The Impact of Financial Statement Disclosure on Conservatism in Financial Reporting: Evidence from Vietnam

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ABSTRACT

The aim of this paper is to test the impact of financial statement disclosure on conservatism in Vietnamese financial statements. I use inter-earning announcement period returns and fiscal year returns to serve as economic news reflected in earnings during the financial statement disclosure period and prior to the financial statement disclosure period. I test conservatism in financial reporting of Vietnamese listed non-financial firms over the period of 2005-2015 using the two returns measures in succession. I find that conservatism principle is only ensured within the audited financial statement disclosure period. The findings have implications for our understanding of the role of auditors as well as rules and regulations of financial statement disclosure in improving the quality of accounting information.

Keywords: Accounting, Accounting Information, Financial Reporting
JEL Classifications: M40, M48

1. INTRODUCTION

This paper examines the impact of financial reporting disclosures on conservatism, defined as the tendency of accountants to recognize bad news on a timelier basis than good news (Basu, 1997). Following Watts (2003), managers and auditors have incentives to exercise conservatism due to litigation risk aversion. Auditors' involvement in the preparation of financial statements is like an important accounting information filter for investors. Because the audited financial statements provide financial information for their making business decisions, they are literally in need of the qualified accounting information. Investors are the public eyes observing auditors' activities. They serve as the market forces to drive financial statements preparers to comply with rules and regulations of financial reporting. As a result, conservatism is predicted to be exercised in the period of audited financial statement disclosure. Moreover, Ball et al. (2003) state that, the lower the demand for disclosure in planning-oriented code-law countries, the less timeliness in incorporating economic income

in accounting income. This indirectly implies that conservatism is unlikely to be ensured in these countries before financial reporting disclosure.

Vietnam is also a planning-oriented code-law country; therefore, financial statement disclosure is predicted to impact conservatism in financial reporting. I perform empirical tests on a sample of firm-year observations over the period of 2005-2015. The results show that conservatism is ensured in intra-financial statement disclosure period, consistent with Basu (1997). On the other hand, I find that Vietnamese firms are inclined not to comply with conservatism in financial reporting unless auditors are involved in preparing financial statements. This supports the important role of auditors, as well as rules and disclosure regulations of financial reports in improving the quality of accounting information.

The paper proceeds as follows. Section 2 outlines the definition of conservatism and hypothesis. Section 3 explains research design. Section 4 presents sample selection procedures and summary

statistics. Section 5 provides results and conclusions are reached in Section 6.

2. DEFINITION OF CONSERVATISM AND HYPOTHESIS

Basu (1997) states conservatism as denoting the accountants' tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as losses. He is also the first researcher who suggests the seminal model testing conservatism in financial reporting. In particular, he tests asymmetric news recognition timeliness specification. He uses inter-announcement period returns and fiscal year returns to measure economic news reflected asymmetrically in earnings. The inter-announcement period return is calculated to end 3 months after fiscal year with the purpose of ruling out the market response to prior year's earnings. Fiscal year return is used as an alternative to exclude the market reaction to the current year's earnings announcement. Negative returns serve as proxies for bad news and positive returns serve proxies for good news. Although, Basu's tests (1997) of conservatism using different economic news measures primarily aim to check the robustness of the model, the results imply the difference in conservatism between the intra-earnings announcement period[1] and the period occurring before earning announcement.

Following Basu (1997), Watts (2003) defines conservatism as the asymmetrical verification requirements for gains and losses. He suggests that conservatism' existence is explained by contracting motivation, tax optimization, litigation risk and regulatory demands. Auditors have incentives to force managers to report conservative values for earnings and net assets due to the pressure of the expected litigation costs. In addition, financial statements mostly are audited and disclosed at the end of annual fiscal period; therefore, firms have to work with auditors in the preparation of financial statements in 3 months after fiscal year. The interval of 3 months after fiscal year is the regulated period of financial statement disclosure for Vietnamese public companies[2]. Auditors' participation in the preparation of financial statements probably leads to conservatism assurance in the financial statement disclosure period.

Ball et al. (2003) uses fiscal year returns (proxy for economic news) to conduct a test of news recognition timeliness in the code-law countries. The findings indirectly show that conservatism in these countries is not warranted due to the lower demand for disclosure. Vietnam is a code-law country; therefore, the impact of financial statement disclosure on conservatism is an empirical question. The hypothesis regarding the role of auditors as well as regulations of financial statement disclosure in enforcing Vietnamese firms to exercise conservatism in financial reporting is stated in null form.

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1   From a disclosure perspective, inter-announcement period returns are called intra-financial statement disclosure period returns measuring economic news recognized in accounting income with auditors' involvement.

2   Circular 155/2015/TT-BTC dated 6th, October, 2015 regarding information disclosure on securities markets.

H_0: There is no difference in the level of conservatism between the audited financial statement disclosure period and the period occurring before audited financial statement disclosure.

3. RESEARCH DESIGN

3.1. Measurement of Conservatism
I test conservatism with its asymmetric news recognition timeliness specification. First off, I estimate the following pooled cross-sectional regression of beginning-of-fiscal-year price deflated accounting earnings (E_{it}/P_{t-1}) on concurrent stock returns (R_{it}) to examine the timeliness of accounting earnings in response to economic news:

$$\frac{E_{it}}{P_{it-1}} = \alpha_0 + \beta_0 R_{it} + \varepsilon_{it}$$

(1)

The timeliness of earnings with respect to economic news implies a positive slope coefficient (β_0). Next, we conduct the regression separately for negative stock returns ("bad news") sample and positive stock returns ("good news") sample in succession. Conservatism implies the higher R^2 (adjusted R^2) of the regression for "bad news" sample than that for "good news" sample: That is, earnings are timelier in recognizing "bad news" than "good news."

Alternatively, conservatism is examined by the pooled cross-sectional regression of beginning-of-fiscal-year price deflated accounting earnings on concurrent stock return with dummy variable (D_{it}), which equals one for negative stock returns ("bad news"), zero otherwise.

$$\frac{E_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it} + \varepsilon_{it}$$

(2)

The asymmetric timeliness of earnings in respect of stock returns implies positive slope coefficients, β_0 and β_1: That is the sensitivity of earnings to "bad news" ($\beta_0 + \beta_1$) is greater than that to "good news" (β_0). The interactive slope coefficient (β_1) measures the difference in the sensitivity of earnings to "bad news" and "good news."

3.2. Measurement of Economic News
I use fiscal returns to measure economic news captured before financial statement disclosure. On the other hand, returns calculated to end 3 months after fiscal year are proxies for economic news purified by auditors. It is named intra-financial statement disclosure period returns.

4. DATA AND DESCRIPTIVE STATISTICS

The sample is obtained from financial statements of non-financial firms listed on Hochiminh Stock Exchange and Hanoi Stock Exchange over the period from 2005 to 2015. Earnings and stock returns, measured per share, are deflated by beginning-of-fiscal-year stock price to control heteroskedasticity. In addition,

Table 1: Descriptive statistics of key variables

Panel A: Full sample – 2393 observations					
Variable	Mean	Standard deviation	1st quantile	Median	3rd quantile
E	0.14	0.11	0.05	0.11	0.19
Intra R	0.14	0.56	−0.28	0	0.44
Fiscal R	0.19	0.63	−0.24	0.11	0.54
Panel B: Positive intra-financial statement disclosure period returns ("good news") versus negative intra-financial statement disclosure period returns ("bad news")					
	Good news			Bad news	
Observations	1,216			1,177	
Mean E	0.19			0.09	
Median E	0.17			0.07	
Mean R	0.56			−0.29	
Median R	0.44			−0.28	
Pearson correlation	0.26			0.41	
Panel C: Positive fiscal returns ("good news") versus negative fiscal returns ("bad news")					
Observations	1.401			992	
Mean E	0.17			0.08	
Median E	0.15			0.07	
Mean R	0.58			−0.36	
Median R	0.43			−0.31	
Pearson correlation	0.32			0.29	

E is beginning-of-fiscal-year deflated earnings, R is stock returns. Fiscal R is fiscal returns. Intra R is intra-financial statement disclosure period returns

I use White standard errors (1980) to compute t-statistic, called heteroskedasitcity-robust t statistic. I exclude observations falling in the top or bottom 1% of beginning-of-fiscal-year deflated earnings and stock returns to avoid the potential influence of outliers on the regression results.

Table 1 demonstrates descriptive statistics of key variables. Average and median of earnings per share are 14% and 11% of the opening stock price. Average and median of intra-financial statement disclosure period returns are 14% and 0%. The considerable difference between mean and median makes the distribution of intra-financial statement disclosure period returns sample skewed, whereas the distribution of fiscal returns sample is less skewed because average and median of fiscal returns are 19% and 11%, respectively. In Panel B of the Table 1, I decompose the full sample into positive stock return sub-sample ("bad news") and negative stock return sub-sample ("bad news") on intra-financial statement disclosure period basis. The good news sample contains 1216 observations with average beginning-of-fiscal-year deflated earnings per share and average stock return of 19% and 56%, respectively. The bad news sample contains 1177 observations with average beginning-of-fiscal-year deflated earnings per share and average stock return of 9% and −29%, respectively. The Pearson correlation coefficient of beginning-of-fiscal-year deflated earnings per share and stock return is largely higher in "bad news" sample than in "good news" sample. It implies that earnings are likely to be more sensitive to "bad news" than "good news." In Panel C, I disaggregate the sample into positive fiscal returns sub-sample ("good news") and negative fiscal returns sub-sample ("bad news"). The results are quite similar to those of Panel B except Pearson correlation coefficient. The tiny difference in the Pearson correlation coefficient of earnings and fiscal returns between "bad news" and "good news" implies that there is no asymmetric sensitivity of earnings to economic news.

5. EMPIRICAL RESULTS

Panel A of Table 2 reports the results of the regression of earnings on intra-financial statement disclosure period returns. Row (1) shows the pooled adjusted R^2 of regression (1) of 25.49%, which is substantially greater than the code-law sample R^2 of 4.63%[3]. The estimated slope coefficient of 0.1 on stock returns is significantly positive at the 1% confidence level. This indicates that Vietnam has very high timeliness. Asymmetric timeliness of earnings can be derived from the difference in adjusted R^2s of separate regressions (1) between the positive return sub-sample and negative return sub-sample found in row (2) and row (3). R^2 of the negative return sample (16.48%) is greatly higher than that of the positive return sample (6.46%). This indicates that earnings are more sensitive to bad news than good news. Moreover, the asymmetric sensitivity of earnings to economic news is revealed by the results of regression (2) given in row (4). The sensitivity of earnings to good news and bad news are 0.062 and 0.166 (0.062 + 0.104), which are significant at 1% confidence level. Taken together, the results suggest the existence of conservatism within the period of audited financial statement disclosure.

Panel B reports the regression results of earnings on fiscal returns. Although the timeliness of earnings is still showed with the high adjusted R^2 of regression (1) of 24.46% and the significantly positive slope coefficient of 0.085, there is no empirical evidence of asymmetric news recognition timeliness. R^2 of the positive fiscal return sub-sample of 10.31% is higher than that of the negative fiscal return sub-sample (8.28%). The asymmetric gain and loss recognition timeliness, as measured by the slope coefficient ($R \times D$) of 0.012, is insignificant. Consistent with Ball et al. (2003), Vietnam as well as Asian countries have no conservatism in accounting earnings in the period occurring before audited financial statement disclosure.

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3   Common-law statistics from Ball et al. (2000).

Table 2: Asymmetric news recognition timeliness

	Regression (1): $E_{it}/P_{it-1} = \alpha_0 + \beta_0 R_{it}$ ....(+) Regression (2): $E_{it}/P_{it-1} = \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it}$ ....(+)......(+)				
	Sample	α_0	α_1	β_0	β_1	**Adjusted R² (%)**
Panel A: Intra-financial statement disclosure period returns[a]						
(1)		0.123 (70.93)***		0.1 (23.26)***		25.49
(2)	$R_{it} \geq 0$ 1.216 obs	0.15 (31.25)***		0.062 (8.51)***		6.46
(3)	$R_{it} < 0$ 1.177 obs	0.135 (31.71)***		0.166 (16.02)***		16.48
(4)		0.15 (31.25)***	−0.016 (−2.45)**	0.062 (8.51)***	0.104 (8.2)***	27.78
Panel B: Fiscal year returns[b]						
(1)		0.12 (70.04)***		0.085 (22.22)***		24.46
(2)	$R_{it} \geq 0$ 1.401 obs	0.133 (32.15)***		0.072 (10.69)***		10.31
(3)	$R_{it} < 0$ 992 obs	0.114 (28.45)***		0.083 (10.97)***		8.28
(4)		0.13 (32.14)***	−0.018 (−3.27)***	0.072 (10.69)***	0.012 (1.16)	24.86

E_{it} is earnings per share for firm i at year t, P_{it-1} is stock price per share of the beginning day of fiscal year t, [a]R_{it} is stock return for firm i over the period from 9 months before fiscal year-end t to 3 months after fiscal year-end t, D_{it} is a dummy variable, equal to 1 if $R_{it}<0$, =0 otherwise. [b]R_{it} is fiscal year return. The dummy variable is redefined to match the adjustment of R_{it}. ***Significant at 1% confidence level, **Significant at 5% confidence level. Heteroskedascity-robust t-statistic is indicated in parentheses below estimated coefficients

6. CONCLUSION

This paper tests the impact of financial statement disclosure on conservatism in financial reporting in Vietnam using the sample over the period of 2005-2015. I find that asymmetric news recognition timeliness is statistically significant in the period of audited financial statement disclosure, whereas the reverse is for the period before financial statement disclosure. In sum, conservatism is only exercised as auditors involve in the preparation of financial statements and Vietnamese firms comply with the regulations of financial statement disclosure. The results provide the financial reporting standard setters and law-makers some implications of rules and regulations to improve the quality of accounting information.

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