EARNINGS AND BALANCE SHEET CONSERVATISM IN MALAYSIA: THE INFLUENCE OF IFRS, CORPORATE GOVERNANCE AND INSTITUTIONAL CULTURE IN MALAYSIA

by

MARZIANA BT MADAH MARZUKI

Thesis submitted in fulfillment of the requirements for the degree of Doctor Philosophy

Supervisor: Dr Effiezal Aswadi Abdul Wahab

Co-Supervisor: Professor Datin Hasnah Haji Haron

OCTOBER 2013

ACKNOWLEDGEMENTS

First and foremost, in the name of Allah Most Gracious Most Merciful, thank to the omnipresent God, Allah S.W.T for giving me strength to complete this thesis. I would like to thank my main supervisor, Dr. Effiezal Aswadi Abdul Wahab whose encouragement, valuable guidance and support from the initial to the final stage enabled me to complete this thesis in a better way. This thesis would have remained a dream had it not been for his guidance and support. I would also like to express my deepest appreciation to my co-supervisor, Datin Professor Hasnah Haron for her continuing and convincing support and sharing of invaluable insights for this study.

I am also indebted to Professor Ferdinand Ful, Associate Professor Simon Fung (Hong Kong Polytechnic University), Associate Professor Mujtaba Mian (Hong Kong Polytechnic University) and Professor Bin Srinidhi (University of Texas) for their valuable inputs during the Monash Sunway Campus Symposium.

My special thanks to the dean of School of Management Universiti Sains Malaysia, Professor Dr.Fauziah Binti Md. Taib for her support and valuable comments during Colloquium in Universiti Sains Malaysia.I would like also to thank all of the faculty members, staff and colleagues at University Sains Malaysia (USM) for their concern and help in fulfilling my academic requirements. I would like to show my gratitude to Kementerian Pengajian Tinggi (KPT), Malaysia as well as Universiti Teknologi Mara (UiTM) for their financial support and the opportunity to pursue my studies up to this level.

Last but not least, I would like to thank my parents, Wan Azizah bt. Wan Ismail, Madah Marzuki Haji Hassan and Wan Yam bt. Wan Sulaiman for their physical and moral support throughout this PhD journey. This thesis is specially dedicated to my beloved husband, Ahmad Fazlan bin Mustapha and all my children for their love, patience and steadfast encouragement to complete this study, Without them, this dissertation would not have been possible.

TABLE OF CONTENTS

LIST OF TABLES

CONTINUED

CONTINUED

CONTINUED

LIST OF FIGURES

LIST OF APPENDICES

LIST OF ABBREVIATIONS

CMP	-	Capital Market Masterplan
EMH	-	Efficient Market Hypothesis
EU	-	European Union
GLCs	-	Government Link Companies
IASB	-	International Accounting Standards Board
IASC	-	International Accounting Standards Committee
IFRS	-	International Financial Reporting Standards
MACC	-	Malaysian Anti-Corruption Commission
MICPA	-	Malaysian Institute of Certified Public Accountant
MASB	-	Malaysian Accounting Standards Board
MCCG	-	Malaysian Code of Corporate Governance
MIA	-	Malaysian Institute of Accountant
MICG	-	Malaysian Institute of Corporate Governance
MSWG	-	Minority Shareholder Watchdog Group
PLCs	-	Public Listed Companies
CCM	-	Companies Commission of Malaysia
SC	-	Securities Commission
SEC	-	Securities and Exchange
TI	-	Transparency International

DEFINITION OF KEY TERMS

Earnings conservatism	-	Accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements
Balance sheet conservatism	-	Consistency understatement of book values of net assets from the market value of net assets
Corporate governance	-	A mechanism by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected.
IFRS	-	International Financial Reporting Standards issued by IASB
Culture	-	Collective of human values, which shape behavior as well as one's perception of the world.
Political connection	-	Being closely-related to top politician
Family-firms	-	Firms which are controlled by family
Elite interlock	-	Firms that have connection with the richest men in Malaysia

KONSERVATISME DALAM PENDAPATAN DAN PENILAIAN ASET: KESAN REFORMASI DALAM PERATURAN DAN BUDAYA PERSEKITARAN INSTITUSI DI MALAYSIA

ABSTRAK

Baru-baru ini, dua pembaharuan pengawalseliaan yang penting yang dimulakan oleh pengawal selia di Malaysia untuk meningkatkan kualiti pelaporan kewangan di kalangan syarikat-syarikat senaraian awam iaitu penguatkuasaan IFRS pada tahun 2006 dan pindaan kepada Kod Tadbir Urus Korporat Malaysia (MCCG) pada tahun 2007. . Walaupun begitu, kredibiliti peraturan-peraturan ini masih dipersoalkan oleh pihak-pihak berkepentingan awam dan pelbagai syarikat oleh kerana kegagalan pentadbiran beberapa syarikat baru-baru ini. Bagi merungkai persoalan ini, tesis ini telah dijalankan untuk meneliti kesan sebelum dan selepas daripada peraturan reformasi yang baru tersebut ke atas ketelusan laporan kewangan (dinilai dari segi tahap 'konservatisme' syarikat). Analisis lanjut dilakukan dengan menyiasat kesan budaya dalam persekitaran institusi di Malaysia yang diwakili oleh hubungan politik, kekeluargaan, golongan elit dan kepelbagaian etnik di kalangan pengarah syarikat ke atas hubungan antara IFRS dan MCCG 2007 pada konservatif .

Dalam kajian ini kami menggunakan dua jenis ukuran konservatif iaitu konservatif syarikat dalampendapatan (*earnings conservatism*) menggunakan model Basu (1997dan konservatif syarikat dalam pengiraan asset (*balance sheet conservatism*) menggunakan model Lara (2004). Konservatisme syarikat dalam pendapatan (*earnings conservatism*) dianggap sebagai langkah terbaik bagi mengukur ketelusan pelaporan kewangan kerana konsep ini tahap pengesahan yang lebih tinggi untuk keuntungan berbanding kerugian berdasarkan berita dari harga saham manakala

konservatif syarikat dalam pengiraan asset (*balance sheet conservatism*) digunakan sebagai kualiti laporan kewangan yang rendah kerana ia semata-mata mengecilkan keuntungan dan terlalu menekankan kerugian tanpa sebarang justifikasi. Kami menjangkakan bahawa konservatisme syarikat dalam pendapatan akan meningkat selepas perubahan peraturan tersebut manakala konservatif syarikat dalam pengiraan asset akan menurun selepas penguatkuasaan IFRS dan MCCG 2007. Selain itu, kami juga menjangkakan bahawa konservatif dalam pendapatan semakin berkurangan dan konservatif dalam pengiraan asset meningkat walaupun selepas IFRS dan MCCG kesan daripada budaya institusi Malaysia.

Berdasarkan sampel akhir 3,083 pemerhatian daripada syarikat-syarikat yang tersenarai di Bursa Malaysia dari tahun 2004 hingga 2009, kami mendapati bahawa konservatif syarikat dalam pendapatan meningkat konservatif syarikat dalam pengiraan asset menurun selepas IFRS dan MCCG.Terdapat pelbagai penemuan bagi kesan kesan budaya dalam persekitaran institusi di Malaysia ke atas kualiti laporan kewangan. Analisis mendapati hubungan politik syarikat tidak mempengaruhi konservatisme syarikat; sama ada dalam pendapatan atau pengiraan aset. Analisis juga mendapati bahawa konservatif pendapatan bagi firma yang mempunyai hubungan kekeluargaan di kalangan pengarah meningkat selepas IFRS dan MCCG 2007 menunjukkan bahawa firma keluarga mempunyai insentif yang kurang untuk memanipulasi laporan kewangann kerana mereka mempunyai kepentingan jangka panjang dengan firma. Keputusan analisa bagi kesan kewujudan lelaki terkaya (golongan elit) di kalangan lembaga pengarah syarikat membuktikan bahawa hubungan firma dengan golongan elit ini membawa kepada kualiti laporan kewangan yang rendah setelah keputusan menunjukkan bahawa konservatif syarikat dalam pengiraan asset meningkat selepas IFRS. Analisa juga mendapati bahawa kualiti laporan kewangan tidak ditentukan oleh etnik semata-mata.

Kajian ini memberi gambaran kepada pengawal selia undang-undang untuk merumuskan dasar perakaunan yang akan mengambil kira budaya institusi di Malaysia. Ini kerana sebahagian daripada budaya i Negara ini mungkin member kesan kepada kualiti laporan kewangan di negara ini. Oleh kerana literatur tentang konservatif syarikat dalam pengiraan aset adalah terhad, kajian ini secara tidak langsung meningkatkan literatur tentang konservatif syarikat dalam pengiraan aset dan dengan itu meningkatkan pemahaman mengenai peranan konservatif dalam ketelusan laporan kewangan di negara ini.

EARNING AND BALANCE SHEET CONSERVATISM IN MALAYSIA: THE INFLUENCE OF IFRS, CORPORATE GOVERNANCE AND INSTITUTIONAL CULTURE IN MALAYSIA

ABSTRACT

Recently, two important regulatory reforms initiated by the regulators in Malaysia to enhance financial reporting quality among the public listed companies which are the enforcement of IFRS in 2006 and the amendment of Malaysian Code of Corporate Governance (MCCG) in 2007. In spite of the regulative reform, the credibility of these regulations is still questioned by the public and various stakeholders of the companies due to recent corporate failures. Stimulated by this dilemma, this thesis examines the pre and post effects of IFRS enforcement in 2006 and the amendment of MCCG in 2007 on financial reporting transparency measured by conservatism. Further analysis is done by investigating the effect of Malaysia's institutional culture proxied by political connection, family connection, richest men connection and ethnicity on the relationship between IFRS and MCCG 2007 on conservatism.

In this study we use two proxies of conservatism which are earnings conservatism using Basu (1997)'s model and balance sheet conservatism using Lara (2004)'s model. Earnings conservatism is used as the best measure of financial reporting transparency as this concept requires a higher degree of verifications for profits compared to losses based on the news from stock prices whereas balance sheet conservatism is used as a poor financial reporting quality as it merely understate profits and overstate losses without any indications. It is hypothesized that earnings conservatism increases whereas balance sheet conservatism decrease after the IFRS and MCCG 2007. We also hypothesized that earnings conservatism is decreasing

and balance sheet conservatism increasing even after the IFRS and MCCG as a result of Malaysia's institutional culture.

Based on a final sample of 3,083 observations from listed companies on Bursa Malaysia from year 2004 till 2009, it was found that earnings conservatism is enhanced after IFRS and MCCG whereas poor financial reporting quality (balance sheet conservatism) is also reduced after IFRS and MCCG. There was mixed findings for results on institutional culture. Politically connected firms are not conservative; either in earnings or balance sheet conservatism. Enhanced earnings conservatism after IFRS and MCCG 2007 provided evidence that family firms have less incentive to manage earnings since they have long interest with the firms. The results for richest men provided evidence that richest men connection lead to poor financial reporting quality as balance sheet conservatism is enhanced after IFRS. In addition, it was found that conservatism is not depend on ethnicity per se.

The study provide insight to the regulators to formulate accounting policies that will take into consideration Malaysia's institutional culture as some of the culture might trigger financial reporting quality in this country. Since the literatures on balance sheet conservatism are scarce, this study also extends the literature on balance sheet conservatism and thus enhances the understanding on the role of conservatism in financial reporting transparency.

CHAPTER 1: INTRODUCTION

1.1 Introduction

This chapter presents the background of the study, followed by problem statement, research questions and research objectives. Then this chapter discusses the contribution of this study and lastly, this chapter presents the organizations of this study.

1.2 Background of the study

The quality of financial reporting has been the topic of discussion by many parties such as regulators, governments, creditors, shareholders and managers. The subject has become an important issue for financial users, especially investors and creditors, as both of them have claims against the firms' resources. For investors and creditors, they have to ensure that whatever amount invested into the firms will be rewarded and paid off in the form of dividend and money lent respectively. Therefore, financial reporting not only acts as a tool for firms to demonstrate their performance, but it goes beyond that by becoming one of the instruments and medium to monitor and control their behavior.

The issue of financial reporting quality has become more prominent due to recent corporate failures that occurred in developed countries, such as the United States of America, where rules and regulations are more stringent and rigid compared to other countries. The collapse of Enron and WorldCom have drawn the attention of regulators, practitioners, auditors and researchers, both in developed and developing countries, to the issue of financial reporting transparency. These cases have shattered the whole nation, particularly the companies' shareholders, as the financial reporting of the companies were ‘decorated’ with promising profits, lower debts and high revenues.

Levitt (1998) defines quality as financial reporting transparency that signifies the basis of any business.[1] He further states that success of capital markets is explicitly dependent on the accounting and disclosure system where high-quality accounting standards will produce financial statements that report events in real-time. High-quality financial reporting ensures no added reserves and deferral of losses, and actual volatility is not smoothed away to portray a false representation of steady and consistent growth. In financial reporting, the issue of corporate transparency is more important as information that is accurate and relevant is needed by investors in their investment decision making and at the same time to ensure the security of their investments. Regulators are also demanding corporate transparency in order to exert more control on company operations and the behaviour of managers.

Numerous tools have been introduced by researchers, such as discretionary accruals, earnings persistence, earnings smoothness and stock market reactions, to measure the quality of financial reporting. In spite of that, Dechow, Ge & Schrand (2010) in their review of earnings quality measurement, stress that measures of earnings quality are measuring different constructs. A particular determinant of earnings quality is not associated with the measurements of earnings quality and each of them has different consequences. Therefore, they conclude that there are no single best measure~~s~~ of earnings quality as each of them have their own strengths and weaknesses based on their constructs.

[1] Arthur Levitt is the former Securities Exchange Commissions (SEC) in U.S.

Following the definition of quality as proposed by Levitt (1998), conservatism is regarded as the best measure for financial reporting transparency as this concept requires a higher level of verification in distinguishing between the good and the bad news. In this concept bad news is recognized earlier than good news and therefore earnings reflect bad news more quickly than good news. This means bad news is identified sooner than good news, thus, earnings reflects bad news faster than good ones. Francis, Lafond, Olsson & Schipper (2004) and Vichitsarawong, Eng & Meek (2010) use conservatism as a measure of financial reporting transparency since conservatism is regarded as a desirable attribute~~s~~ of accounting earnings that can be used in order to avoid unexpected economic downturn and corporate failure.

The concept of conservatism has dominated other accounting principles including historical cost and realization conventions for centuries (Basu, 1997). Accordingly, conservatism can be categorised into two types: earnings conservatism and balance sheet conservatism. Basu (1997) defined earnings conservatism as the tendency to recognize bad news than good news in a timelier manner and this tendency is measured with slope coefficients from regressions of earnings on returns (Basu, 1997). On the other hand, Feltham and Ohlson (1995) define balance sheet conservatism as ‘the existence of a persistent understatement of the book value figure with respect to market’s valuation of the firm’.

Prior literatures (Black & White, 2003;Gassen, Fulbier, & Sellhorn, 2006; Joos & Lang, 1994) support that earnings conservatism is more apparent in common-law countries where financial reporting quality is higher compared to code-law countries. Earnings conservatism is regarded as having higher financial reporting quality compared to balance sheet conservatism as it has a significant role in reducing organizations' problems and curbing deadweight losses from poor investment decisions. Watts (2003)argues that earnings conservatism reduces managers' ability and incentives to overstate earnings and net assets by requiring higher verification standards for gain recognition and reduces managers' ability to withhold information on expected losses**.** Conservatism also serves a monitoring role on firms' investment policies. It also helps to identify negative net present value (NPV) projects or poorly performing investments by requiring more timely recognition of economic (or expected) losses. This, in turn, signals to the companies' board of directors to investigate both the project and the managers. Thus, deadweight losses from poor investment decisions can be reduced and firm and equity values can be increased.

Nonetheless, according to Ball & Shivakumar (2005), balance sheet conservatism is less effective in contracting role as it causes randomness in decisions derived from financial information. In addition, balance sheet conservatism reduces the opportunities of firms to account value in a conditionally conservative fashion by understating the book value of assets compared to the market value. Gassen*et al.*(2006) state that balance sheet conservatism causes 'cookie-jar reserves' to be created which may lead to earnings management.[2]Therefore, balance sheet is more apparent in code law countries in which debt financing systems depend very much on internal funds, ownership structures are more concentrated, less shareholder activism, low legal enforcement and taxation policies that rely more on the lower value of assets.

Even though earnings conservatism has also been criticized by many researchers as being less predictable (Chan, Lin, & Strong, 2009; Penman & Zhang, 2002), less

[2]Cookie jar reserves are an accounting practice in which a company uses generous reserves from good years against losses that might be incurred in bad years.

informative for firms with high growth (Ahmed & Duellman, 2007) and may lead to higher opportunistic behaviour (Beekes, Pope, & Young, 2004), due to its governance and informational role, earnings conservatism is still the most suitable proxy for transparency. The concept of earnings conservatism embraces several behavioural aspects which can educate managers to be more ethical and accountable on whatever actions that have been taken. The behavioural aspects which are being cautious and alert can inculcate a sense of responsibility and caution among managers as they are controlled by people who are also their stakeholders.

This concept has also been argued as leading to manipulation. Despite that, it is argued that such manipulation can only occur if managers practice excessive conservatism. Watts (2003) questions the practice of excessive conservative reporting as being a potential cause for the distortion of earnings-returns relation. This practice has also been rejected in FRS18 (Disclosure of Accounting Policies) as it requires the companies to adopt accounting policies appropriately according to its circumstances so as to provide a ‘true and fair view’ of financial statements (Accounting Standards Board, 2000). Rationally, conservatism is regarded as a proxy for transparency due to the natural behaviour of humans who are more devoted to profits and thus tend to present good news more than bad news, particularly in matters concerning money and businesses. It is hard for an individual to disclose information which may impede their wealth especially in capitalist economies.

Due to its role and its transparency nature, the concept of earnings conservatism has been used by many researchers as a proxy of financial reporting quality (Ahmed & Duellman, 2007 Basu, 1997; Lara & Mora, 2004; Lara, Osma &Penalva, 2009a; Lara, Osma & Penalva, 2009b; Vichitsarawong et al., 2010). Conservatism has been linked with factors that contribute to financial reporting quality. Factors such as corporate governance, ownership structure, financial reporting standards and Securities Commission Act have long been debated as the main factors that contribute to the financial reporting quality and these factors become the main concern of regulators.

The role of regulators is considered as the most important to ensure that the firms are aware of their responsibilities in protecting the interest of all their stakeholders. Regulation is seen as an additional control mechanism to discipline managers to act in the best interests of the investors. Even though auditors are appointed as the main intermediary between financial users and firms in controlling the behaviour of managers, the role of auditors itself are also subject to the regulators to monitor and ensure that they act on behalf of the stakeholders. Thus, regulators act as the ‘controller’ of the whole business relationship to maintain a fair and orderly capital market and this effect will be translated into a better financial reporting quality.

Previous studies have shown that there is a strong relationship between conservatism and regulation as they found a positive relationship between corporate governance and conservatism (Ahmed & Duellman, 2007; Beekes et al., 2004), IFRS and conservatism (Barth, Landsman, & Lang, 2008; Gassen et al., 2006; Lara, Torres, & Veira, 2008) and Sarbanes-Oxley (SOX) Act and conservatism (Lobo & Zhou, 2006; Rezaee & Jain, 2004).[3] Previous studies also found that there is a strong relationship between institutional factors or a country’s culture and conservatism. Ball, Kothari & Robin (2000) and Ball, Robin & Shuang Wu (2003) examine the degree of political influence proxied by code- or common-law countries and conservatism and found

[3]SOX is an accounting standards set by U.S. federal law for all U.S. public company boards, management and public accounting firms

that conservatism is greater in common-law countries as they have better enforcement on regulations. Chan *et al.*(2009) investigate the effects of family firms on conservatism and Doupnik, Gotti, Kang &Salter (2010) investigate the effects of culture identified by Schwartz (1994) on conservatism. Both studies concluded that culture does play a role in accounting practices.

However, the above studies investigated the relationship between conservatism on specific regulations or culture. A study by Bushman & Piotroski (2006) investigated the effects of regulation and other institutional factors, such as political connection, on conservatism. Additionally, Bushman &Piotroski (2006) examine the effect of country-level institutions such as legal or judicial systems, securities law, tax regime and political economy of 38 countries on conservatism. However, the study did not investigate how these two factors (regulation and culture) interact with each other and affect conservatism. It only investigated the effect of these two factors on earnings conservatism. Furthermore, the investigation, which was done in 38 countries, may not capture specifically the differences of culture in those countries which might have important interpretation to the results.

Another study that examines the effect of regulation and institutional culture which is political connection is a study by Mohammed, Ahmed & Ji (2011) which was also done in Malaysia. Mohammed *et al.*(2011) examine the effect of corporate governance and political connection on earnings conservatism in Malaysia measured using Basu (1997)'s model. This study differs from Mohammed *et al.* (2011) in a number of important aspects. Firstly, Mohammed *et al.* (2011) investigate the effect of corporate governance variables implemented using the Anglo-Saxon model of corporate governance in the Malaysian market while this study takes the current changes of corporate governance code as it investigates the effect of corporate governance code amendment implemented in 2007 on conservatism. The purpose of using the amended code is to analyze the effect of current changes and, thus, contribute to the reviewing and revision of those changes by the regulators for the purpose of regulation enhancement. Even though some of the corporate governance variables used are quite similar, some of the variables that differ highlight the important changes in Malaysia which has never been tested its effect on conservatism, such as audit committee meetings. Thus, it is imperative to stress that the new amended code of corporate governance in 2007 emphasizes on the importance of communication between board of directors and audit committee.

Secondly, Mohammed *et al*. (2011) utilise only a single measure of conservatism which is earnings conservatism measured by using Basu's (1997) model, while this study uses two different measures of conservatism which are earnings and balance sheet conservatismmeasured by using a valuation framework provided by Feltham &Ohlson (1995). Previous literatures have documented that earnings conservatism is apparent in common-law countries, while balance sheet conservatism is more evident in code-law countries. Thus, it is also imperative to stress that the use of balance sheet conservatism in Malaysian context is highly relevant due to its institutional background. Principally, Malaysia uses International Accounting Standards (IAS) adopted common-law countries such as the US and UK which have been known as having high quality of financial reporting. Nevertheless, primarily, accounting practices in Malaysia are highly influenced by its institutional culture similar to the code-law countries' such as political connection and family firms. Therefore, investigating the effect of regulations like IFRS and corporate governance on both types of conservatism is interesting as the influence of code- and common-law countries prevails in Malaysia’s institutional setting.

Thirdly, this study provides a detailed explanation on the attributes of conservatism as a proxy for financial reporting quality and explains in detail the reason why managers should practice conservatism. This study extends the current literatures of conservatism by focusing on various mechanisms of regulation which are IFRS and corporate governance and take into consideration other factors that may mitigate such regulations. Instead of testing the direct relationship as Mohammed *et al.* (2011), this study puts the two factors, which are regulation and culture, in a more complex relationship and sees how the two factors interact with each other in one institutional setting. The variables used for culture in this study are also more comprehensive as those variables are chosen based on the institutional background of Malaysia.

Hence, this study is brought about by these factors. The collapse of global financial markets in September 2008 has detonated a debate on what are the causes of this global financial crisis. The crisis has also been attributed to, among other things, a perceived lack of transparency in the financial markets. In addition, the Secretary General of Organization for Economic Co-operation and Development (OECD), Angel Gurría, commented on his view that one the factors to be blamed for the crisis is poor corporate governance. Lack of enforcement of corporate governance has allowed the transparency, accountability and integrity of companies to be compromised and eventually may lead to corruption (Kousenidis, Ladas, & Negakis, 2009). In 2008, the US experienced one of the worst economic crises in two decades, including failures in its subprime market leading to housing foreclosures, and a complete dissolution of its banking and financial system. The US and other European governments have stepped in to bail out companies experiencing huge losses, whilst the stock markets worldwide have dropped to dangerous levels. This also includes the Asian markets in which Japan, Hong Kong, South Korea, Taiwan, Singapore and Malaysia have and will continue to experience its shock.

Previously, Malaysia was hit by financial crisis in 1997. The crisis caused the Bursa Malaysia index to drop, the gross domestic product index fell, high volatility in the value of the Ringgit and the number of non-performing loans escalated. Consequently, Malaysia introduced the corporate governance code and more importantly, set up task force agencies such as Danaharta and Danamodal which successfully steered the country out of the 1997 economic crisis. These factors ensured the impact on Malaysia was not as much as on other markets when the recent 2008/2009 global financial crisis hit the world (Lim & Kanesalingam, 2010). Therefore, this study is seen as an interesting enquiry to investigate whether the enforcement of IFRS in 2006 and the amendment of code of corporate governance in 2007 have successfully increase conservatism in Malaysia and give input to regulators to improve regulatory system in the country.

Secondly, recent corporate failures that occurred all over the world have called into attention the revamp of regulation systems. The 2008 financial crisis led political transformations in many Asian countries which, in turn, exposed fundamental weaknesses in both the financial and political systems and thus, orchestrated the failures in policy, regulations, oversight, and enforcement mechanisms. High profile cases of corporate mismanagement or employee misconduct from Siemens in Germany and UBS in Switzerland to IBM in Argentina and Samsung in South Korea had demonstrated what can happen when the principles of corporate governance (transparency, accountability and integrity) are absent, inadequate or abused. Corporations fail to realize the potential benefit of corporate governance, hence, their corporations still collapse even with the existence of good corporate governance system. Most of the large corporations carried out corporate lobbying and financing of political activities to assist them in understanding, tracking and shaping the development of regulations and legislations. When performed with integrity and transparency by a company, these activities can be legitimate and lead to positive impact. However, large funds that are available at the disposal of businesses and the close relationship that exists between companies and lawmakers can lead to undue and unfair influence on a country’s policies and politics (Transparency International (TI), 2009a).

In Malaysia, for example, a high profile case of a government-owned company which is under Khazanah Nasional Berhad has made the role of government and regulations in Malaysia questionable. Those cases have opened the eyes of many professionals to look forward into the cases and have also promoted shareholder activism in Malaysia. Sime Darby and Pos Malaysia has incurred losses over RM1 billion and RM546 million respectively due to overrun cost in big investment (Ismail, 2010; News Straits Times, 2010). According to Corruption Perceptions Index (CPI) 2009 produced by Transparency International (TI), the CPI score for Malaysia has declined from 5.1 in 2008 to 4.5 in 2009 (Transparency International (TI), 2009b). This can be attributed to theperception that not much progress has been made to combat corruption and the lack of political will toimplement effective anti-corruption measures. TI suggests that the Malaysian Anti-Corruption Commission

(MACC)seems to target “small fish” and opposition politicians (Transparency International (TI), 2009a) in its fight against corruption in Malaysia.

Thirdly, as the Group of 20 (G-20) set 2012 as the current deadline for financial system reformation, years before, 2012 is regarded as an important date to pursue regulation reformation in order to ensure that loopholes in the current financial systems are closed to prevent illicit financial flows and corporate transparency is promoted in a more systematic manner. Malaysia, as well, will adopt full convergence of IFRS in 2012. Therefore, this study is regarded as an initial effort to explore the effect of institutional environment in improving corporate disclosure and transparency as Fan & Wong (2002) state that the implementation of international accounting standards and disclosure rules without considering the institutional environment in East Asia will not improve corporate transparency in this region. Transparency International (TI) organization in its recommendation states that “efforts towards better financial regulation remain uneven.[4] Enhanced regulation and oversight has to be accompanied by full transparency through public reporting of findings of all oversight institutions” (Transparency International, 2009c).

1.3 Problem Statement

The role of regulators in Malaysia is to ensure a balanced development of vibrant markets through innovation leading to growth, while at the same time, they have to ensure that the market is properly regulated. There is a call for regulators to determine their direction in the regulation of capital markets. They have to ensure that whatever directions or steps taken, it will enhance the quality of financial reporting as financial reporting acts as a medium for stakeholders to monitor firm’s

[4]TI is a non-governmental organization that monitors and publicizes corporate and political corruption in international development

performance and behaviour. At the same time, they have to face challenges to enforce regulations due to the institutional setting factors such as government intervention in standard setting and business operations and lower shareholder activism among the stakeholders that lead to lower demand of financial reporting quality.

In Malaysia, several reforms have been done by the regulators such as Securities Commission, Bursa Malaysia, Minority Shareholder Watchdog Group (MSWG), Malaysia Accounting Standards Board (MASB) to ensure quality financial reporting by the listed companies. For example, the Malaysian Code of Corporate Governance (MCCG) has been formulated in 2000 and revised in 2007 as a continuous joint effort between the government and the industry to strengthen the board of directors and audit committees and to ensure they carry out their roles and responsibilities accordingly. MSWG was established in 1999 in order to protect minority shareholders' interest and to stimulate shareholder activism among them. MASB has made a lot of effort such as to converge local accounting standards with International Accounting Standards (IAS) gradually in order to provide a platform for the Malaysian PLCs to understand the standards and to look forward to its implementation in enhancing financial reporting quality and comparability.

Nevertheless, the credibility of the regulations formulated is questioned by the public or the stakeholders of the companies due to recent corporate failures, especially among Malaysian GLCs such as Sime Darby Berhad and Pos Malaysia Berhad. The corporate failure has raised the issue of how can these companies fail as they are well-regulated with updated regulation such as MCCG and IFRS. Are there other factors that might overrule the endorsement of the rules?

These cases have raised up the issue of companies' transparency in terms of loss recognition that can provide signals to the stakeholders to be wary and put pressures on the firms to portray good quality of financial reporting.

Therefore, this study is conducted to examine the effect of recent regulations such as MCCG 2007 and IFRS towards company's financial reporting transparency by examine the loss recognition measured by earnings conservatism and at the same time try to explore other factors from Malaysia institutional setting that might contribute to this corporate failure.

1.4 Research Questions

This study is carried out to answer the following research questions:

1. Does conservatism increase in the period after the adoption of IFRS?
2. Does conservatism increase in the period after the amendment of MCCG 2007?
3. Which corporate governance variables contribute to better financial reporting quality?
4. What is the effect of institutional culture (i.e. political connection, family ownership, elite connection and ethnicity) on the relationship between regulations (i.e. IFRS and corporate governance) and conservatism.

1.5 Research Objectives

The objectives of this study are:

1. To examine whether the practice of conservatism increases in the period after the adoption of IFRS.

2. To examine whether the practice of conservatism increases in the period after the amendment of MCCG 2007.
3. To investigate which corporate governance variables contribute to the enhancement of financial reporting quality
4. To investigate the effect of institutional factors (i.e. political connection, family ownership, elite connection and ethnicity) on the relationship between regulations (i.e. IFRS and corporate governance) and conservatism.

Based on a final sample of 3,083 observations from listed companies in Bursa Malaysia from year 2004 till 2009, we found strong evidence that financial reporting quality is enhanced after adoption of IFRS and amendment of MCCG 2007 as we find significant results that shows earnings conservatism is enhanced after the reformation of the regulation. Our results are robust as we find that poorer financial reporting quality measured by balance sheet conservatism is also reduced after the reformation.

We extend the test to examine which corporate governance variables contribute to the enhancement of financial reporting quality. Among the corporate governance variables that contribute to the enhancement are board accountancy qualifications, audit committee expertise and the number of audit committee meetings. We find strong evidence that those variables also contribute to lower poor financial reporting quality measured by balance sheet conservatism. Therefore, the results support contracting theory.

Nevertheless, we found no evidence that board independence can enhance financial reporting quality. Therefore, we extend the test to investigate whether financial reporting quality in this country is influenced by its institutional setting which highly influenced by political connection, family dominance and economic inequality. Our results indicate that Malaysia's financial reporting quality is still influenced by its institutional setting which is constructed on relationship-based economy and economic inequality as we find strong evidence that earnings conservatism is reduced for politically-connected firms and elite-connected firms. Overall, our study finds that Malaysia's financial reporting quality is still influenced by its institutional setting, thus, supporting institutional theory.

1.6 Contribution of the study

The contributions of this study are as follows. Practically, this study will help the regulators to formulate accounting policies, rules and standards that take into consideration Malaysia's institutional culture. Since Malaysia's financial reporting quality is significantly affected by culture (CLSA, 2010), this study will give input to the regulators on its institutional culture that can be focused on. As Malaysia has decided to move towards full convergence of IFRS in 2012, this study will provide some input to the regulators to have a look at their decision and to conjure up certain changes that might take place in the future.

For example, MFRS 124 Para 18 stated that if an entity has had related party transactions during the periods covered by the financial statements, it needs to disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. In addition, the standards also specify that disclosures shall also include s the amount of the transactions, the amount of outstanding balances, including commitments, and etc.

Nevertheless, such requirement is exempted for government control entities. Para 25 states that a reporting entity that has control, joint control or significant influence from the government is exempted from the disclosure requirements of paragraph 18 in relation to related party transactions and outstanding balances. The exclusion should not exist if we want to promote financial reporting transparency.

There is no specific rule or code of corporate governance to date which is formulated to consider the issue of family firms and politically connected firms. For example more rules are needed to restrict the number of family directors or politically-connected directors in composition of board of directors or otherwise all audit committees in these types of companies should be independent. Such policies and rules are very important since these types of firms are apparent in our country.

Ball et. al. (2000) state that financial opacity in emerging markets such as Malaysia do not depend on the accounting system alone, but rather it depends on the role of the regulators as a strong institution to enforce accounting rules. Regulators should play their strict role to enforce legislation in the court system to ensure adequate governance as has been practised by developed countries such as U.K. and U.S.

As for the government, this study can motivate them to improve their role in the country's business environment, especially their role in GLCs, to overcome these companies' failures in the future and, thus, can enhance the government's credibility in business environment. Since Malaysia place heavily on government and political parties in business, the quality of government policies is a critical factor to ensure that all those policies can benefit all citizens of Malaysia. The role of government is needed to correct the market failure rather than for self-interests intervention as has been practiced in developed countries.

This study will stimulate stakeholders' activism in Malaysia to protect their own interest and actively play their role especially in annual general meetings as part of the incentives for the firm to practice corporate transparency. CLSA report 2010 states that most firms in Malaysia continue to fail to have a meaningful dialogue with theirshareholders. Even though these companies are open to answering questions posed to themat AGMs, they will not consider voting by poll or even publish proxy results.Not even one company in this country has voluntarily started voting by poll, unlike in Thailand and Singapore (CLSA, 2010).

Theoretically, since conservatism is still a new concept in emerging countries, this study can enhance awareness among Malaysia's PLCs in understanding the concept of conservatism as part of the financial reporting concept and financial reporting quality measurement. This concept has always been misunderstood as a 'pessimistic' concept and, hence, will impede the firm's growth. The public understanding of this concept is also important in order to consider conservatism as part of the firms' monitoring mechanism.

Secondly, this study aims to extend the existing literatures on importance of conservatism as part of earnings quality measurements. Although many studies have been done by using conservatism as earnings quality measurement, this study highlights on its different roles by using both types of conservatisms which are earnings and balance sheet conservatism which can provide a clearer understanding on the concept and how it can help to promote good governance among public listed companies.

Thirdly, this study brings in a new theory to the concept of conservatism which is institutional theory. This theory has been used in this study since it is hypothesized that the quality of financial reporting in Malaysia is considerably influenced by its institutional structure and social processes of the environment. The introduction of this theory into the concept of conservatism also recognizes the importance of both earnings and balance sheet conservatisms as both conservatisms are distinguished by the institutional structure of a country.

1.7 Organizations of the Study

The remaining chapters are organized as follows. Chapter 2 outlines the institutional setting in Malaysia, focusing on regulations such as IFRS and MCCG, its political economy and ethnicity. Chapter 3 summarizes the relevant past research on corporate governance. The main hypotheses are developed in Chapter 4. Chapter 5 discusses the research methods and sample profile with the empirical results provided in Chapter 6. Finally, Chapter 7 summarises and concludes this thesis.

CHAPTER 2: INSTITUTIONAL BACKGROUND

2.1 Introduction

This chapter presents the background of financial reporting quality, regulation development and institutional culture of Malaysia. Section 2.2 discusses the general overview of financial reporting quality in Malaysia. It is followed by Section 2.3 and 2.4 which discuss Malaysia's capital market and the regulatory regime in Malaysia respectively. Then, this chapter discusses in detail the financial reporting system and code of corporate governance in Malaysia in Section 2.5 and 2.6 respectively. Section 2.7 discusses on the background of Malaysia's two main institutional cultures which consist of the country's political economy and ethnicity. At the end of the chapter, the whole background of Malaysia's institutional setting is summarized.

2.2 Financial Reporting Quality in Malaysia

CLSA Asia Pacific Market report on Malaysia's overall performance in Corporate Governance Watch 2007 states that:

> "*The quality of financial reporting among small listed companies is poor, while the standards of non-financial reporting among companies leave a lot to be desired. Few companies report their audited annual results within 60 days. Securities laws do not appear to provide a credible deterrent against insider trading. Legal remedies for shareholders are limited. There is virtually no voting by poll at AGMs. There is little confidence in the market that independent directors are genuinely independent in Malaysia. While public enforcement efforts have improved, regulators do not have the reputation for treating companies and individuals equally. Indeed, the consensus is that politic hampers the ability of regulators to do their job properly. Private enforcement by the market is limited (at*

both the institutional and retail level), with many investors have a low opinion of the ethical standards of the average listed company"

(CLSA, 2007, pg. 25)

Compared to other developing countries such as Singapore and Hong Kong, the quality of financial reporting in Malaysia is still low. A survey conducted by CFA Institute for Financial Market Integrity 2004 Asia-Pacific Corporate and Financial Disclosure Survey rated the quality of corporate and financial reporting in Malaysia as average.[5] The report of the survey revealed that the "average" rating for the quality of corporate and financial disclosure given by respondents ranges from a low of 28% in Australia to a high of 58% in Malaysia. In the meantime, a "good" rating by respondents ranges from as low as 23% in Mainland China and Malaysia to as high as 64% in Australia.

Consequently, one of the major criticisms on the lower quality of financial reporting in Malaysia is lack of transparency. Thus, financial reporting transparency has been a topic of debate in Malaysia since the Asian financial crisis in 1997/1998. Weak corporate transparency has been identified as one of the major factors behind the crisis. Levitt (1998) stated that "The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia are stark examples of this new reality. These markets learnt a painful lesson taught many times before: investors panic as a result of unexpected or unquantifiable bad news".

[5]CFA Institute is a global, non-profit professional association that administers the CFA curriculum and examination program worldwide and, through its CFA Centre for Financial Market Integrity, sets voluntary, ethics-based professional and performance reporting standards for the investment industry. From 1990 to early 2004, CFA Institute was known as AIMR (Association for Investment Management and Research).

Nevertheless, the results of the CFA survey, which were released in the second half of 2005 generalized that the quality of corporate information released by listed companies in the Asia-Pacific region is improving. The survey respondents agree that the result is being driven by greater requirements from regulators. Executive director of the CFA Centre for Financial Market Integrity, Kurt Schacht concludes that the disclosure practices and financial statement quality of companies, which also includes their corporate governance practices, are critical information to investment decision making (CFA Institute, 2005).

The improvement is seen to be greater when the CLSA Asia Pacific Market reports on Malaysia's overall performance in Corporate Governance Watch 2010 which states that:

> "*The average CG score for Malaysian corporations at 55% is slightly higher than regional average at 53%. Malaysian companies do well particularly on transparency and independence as well as on the C&G/CSR scores. Their main area of weaknesses in our scoring is on accountability, viz the number of independent directors, whether the audit committee appoints external auditors, voting by poll, etc.*"
>
> *(CLSA, 2010, pg. 91)*

Recently, Malaysia has been doing well in their corporate governance rules and practices. The CLSA Asia Pacific Market reports on Malaysia's overall performance in Corporate Governance Watch 2010 also noted that the most improved category for Malaysian companies is on CGrules and practices with an increased score from 44% in 2007 to 49% in 2010. Enforcement category has also been improved as SC has been actively promoting good governance. The report revealed that regulators are trying hard to better the system as the political and regulatory environment show better improvement compared to 2007.

In spite of that, Malaysia's score for corporate governance culture dropped one percent from 33% in 2007 to 32% in 2010. When comparing the governance score between political and regulatory and CG culture of 11 capital markets in Asia, the gap between these two scores is greatest in Malaysia which shows that CG culture still poses a threat to the corporate governance practices here even though there is improvement in the enforcement and regulatory system. Measuring CG culture based on what companies, investors, intermediaries, non-profit organizations and what the media are doing to raise CG standards voluntarily, CLSA (2010) reports that:

> *Malaysia retained its sixth spot in our rankings this year, but with a higher overall score of 52% compared to 49% in 2007. Regulators have been making steady progress in the past three years and appear more open to listening to the market. Yet doubts remain. A major issue we have is how much of this is window dressing and how much is genuine change? Will this take corporate governance practices beyond box-ticking? These uncertainties are why Malaysia's CG culture score recorded a one-percentage drop this year, whereas all other categories saw improvement.*
>
> *(CLSA, 2010, pg. 87)*

2.3 Malaysia's Capital Market

Malaysia's capital market has been observed to have undergone significant development since the financial crisis in 1997/1998. Ensuing the crisis, the regulators have carried out various initiatives to improve market infrastructure and processes and to reinforce the regulatory framework. This is done to enhance the role of capital market in meeting investors' preferences and to ascertain the effectiveness of regulation in the changing market environment. In 2001, for example, the MalaysianCapital Market Masterplan (CMP) was launched to boost the development of the Malaysian corporate governance reform agenda. The CMP consists of 152 recommendations that deal with the development of institutional and regulatory framework for the capital market from 2001 to 2010. Ten of the recommendations specifically address corporate governance with a focus on fair treatment of all shareholders and protection of shareholder rights including minority shareholder rights, transparency and disclosure, corporate ownership, accountability and independence of the board of directors, regulatory enforcement, and training and education (Malaysia Securities Commission, 2001).

Malaysian equity market is considered well developed if compared to most other East Asian economies (Abdul Rahman, Mohd Sidek, & Tafri, 2009), whereas its debt market is still developing (Lian, 2007). According to Ball, Robin &Sadka (2008), there is a high demand for financial reporting in the debt markets and have highly influence on the association between stock prices and earnings as presented by Ball & Brown (1968).Therefore, they conclude that debt markets are primarily responsible for accounting conservatism. Accounting conservatism and earnings timeliness is important in debt contracting as debt holders strongly depend on financial statement variables to know their contractual rights. In contrast, shareholders in the equity markets are able to get information of gains or losses either from financial statements or other non-financial disclosure, as long as they receive the information.

After the financial crisis of 2008, the equity capital market in Malaysia has experienced significant growth with a steady rise in the number of listed companies and the amount of funds acquired. Before the Asian financial crisis, there were a total of 621 companies listed on the Kuala Lumpur Stock Exchange (presently known as Bursa Malaysia), which amounted to a total market capitalisation of RM806 billion in 1996.However, during the crisis period in 1997 and 1998, a total of 708 and 736