USEFULNESS OF FINANCIAL REPORTING: FAIR VALUE ACCOUNTING, EVIDENCE FROM MALAYSIA

BY

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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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A dissertation submitted in fulfilment of the requirement for the degree of Master of Science (Accounting).

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ABSTRACT

Usefulness of financial reporting comprises of relevance and faithful representation. The former is measured by value relevance and earnings persistence, whereas the latter is measured by earnings management (EM). Thus, this study's objectives are to examine the value relevance and earnings persistence of FV model in comparison to HC model. Another objective of this research is to compare earnings management in companies that applied the FV and HC models. Finally, the impact of COVID-19 pandemic period on the value relevance and earnings persistence in these companies is addressed. This study investigates the usefulness of financial reporting specifically the fair value (FV) model for investment property (IP) in Malaysia. The usefulness of FV is evaluated in comparison to the Historical Cost (HC) model. This research employed Positive Accounting Theory and semi-strong form of Efficient Market Hypothesis (EMH) to frame the hypotheses. In addition, the test of value relevance uses the Ohlson model. Secondary data were collected from 128 listed companies on Bursa Malaysia that held substantial amounts of IPs as their assets in the financial statement. The sample period of the study was 2018, 2019 and 2020. According to the regression results, overall findings indicate that financial reporting particularly the FV model for IP is useful. FV is more value relevant compared to the HC model. However, earnings are less value relevant in the FV model compared to the HC model. In the earnings persistence test, earnings were more persistent in the HC model in comparison to the FV model. Thus, both FV and HC models are useful under different measures of relevance. Moreover, this study has not found strong evidence to support that FV model is used for EM purposes, at least not in the case of IP listed companies in Malaysia. The FV and HC models' value relevance and earnings persistence are not significantly impacted by COVID-19. However, the value relevance of FV seem to decline and EM, measured by positive discretionary accruals, was higher in the year 2020 compared to the HC model. The findings of this study suggest that it is consistent with the EMH, at least the semi-strong form. Finally, the findings of this study could be of interest to companies with IPs, stakeholders, regulators and accounting researchers as the findings reveal that both models have their own advantages in terms of usefulness. Hence, it is suggested to regulators to consider dual measurements for financial statements to be truly useful.

خلاصة البحث

تشتمل فائدة التقارير المالية على الملاءمة والتمثيل الصادق. الأول يقاس بالقيمة الملائمة واستمرارية الأرباح، بينما يقاس الأخير بإدارة الأرباح (EM). وبالتالي، فإن أهداف هذه الدراسة هي فحص أهمية القيمة واستمرارية الأرباح لنموذج FV مقارنة بنموذج HC. الهدف الآخر لهذا البحث هو مقارنة إدارة الأرباح في الشركات التي طبقت نماذج FV و HC. أخيرًا، تتم معالجة تأثير فترة جائحة COVID-19 على أهمية القيمة واستمرار الأرباح في هذه الشركات. تبحث هذه الدراسة في فائدة التقارير المالية على وجه التحديد نموذج القيمة العادلة (FV) للعقار الاستثماري (IP) في ماليزيا حيث يتم تقييم فائدة FV بالمقارنة مع نموذج التكلفة التاريخية (HC). استخدم هذا البحث نظرية المحاسبة الإيجابية وشكل شبه قوي من فرضية السوق الفعالة (EMH) لتأطير الفرضيات. بالإضافة إلى ذلك، يستخدم اختبار ملاءمة القيمة نموذج Ohlson. تم جمع البيانات الثانوية من 128 شركة مدرجة في بورصة ماليزيا والتي تحتفظ بكميات كبيرة من الملكية الفكرية كأصول لها في البيانات المالية. كانت فترة عينة الدراسة 2018 و 2019 و 2020. ووفقًا لنتائج الانحدار ، تشير النتائج الإجمالية إلى أن إعداد التقارير المالية وخاصة نموذج القيمة العادلة للملكية الفكرية مفيد. القيمة FV أكثر صلة بالموضوع مقارنة بنموذج HC. ومع ذلك ، فإن الأرباح ذات قيمة أقل في نموذج القيمة العادلة مقارنة بنموذج HC. في اختبار استمرارية الأرباح، كانت الأرباح أكثر ثباتًا في نموذج HC مقارنة بنموذج FV. وبالتالي، فإن كلا النموذجين FV و HC مفيدان في ظل مقاييس مختلفة ذات صلة. علاوة على ذلك، لم تجد هذه الدراسة أدلة قوية تدعم استخدام نموذج FV لأغراض EM، على الأقل ليس في حالة الشركات المدرجة في قائمة الملكية الفكرية في ماليزيا. لا تتأثر ملاءمة قيمة نماذج FV و HC واستمرار الأرباح بشكل كبير بواسطة COVID-19. ومع ذلك، يبدو أن أهمية قيمة FV في انخفاض، وكانت EM،

التي تم قياسها من خلال الاستحقاقات التقديرية الإيجابية، أعلى في عام 2020 مقارنة بنموذج HC. تشير نتائج هذه الدراسة إلى أنها متوافقة مع EMH، على الأقل الشكل شبه القوي. أخيرًا، قد تكون نتائج هذه الدراسة ذات فائدة للشركات التي لديها شركاء IP وأصحاب المصلحة والمنظمون وباحثو المحاسبة حيث تكشف النتائج أن كلا النموذجين لهما مزايا خاصة بهما من حيث الفائدة. ومن ثم، يُقترح على المنظمين اعتبار القياسات المزدوجة للبيانات المالية مفيدة حقًا.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature……………………………… Date……………………

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This dissertation is dedicated to my honourable parents; without them, I would not exist in this life and to them I learned a valuable lesson, to endure, no matter the difficulties.

To honest friends who extended their support without any hesitation in this journey.

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LIST OF ABBREVIATIONS

IFRS	International Financial Reporting Standards
IASB	International Accounting Standards Board
FV	Fair Value
HC	Historical Cost
MASB	Malaysian Accounting Standards Board
REITs	Real Estate Investment Trust Funds
EM	Earnings Management
IP	Investment Property
EP	Earnings Persistence
ERC	Earnings Response Coefficient
PAT	Positive Accounting Theory
BPH	Bonus Plan Hypothesis
DEH	Debt to Equity Hypothesis
PCH	Political Cost Hypothesis
EMH	Efficient Market Hypothesis
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Financial reporting has always played an essential part in business decision-making. This is because the primary objective of financial reporting, as specified by the International Accounting Standards Board (IASB) in its Conceptual Framework (IASB, 2018)[1], is to provide useful information for stakeholders' decision-making. In order for the information to be useful, it has to have the qualities of relevance and faithful representation (IASB, 2018). The International Financial Reporting Standards (IFRS) that are issued by the IASB have the above qualities in mind when designing these standards; therefore, IFRS tend to be favourable towards fair value (FV) measurements instead of the traditional historical cost (HC) method (Kaur, 2013).

According to Paragraph 9 of the IASB's Conceptual Framework, which was adopted by the Malaysian Accounting Standards Board (MASB), FV is the market price that is exchanged between knowledgeable market participants to sell assets or transfer liabilities at the exact date of measurement (MASB, 2018). FV is therefore at exit price. On the date of the transaction, the FV of an asset would be its HC. However, these values differ upon subsequent recognition. In subsequent recognitions, FV revalues assets based on market price, whereas HC maintains the original cost of the asset, but requires assets to be depreciated. The specific standard on FV is Malaysian Financial Reporting Standard (MFRS) 13, which is equivalent to IFRS 13. On the other hand, companies that use the HC model refer to MFRS 116, equivalent to IAS 16 for property, plant and equipment.

Due to continual adjustment towards market price, FV measurements are perceived as more relevant to investors and creditors as it presents updated values in the financial

[1] The Conceptual Framework issued by the International Accounting Standards Board (IASB) was adopted by the Malaysian Accounting Standards Board (MASB).

statements, hence better for decision-making (Kaur, 2013; Ibidunni & Okere, 2019). Nevertheless, critics of FV state that one accounting model cannot be preferred and judged supreme over another accounting model and it must be suitable to the needs of that particular context (Bloom, Fuglister & Myring, 1998). The main criticism with the FV measurement model is that it is considered to be less objective than HC and possibly subject to manipulation as managers tend to manipulate the earnings disclosure in the reported earnings through the FV measurements option (Hsu & Lin, 2016). Details of the pros and cons of both methods are discussed in chapter two.

An example of a specific type of asset is investment properties (IPs). The accounting treatment for IPs is in a specific standard, that is MFRS 140, which is equivalent to IAS 40. MFRS 140 defines Investment Property (IP) as land or a building, part of a building, or both owned by the lessee through a finance lease to gain rental income or for capital appreciation. Any property that does not take part in the production of goods and services and administration activity is considered as IP. The goal of MFRS 140 is to define and assist in identifying IPs and its related disclosure requirements (MASB, 2018, para 5). An industrial sector that makes substantial investments in and generate income from IPs is the real estate investment trust funds (REITs). In addition to REITs, construction and property sectors as well as other sectors could also have IPs. Thus, IPs are quite common in the context of certain Malaysian business sectors.

The issue with IP measurement is that there is no unanimously agreed upon valuation method after initial recognition is made. The suggested alternatives are either HC model or FV model (Lourenço & Curto, 2007). Generally, it has been accepted in Malaysia, based on MFRS 140, that IP can be measured using either of these two methods, i.e. HC or FV. However, as mentioned before, there is a trade-off, where FV and HC are considered to be more relevant and objective, respectively.

Despite the relevance of FV, the current pandemic challenges the value relevance of financial reporting, as a whole. The outbreak of Coronavirus (COVID-19) being declared as a pandemic on 11 March 2020, affected economic activity worldwide severely. It is believed that the pandemic paved the way for earnings management (EM) action (Šušak, 2020) particularly due to the financial and economic crisis as a consequence of the pandemic. Practices such as EM could jeopardise value relevance and faithful representation, thus have an effect on FV valuation in particular, as discussed in the next section.

1.2 PROBLEM STATEMENT

As inferred from the discussion above, there are certain problems associated with FV measurement. The first problem is the dilemma in choosing between FV or HC models as it is a controversial debate that does not seem to have a consensus (Lourenço & Curto, 2007; Mora, McGeachin, Barth, Barker, Wagenhofer, and Joos, 2019). By permitting Malaysian companies to choose between HC and FV models for their IP seems to be a choice between objectivity and relevance, respectively. These Malaysian companies with IP may provide more relevant information by using FV, but at the same time, these companies could produce less faithfully represented information due to the subjectivity of FV. Under such circumstances, the information will not be as useful. Furthermore, there is a substantial difference between the value of IP when calculated under the FV and HC models and such discrepancies between the values could have an implication on the decisions made by uninformed investors.

Next is the consideration that IFRS is issued by developed countries, hence FV is promoted by these countries. Thus, even though FV may be relevant to developed countries, it may not be suitable in developing countries. The main reason that FV may be too advanced for developing countries is the fact that the capital markets of these countries are not as active or developed. In the absence of an active market or irregular trading, [2]level

[2] Under MFRS 13, three levels of inputs of FV hierarchy are introduced. Level 1 inputs are quoted price of identical property from an active market. Level 2 inputs are either quoted prices, or prices of a similar property, not an identical property but from an inactive market. Level 3 inputs are unobservable inputs, which is based on calculation, estimation and projection.

2 or level 3 measures have to be used to determine FV (Landsman, 2007; Ahmad & Aladwan, 2015). Levels 2 and 3 valuation inputs are deemed to be highly subjective. Therefore, many developing countries do not prefer FV measurements model, as seen in the context of Fiji (Chand & Patel, 2011) and Vietnam (Nguyen, 2018). Furthermore, FV valuation method is not considered to be of value by investors in developing countries as there is no increase in share price when this method is used (Jabar & Mohamed, 2015). As Malaysia is a developing country as well, it may face similar obstacles in Malaysian companies valuing their IP based on FV, hence may not be as value relevant as evidenced by literature in developed countries.

In addition to the above concerns, one of the fundamental criticisms about FV is that it could be used as an avenue for EM. This is because various valuation techniques and input levels are allowed under MFRS 13 (IFRS 13) in measuring FV; hence considerable subjectivity and discretion remains at the hands of management. Managerial discretion is still a challenge in the implementation of the FV model as has been acknowledged in the IASB's post-implementation review of IFRS 13 (IASB, 2018). Therefore, there is a possibility that management of companies may use these numerous measurement alternatives under FV to manage earnings at the expense of shareholders and other stakeholders. Enhanced subjectivity and EM are particularly of concern if companies in developing countries tend to use level 3 inputs in their measurement of FV. Moreover, the FV accounting method has made it easier for managers to recognise unrealised earnings and losses in the income statement (Hsu & Lin, 2016). Specifically, companies can easily report the unrecognised gains as recognised gains to show higher performance to their stakeholders, hence affecting the latter's decision-making (Emerson¸ Karim & Rutledge, 2010).

The possibility of utilising FV measurement for EM purposes has been increased with the outbreak of COVID-19 pandemic. Prior literature (Ayedh, Fatima & Mohammad, 2019) has reported that EM practices increase in frequency and severity during a financial crisis. As the COVID-19 pandemic affected the economies of nearly all countries leading towards a financial crises throughout the globe, this pandemic has impacted financial reporting (Šušak, 2020). It has, thus, created uncertainty that could result in EM and material misstatements (IAASB, 2020). Consequently, there is a likelihood that companies with IPs, particularly REITs, could rely on EM to sustain their performance, especially since the property market as well as rental income were facing downward trends during the pandemic (Tanrıvermiş, 2020). Therefore, REITs were expected to be badly affected at the end of 2020, although they were less affected compared to other sectors at the beginning of the pandemic (Lee, Jais & Chan, 2020).

Based on the various issues with FV measurement, as discussed above, in particular in relation to valuing IP, and the added challenge of the pandemic, have motivated this study. Therefore, the next section proceeds with the discussion on the motivations for this research.

1.3 RESEARCH MOTIVATION

One of the reasons for the study is that IP has been one of the largest contributors to the Malaysian economy. For instance, market capitalisation of Real Estate Investment Trusts (REITs), which primarily deal with IPs, is about 43.4 billion Ringgit Malaysia in 2019 (Lim, 2020). However, it is not only REITs who own IPs, as other companies could also have IPs. As IPs are a substantial part of REITs and of considerable value to other companies, they play a significant role in the Malaysian economy. This study is not only motivated by the fact that IPs are of considerable value to the Malaysian economy, but also that these assets could be reported at extensively different values under MFRS 140, depending on whether FV or HC models are used in their valuation.

In Malaysia, prior literature on IPs (Mei, Hassan & Embong, 2014; Jabar & Mohamed, 2015) used data from 2006 to 2011. This sample period was prior to the full adoption of IFRS in Malaysia, which was in 2012. Furthermore, MFRS 13 on FV was only applicable effective January 2013. Therefore, this study is motivated to test the relevance and faithful representation of IP valuation based on FV and HC models using more recent