CONSTRUCTING A FINANCIAL REPORTING DISCLOSURE QUALITY MODEL OF LISTED FIRMS IN MALAYSIA

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ABSTRACT

The national accounting standards set by the Malaysian Accounting Standards Board (MASB) is largely converged with the International Financial Reporting Standards (IFRS). The benefit arising from this is to enable foreign investors to analyse their investments via a standardised financial reporting system in Malaysia. Financial reporting disclosure quality by the listed firms in the consumer product and service sector on Bursa Malaysia is an essential feature in the firms' financial reporting to the public. This research evaluates the development of financial reporting disclosure quality assurance by firms listed on Bursa Malaysia, by examining financial reporting disclosure quality and subsequent compliance with the International Financial Reporting Standards. This study uses a content analysis approach to identify a financial reporting standard compliance disclosure index, based the financial statements issued by firms listed on Bursa Malaysia from 2008 – 2016. A panel regression model is utilised to construct a model of financial reporting disclosure quality of the firm, based the extent of compliance with IFRS disclosure requirements from the following perspectives: corporate governance practice, audit quality and corporate social responsibility. The sustainability of financial reporting disclosure quality by the listed firms and subsequently the Malaysian capital markets will enable the same to attain a competitive edge in the international markets. In addition, this study will discuss financial reporting disclosure quality implications relevant to the policy makers in Bursa Malaysia, and it is envisaged that such model can be utilised in the improvement of future financial reporting policies.

Keywords: Financial Reporting, Disclosure Quality Model, Compliance, IFRS, Malaysia.

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1. INTRODUCTION

Converging national accounting standards with the International Financial Reporting Standards is a popular initiative around the world, starting from early 2000s. The Malaysian Accounting Standards Board (MASB) is an important regional accounting standard setter in Asia which is recognized by the International Accounting Standards Board (IASB). All listed companies are mandated to adopt the Malaysian Financial Reporting Standards (MFRS)/ equivalent to IFRS). Almost all of the Financial Reporting Standards in Malaysia are adopted from the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRSs); these standards are issued by the International Accounting Standards Board (IASB). The Bursa Malaysia and Securities Commission (SC) Malaysia have jointly launched a framework for listing and equity fund raising, which streamlines the rules and processes to provide greater certainty, shorter time-to-market and lower regulatory costs. Under the framework, the SC's review of corporate proposals will focus on, inter alia, the adequacy of disclosures to enable investors to make informed investment decisions.

As the Bursa Malaysia becomes more and more globalised, high financial reporting disclosure quality of its listed firms is essential to provide reliable information to management and stakeholders for planning and making business decisions. Financial reporting disclosure quality is also a reason to have more international investors invest in Malaysia. On 1 August 2008, the MASB announced a plan to fully comply with the International Financial Reporting Standards (IFRS) by 1 January 2012. The listed companies on Bursa Malaysia are mandated to use the Malaysian Financial Reporting Standards (MFRSs), in compliance with IFRS, starting from the 2012 fiscal year. In Malaysia, financial reporting disclosure quality is monitored by two bodies: the Financial Statements Review Committee of the Malaysian Institute of Accountants and the Financial Reporting and Corporate Surveillance Department (of the Malaysia Securities Commission). However, there is a paucity of compelling confirmation for quality assurance in financial reporting. There is no evidence to highlight any improvement in financial reporting disclosure quality and its sustainability among firms in the equity capital market. Prior research has suggested that enforcement is weak (e.g. Zhuang, 1999; Berglöf & Claessens, 2006; Okpara, 2011; Solomon, 2021). The time pattern of the financial reporting disclosure quality, to confirm the achievement of full compliance with IFRS and the subsequent benefits to the equity capital market, has also yet to be determined. In view of the foregoing, there is a need to investigate the pattern of financial reporting disclosure quality in Malaysia.

From a global perspective, a meeting of G20 Finance Ministers and the Central Bank Governors held in Moscow on 19-20 July 2013 has reiterated the call for the finalisation of accounting globalisation to promote financial market resilience. Achieving accounting globalisation not only depends on the accounting standard setters but also relies highly on the standard implementers or the firms listed on the stock markets. Hence, the financial reporting disclosure quality of a firm plays an important role to bring about accounting globalization and economic benefits to the capital market. Financial reporting disclosure quality can be observed at the national level, industry level and firm level. To achieve the financial reporting disclosure quality at the national level, financial reporting disclosure quality at the firm level needs to be consistent in the same sector of businesses.

The meaning of financial reporting disclosure quality is more qualitative than that of accounting quality. Accounting quality is mainly concerned with value relevance, whereas financial reporting disclosure quality encompasses IFRS compliance and the quality of non-accounting information disclosed in the annual reports of firms. Prior studies have been conducted on the determinants of financial reporting disclosure quality across countries, which are represented by external factors such as the political and legal environment. Such factors are opportunities and threats to the firms and are beyond their control. A study on disclosure quality at the firm level is, hence, more specific, and is essential towards achieving accounting internationalisation.

This research focuses on the companies in the sector of consumer products and services listed on the market of the Bursa Malaysia. The research objective is to construct a model of financial reporting disclosure quality of the firms with reference to corporate governance practice, audit quality and corporate social responsibility by using content analysis and panel regression model analysis.

2.   LITERATURE REVIEW

2.1   IFRS compliance as a measure of financial reporting disclosure quality

The term "financial reporting disclosure quality" is vague and without a specific definition. However, financial reporting disclosure quality has been linked to information usefulness for investors (Beest et al., 2009; Ashford, 2011; Cascino et al., 2016) and value relevance (Barth et al., 2008; Daske et al., 2008; Armstrong et al., 2009; Badu & Appiah, 2018), whereby the latter is described as "*the ability of financial statement information to capture or summarise information that effects share values*" (Hellstrom, 2006, p.325). High quality financial reporting provides superior firm-specific information that reduces information asymmetry and limits agency conflicts through improved external monitoring. At this point, we review past methods used to measure disclosure quality at the firm level. Kothari et al. (2005) and Mouselli et al. (2012) noted that accrual measures could be used to measure financial reporting disclosure quality. Barth et al. (2008) measured financial reporting disclosure quality using matrices pertaining to value relevance, loss recognition on a timely basis and earnings management. Since IFRS are concept-based accounting standards, the accounting accrual ratio was also used to improve the measurement of disclosure quality (Dechow & Dichev, 2002; Leuz et al., 2003; Richardson & Tuna, 2020). Moreover, higher audit fees can indicate the restatement of financial reports and can also be used to assess the quality of financial reporting of a firm. Therefore, the audit fees ratio index has also been used as a determinant of financial reporting disclosure quality, consistent with Tang (2008), Bala et al. (2018) and Shakhatreh et al. (2020). Lantto and Shalström (2009) used key financial indicators as proxy indicators to measure a firm's financial reporting disclosure quality.

In view of the foregoing, the determinants of financial reporting disclosure quality vary due to a complex interaction of different factors, which makes it difficult to measure across countries, especially in developed and emerging markets. However, financial reporting disclosure quality and compliance with IFRS have been noted to have an impact on key financial ratios, consistent with that noted by earlier studies (Hope et al., 2005; Ding et al., 2006; Jones & Higgins, 2006; Barth et al., 2008; Balsari et al., 2010; Rad & Embong, 2013; Dayanandan et al., 2016; Neel, 2017).

Hence it is possible and likely for compliance with IFRS, therefore, to become a proxy for financial reporting disclosure quality.

Support for this can be found in the similar relationships between IFRS compliance and financial reporting quality with capital market benefit. For example, it had been noted that the general market liquidity increased when the IFRS was first introduced, leading to a reduction in cost of capital and a corresponding increase in equity valuation. In other words, only countries which demonstrate compliance with IFRS experienced capital market benefits (Daske et al., 2008). At the same time, there had been studies which noted that higher quality financial reporting also reduces the cost of capital (Leuz & Verrecchia, 2000; Francis et al., 2004; Daske et al., 2008; Habib et al., 2019) and is further positively associated with capital resource allocation efficiency (Sun, 2005; Bushman et al., 2011).

Another point to support the use of IFRS compliance as a proxy for financial reporting disclosure quality lies in the study of Devalle et al. (2010) which noted that the value relevance of accounting data can be linked to IFRS compliance.

In summary, the firm's financial reporting disclosure quality, if IFRS has been adopted, is assessed by analysing the annual reports with IFRS terminology disclosures (both mandatory and voluntary). Thus, working definition of financial reporting disclosure quality for this study is as follows:

Financial reporting disclosure quality can be defined as the firms' compliance with the IFRS mandatory disclosure requirements and the disclosure thereof together with other compulsory requirements, corporate social responsibilities, and voluntary disclosures in their annual reports.

The measurement of IFRS compliance as a determinant of financial reporting disclosure quality can be viewed from two perspectives: firstly, studies on the compliance of national accounting standards with IAS/IFRS; secondly, literature on the level of compliance with IAS/IFRS disclosures by financial reports at the firm level. An example of the former is Qu and Zhang (2008) who focused on the methodology for measuring accounting convergence; the level of accounting harmonization/convergence between the existing 33 Chinese National Accounting Standards and the IFRS was measured. Qu and Zhang proposed a new method of matching and fuzzy clustering analysis to assess the convergence progress of the Chinese National Accounting Standards (NAS). The results revealed that their new method could measure the convergence level of NAS with IFRS in a clearer and more informative way. Their study noted the overall level of compliance with IFRS requirements by the national accounting standards of China, but did not examine the individual level of IFRS compliance by firms.

At the firm level, studies have examined the level of compliance with IFRS mandatory disclosure requirements of cross-listed companies (e.g. Carlin & Finch, 2010). To measure disclosure quality, Carlin and Finch (2010) applied self-constructed indices based on selected IFRS utilised in company annual reports. Average compliance scores for the period 2005-2007 were noted to be 63% for the emerging markets. Malaysia's compliance level was noted to be only 26% as of 1999, which improved to 59% in 2003 (Hassan et al., 2009).

2.2 Past empirical studies on IFRS compliance, corporate governance and audit quality

Past literature has found that strong corporate governance leads to a higer level of accounting disclosure and better compliance with IFRS (e.g. Chen & Rezaee, 2012; Verriest et al., 2013), as it is an effective enforcement mechanism for compliance (Juhmani, 2017). However, Chen and Cheng (2007) in their studies for China noted that corporate governance had not made a significant contribution towards the harmonisation of Chinese accounting practices with that recommended by the IFRS.

As for audit quality, it has been generally found that a firm's compliance with IFRS disclosure requirements is significantly related to it being audited by a firm with international affiliation or a Big Four auditor (e.g. Stokes & Webster, 2010; Ebrahim, 2014; Bepari & Mollik, 2015). In particular, Stokes and Webster (2010) noted that having a Big 4 auditor provides greater assurance of IFRS enforcement and implementation.

Some studies examined both audit quality and corporate governance as multiple factors in influencing IFRS compliance. For instance, Chen and Rezaee (2012) found that effective internal corporate governance enables companies to increase their level of compliance with IFRS, and that audit quality mediates that relationship. In the Malaysian and Singaporean context, Hla and Md Isa (2015) found that financial reporting quality is positively impacted by audit quality and corporate governance for non-financial listed firms from 2005 to 2013.

3. METHODOLOGY

This study is an empirical research in accounting paradigm. Qualitative and quantitative methods are applied in this study to investigate the financial reporting disclosure quality of firms listed on the Bursa Malaysia, from the consumer products and services sector. The consumer products and services sector was selected because past findings have shown that companies in these sectors have not shown good compliance with MFRS.

Sampling method applied in this research is systematic random sampling; annual reports of listed companies in the Consumer Products and Services sectors were collected. Companies that had no data for 10 years (due to the fact that they were only listed after 2008), and non-actively trading companies, were excluded. The final sample size totalled 52, representing 65% of the sector. These companies were already listed in the early 2000s, are actively trading and have readily available market information. Nine years' of data (2008 – 2016) were collected for each company from Thompson data stream.

Financial reporting disclosure quality is postulated as an impact of good corporate governance, transparency and corporate social responsibility. This study investigates the improvement of financial reporting disclosure quality of the firms and identifies the determinants of the development of their financial reporting disclosure quality, based on the theoretical framework of financial reporting represented by the agency and stakeholder theories.

The financial reporting disclosure quality development is also analysed. Time series regression analysis is used to interpret and predict the developments of financial reporting disclosure quality of the firms in the Bursa Malaysia throughout the period from 2008 to 2016. The measurement attributes are based on the disclosure requirements of International Financial Reporting Standards adopted by MASB; and commonly applied in their annual reports by the listed companies in the consumer products and service sector. Financial reporting disclosure quality is measured by content analysis of the notes to the financial statements in the annual reports, via a qualitative analysis software, Nvivo10. The qualitative information and disclosure in annual reports are matched with accounting standard disclosures of commonly used international financial reporting standards.

The relevant scores are then manipulated by using the model (Eq.1). The level of financial reporting disclosure quality is assessed and the improvement pattern of financial reporting disclosure quality from 2008 to 2016 is examined to test the hypothesis. The following models are applied to test the above-mentioned hypothesis and achieving the particular objectives of this study.

Model 1: The first model is to measure the financial reporting disclosure quality of firms; this extends the ideas drawn from the literature review (Tang, 2008; Dechow et al., 2003).

$$FRDQ_{it} = \frac{\sum_{j=1}^{14} Dis_{jt}}{S} \tag{1}$$

where: $FRDQ_{it}$ is the financial reporting disclosure quality of firm *i* at year *t;*

$\frac{\sum_{j=1}^{14}(Dis_{jt})}{S}$ is the mean value of IFRS compliance disclosure index of firm *i* at year *t;*
S is the total number of accounting standards equivalent to IAS/IFRS applied in a firm annual report. A high value $FRDQ_{it}$ means a high level of financial reporting disclosure quality of firm *i* at year *t.*

The second method is to determine the trend of financial reporting by the firms in Malaysia. Model 2 shows the time pattern of the improvement of financial reporting disclosure quality and is as follows:

Model 2:
$$FRDQ_t = f(FRDQ_{t-1}, FRDQ_{t-2}, FRDQ_{t-3}, - - -, FRDQ_{t-n}) + e_t \tag{2}$$

Where: *n* is the total number of years.

$FRDQ_{it}$ is denoted as the financial reporting disclosure quality of firm *i* at time *t*, which is a function of the financial reporting disclosure quality in a lagged time period. It employs the projection theorem and tests the linear trend.

The third model (Eq.3) includes the determinants of financial reporting disclosure quality in an optimal model of high-quality financial reporting. Panel regression analysis method is applied to test the financial reporting disclosure quality and its association with audit quality, corporate governance and corporate social responsibility.

Model 3:

$$FRDQ_{it} = \alpha_1 + \beta_1 AuditQ_{it} + \beta_2 CorGov_{it} + \beta_3 CSR_{it} + \varepsilon_{1it} \tag{3}$$

where:
$FRDQ_{it}$ represents the financial reporting disclosure quality of firm *i* at time interval *t*. Similarly; $CorGov_{it}$ is corporate governance practice and CSR_{it} is corporate social responsibility level of firm *i* at time *t*. $AuditQ_{it}$ is the proxy for audit quality of firm *i* at time interval *t*.

The measurement of audit quality is based on DeAngelo (1981) who noted that large auditors are more reputable, and therefore tend to endeavour to issue accurate audit reports. This was concurred by Khurana and Raman (2004) who noted that fear of litigation exposure was the main factor behind the motivation to provide a high quality audit by Big Four auditors. This study thus focuses on the audit quality measures based on whether a firm is audited by a Big Four firm and content analysis of the external audit report.

As for corporate governance, the current study uses the measures of corporate governance practices based on corporate governance activities disclosed in the annual reports (Hla & Md Isa, 2015). Hopkins (2005) stated that corporate social responsibilities of a company are measured based on the Sustainable Asset Management (SAM) Research's sustainability Assessment defined by Price Waterhouse Coopers, the indicators are based on (i) sustainability reports, (ii) environmental reports, (iii) health and safety reports, (iv) social reports, (v) annual reports, (vi) special reports such as corporate governance, research and development, employee relations, (vii) all other sources of company information such as documentation, brochures and websites. The measurements of corporate social responsibility of a company comprise in the current research based on the content analysis on the first four measures disclosed in the annual reports of the firms.

4. FINDINGS AND CONCLUSIONS

Table 1 below presents the results of the analysis:

Table 1: Pooled Regression Estimation

Coefficients	Estimates	Std errors	t value	Pr
Cons	0.58556	0.02667	21.96	0.000
CorGov (Corporate Governance)	-0.19601	0.05476	-3.58	0.000
AuditQ (Audit Quality)	-0.02318	0.0155	-1.5	0.173
CSR (Corporate Social Responsibility)	-0.03397	0.01839	-1.85	0.000
Multiple R sq.	0.122			
F-Statistics	74.54 on 3 and 412 degree of freedom			
P-value	<0.0000			

From the p-values of the explanatory variables in Table 1, it is clear that the variables corporate governance, audit quality and corporate social responsibility are associated with the financial reporting disclosure quality at a significance level of 1 per cent; R-square of this model represents a good model fit. All variables show negative coefficients in the model. In other words, it appears that corporate governance, audit quality and corporate social responsibility are negatively associated with financial reporting disclosure quality in terms of IFRS compliance over the past 9 years. The negative sign might be due to the adaptation of MFRS after the adoption of IFRS in their financial reporting in the earlier 2000's. The findings indicate that eventhough the observed firms implemented the MFRS, they practised lower compliance with IFRS disclosure requirements, while maintaining good corporate governance practices, high quality audits and good corporate social responsibility disclosure. In the area of financial reporting, the firms adopted IFRS since 15 November 2009 and full compliance with IFRS was met in 2012.

The fixed-effects model is designed to study the causes of changes within a firm. A time-invariant characteristic cannot cause such a change, because it is constant for each firm (Kohler & Kreuter, 2009).

Table 2: Fixed Effects Regression Model Estimation

Coefficients	Estimates	Std errors	t value	Pr
Intercept	0.61536	0.03925	15.68	0.000
Corporate Governance	-0.23266	0.04582	-5.08	0.000
Audit quality	-0.01457	0.02491	-0.59	0.559
Corporate Social Responsibility	-0.05696	0.01227	-4.64	0.000
Multiple R sq.	0.149			
F-Statistics	24.06 on 3 and 412 degree of freedom			
P-value	<0.0000			

The result of the fixed effects model (Table 2) resembles that of the pooled regression model. The variables corporate governance and corporate social responsibility remain significantly different from zero at the 1% level; audit quality found to be not significant. However, the overall financial reporting disclosure quality model continues to hold significant with p-value of F-statistics at 1 per cent significance level.

Table 3: Random Effects GLS Regression Model Estimates

Coefficients	Estimates	Std errors	z value	Pr
cons	0.60715	0.03292	18.44	0.000
Corporate Governance	-0.22066	0.04222	-5.23	0.000
Audit quality	-0.01676	0.01785	-0.94	0.348
Corporate Social Responsibility	-0.05341	0.01199	-4.45	0.000
R-sq: within	0.1491			
between	0.1254			
overall	0.1198			
Wald chi2(3)	77.32			
P-value	<0.0000			

The random effects model results are similarly significantly to that of the fixed effects model. Although the audit quality variable remains insignificant; the financial reporting disclosure quality with corporate governance and corporate social responsibility are significant at less than 1 per cent level. Hence, this study can conclude that the corporate governance and corporate social responsibility are key determinants of financial reporting disclosure quality.

Each of the two models comprise three estimators with different properties depending on the correlation between the error term and regressors. The random effects estimator would be more consistent and efficient if the said effects are uncorrelated with the explanatory variables. If the effect is correlated with the explanatory variables, the fixed effect estimator is consistent and efficient. Hausman test is applied to test the null hypothesis which is that the random effects model is preferred while the fixed effects model is the alternative. In other words, it tests whether the unique errors are correlated with the regressors; the null hypothesis is that they are not (Kohler & Kreuter, 2009).

Table 4: Hausman Test

	Fixed	Random	Difference	S.E
Corporate Governance	-0.23266	-0.220659	-0.012001	0.017829
Audit Quality	-0.01458	-0.01676	0.00218	0.017378
Corporate Social Respobsibility	-0.05696	-0.053409	-0.003551	0.002555
T Chi2	2.93			
Prob>chi2	0.4019			

The results of the Hausman test indicates that the p-value of Chi-squared is greater than 0.05 and the null hypothesis is to be accepted; therefore, the random effects model is more appropriate. Random effects assume that a firm's error term is not related to the predictors and the rationale behind random effects model is that the variation across firms is assumed to be random and uncorrelated with the error term to predictors or independent variables included in the model.

The findings conclude that the financial reporting disclosure quality has significant negative relationships with corporate governance, audit quality and corporate social responsibility. The inference is that listed firms in the consumer products and service sector are more focused on accounting standard applications and less on the disclosure quality of IFRS compliance in their financial reporting, while maintaining good levels of disclosure of good corporate governance practices, audit quality and corporate social responsibility.

These findings are not consistent with the prior research conducted by Hla and Md Isa (2005), who noted that audit quality and corporate governance had positive impacts on financial reporting quality. The reason for this is that the aforesaid study was conducted for the whole Malaysia and the time period was also different to the current study. The difference in findings suggest that companies in different sectors may vary in their financial reporting disclosure quality, and this could be an area of future research.

The contribution of this research lies in the development of a financial reporting disclosure quality index for firms in Malaysia, which can be utilised by setters of accounting standards (MASB in Malaysia) to assess and improve companies' convergence with globalised accounting standards. It

is also envisaged to be an important tool for the accounting standard regulator (Bursa Malaysia) in the development of financial reporting policies for the safeguarding of the investment community. It can also be utilised by international investors and stakeholders for business decision-making. The findings of this study could increase firms' awareness of the significant determinants of financial reporting disclosure quality, which would then enable them to improve not only on disclosure quality, but also on the associated factors audit quality, corporate governance, and corporate social responsibility. These in turn support business sector development which contributes to the good image of the Malaysian economy and attract more international investors. As the sustainability and quality of financial reporting is established, the listed firms and subsequently the Malaysian capital markets are able to attain a competitive edge in the international markets; this promotes further capital inflows into Malaysia.

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