ACCOUNTING CONSERVATISM IN GOVERNMENT-LINKED COMPANIES: A CONSERVATISM ESTIMATING MODEL

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ABSTRACT

In GLCs, managers are oftentimes hired by the government due to their relationship-based resources. The managers have the ability to manage and operate a firm without any intervention from others when the firm is controlled and managed by them. This enable the managers to act on behalf of the organization and give them the ability to redirect the firm resources to maximize their wealth. They also tend to focus on short-term performance and therefore are less likely to adopt conservative reporting as aggressive accounting practices enable them to window-dress their short-term performance. This study recommends that the conservatism estimating model in the study of Ball and Shivakumar (2005) be applied to compare the degree of conservatism between GLCs and non-GLCs in Malaysia and examine the effects of government ownership on conservative reporting in GLCs and non-GLCs in Malaysia. It is expected that GLCs tend to have less conservative accounting practices as compared to non-GLCs. A preliminary analysis through robust least squares confirms our prediction.

Key words: Conservatism; Government-linked companies; Monitoring.

Introduction

In the literature, while Basu's (1997) income-return model is an effective measure for conservatism, Ball and Shivakumar (2005) argue that Basu's model does not distinguish transitory gain or loss components in earnings from random errors in accruals (such as miscounting inventory); all of which are transitory and cause negative serial dependence in income changes. Furthermore, the model is only effective to identify the existence of transitory components, but not about the timeliness of recognition. Hence, the models as in Ball and Shivakumar (2005) and Givoly, Hayn and Katz (2010) to examine "the speed in which earnings reflect bad news as compared with good news" are presented in this study. Specifically, we suggest researchers to use the conservatism estimating model in the study of Ball and Shivakumar (2005) to gauge the degree of conservatism.

Government-linked companies (GLCs) are publicly traded companies in which the government owns major control rights and cash flow rights (Ang and Ding, 2006). In GLCs, managers are oftentimes hired by the government due to their relationship-based resources. In this scenario, the managers are unlikely to be closely monitored by the major shareholder, viz. government. Therefore, the managers are in fact able to act at their discretion. Furthermore, it is important to notice that the true ultimate shareholder rights reside in the taxpayers. In other words, the ownership interests are widely dispersed, implying the poor monitoring mechanism in GLCs. Another feature of GLCs is that their managers tend to focus on short-term performance. Therefore, managers in GLCs are less likely to adopt conservative reporting as aggressive accounting practices enable them to window-dress their short-term performance. Note that accounting conservatism reflects the fundamental quality and thus reliability of financial statements. That is, it is a complement to effective monitoring of the self-interested managers. Taken together, accounting conservatism in GLCs warrants an empirical examination. Hence, this study is conducted to compare the degree of conservatism between GLCs and non-GLCs in Malaysia. We also tend to examine the effects of government ownership on conservative reporting as a result of poor monitoring system in GLCs.

One shareholder and/or diverse shareholders would not be able to restrain managers' possible self-interest behavior under a widely distributed ownership structure (Cullinan, Wang, Wang and Zhang, 2012). In the literature, it has been shown that results about the role of government ownership in conservatism of financial reporting are varied, whereby government ownership might either encourage or discourage conservatism. Using the conservatism estimating model in the study of Ball and Shivakumar (2005), researchers are able to not only compare the levels of accounting conservatism between GLCs and non-GLCs in

Malaysia, but also to examine the effects of government ownership on conservative reporting in GLCs and non-GLCs in Malaysia. It is expected that GLCs tend to have less conservative accounting practices as compared to non-GLCs.

This conceptual paper proceeds as follows. The following section presents relevant prior studies and discusses the proposed hypothesis relating to GLC and conservatism. The next section explains the suggested techniques and the preliminary analysis. A final section concludes this paper.

Literature Review

Government-Linked Companies

In Malaysia, GLCs are "companies that have a primary commercial objective and in which the Malaysian Government has a direct controlling stake" (http://www.khazanah.com.my). This enables the Malaysian Government to own the percentage of ownership as well as the right to hire board of directors and/or top managers who make key financing and operating decisions (http://www.khazanah.com.my).

Unlike other countries, private enterprises drive the economic growth in Malaysia. With this regard, the strategy of state capitalism has been introduced to resemble the private enterprise and contributed to important national institutions. To date, GLCs exist in most industries in Malaysia such as manufacturing, plantation, finance, trading, transportation, shipbuilding and services and many of them have been privatized and listed in the Malaysian Stock Exchange, the Bursa Malaysia.

Despite the fact that GLCs in Malaysia is relatively few, these companies are the ones that play significant roles in boosting Malaysia's economic growth and development. 10 percent out of the total companies listed in Bursa Malaysia accounts for roughly 260 billion of Malaysian Ringgit in terms of market capitalization, which is about 36 percent of the total market capitalization in Malaysia (Wan Ismail, Kamaruddin and Othman, 2012). Beside the impressive achievement and contribution of GLCs, many critics oppose that the government controlled companies could produce better performance as compared to private firm because of the advantages of close relationship with the government. However, an Overview of 2011 National Audit Report Initiatives and Updates Related to State Owned Corporations documented that around 28.6% of the GLCs reported loss with total of RM1.720 billion (Said and Jaafar, 2014). On the other hand, the National Audit Department reported, for the year ended 2008 to 2010, the total of 11 GLCs was suffered losses. Among the reasons for these losses is because of ineffective and unsuccessful business strategy (Lau and Tong, 2008). This situation, if continuously happen not only will mar the image of GLCs, but also will reduce the public trust on the Malaysian government.

Conservatism

As the financial information in annual reports are important inputs for various users, conservatism is an important subject that must be noted by annual reports users to protect their own interest (Srivastava and Tse, 2009). Note that an enterprise is "a combination of a set of contracts, in which the benefits and welfares of all parties referred to in these contracts are reflected in the firm's financial statements" (Coase, 1937). The conservatism concept requires more verification to recognize gains than to recognize losses in the time of uncertainty. Basu (1997) defined conservatism as the asymmetric verification threshold for gains versus losses, in which the verification for gains is higher than losses. Conservatism is applied as most of the equity investors find that this concept can mitigate agency problems in two directions (Ball, 2001; Watts, 2003). In one way, conservatism can discipline managers' investment decisions by sending an early warning signal to shareholders to investigate the losses as conservative accounting requires the managers to recognize economic losses in timelier manner (Ball, 2001). Secondly, Watt (2003) posited that the conservative accounting will lower the managers' incentive and ability to overstate earnings. This is because, conservatism will immediately penalize managers for their failures but acknowledge rewards for economic gains only after the benefits are being realized, hence lower their intention to overstate the earning. Besides that, LaFond and Watts (2008) also proved that conservatism being a symmetry response to agency problems arising from asymmetric information between informed and uninformed investors.

GLC and Conservatism

The managers have the ability to manage and operate a firm without any intervention from others when the firm is controlled and managed by them (Jensen and Meckling, 1976). This position enable the managers to act on behalf of the organization and give them rooms to drive corporate resources to maximize their wealth. One shareholder and/or diverse shareholders would not be able to restrain managers' possible self-interest behavior under a widely distributed ownership structure (Cullinan, Wang, Wang and Zhang, 2012). In the literature, it has been shown that results about the role of government ownership in conservatism of financial reporting are varied, whereby government ownership might either encourage or discourage conservatism. In Malaysia, Mohammed et al. (2010) document that government ownership is related to more conservative financial reporting. In other words, a GLC would tend to demand for higher levels of accounting conservatism as compared to a non-GLC. However, some prior studies (for example, Zhu and Li, 2008) argue that GLCs have incentives to opportunistically report higher earnings. Due to its complex ownership structure, more severe agency problems might occur in GLCs, resulting in less conservative report. In support of the latter argument, a researcher can test the following hypothesis:

Hypothesis: GLCs tend to delay in recognising bad news and to accelerate in recognising good news as compared to non-GLCs.

Description of Methodology

We collected financial data from the Bloomberg Terminal/Thomson One/Datastream Database for the period from 2007 to 2013. Focusing on the periods after 2007 would allow us to highlight the consequence of revised Malaysian Code on Corporate Governance 2007. This study will exclude the finance, investment, trust and funds companies because of the different regulatory requirement on these industries according to Bank and Financial Institution Act 1989 (BAFIA) . Finally, observation with missing data will be eliminated from our dataset.

Empirical Model

Following Ball and Shivakumar (2005) and Givoly, Hayn and Katz (2010), researchers can employ conservatism to examine "the speed in which earnings reflect bad news as compared with good news". In line with prior studies, the following regression can be estimated:

$$\Delta NI_{i,t} = \chi_0 + \chi_1 D\Delta NI_{i,t-1} + \chi_2 \Delta NI_{i,t-1} + \chi_3 D\Delta NI_{i,t-1} \times \Delta NI_{i,t-1} + \chi_4 GLC_{i,t}$$
$$+ \chi_5 GLC_{i,t} \times D\Delta NI_{i,t-1} + \chi_6 GLC_{i,t} \times \Delta NI_{i,t-1} + \chi_7 GLC_{i,t} \times D\Delta NI_{i,t-1} \times \Delta NI_{i,t-1} + \varepsilon_{i,t}$$

(1)

where $\Delta NI_{i,t}$ is change in income deflated by prior-year total assets. $D\Delta NI_{i,t-1}$ is an indicator variable equal one if prior-year ΔNI is negative, and zero otherwise. $GLC_{i,t}$ is an indicator variable equal one for a GLC, and 0 otherwise. Among all, the coefficient of interest is χ_7, which captures the difference in the level of conservatism between GLCs and non-GLCs. Based on the above discussion, the coefficient χ_7 is thus predicted to be significantly positive.

Besides that, a researcher also can estimate the following model, which is to test the association between cash flows and accruals (Ball and Shivakumar, 2005) with the presence of GLCs. The regression is:

$$ACC_{i,t} = \mu_0 + \mu_1 DCFO_{i,t} + \mu_2 CFO_{i,t} + \mu_3 DCFO_{i,t} \times CFO_{i,t} + \mu_4 GLC_{i,t}$$
$$+ \mu_5 GLC_{i,t} \times DCFO_{i,t} + \mu_6 GLC_{i,t} \times CFO_{i,t} + \mu_7 GLC_{i,t} \times DCFO_{i,t} \times CFO_{i,t} + \varepsilon_{i,t}$$

(2)

where $ACC_{i,t}$ is total accruals deflated by prior-year total assets. $CFO_{i,t}$ is operating cash flow deflated by prior-year total assets. $DCFO_{i,t}$ is an indicator variable equal one if $CFO_{i,t}$ is negative, and zero otherwise. $GLC_{i,t}$ is an indicator variable equal one for a GLC, and zero otherwise. The coefficient of interest is μ_7, which is expected to be significantly negative. For both (1) and (2), the GLC can be replaced by a continuous variable, viz. the government ownership. As discussed, one would probably find that GLCs are less conservative in financial reporting as compared to non-GLCs.

Preliminary Analysis

To prove our recommendation that the models are able to compare the levels of accounting conservatism between GLCs and non-GLCs in Malaysia, we run a preliminary analysis, where the results are reported in Table 1. As predicted, the coefficient on GLC × DΔNIt-1 × ΔNIt-1 is significantly positive at 0.01 percent. This preliminary regression analysis suggests that not only theoretical reasoning but also statistical analysis support the notion that GLCs are less conservative in financial reporting as compared to non-GLCs.

Table 1: Robust Least Squares

$\Delta NI_{i,t} = \chi_0 + \chi_1 D\Delta NI_{i,t-1} + \chi_2 \Delta NI_{i,t-1} + \chi_3 D\Delta NI_{i,t-1} \times \Delta NI_{i,t-1} + \chi_4 GLC_{i,t}$ $+ \chi_5 GLC_{i,t} \times D\Delta NI_{i,t-1} + \chi_6 GLC_{i,t} \times \Delta NI_{i,t-1} + \chi_7 GLC_{i,t} \times D\Delta NI_{i,t-1} \times \Delta NI_{i,t-1} + \varepsilon_{i,t}$				
Variable	Coefficient	Std. Error	z-Statistic	Prob.
Constant	-9.02E-08	5.01E-08	-1.801265	0.0717
$D\Delta NI_{t-1}$	-2.43E-07	6.67E-08	-3.640764	0.0003
ΔNI_{t-1}	-0.005114	6.52E-06	-784.7964	0.0000
$D\Delta NI_{t-1} \times \Delta NI_{t-1}$	0.005152	7.00E-06	735.6253	0.0000
GLC	1.14E-07	1.14E-07	1.003217	0.3158
$GLC \times D\Delta NI_{t-1}$	2.50E-07	1.67E-07	1.495722	0.1347
$GLC \times \Delta NI_{t-1}$	0.003196	0.000144	22.22768	0.0000

$GLC \times D\Delta NI_{t-1} \times \Delta NI_{t-1}$	0.0241	0.0031	7.6579	0.0000

Included observations	8,0170
Adjusted R-squared	0.6822
Prob (Rn-squared stat.)	0.0000

Conclusion

The conservatism estimating model in the study of Ball and Shivakumar (2005) is able to compare the levels of accounting conservatism between GLCs and non-GLCs in Malaysia and examine the effects of government ownership on conservative reporting in GLCs and non-GLCs in Malaysia. This paper is important in that the topic highlights potential aggressive reporting in GLCs and thus managers' investment decisions can be disciplined by sending an early warning signal to shareholders to investigate the losses. The policy implication is that this paper will create the awareness and attention to lower the managers' incentive and ability to overstate earnings. This is because, conservatism will immediately penalize managers for their failures but acknowledge rewards for economic gains only after the benefits are being realized, hence lower their intention to overstate the earning.

Mixed empirical results have been found on the role of government ownership in conservatism of financial reporting, whereby government ownership might either encourage or discourage conservatism. Due to its complex ownership structure, more severe agency problems might occur in GLCs, resulting in less conservative report. Therefore, in this study, it is expected that GLCs tend to have less conservative accounting practices as compared to non-GLCs. A preliminary analysis through robust least squares confirms our prediction.

This study will provide a valuable explanation on the relationships between government ownership and the levels of accounting conservatism. Policy makers in Malaysia may have to monitor GLCs more closely than non-GLCs to ensure the credibility of its financial markets. This study will contribute to the study on accounting conservatism from the perspective of government ownership in Malaysia.

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