

POLICY BRIEF

YOUNG ECONOMISTS' PERSPECTIVE

2023-12-018, DECEMBER 2023

ISSN # 2094-3342



De La Salle University

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Policy Recommendations

- 1. Reinstate accounting conservatism in the Conceptual Framework** – Our findings should be of interest to accounting standard setters, given the ongoing debate on the necessity for accounting conservatism as a characteristic for useful financial statements after its initial removal from the conceptual framework in 2010. While there are arguments that conservatism violates the neutrality of financial reports, further discussions show that conservatism can give a more faithful representation of firm performance (Cooper, 2015; International Accounting Standards Board, 2018). Given this, our study provides further evidence from an emerging market that the demand for conservatism is possibly caused by weak corporate governance, poor financial reporting quality, and rampant information asymmetry. In turn, this suggests that accounting conservatism is essential in providing useful financial reports and is especially applicable to investors facing informational disadvantages, such as in the case of foreign investors. Hence, our findings support the idea of considering the reinstatement of conservatism in the conceptual framework.

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2. Increase foreign equity participation in the Philippines – Our findings may also aid Philippine policymakers who seek to increase the country’s inflow of foreign capital and amend current policies on foreign equity participation. Our results provide evidence that the presence of foreign investors may be a main driver to encourage companies to improve transparency, lessen information asymmetry, and prevent managers’ opportunistic behaviors by demanding for more conservative reporting, which in turn increases the quality of financial reporting. As such, our results provide evidence in support of the recent amendments to the FIA and PSA, which now allow 100% foreign equity participation in certain sectors as opposed to the long-standing 40% foreign equity participation, for two reasons: (1) These amendments give an opportunity for more foreigners to be on the board of directors. Given that a foreigner may be elected as a director in proportion to their allowable shares in accordance with Section 2-A of the Anti-Dummy Law (Securities and Exchange Commission, 2015), such an amendment implies that more foreign directors can be elected in Philippine corporate board since the increase in foreign equity participation in certain sectors will allow an increase in foreign investors’ proportion of allowable shares; and (2) The increase in foreign equity participation from 40% to 100% in certain sectors allows more firms to cross this 50% foreign ownership percentage and encourages the presence of foreign majority shareholders. Hence, by allowing the presence of foreign majority shareholders in more sectors, this may eventually influence firms to report more conservatively and increase the quality of financial reporting.

Introduction

Many countries across the world, including the Philippines, have become increasingly aware of the importance of foreign capital given the liberalization of capital markets and the integration of the global economy (Khalil *et al.*, 2020). However, foreign investors may still hesitate to invest in the Philippines due to the informational disadvantages that come with investing in a different country as well as the Philippines’ weak corporate governance mechanisms and compliance-driven disclosures and reports (Asian Development Bank, 2019; Ferreira *et al.*, 2017; Khalil *et al.*, 2020). Consequently, foreign investors demand more high-quality financial reporting (Asiriwa *et al.*, 2019; R. Shubita & M. F. Shubita, 2019). Accounting conservatism plays a crucial role in

providing this due to its tendency to require more stringent verification when recognizing economic gains over losses (Watts, 2003). In this light, this paper aims to study if foreign investor presence drives accounting conservatism in the case of the Philippines.

Methodology

We study the relationship between foreign investor presence and accounting conservatism using a final sample consisting of 2,025 firm-year observations for non-financial and frequently traded firms listed in the Philippine Stock Exchange (PSE) from 2010 to 2019 using standard panel regression. Accounting conservatism is proxied by a market-based and an accrual-based measure of conservatism, which are the Khan and Watts (2009) and Ball and Shivakumar (2005) measures, respectively. Foreign investor presence is proxied by foreign ownership, substantial foreign ownership at the 10%, 20%, and 50% levels, and foreign shareholder board representation. We also include firm size, market-to-book ratio, leverage ratio, firm age, volatility, investment cycle, and the presence of Big 4 auditors as control variables.

Empirical Results

- 1. Substantial foreign ownership at the 50% level and accounting conservatism** – The positive relationship between the presence of substantial foreign ownership over 50% level and accounting conservatism implies that firms are more likely to report conservatively in the presence of a foreign majority shareholder as Le *et al.* (2017) posits that the degree of substantial foreign ownership can influence the demand for conservative reporting only when it reaches a certain percentage. Thus, our result implies that the presence of foreign majority shareholders drives accounting conservatism in the Philippines. Consistent with the active monitoring and informational asymmetry hypotheses, our result suggests that foreign majority shareholders in the Philippines tend to invest in a longer horizon. Hence, they are incentivized to strictly monitor management to mitigate informational disadvantage by demanding for more conservative reporting (Ang & Ma, 1999; Ball *et al.*, 2000; Sachs & Warner, 1995).

2. **Foreign shareholder board representation and accounting conservatism** – We find a positive relationship between foreign shareholder board representation and accounting conservatism implies that the greater the foreign shareholder representation in the board, the higher the degree of accounting conservatism. This is because the presence of foreign directors in a company's board of directors gives foreign investors a concrete direct representation in influencing the organization's strategic direction (Fan & Wong, 2002; LaFond & Roychowdhury, 2008; LaFond & Watts, 2008; Ramaswamy & Li, 2001; Yousef *et al.*, 2020).
3. **Other notable findings** – We find a negative relationship between both measures of accounting conservatism and both firm size. This means that larger firms in the Philippines tend to not report more conservatively since they already enjoy the benefits of better information environments (Easley *et al.*, 2002). Moreover, we also find a positive relationship between both measures of conservatism and leverage ratio. This suggests that bad news is recognized more quickly than good news as firm leverage increases, indicating that leverage drives conservatism. This is due to higher leverage ratios being associated with a higher likelihood of the company being sued due to financial distress. Therefore, highly levered firms tend to demand for more conservative reporting to prevent litigation concerns (Hui *et al.*, 2012). We find a positive relationship between conservatism and the presence of Big 4 auditors but only when using the Khan and Watts (2009) measure of conservatism. our results indicate that firms in the Philippines are expected to report more conservatively when their external auditor is a Big 4 auditing firm because the oversight provided by these auditing firms act as an additional corporate governance measure to ensure the reliability and overall quality of financial reports (Basu *et al.*, 2001). Lastly, we find a negative relationship between conservatism and market-to-book ratio but only when using the Khan and Watts (2009) measure. Firms with lower *MTB* are more likely to encounter financial distress. Thus, they are more likely to be sued due to overstated net assets relative to its market values (Vishnani & Misra, 2016). A higher probability of litigation entails greater claims for damages. Hence, conservative reporting is demanded more in such circumstances to prevent litigation.



Conclusion

Overall, our results suggest that the presence of foreign directors representing foreign investors in Philippine corporate boards and the presence of foreign majority shareholders in Philippine firms may be the main drivers to encourage companies to improve transparency, lessen information asymmetry, and prevent managers' opportunistic behaviors by demanding for more conservative reporting, which in turn increases the quality of financial reporting.

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*This publication is based on an undergraduate thesis for the Economics program of the School of Economics of De La Salle University.