acquisition date, which is the date the acquirer effectively obtained control (para 14).	MASB 21 permitted business combination to be accounted for using either the merger method or the acquisition method.
Recognition of the identifiable assets acquired, liabilities and contingent liabilities	FRS 3 requires (1) the liabilities for terminating or reducing activities of the acquiree and (2) contingent liabilities of the acquiree to be recognised separately at the acquisition date (para 36, 37); and clarifies the criteria to separately recognise acquiree's intangible assets as part of the process of allocating the cost of business combinations (para 45, 46).	Under MASB 21, acquiree's contingent liabilities were subsumed within the amount recognised as goodwill or negative goodwill.
Excess of the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over the cost of business combination	In circumstances where the acquiree's identifiable assets, liabilities and contingent liabilities recognised during the business combination exceed the cost of combination, FRS 3 requires the acquirer to reassess the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of combination. Any excess should be recognised immediately in the profit and loss (para 56).	There is no accounting standard regarding this matter in MASB 21. Although MASB 21 is equivalent to IAS 22, it excluded all of the sections relating to goodwill. IAS 22 requires the excess to be accounted for as negative goodwill, but this is not included in MASB 21.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Recognition of goodwill	Under FRS 3, goodwill acquired in a business combination should be recognised as an asset. Goodwill should be initially measured at its cost, which is the excess of cost of business combinations over the acquirer's interest in the net fair value of identifiable assets, liabilities and contingent liabilities (para 51).	There was no accounting standard for the recognition and measurement of goodwill in Malaysia before the adoption of FRS 3. Although MASB 21 Business Combinations is equivalent to IAS 22, the standard excluded the section on accounting for goodwill. There were a number of accounting practices related to goodwill in Malaysia including (1) goodwill was immediately written off against reserves, (2) goodwill was treated as a one-time expense, (3) goodwill was capitalised as an intangible asset and written down when impaired ³⁰ , and (4) goodwill was recognised as an intangible asset and amortized over its useful life. ³¹
Goodwill amortisation	FRS 3 does not allow goodwill acquired from business combination to be amortized. The standard requires goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired (para 55).	
Impairment of Assets	FRS 136 Impairment of Assets (effective from January 1, 2006).	MASB 23 Impairment of Assets, renamed to FRS 136 ²⁰⁰⁴ Impairment of Assets (effective from January 1, 2002).
Goodwill impairment	FRS 3 (para 55) and FRS 136 (para 10(b)) requires goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired.	MASB 23 required the recoverable amount of an asset to be measured whenever there is indication that the asset may be impaired.

³⁰ Goodwill capitalised under this method was usually reviewed periodically to assess its impairment. The impairment tests of goodwill were prescribed in MASB 23 Impairment of Assets.

³¹ The inconsistent accounting treatment for goodwill in Malaysia was highlighted by the MASB chairman, Raja Datuk Arshad Raja Tun Uda in a press conference on 14 November 2000, when he announced that the Board would issue Exposure Draft 28, Goodwill by the end of the year 2000.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Impairment of Intangible Assets	<p>FRS 136 (para 10(a)) requires the intangible assets to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired.</p> <p>FRS 136 provides clarification of elements to be considered in determining value in use (para 30) and guidance on estimation of future cash flows (para 33).</p> <p>FRS 136 requires that cash flows from any assets or cash generating units affected by internal transfer pricing should be estimated using value in arms-length transactions.</p>	<p>MASB 23 required the recoverable amount of an asset to be measured whenever there was indication that the asset may be impaired.</p> <p>MASB 23 did not provide such clarifications and guidance.</p> <p>MASB 23 required an asset or group of assets to be identified as a cash generating unit if an active market existed for the output produced by the asset, even if the output was used internally. Under MASB 23, the management's best estimates of future market prices for the output was to be used in estimating the future cash flows.</p>
Intangible Assets	FRS 136 Intangible Assets (effective from January 1, 2006).	<p>No standard for intangible assets.</p> <p>FRS 138 supersedes MASB 4 (FRS 109₂₀₀₄) Research and Development Costs</p>
Scope of Intangible Assets	FRS 138 includes a wider scope of accounting for intangible assets which is not dealt with in other standards (para 1–3).	There was no accounting standard for intangible assets in Malaysia before the adoption of FRS 138. MASB did not adopt IAS 38 Intangible Assets.
Measurement and Recognition of Intangible Assets	Under FRS 138, the probability recognition criteria for intangible assets acquired separately or acquired through business combination is always considered to be satisfied (para 33). FRS 138 provides that if an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably (para 35–41).	The only standards that related to intangible assets was MASB 4 Research and Development Costs (renamed to FRS 109 ₂₀₀₄ Research and Development Costs), effective from July 1, 1999.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Subsequent Recognition of Intangible Assets	FRS 138 allows intangible assets to be carried at a revalued amount after initial recognition, which is fair value less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. The fair value should be determined by reference to an active market (para 75).	FRS138 requires companies to assess the useful life of an intangible asset; an intangible asset with finite useful life is amortized, and an intangible asset with indefinite useful life is tested for impairment in accordance to FRS 136 (para 88-110).
Disclosure Requirements for Intangible Assets	FRS138 requires additional disclosures for intangible assets with indefinite useful life, including justifications for the assessment of indefinite useful life (para 122(a)).	FRS 138 requires disclosure on the existence and carrying amounts of intangibles which have restricted titles and disclosure of carrying amounts of intangibles which are pledged as security for liabilities (para 122(d)).
		FRS 138 requires disclosure on the amount of contractual commitments for the acquisition of intangible assets (para 122(e)).
		FRS 138 requires additional disclosure if intangible assets are accounted for at revalued amounts (para 122).

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards		MASB Standards	
	Amortisation of Development Costs			
		Similar to MASB 4, FRS138 requires companies to recognise research costs as expenses in the profit and loss, and capitalise the development costs as an asset.	Similar to FRS138, MASB 4 required companies to recognise research costs as expenses in the profit and loss, and capitalise the development costs as an asset.	
		FRS 138 requires companies to determine whether the development cost that was recognised as an asset has either finite or indefinite useful life.	MASB 4 required development cost that was recognised as assets to be amortized and recognised as an expense on a systematic basis, so as to reflect the pattern in which the related economic benefit is recognised.	
		Under FRS 138, development cost that has finite useful life is amortized, and development cost with indefinite useful life is tested for impairment in accordance to FRS 136 (para 88–110).	If the development cost ceased to meet recognition criteria as stated in para 17 of the standard, the development cost should be written down or written off as an expense.	
			No standard for share-based payments.	
	Share-based payments	FRS 2 Share-based Payments (effective from January 1, 2006).		
	Recognition and measurement of share-based payments	FRS 2 covers the recognition and measurements of shares or share options granted to employees and other parties.		There was no standard on share-based payments before the adoption of FRS 2. The only standard that was related to share-based payments was MASB 29 Employee Benefits (renamed to FRS 119 ₂₀₀₄ Employee Benefits), effective from January 1, 2003.
		FRS 2 sets out the measurement principles and specific requirements for three types of share-based payments transactions including the (a) equity-settled, (b) cash-settled and (c) the choice of equity-settled or cash-settled transactions.		MASB 29 specified that equity compensation benefits includes benefits in such forms as (1) shares, share options, and other equity instruments issued to employees at less than the fair value at which those instruments would be issued to a third party; and (b) cash payments which depended on the future market price of the reporting entity's shares. However, MASB 29 did not specify recognition and measurement requirements for equity compensation benefits.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Disclosure requirements of share-based payments	FRS 2 does not only require the disclosure of information to enable users of financial statements to understand the nature and extent of share-based payments that existed during the period and the effect of share-based payment transactions on companies' financial position and performance (IN8(a), (c)). FRS 2 also requires disclosure of information to understand how fair value of the goods and services, or the fair value of the equity instruments granted during the period, was determined (IN8 (b)).	MASB 29 required companies to disclose information relating to the employee compensation benefits to enable users of financial statements to assess its effect on companies' financial position, performance and cash flows.
Non-current Assets Held for Sale and Discontinued Operations	FRS 5 Non-current Assets Held for Sale and Discontinued Operations (effective from January 1, 2006).	MASB 28 Discontinuing Operations, renamed to FRS 135 ₂₀₀₄ Discontinuing Operations (effective from January 1, 2003).
Scope of non-current assets held for sale and discontinued operations	Under FRS 5, non-current assets held for sale and discontinued operations includes subsidiaries, investment in associates and investments in jointly-controlled assets intended to be disposed of within 12 months. FRS 5 introduces the concept of a disposal group, which is a group of assets to be disposed of in a single transaction (IN6 (b)).	Under MASB 28, a discontinuing operation was a relatively large component of an enterprise – such as a business or geographical segment that the enterprise, pursuant to a single plan, either was disposing of substantially in its entirety or was terminating through abandonment or piecemeal sale.
Measurement and recognition of non-current assets held for sale and discontinued operations	FRS 5 requires assets held for sale or a disposal group held for sale to be measured at the lower of carrying amount and fair value less cost to sell (para 15).	MASB 28 did not establish any recognition and measurement principles. The standard required companies to follow recognition and measurement principles established in other relevant standards, such as MASB 20 Provisions, Contingent Liabilities and Contingent Assets (renamed FRS 137 ₂₀₀₄) and MASB 23 Impairment of Assets (renamed FRS 136 ₂₀₀₄).

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Subsequent measurement of assets held for sale	FRS 5 specifies that an asset classified as held for sale, or included within a disposal group held for sale, should not be depreciated (IN6(d)).	MASB 28 did not specify that an asset classified as held for sale, or included within a disposal group held for sale, should not be depreciated.
	FRS 5 requires companies to recognise any initial or subsequent impairment losses of the assets (or disposal group) to fair value less cost to sell. FRS 5 also requires companies to recognise gain for any subsequent increase in fair value less cost to sell of the assets, but not in excess of the cumulative impairment loss that has been recognised.	MASB 28 required companies to estimate the recoverable amount of each asset of the discontinuing operation (the higher of the asset's net selling price and its value in use) and recognise an impairment loss or reversal of a prior impairment loss, if any.
Timing of the classification of an operation as discontinued	FRS 5 classifies an operation as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation (IN6(f)(i)).	MASB 28 classified an operation as discontinuing based on the occurrence of one of the following, whichever occurred earlier: (1) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or (2) the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.
	FRS 5 prohibits retroactive classification of an operation as discontinued, when the criteria for that classification are not met until after the balance sheet date (IN6(f)(iii)).	
Disclosure of discontinued operation	FRS 5 requires an asset classified as held for sale, and the assets and liabilities included in a disposal group held for sale, to be presented separately in the balance sheet. The assets and liabilities in a disposal group should not offset each other, or be presented as a single amount (para 38). Under FRS 5, non-current assets shall be classified as current when they meet the 'held-for-sale' criteria (para 3). FRS 5 also specifies that the results of discontinued operations (profit/loss) should be shown separately in the income statement (para 33(a)).	MASB 28 only required companies to disclose the information relating to a discontinuing operation in the financial statements; it could be presented either in the notes to the financial statements or on the face of the financial statements.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards		MASB Standards	
	Financial	FRS 101 Presentation of Financial Statements (effective from January 1, 2006).	MASB 1 Presentation of Financial Statements, renamed to FRS 101 ₂₀₀₄ Presentation of Financial Statements (effective from July 1, 1999)	
Fair presentation of financial statements		FRS 101 emphasizes that the application of FRSs is 'presumed' to result in financial statements that achieve a fair presentation (para 13).	MASB 1 specified that financial statements should fairly present a firm's financial position, financial performance and cash flows; and the appropriate application of the MASB standards resulted in virtually all circumstances in financial statements that achieved a fair presentation.	
Presentation and disclosure requirements for current and non-current items		FRS 101 specifies tighter requirements for classification and disclosure of current and non-current items on the balance sheet (para 51, 57-67). For example, FRS 101 requires companies to classify and present current and non-current assets, and current and non-current liabilities separately in the balance sheet, unless presentation based on liquidity would provide more relevant and reliable information.	Under MASB 1, companies were given the choice of whether or not to present and classify current and non-current assets and current and non-current liabilities separately in the balance sheet, based on the nature of their operation. If the firm chose not to classify current and non-current assets and current and non-current liabilities separately, the assets and liabilities were to be presented broadly in order of their liquidity.	
Presentation and disclosure requirement for minority interest		FRS 101 specifies that minority interest should be presented within equity in the balance sheet (para 68(o)).	Under MASB 1, there was no specification for minority interests to be presented within equity in the balance sheet.	
Presentation and disclosure requirement for biological assets		FRS 101 specifies that biological assets should be disclosed as a line item in the balance sheet (para 68(f)).	MASB 1 did not require the disclosure of biological assets as a separate line item in the balance sheet.	
Presentation and disclosure requirement for non-current assets held for sale		FRS 101 requires companies to disclose total assets held for sale, assets in disposal groups held for sale and liabilities in disposal groups held for sale as a separate line item in the balance sheet (para 68A).	MASB 1 did not specify the presentation and disclosure requirement for non-current assets held for sale.	

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Presentation and disclosure of profit, loss, income and expenses	FRS 101 requires the disclosure of the profit, loss, total income and total expenses attributable to equity holders and minority interests to be shown separately in income statement (para 82, 96).	MASB 1 did not require the disclosure of the profit, loss, total income and total expenses attributable to equity holders and minority interest to be shown separately in income statement.
Presentation of extraordinary items	FRS 101 prohibits the presentation of income and expense as extraordinary items, either in the income statement or in the notes (para 85).	MASB 1 required extraordinary items to be disclosed as a line item in the income statement.
Inventories	FRS 102 Inventories (effective from January 1, 2006).	MASB 2 Inventories, renamed to FRS 102 ₂₀₀₄ Inventories (effective from July 1, 1999).
Cost of inventory	FRS 2 clarifies that the difference between the price paid for inventories acquired through deferred purchase and the price paid for inventories using normal purchase is interest expense (para 18)	MASB 2 did not provide explanation on inventories purchased on deferred settlement terms.
Measurement of Inventories	FRS 102 provides clarification on the difference between the net realizable value and fair value less cost to sell (para 6-7). Under FRS 102, the use of LIFO method to measure the cost of inventories is prohibited; and the same cost formula is required to be used for inventories of similar nature and use (para 25).	MASB 2 only provided the definition for net realizable value, not the fair value. Under MASB 2, the use of LIFO method to measure inventories was considered as an allowed alternative treatment. MASB 2 did not specify that the same cost formula should be used for inventories of similar nature and use.
Disclosure requirements for inventories	FRS 102 requires companies to disclose the carrying amount of inventories at fair value less cost to sell (para 36 (c)). FRS 102 does not require the disclosure of the carrying amount inventories at net realisable value (para 36). FRS 102 requires the amount of any write-down of inventories recognised as an expense in the period to be disclosed (para 36(e)).	Under MASB 2, there was no requirement for the carrying amount of inventories to be disclosed at fair value. MASB 2 required a separate disclosure of inventories held at net realizable value and those held at cost. MASB 2 did not specify the requirement that the amount of any write-down of inventories recognised as an expense in the period should be disclosed (para 36(e)).

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Accounting Policies, Changes in Accounting Estimates and Errors	FRS 108 Accounting Policies, Changes in Accounting Estimates and Errors (effective from January 1, 2006).	MASB 3 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies, renamed to FRS108 ²⁰⁰⁴ Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies (effective from July 1, 1999).
Accounting for material errors	FRS 108 uses the concept of material errors, which are errors that could influence the economic decisions of users taken on the basis of the financial statements (para 5, 41); and provides detailed guidance on how to account for material errors (para 41-48). FRS 108 eliminates the fundamental error concept (IN12).	MASB 3 used the concept of fundamental error, which refers to error that has significant effect on the financial statements of one or more prior periods such that those financial statements can no longer be considered to have been reliable at the date of their issue.
Accounting for changes in accounting policy	FRS 108 requires the correction of errors to be applied retrospectively, and does not allow alternative prospective application (para 41–48).	Under MASB 3, the correction of fundamental errors could be applied retrospectively (benchmark treatment) or prospectively (alternative treatment). MASB 3 allowed the change in accounting policy to be applied either retrospectively or prospectively.
Accounting for changes in accounting estimates	FRS 108 specifies that the change in accounting estimates that give rise to assets and liabilities, or relates to equity, should be recognised in the period of change.	MASB 3 did not provide such specification.
Disclosure requirements for the effect of changes in accounting policies and errors	FRS 108 requires a more comprehensive disclosure of the effect of changes in accounting policies and error. For example, the standard requires the disclosure of the effect of changes in accounting policies and errors on each line item and on basic and diluted EPS (para 28–31)	The disclosure requirement for the effect of changes in accounting policies and errors under MASB 3 was less comprehensive.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Events After the Balance Sheet Date	FRS 110 Events After the Balance Sheet Date (effective from January 1, 2006).	MASB 19 Events After the Balance Sheet Date, renamed to FRS 110 ₂₀₀₄ Events After the Balance Sheet Date (effective from July 1, 2001).
Clarification on dividends declared after the balance sheet date.	FRS 110 provides further clarification relating to dividends declared after balance sheet date, which should not be recognised as liabilities at balance sheet date (para 12-13).	MASB19 contained limited clarification on dividends declared after balance sheet date.
Property, Plant and Equipment (PPE)	FRS 116 Property, Plant and Equipment (effective from January 1, 2006).	MASB 15 Property, Plant and Equipment, renamed to FRS 116 ₂₀₀₄ Property, plant and Equipment (effective from July 1, 2000).
Initial recognition and measurement of Property, Plant and Equipment	<p>FRS 116 introduces the concept of commercial substance for recognition of exchanged assets. The standard requires the recognition of exchanged assets to be at fair value unless the exchanged transaction does not have commercial substance, or the fair value of neither the assets given up nor assets acquired can be measured reliably (para 24-25).</p> <p>FRS 116 allows the cost of dismantling, removing the asset and restoring the site on which it is located to be included in the initial cost of the property, plant and equipment (para 16(c)).</p>	<p>MASB 15 required the recognition of acquired assets at fair value, unless the exchanged assets were similar.</p> <p>MASB 15 only allowed the cost of purchase and any cost directly attributable in bringing the assets into working condition, intended location and use to be included in the initial cost of the property, plant and equipment MASB 15 included the cost incurred as a result of installing the property, plant and equipment; but did not allow the cost of dismantling, removing the asset and restoring the site on which it was located, as part of the cost of PPE.</p>
Subsequent measurement of Property, Plant and Equipment	FRS 116 allows the recognition of subsequent expenditure as an asset if it meets the general asset recognition criteria. A replacement component of a property, plant and equipment that is recognised as it meets the recognition criteria requires derecognition of the carrying amount of the replaced part of the asset (para 70). FRS 116 provides that a firm may carry all items of property, plant and equipment of a class at a revalued amount only if fair value can be measured reliably (para 31).	MASB 15 did not allow the cost of replacement of part of a property, plant and equipment to be recognised as part of the item. MASB 15 only allowed the recognition of subsequent expenditure as asset if the expenditure improved the condition of the asset beyond its original capacity. Under MASB 15, the use of a revalued amount did not depend on whether fair values could be reliably measured.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Depreciation of Property, Plant and Equipment	<p>FRS 116 emphasizes the component approach to measure depreciation. A firm is required to determine the depreciation charge separately for each significant part of an item of property, plant and equipment (para 43–47).</p> <p>FRS 116 requires firms to determine the residual value of property, plant and equipment based on the amount it estimates it would receive at the balance sheet date if the asset were already of the age and in the condition expected at the end of its useful life, i.e. no adjustment for the effect of inflation (para 6).</p> <p>FRS 116 requires firms to assess the residual value and estimated useful life of a property, plant and equipment annually at balance sheet date (para 51).</p> <p>Under FRS 116, companies are required to start depreciating property, plant and equipment when the asset is made available for use and continue depreciating until the asset is derecognised, even if during the period the asset is idle. However, if the firm applies usage method in calculating depreciation, the depreciation expense during the idle period could be zero (para 55).</p>	<p>MASB 15 did not clearly set out the requirement to determine the depreciation charge separately for each significant part of an item of property, plant and equipment.</p> <p>MASB 15 did not specify whether the residual value should be the estimated amount a firm would obtain currently from the disposal of an asset, if the asset were of the age and in condition expected at the end of its useful life; or whether it should be adjusted for the effect of changing prices.</p> <p>MASB 15 did not require the annual assessment of residual value and estimated useful life of a property, plant and equipment.</p> <p>MASB 15 did not specify the starting period to depreciate a property, plant and equipment item. But, FRS 116²⁰⁰⁴ specified that the asset should be depreciated until it was retired from active use or it was held for disposal.</p>
Disposal of Property, Plant and Equipment	<p>FRS 116 requires gain or loss on disposal of property, plant and equipment to be included in profit and loss account. However, the standard prohibits the classification of the gain as revenue (para 68).</p>	<p>MASB 15 did not contain this provision.</p>

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Disclosure requirements for Property, Plant and Equipment	FRS 116 requires companies to disclose the aggregate amount of accumulated impairment losses and accumulated depreciation (para 73(d)).	MASB 15 required the disclosure of the gross carrying amount of accumulated depreciation and accumulated impairment losses at the beginning and end of the period. However, it did not require the disclosure of the aggregated amount of both items.
	Under FRS 116, prior-year comparatives for property, plant and equipment is mandatory (para 73(e)).	Under MASB 15, prior-year comparatives for property, plant and equipment were not mandatory.
	FRS 116 requires additional disclosure for property, plant and equipment that is stated at revalued amount (para 77).	MASB 15 also required disclosure for property, plant and equipment that was stated at a revalued amount, but not in as much detail as required by FRS 116.
	FRS116 does not require companies to disclose the name of firm of an independent valuer, the name of valuer, and his qualification in the year of valuation.	MASB 15 required companies to disclose the name of the firm of an independent valuer, the name of the valuer, and his qualification in the year of valuation.
Leases	FRS 117 Leases (effective from January 1, 2006).	MASB 10 Leases, renamed to FRS 117 ₂₀₀₄ Leases (effective from January 1, 2000).
Measurement for investment properties held under leases	Under FRS 117, investment properties held under operating lease and finance leases should be measured using the finance lease accounting (para 19).	MASB 10 did not contain this requirement.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Measurement and recognition of initial direct cost of lease	<p>FRS 117 provides the definition for initial direct cost as incremental cost directly attributable to negotiating/arranging a lease (para 4).</p> <p>Under FRS 117, lessor's initial direct costs on finance lease are accounted as part of finance lease receivable. (para 38).</p> <p>FRS 117 excludes the costs incurred by manufacturer or dealer lessor in connection with negotiating and arranging a finance lease from the definition of initial direct costs. The costs are recognised as expense when the selling profit is recognised (para 38).</p> <p>For lessor's initial direct cost on operating lease, FRS 117 requires it to be capitalised as part of carrying value of assets and realized over lease term (para 52).</p>	<p>MASB 10 did not provide the definition for initial direct cost of lease. However, the standard stated that initial direct costs, such as commissions and legal fees, were often incurred by lessors in negotiating and arranging a lease.</p> <p>Under MASB 10, lessor's initial direct costs on finance lease were either recognised immediately in income or allocated against this income over the lease term.</p> <p>MASB 10 recognised the manufacturer or dealer lessor's initial direct costs as an expense at the commencement of the lease term because they were mainly related to earning the manufacturer's or dealer's selling profit.</p> <p>MASB 10 required the lessor's initial direct cost on operating lease to be either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognised as an expense in the income statement in the period in which they were incurred.</p>
Measurement and recognition of lease of land and building	<p>FRS 117 requires the leases of land and building to be split into two components, land component and building component (para 14–17).</p> <p>Under FRS 117, the lease of land should be treated as an operating lease and payments made for the lease represent prepaid lease rentals, unless the title passes to lessee (para 15).</p>	<p>MASB 10 did not require the leases of land and building to be split into two separate components.</p> <p>Under MASB 10, leases of land and buildings were required to be classified as operating or finance leases in the same way as leases of other assets.</p>

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
The Effects of Changes in Foreign Exchange Rates	FRS 121 The Effects of Changes in Foreign Exchange Rates (effective from January 1, 2006).	MASB 6 The Effects of Changes in Foreign Exchange Rates, renamed to FRS 121 ²⁰⁰⁴ The Effects of Changes in Foreign Exchange Rates (effective from January 1, 2006).
Requirement for hedge accounting and foreign exchange derivatives	FRS 121 excludes hedge accounting and foreign currency derivatives from its scope. The requirements for hedge accounting and foreign currency derivatives are moved to FRS 139.	MASB 6 permitted a limited aspect of hedge accounting to be applied to trading transactions covered by forward exchange contracts, as well as foreign currency liabilities and other financial instruments which were designated as, and which provided an effective hedge of, net investments in foreign entities and foreign equity investments.
Introduction of functional and presentation currency, and elimination of reporting currency.	FRS 121 introduces the concept of functional currency as the primary currency of an entity's operating environment and presentation currency as the currency used to present financial statements. The term 'reporting currency' is no longer used (para 8).	MASB 6 use the term 'reporting currency' to represent the currency used in presenting the financial statements.
Translation of foreign operations.	FRS 121 requires only one method to be used to translate all foreign operations. The method is the one previously called the "foreign entity method" (para 11).	MASB 6 specified that the method used to translate the financial statements of a foreign operation depended on the way in which it was financed and operated in relation to the reporting enterprise. Foreign operations were classified as either "foreign operations that are integral to the operations of the reporting enterprise" or "foreign entities".
Change in Functional Currency	FRS 121 requires that when there is a change in a firm's functional currency, it should be accounted for prospectively (para 35).	There was no such requirement in MASB 6.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Capitalisation of foreign exchange differences	FRS 121 does not permit capitalisation of foreign exchange differences incapable of being hedged in any circumstances. The exchange differences are required to be recognised in profit and loss.	MASB 6 provided an option to capitalize foreign exchange differences resulting from a severe devaluation or depreciation of a currency, when there was no means of hedging.
Goodwill and fair value adjustment on acquisition of foreign entity	FRS 121 requires goodwill and fair value adjustment to assets and liabilities arising on acquisition of a foreign entity to be treated as part of the assets and liabilities of the foreign entity and translated at the closing rate (para 47).	MASB 6 allowed goodwill and fair value adjustment to assets and liabilities arising on acquisition of a foreign entity to be treated as part of (1) the assets and liabilities of the foreign entity and translated at the closing rate; or (2) the assets and liabilities of the reporting entity which either were already expressed in the reporting currency or were non-monetary foreign currency items which were reported using the exchange rate at the date of the transaction.
Disclosure for the effect of changes in the foreign exchange rates	FRS 121 does not require the analysis of realized and unrealized exchange differences, and closing rates to be disclosed (para 52). FRS 121 requires companies to disclose the reasons for using a different currency from the functional currency for presentation of items in financial statements (para 53). FRS 121 requires the disclosure of the details of, and reason for any change in functional currency (para 54).	MASB 6 required the analysis of realized and unrealized exchange differences, and the closing rate to be disclosed. There was no such requirement in MASB 6. There was no such requirement in MASB 6.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards		MASB Standards	
	Related Party Disclosures	FRS 124 Related Party Disclosures (effective from January 1, 2006).	MASB 8 Related Party Disclosures, renamed to FRS 124 ²⁰⁰⁴ Related Party Disclosures (effective from January 1, 2000)	
Exemption for disclosure of related party disclosure.	FRS 124 does not allow exemption of related party disclosure in (1) parent financial statements when it is available or published with consolidated financial statements; and (2) financial statement of wholly-owned subsidiary if its parent is incorporated in Malaysia and provides consolidated financial statements.		MASB 8 provided exemption of related party disclosure for the two categories.	
Definition of related party	FRS 124 extends the definition of 'related party' to include a party that has joint control over the entity (para 9 (a)(iii)); and a joint venture in which the entity is the venture (para 9 (c)). The definition of related party in FRS 124 excludes enterprises (a) controlled by the same enterprise which exercises significant influence over the reporting enterprise; (b) subject to significant influence by the same enterprise which controlled the reporting enterprise.		MASB 8 did not include a party that had joint control over the entity; and a joint venture in which the entity was the venture, in the definition of related party. The definition of related party in MASB 8 included enterprise (a) controlled by the same enterprise which exercised significant influence over the reporting enterprise; (b) subject to significant influence by the same enterprise which controlled the reporting enterprise.	
Definition of close members of family	FRS 124 define close members of the family of an individual as those family members who are expected to have influence or to be influenced by that individual in dealing with the entity, including (a) the individual's domestic partner and children (b) the domestic partner's children and (c) the dependents of the individual or the domestic partner (para 9).		MASB 8 defined close family members as spouse; parent; child (including adopted child and step-child); brother; sister; and spouse of his/her child, brother or sister. This was in accordance with the definition in Section 122A of the Companies Act 1965.	

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Disclosure requirement for related party	FRS 124 provides further clarification on the disclosure requirement of outstanding balances with related parties, including terms and conditions, whether they are secured, and the nature of consideration to be provided in settlement and details of any guarantees given or received (para 17(b)); and the provision of doubtful debts related to the amount of outstanding balances (para 17(c)).	MASB 8 did not contain such clarification.
	FRS 124 requires separate classification of amounts receivable and payable to related parties into different categories of related parties (para 18–19).	MASB 8 did not state such requirements.
Earnings Per Share	FRS 133 Earnings Per Share (effective from January 1, 2006).	MASB13 Earnings Per Share, renamed to FRS 133 ₂₀₀₄ Earnings Per Share (effective from January 1, 2000).
Measurement of EPS	FRS 133 provides guidance on how to calculate EPS when there is a transaction that involves an entity's preference shares and equity instruments (para 12–18). FRS 133 requires that ordinary shares issued upon the conversion of a mandatory convertible instrument should be included in the basic EPS from the date the contract is entered into (para 23). Under FRS 133, if there are any changes to the number of shares as a result of a capitalisation, bonus issue, share split or reverse share split after the balance sheet date, but before the financial statements are authorized for issue, the computation of EPS should take into account the changes (para 64).	There was no such guidance in MASB 13. There was no such requirement in MASB 13.
Disclosure requirements for earnings per share	FRS 133 requires the disclosure of the basic and diluted EPS for discontinued operation, in the income statement or in the notes (para 68).	Under MASB 13, if there were any changes to the number of shares as a result of a capitalisation, bonus issue, share split or reverse share split after the balance sheet date, but before the financial statement was authorized for issue, no adjustment to EPS should be made to account for those changes. However, an additional proforma EPS should be disclosed. No such requirement was included in MASB 13.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Disclosure requirements for earnings per share	FRS 133 prohibits the disclosure of parent-only EPS in the consolidated financial statements. If the entity presents both a consolidated financial statement and separate financial statement, the EPS presented in the consolidated financial statement should be based on consolidated information. FRS 133 allows EPS based on separate financial statements to be presented only on the face of the separate income statement, but not on the consolidated income statement (para 4).	No such requirement is included was MASB 13.
Consolidated and Separate Financial Statements	FRS 127 Consolidated and Separate Financial Statements (effective from January 1, 2006).	MASB 11 Consolidated Financial Statements and Investments in Subsidiaries, renamed to FRS 127 ₂₀₀₄ Consolidated Financial Statements and Investments in Subsidiaries (effective from January 1, 2000).
Exemption for parent companies from preparing consolidated financial statements	FRS 127 gives exemption for parent companies from preparing consolidated financial statements, if (a) the parent firm is a wholly owned subsidiary, or a partially owned subsidiary where all owners have been informed about and do not object to the fact that the parent does not present a consolidated financial statement; (b) the parent's debt and equity instruments are not traded in the public market; (c) the parent is not filing or in the process of filing its financial statement for the purpose of issuing any instruments in a public market; and (d) the ultimate or intermediate parent of the parent is incorporated in Malaysia and produces financial statements that comply with FRS (para 10).	MASB 11 gave exemption for parent companies from preparing consolidated financial statements, only if the parent was a wholly-owned subsidiary of another parent incorporated in Malaysia (para 8).
Consolidation of subsidiaries acquired temporarily	FRS 127 allows subsidiaries acquired, but intended to be disposed of "within 12 months", to be excluded from consolidated financial statements and accounted for under FRS 5 (para 27–28).	MASB 11 allowed subsidiaries acquired to be excluded from consolidated financial statements if it was intended to be disposed of "in the near future".

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Consolidation of subsidiary with severe long-term restrictions	FRS 127 requires the consolidation of a subsidiary that is under severe long-term restriction, even if the restriction has impaired its ability to transfer funds to the parent. Consolidation is required unless the parent has lost control over the subsidiary (IN9).	MASB 11 required the consolidation of a subsidiary that was under severe long-term restriction, unless the parent had lost control over the subsidiary, including the ability of parents to control the transfer funds of the subsidiary.
Measurement and recognition of investment that ceases from being a subsidiary	Under FRS 127, investment that ceases to be a subsidiary should be accounted under FRS 139 Financial Instruments and the carrying amount at the date should be regarded as the cost (para 31–32)	Under MASB 11, an investment that ceased to be a subsidiary was to be accounted under IAS 25 Accounting for Investments and the carrying amount at the date was to be regarded as the cost.
The use of uniform accounting policies	FRS 127 requires the use of uniform accounting policies for reporting like transactions and events in similar circumstances (IN11).	MASB 11 allowed the use of different accounting policies for reporting like transactions and events in similar circumstances, when it was not 'practicable' to use uniform accounting policies.
Disclosure of minority interest	FRS 127 requires minority interests to be presented in the consolidated balance sheet within equity, but separately from parent shareholders equity.	MASB 11 prohibited minority interests to be presented within liabilities, but it did not require presentation of minority interests within equity.
Investment in Associates	FRS 128 Investment in Associates (effective from January 1, 2006).	MASB 12 Investment in Associates, renamed to FRS 128 ²⁰⁰⁴ Investment in Associates (effective from January 1, 2000).
Application of equity method	FRS 128 clarifies that equity method should be used when the investor has significant influence over the investment in associates, regardless of whether the investor has subsidiaries or not (IN8, para 13). FRS 128 requires equity method to be used, even when the influence is severely restricted. The equity method is not applicable only when the influence is lost (IN10).	MASB 12 stated that investment in an associate was to be accounted for in consolidated financial statements under the equity method except when the investment was acquired and held exclusively with a view to its disposal in the near future. However, if an entity did not issue consolidated financial statements, the investment in an associate should be carried at cost or revalued amounts.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Measurement and recognition of investment that ceases from being an associate	FRS 128 clarifies that an entity loses its significant influence over an investee when it loses power to participate in the financial and operating policy decisions of the investee (para 10). Under FRS 128, investment that ceases to be an associate should be accounted under FRS 139 and the carrying amount at the date should be regarded as the cost (para 18–19).	MASB 12 did not provide such clarification. MASB 12 did not provide such clarification.
The use of uniform accounting policies	FRS 128 requires the use of uniform accounting policies for reporting like transactions and events in similar circumstances (IN13, para 26).	MASB 12 allowed the use of different accounting policies for reporting like transactions and events in similar circumstances, when it was not 'practicable' to use uniform accounting policies.
Determination of group total interests in an associates	FRS 128 clarifies that interests held by joint ventures and other associates are not included in the determination of the group's total interests in associates (para 21).	MASB 12 stated that interests held by other associates were not included in the determination of the group's total interests in associates. No explanation was given for interests held by joint ventures.
Recognition of the share of losses in associates	FRS 128 requires an investor to consider the carrying amount of its equity investment in the associate and other long-term interests in associates when recognising its share of losses in associates (para 29).	MASB 12 did not provide such a requirement.
Disclosure for goodwill in associate	FRS 128 requires the goodwill in associates to be included in the carrying value of the investment in the associate and not separately recognised (para 23,33)	MASB 12 required any difference between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the associate to be accounted for under MASB 21, Business Combinations. Adjustment to depreciation and amortisation were required to be made accordingly.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Disclosure of information relating to investment in associates	<p>FRS 128 requires the financial information of associates, including the total assets, liabilities, revenues and profit or loss to be disclosed (para 37 (b)).</p> <p>FRS 128 also requires the disclosure of financial information of investments in associates not accounted using equity methods (para 37(i)); the fact that an associate is not accounted for under equity method (para 37(h)); the nature and extent of long-term restrictions placed on an associate (para 37(f)); and the reporting date of associates if it is different from the investor's and the reason for using a different reporting date or period (para 37(e)).</p>	<p>There was no such disclosure requirement under MASB 12.</p>
Disclosure of information relating to investment in associates	<p>The standard also requires the investor's share of changes in an associate's equity to be disclosed as a separate line item in the statement in changes in equity (para 39).</p>	<p>There was no such disclosure requirement under MASB 12.</p>
Interests in Joint Ventures	FRS 131 Interests in Joint Ventures (effective from January 1, 2006).	<p>MASB 16 Financial Reporting of Interest in Joint Ventures, renamed to FRS 131₂₀₀₄ Financial Reporting of Interest in Joint Ventures (effective from July 1, 2000).</p>
Changes in scope and definition of interests in joint ventures	FRS 131 does not apply to venturers' interests in jointly controlled entities held by venture capital organizations, mutual funds, unit trusts and similar entities, when those investments are classified as held for trading and measured at fair value. The changes in fair value of those investments are recognised in profit and loss in the period they occur (IN5).	<p>MASB 16 applied to all venturers' interest in all jointly controlled entities in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities took place (para 1).</p>

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Measurement and recognition of interests in jointly controlled entity	<p>FRS 131 allows a venture to recognise its interest in joint ventures using either the proportionate consolidation or the equity method (IN6A).</p> <p>Under FRS 131, there is a provision that permits a venture to be exempted from the application of proportionate consolidation or equity method, similar to exemptions provided to parent companies from preparing consolidated financial statements, when the venture meets the exemption criteria under FRS 127 (IN6).</p> <p>FRS 131 clarifies that the proportionate consolidation or equity method should be used regardless of whether the investor has subsidiaries or not (para 31).</p>	<p>MASB 16 only allowed a venture to recognise its interest in joint ventures using the equity method.</p> <p>There was no such provision in MASB 16.</p> <p>Under MASB 16, a venture that did not prepare consolidated financial statements were required to measure its interests in joint ventures using the cost or revalued amount under the accounting policy for long-term investments. However, the standard also required the disclosure in the notes to the financial statements of the effect if the equity method had been applied.</p>
Measurement and recognition of interests in jointly controlled entity	<p>Under FRS 131, when joint control ceases, the investment in an associate should be accounted for under FRS 139, or under FRS 127 if control is obtained, or under FRS 128 if significant influence is held (para 44, 51).</p>	<p>Under MASB 16, when a joint control ceased, the investment in the associate was to be accounted for under FRS125²⁰⁰⁴ (Accounting for Investment), or under FRS127²⁰⁰⁴ (Consolidated Financial Statements and Investments in Subsidiaries) if control was obtained, or under FRS128²⁰⁰⁴ (Investment in Associates) if significant influence was held.</p>
Exemption for investment in joint venture acquired temporarily	<p>FRS 131 allows an interest in joint venture acquired, but intended to be disposed of “within 12 months”, to be excluded from being accounted for using proportionate consolidation or equity method. Such investment is considered under FRS 5 (IN7).</p>	<p>MASB 16 allowed an interest in a joint venture acquired to be excluded from applying equity method, if it was intended to be disposed of “in the near future”.</p>

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Application of proportionate consolidation or equity method for interest in joint ventures that operates under a severe long-term restriction, even if the restriction has impaired its ability to transfer funds to the venturer. The application of proportionate consolidation or equity method is required unless the joint control is lost (IN8).	FRS 131 requires the application of proportionate consolidation or equity method for interest in joint ventures that operates under a severe long-term restriction, even if the restriction has impaired its ability to transfer funds to the venturer. The application of proportionate consolidation or equity method is required unless the joint control is lost (IN8).	MASB 16 allowed an interest in a joint venture to be excluded from applying equity method, and required it to be accounted in accordance to FRS 125 ₂₀₀₄ (Accounting for Investment) when the interest in a jointly controlled entity operated under severe long-term restrictions that significantly impaired its ability to transfer funds to the venturer.
Preparation of an investor's separate financial statements	FRS 131 clarifies that the requirement for the preparation of an investor's separate financial statements should be based on the requirements established in FRS 127 (para 46).	There was no such clarification in MASB16.
Disclosure requirements for jointly controlled interests in jointly controlled entities	FRS 131 requires a venture to disclose the method used in recognising its interest in jointly controlled entities, either the benchmark treatment (proportionate consolidation) or allowed alternative (equity method)(para 57); and present its interests in joint ventures using one of the two formats (para 30).	There was no such disclosure requirement in MASB 16 as it only allowed equity method.
Financial Instruments	FRS 132 Financial Instruments: Disclosure and Presentations (effective from January 1, 2006).	MASB 24 Financial Instruments: Disclosure and Presentations, renamed to FRS 132 ₂₀₀₄ Financial Instruments: Disclosure and Presentations (effective from January 1, 2002).
Changes in the scope and definition of financial instruments	Under FRS 132, the definition of financial assets and financial liabilities includes contracts settled in an entity's own instrument. The definitions for derivatives, hedged item, hedging and hedging instrument are removed to avoid redundancies with FRS 139 (para 11).	

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Initial measurement of the components of a compound financial instrument	FRS 132 provides no option to measure the liability component of a compound financial instrument on initial recognition. Any assets and liabilities are required to be separated first and the residual is the amount of the equity component (IN13).	MASB 24 provided the option to measure the liability component of a compound financial instrument on initial recognition, either as the residual amount after separating the equity and assets, or by using a relative-fair-value method.
Acquisition of an entity's own equity instrument (treasury shares)	Under FRS132, if an entity acquires its own equity instrument (treasury shares), the equity instruments should be deducted from equity. No gain or loss should be recognised relating to the dealing of treasury shares (para 33).	
Transaction costs incurred during equity transactions	FRS 132 requires transaction costs incurred as part of an equity transactions to be deducted from the equity (para 35, 37, 38, 39, 41).	
Disclosure requirement for financial instruments	FRS 132 requires additional disclosure on (a) information about valuation techniques, (b) information about financial assets that are partially derecognised, (c) carrying amounts of financial assets and financial liabilities held for trading, and financial assets and financial liabilities designated at fair value through profit and loss, (d) the amount of the change in fair value of a financial liability designated at fair value through profit and loss that is not due to changes in interest rates, (e) detailed information about issued compound financial instruments with multiple embedded derivatives features that have interdependent values, and (f) details of any defaults and breaches of loan agreements (IN17).	

Category	FRS Standards	MASB Standards
Investment Property	FRS 140 Investment Property (effective from January 1, 2006).	No standard for investment properties. MASB did not adopt IAS 40 Investment Property.
Changes in scope and definition of investment property	FRS 140 defines investment property as land or building or part of a building or both; held (by owner, or by lessee under finance lease) for rentals, or capital appreciations or both, rather than for use in the production or supply of goods or services or for administrative purposes or for sale in the ordinary course of business (para 5). Under FRS 140, an investment property includes properties under operating lease that (a) meet the definition of an investment property, (b) are accounted for as if they were finance leased, and (c) use the fair value model for the assets recognised (para 6). FRS 140 clarifies that property (a) intended for sale in the ordinary course of business, (b) constructed or developed on behalf of third parties, (c) occupied by owner, (d) constructed or developed for future use as investment property, and (e) leased to another entity under finance lease; should be excluded from being recognised as an investment property (para 9).	FRS 140 supersedes part of IAS 25 Accounting for Investment that deals with investment properties. IAS 25 was then renamed to FRS 125 ²⁰⁰⁴ Accounting for Investment (effective from September 1, 1998). IAS 25 defined investment property as an investment in land or buildings that were not occupied substantially for use by, or in the operations of, the investing enterprise or another enterprise in the same group as the investing enterprise. No such clarification was provided in IAS 25.
Recognition and measurement of investment property	FRS 140 requires investment property to be initially measured at cost and subsequently at (1) cost less accumulated depreciation and impairment losses (para 56), or (2) at fair value with changes in fair value recognised in profit and loss (para 33).	Investment property could be recognised and measured under MASB 15 (depreciated cost or revaluation with depreciation); or IAS 25 (cost less impairment or revaluation), with changes in value taken to reserve. No such clarification was provided in IAS 25.

Appendix 2 Main differences between FRS and MASB standards (continued)

Category	FRS Standards	MASB Standards
Initial measurement of investment properties acquired on exchange	FRS 140 uses the commercial substance criteria in recognising the initial cost of investment properties acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets (para 27–28).	No such clarification was provided in IAS 25.
Recognition of individual investment properties under operating lease	FRS 140 allows the recognition of individual investment properties for investment properties obtained under an operation lease, which uses fair value method (para 6). FRS 140 also clarifies that the use of an option to recognise investment properties under an operating lease individually requires the adoption of fair value model for all investment properties (para 6).	No such clarification was provided in IAS 25.
Change in accounting method for investment property	Under FRS 140, a change from one model to the other shall only be made if it will result in a more appropriate presentation. Thus, it is unlikely there will be a change from the fair value model to cost model as it is unlikely to result in more appropriate presentation (para 31).	No such clarification was provided in IAS 25.
Recognition of third party compensation for the impairment of investment property.	FRS 140 requires the compensation from third party for impairment of investment property to be recognised in profit and loss when the compensation becomes receivable (para 72).	No such clarification was provided in IAS 25.
Disclosure requirement for investment properties	FRS 140 requires the disclosure of the method chosen for measuring investment properties (cost or fair value), and other related information (para 75 (a)–(h)). Under FRS 140, when a valuation obtained for investment property is adjusted significantly for the purpose of financial statement, a reconciliation between value obtained and adjusted valuation should be disclosed (para 77). FRS140 requires an entity that applies the cost model for the investment properties to disclose the fair value of the investment properties (para 79 (e)).	IAS 25 only required the disclosure of the fair value of investment properties if they were accounted for as long-term investments and not carried at fair value.