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FACTORS INFLUENCING THE TIMING OF ADOPTION OF FINANCIAL REPORTING STANDARD (FRS) 121 IN MALAYSIAN COMPANIES

BY

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A thesis submitted in partial fulfilment of
the requirements for the degree of Masters of Science in Accounting

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ABSTRACT

Financial Reporting Standard 121 The Effects of Changes in Foreign Exchange Rates (FRS 121) replaces FRS 121_{2004} The Effects of Changes in Foreign Exchange Rates (previously known as MASB 6) and has been enforced for annual periods beginning on or after 1st January 2006. The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements. Primarily this concerns the accounting for foreign currency transaction and translation for financial statements which are influenced by financial and non financial factors. Hence, the main purpose of the study is to analyze timing of adoption of FRS 121 by Malaysian companies and to examine whether financial characteristics (i.e. firms size, leverage, management compensation, profitability and growth) of the firm has influence in the timing of adoption. Equally the study also tends to discover whether non financial factors like corporate governance, auditor effects do influence the firms accounting policy choice. The responsiveness of the firm towards the standard FRS 121 was captured by examining the annual accounts of the year 2005, 2006 and 2007. T-Test and Regression was basically used to see whether various factors selected for the study have statistically significant relationship with timing of adoption. It was found that only 2 companies out of 84 companies early adopted FRS 121. Hence the study was extended on the amendments of FRS 121 where by 20 companies out of 84 companies early adopted. It was also found that factors of, firm size, growth and auditor effects provide a statistically significant result on the firm's timing of adoption of FRS 121.

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APPROVAL PAGE

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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 the IIUM or other institutions.

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LIST OF ABBREVIATIONS

IFRS	International Financial Reporting Standard
FRS	Financial reporting Standard
FX	Foreign Exchange
MASB	Malaysian Accounting Standard Board
UK	United Kingdom
SSAP	Statement of Standard Accounting Practice
IAS	International Accounting Standard
SFAS	Statement of Financial Accounting Standard
GAAP	Generally Accepted Accounting Principles
et al.	(et alia); and others
e.g.	For example
etc.	*(et cetera)*: and so forth
PSAK	Pedoman Standar Akuntansi Keuangan
IOS	Investment Opportunity Set
GO	Growth Option
USA	United States of America
KLSE	Kuala Lumpur Stock Exchange
CPA	Certified Public Accountants
CEO	Chief Executive Officer
i.e.	That is
AIP	Asset in-Place
df	difference in freedom

CHAPTER 1

BACKGROUND OF THE STUDY

1.1 INTRODUCTION

Accounting for the translation of foreign currency is a topic that has received a great deal of attention from the various accounting standard-setting bodies recently. The attention given to this topic is a natural result of the phenomenal increase in international trade that has taken place. A number of papers have analysed factors affecting the timing of a firm's adoption of the new standard and the economic impact on the firm value (eg. Iatridis and Joseph (2006), Schneider, Kohmeyer, & Reiman (2008), Astami and Tower (2006)). Others have examined the extent to which the new requirements of the standard succeed in improving the quality of publicly available information. Many studies like El-Gazza and Jaggi (1997) also examined management motivation for the timing of adoption (late versus early) of mandatory changes from different perspectives such as earnings management, political cost or legal proceedings against the firm for its pricing policies, avoiding the cost of debt covenants violations and reduction of compliance cost.

The issue is more problematic when countries adopt foreign accounting standards which are not directly applicable due to the differences in accounting systems between the standard setting country and the standard adopting country. That is because accounting is a socio technical activity and one cannot divorce accounting from an accountant. In other words, the accounting standards reflects the society and the organisation in which it operates. Therefore adopting a foreign accounting

standard does not provide the solution which it intends. The issue is more visible among developing countries. Mir and Rahaman (2004) state that:

> Developing countries continue to adopt foreign accounting and educational systems. This is often expensive, and the adopting country has little control over the relevance of imported accounting. The biggest problem developing countries have is that of too many foreign "experts" marketing half-baked solutions to problems that neither they nor the recipient nations understand.

Therefore, having local standards may be a good strategy in resolving issues of adoption of foreign accounting standards specially on the complicated issues like foreign currency translation. Thus is the process of expressing amounts denominated in one currency in terms of a second currency, by using the exchange rate between the currencies. Assets and liabilities are translated at the current exchange rate at the balance sheet date. Income statement items are typically translated at the weighted-average exchange rate for the period.

Iatridis and Joseph (2006) argue that translation/accounting exposure arises from the need to convert the foreign currency denominated financial statements of a parent firm's subsidiaries into home currency for reporting and consolidating purposes.

According to IFRS 21, the foreign currency translation measures all transactions, assets and liabilities in its functional currency and an entity can choose to present its financial statements in a currency other than its functional currency. (This could be for the purpose of stand-alone financial statements or because the financial statements are included in the consolidated accounts of a reporting entity.)

Malaysia has adopted its own accounting standard for foreign currency translation which is Financial Reporting Standard 121 (FRS 121). Financial Reporting Standard 121 "The Effects of Changes in Foreign Exchange Rates" (FRS 121)

replaces FRS 121_{2004} "The Effects of Changes in Foreign Exchange Rates" (previously known as MASB 6) and has been enforced for annual periods beginning on or after 1st January 2006. The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. The principal issues are (1) which exchange rate(s) to use and (2) how to report the effects of changes in exchange rates in the financial statements. Primarily, this concerns the accounting for foreign currency transactions and translation for financial statements. FRS 121 has been developed based on IAS 21 and follows similar characteristics.

FRS 121 basically requires an entity to determine its functional currency and to measure its results i.e. income statement, and financial position i.e. balance sheet in the functional currency. It also allows an entity to present its financial statements using any currency. However, for financial statements presented in Malaysia, FRS 121 requires the presentation currency to be Ringgit Malaysia. Therefore, if an entity that enters into a transaction that is denominated in a currency that is not its functional currency, it will have to account for foreign currency translation. Moreover, if an entity's financial statements are to be presented in a currency that is not its functional currency, it will have to translate its financial statements. In a group scenario, if the subsidiary and associated companies present their financial statements in a currency other than the parent company's presentation currency, the parent company will have to translate financial statements of subsidiaries and associated companies.

FRS 121 defines an entity's functional currency as the currency of the primary economic environment in which the entity operates. It further explains that the primary economic environment in which an entity operates is normally the one in

which it primarily generates and expends cash. Multinational firms might be more exposed to the risk of foreign exchange differences (Pinto, 2005). Therefore, translation or accounting exposure arises from the need to convert the foreign currency denominated financial statements of a parent firm's subsidiaries into the home currency for reporting and consolidating purposes.

The Malaysian FRS 121 requires firms to recognise foreign exchange (FX) differences arising when (1) monetary items are settled or (2) when monetary items are translated at rates different from those at which they were translated when initially recognized or (3) in previous financial statements to report in profit or loss in the period with one exception. The exception is where gains or losses of non monetary items are recognised in equity, any exchange components of that gain or loss are also recognised in equity. On the other hand, exchange differences arising from translating functional currency into presentation currency are recognized as separate components of equity. In addition to that the amendments to FRS 121 by 15th February 2007 require exchange differences on monetary items that form part of the net investment in a foreign operation to be recognised in equity instead of in income statement regardless of the currency in which these items are denominated.

Prior literature has argued that the recognition of FX differences in income statement would lead to volatile incomes and earnings figures. The location of translation differences in the financial reports has important implications for a firm's performance and stock returns (Iatridis and Joseph, 2006). These include the action that managers might take to mitigate any adverse financial effects and stock market response that might be related to a change of accounting policy as well as their decisions to adopt or defer the adoption of the related accounting regulation.

Positive theories of accounting choice make several empirical predictions regarding managerial behaviour in the presence of financial incentives and accounting change (Iatridis and Joseph, 2005). A useful implication of the work in this area is whether a particular accounting method/rule has real economic consequences such that users of accounting information, who are exposed to the new accounting rule, revalue a firm's stock. The economic consequences of alternative accounting methods have been taken to include not only the impact of accounting change on cash flows, but also the impact of accounting change on political cost and contractual arrangements. Therefore, managers' decision making is closely dependent upon the economic and market conditions that prevail within the market place at a given time period. It follows that movements in FX rates can significantly affect their behaviour and accounting policy choice.

An assessment of the interpretation of managerial behaviour on accounting policy choice due to the impact on a firm's value in general suggests that the timing of adoption is closely related to the financial characteristics of the firms. The underlying assumption is that costly contracting theory is a pull factor for managers to behave opportunistically and is closely related to the timing of adoption. This implies that firms tend to adopt a standard when its adoption is likely to result in minimal adverse economic and political consequences (Iatridis and Joseph 2006).

In turn this suggests that it is the corporate governance mechanism that facilitates the flexible accounting structure with which managerial discretion plays an important role to be recognised when factors related to accounting standards are taken into account. Goodwin and Sew (2002) state that sound governance by the board of directors is recognised as influencing the quality of financial reporting and should reduce the adverse effects of earnings management as well as reducing the likelihood

of misstatements arising from fraud or error. The study further states that in any corporate governance regime auditors and directors should have considerable influence over the accountability of management and the integrity of financial reporting. That is because directors are in a position to set the tone from the top with regard to strong governance in their companies. External auditors through their interaction with the audit committee and the management are able to influence the internal controls and integrity of financial reporting.

1.2 OBJECTIVES OF THE STUDY

The purpose of the study is to analyse the timing of adoption of FRS 121 by Malaysian companies and to examine whether financial characteristics of the firm have an influence in the timing of adoption. Financial characteristics of the entities can be described as those attributes of the entities which are basically related to the company's reported result or performance. Therefore, factors like firm size, leverage, the manager's compensation scheme and profitability can be concluded as the financial characteristics of an entity. The paper also tends to discover factors other than the financial characteristics of firms which might have influenced the timing of adoption of accounting standards and so in the adoption of FRS 121. Therefore, the role of the audit committee, which is an important aspect of corporate governance has been considered for the study. In addition to that the effect of the external auditor on the accounting policy choice are examined as a one of the non financial factors in the firm's accounting policy choice.

1.3 RESEARCH QUESTIONS

Based on the research objectives discussed in the previous section, the following research questions have been developed.

- What is the response of the companies like towards FRS 121?
- Do companies adopt FRS 121 before effective date or after effective date?

Additionally, the study also examines the factors which differentiate between companies which adopt FRS 21 within the effective date and companies that adopt FRS 121 late. Specifically, the following research questions have been developed.

- What are the financial characteristics of companies that have influenced the timing of adoption of the new regulation, FRS 121?
- Are there factors other than the financial characteristics (i.e. corporate governance, auditor effects) of the firm that influence the timing of adoption of FRS 121?

1.4 MOTIVATION OF THE STUDY

It is generally believed that the timing of adoption tends to vary from firm to firm. Empirical studies have shown that firm's tend to adopt when the adverse economic consequences of the adoption are likely to be minimal. They also appear to defer the adoption of the standard to influence their financial performance and hence, to achieve certain corporate financial objectives (eg. Iatridis and Joseph, 2006). This implies the managerial discretion over accounting policy choice as managers are accountable for the firm's missions and visions. In turn, this implies that financial characteristics are more closely attached to the discretion of managers and hence the timing of adoption. Therefore, I believe that empirical evidence "capitalise" on the understanding and

hence influences me to identify the firm's behaviour and reaction towards FRS 121 inclusive of the factors influencing the timing of adoption.

1.5 SIGNIFICANCE OF THE STUDY

This study may be of significance for standard setters and stakeholders, particularly potential investors, and managers. The study may provide useful information for standards setters which can be considered when they prepare for a change in the accounting regulation or set an appropriate date for the implementation of an accounting standard. It may also provide an insight into a firm's objectives and the potential attitude and reaction to the issues of accounting standards. Therefore, it may explain the behaviour of the firms with the associated impact of the financial markets and regulations on the firm's decision making process. The study also formulates the basis for studying a firm's behaviour and reaction with regard to the adoption of new accounting regulations.

On the other hand the study may have significant implications for auditors and professional accountants and analysts. It has been argued by the prior studies that the adoption of accounting choice is closely related with the auditor's perceptions of the post effects of the standards. Simon and Costigan (1996) states that, auditor identity is a variable that should be considered in studies of accounting policy choice. Hence, changing accounting policy choice sometimes provides a general idea for auditors to acknowledge the firms behaviour for the opinion they provide. It enhances the test of the auditors in the area of changing accounting policy choice which, in turn, may increase the credibility of the qualification they provide.

1.6 OUTLINE OF THE STUDY

This study consists of six chapters including this chapter. Chapter two provides a theoretical consideration of foreign currency translation that covers the concepts of foreign currency translation and the requirements of FRS 121 with the main changes of FRS 121_{2004}. Chapter three reviews prior studies regarding the timing of adoption of accounting standards in general and specifically on foreign currency translation issues. The chapter also discusses some of the factors which have been tested by the previous literature that influence the timing of adoption of accounting standards. Chapter four states the research methodology that provides the hypotheses developed for the factors affecting the timing of adoption of accounting standards, variable measurement, data and sample selection. Chapter five provides the data analysis which basically presents and interprets the findings of the statistical tests performed on the data. Finally, chapter six covers the summary of the study, its limitations and recommendations for future research.

CHAPTER 2

CONCEPTS OF FOREIGN CURRENCY TRANSLATION

2.1 INTRODUCTION

This chapter explains the theoretical concepts relating to foreign currency translation and its impact on the company which plays a wider role in the adoption of accounting standards for foreign currency translation based on the prior studies. The chapter is organised as follows: First, it explains the concepts of translation. This section provides a general discussion regarding FX translation and a review of the recognition and reporting issues of FX differences. Secondly, it presents the main changes brought about by the FRS 121 based on the standard. Thirdly, it discusses the recognition and reporting requirements of FRS 121. Lastly, the conclusion of the chapter is presented.

2.2 CONCEPTS OF TRANSLATION

The objective of accounting translation should be to report foreign held resource value after translation in the context of the economy in which it will be employed to generate a stream of future earnings since it is this earnings stream which is to be predicted. Because of the fundamental changes in the conduct of international operations for most foreign held resources this economy will be the foreign economy and not the home country economy since it is intended that most of these resources will remain abroad. For these resources translation should involve only a change in the currency in which the financial information is stated and not a change of the context of the information.

Accounting for foreign operations and transactions has taken many forms throughout history. Basically, translation adjustments arise when firms enter into transactions which are denominated in a currency other than their functional currency. In accounting for foreign currency transactions and translation of financial statements, the two accounting issues arise. In both situations the main concern is which the exchange rate is to be used for translation and how to deal with exchange differences arising therefrom.

Due to changes in exchange rates, a question arises as to which exchange rates should be used to translate the various items in financial statements. It has been seen that the objectives of the accounting for FX are to provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity. However, accounting for FX differences has been the subject of much debate between financial statement users, regulators, accountants and academics for many years (Pinto, 2005). This is because movements in foreign exchange rates can adversely impact on the company's reported results especially when operating internationally. The size and sign of translation gains and losses are closely linked to the FX rate fluctuations, which involve an element of risk and uncertainty and which have an economic impact on the firm's future cash flows. That could be due to the provision of the requirement to recognize immediately all gains and losses from foreign currency rate changes in the income statement, whether realised or unrealised.

The concern of the critics is that such a provision unnecessarily increased the volatility of reported earnings. The foreign exchange gain or loss component of earnings is not, however, a simple unambiguous number, measured identically across all firms. First, it is a mixture of realised and unrealised gains and losses, some of

which may be a consequence of remeasuring foreign currency financial statements and others a result of converting foreign cash, receivables, and payables into dollars. Gains and losses from forward contracts, for example, may be significant for one firm but not for another. Moreover, gains and losses properly included in certain revenue and expense accounts for some firms (notably, banks) may for practical reasons be incorporated into the reported exchange gain or loss item for others. Finally, the exchange gain or loss item is usually calculated as a reconciling item.

The foreign exchange gain or loss item is the difference between net income and that number which results from having translated the various other revenue and expense accounts at the appropriate exchange rates. In other words, the exchange gain or loss item is fully dependent on the measurement of other expense and revenue items and, in this sense, is a 'plug' item (Meyer, 1980). Therefore, their recognition has been an issue of controversy.

Iatridis (2007) states that the location of translation losses and gains in the accounting statements have significant implications on firm’s profitability, credibility, management compensation and overall financial performance. One part of the literature argues that translation differences affect the firm’s market value and should be recognised in the income statement. In contrast, another part of literature argues that translation differences are paper gains and losses and should be recognised in the balance sheet (Soo & Soo, 1994). It has also been debated that the difference recognition in the balance sheet would tend to make the income statement more stable (Moses, 1987).

Stable earnings would strengthen the financial position of firms, assist them to meet their financial obligations and abide by the underlying debt covenants. This would, in turn, reduce the risk of financial distress and debt covenant violation and

also reinforce a firm's credibility. This could be interpreted as a positive signals for their future prospects and corporate health. The positive effects would, in turn, favourably affect the stock returns of the firms. Iatridis and Joseph (2006) state that the location of translation differences in the financial reports has important implications for s firm's performance and stock returns.

Bever and Wolfson (1982) argue that because the fluctuation in FX rates affects the firm's market value, the associated impact would be reported in the income statement. In contrast Soo and Soo (1994) show that the effects of foreign currency translation reported in the income statement lead to volatile earning and income figures. Therefore it should be treated in the balance sheet.

Louis (2003) states that the translation adjustment is added to book value simply for the sake of the double entry system, and not because of any need to record a transaction. It is further stated that the need for the adjustment is due mainly to the translation of net assets at current exchange rates.

Whatever the impact is, the accounting standard bodies and prior literature too have devised three alternatives for the issue of translation of FX; the 'current/non-current' method, the 'monetary/non-monetary' method and the 'temporal' method.

2.2.1 Current/Non- current method

The underlying principle is that assets and liabilities should be translated based on their maturity. Current assets should be translated at the spot rate while noncurrent assets should be translated at the historical rate in effect when the item was first recorded on the books.