



ACCOUNTING CONSERVATISM AND FINANCIAL PERFORMANCE: ACCOUNTABILITY OF SHARIAH COMPLIANT COMPANIES IN MALAYSIA

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ABSTRACT

Article History

Received: 27 April 2020

Revised: 2 June 2020

Accepted: 6 July 2020

Published: 23 July 2020

Keywords

Accounting conservatism
Financial performance
Accountability
Shariah-compliant companies
Malaysia.

The accountability of Shariah-compliant companies is essential to ummah to ensure the quality of earnings and enhance performance. This study examined the association of accounting conservatism, which is a proxy for accounting quality and the financial performance of Shariah-compliant companies in Malaysia. Financial statements with high quality assist in better decision making, thus preventing fraud activities and misappropriation of assets. The data consisted of 144 firm-year observations of Shariah-compliant companies from 2012 to 2017. The results revealed that accounting conservatism is a feature of financial statements of Shariah-compliant companies in Malaysia and accounting conservatism had a positive association with financial performance. The findings gave insights on the accounting quality and performance of the Islamic capital market in Malaysia. This study contributes to the knowledge of financial reporting quality by explaining the ethical behavior of companies using stewardship theory.

Contribution/Originality: This study is one of very few studies which have investigated financial performance in relation to conservatism on listed Shariah-compliant companies by using two models which is Basu (1997) and Khan and Watts (2009) model.

1. INTRODUCTION

Being one of the leading countries in the Islamic Capital Market (hereafter referred to as ICM), Malaysia is aiming for the goal of National Transformation 2050, to become a developed, advanced and high-income nation. ICM is part of a primary market where the traded shares come from firms that transact following the Islamic principles (Mohd-Sanusi, Ismail, Hudayati, & Harjito, 2015). The government of Malaysia has given strong support in encouraging the growth of ICM while aiming for Malaysia to become an advanced capital market. The Malaysian Government Securities contribute half of the total gross borrowing aggregating to RM54 billion (Economic Report of Malaysia, 2017/2018).

The report also mentions that the allocation of the Malaysian Government Investment Issues that constitute of 49.5%, is more than the earlier periods of 2010 to 2015 that is only 39.1% and this is predicted to ascend the Islamic market (Economic Report of Malaysia, 2017/2018). With the growth of the ICM where Shariah-compliant

companies (hereafter referred to as SCC) are trading, high quality of financial statements is demanded for effective investment decision making.

Prior studies assert that ethical behavior in the business organization gives rise to the accounting quality (Wan, Kamarudin, & Sarman, 2015). Accounting quality is high in demand as it is an essential source of information for the business execution assessment for decision-making. In the process of preparing financial statements, earnings management behavior may occur therefore there are approved accounting standards. This occurrence may mislead and influence stakeholders in their decision making. Low quality of information reflects less transparency, which may encourage unethical behaviour such as fraud activities and misappropriation of assets. The result of the action may distract the real economic performance of the company (Mohammed, Ahmed, & Ji, 2017).

One of the ethical behavior mechanisms in business engagement is religion. As SCC practice Islamic principles, the main goal is the stakeholders' wellbeing and good life instead of materialism. It also focuses on the avoidance of inequity injustice, exploitation, oppression, and wrongdoing towards society (Rahman, Yammesri, & Perera, 2010). Hence, religion is the mechanism that can prevent oneself from unethical behavior in business engagement. In short, religion is a powerful tool to mitigate opportunistic behavior through earnings management. Thus, through its accountability to society, SCC are expected to report their earnings.

According to Farooq and AbdelBari (2015); McGuire, Omer, and Sharp (2012) and Wan et al. (2015) SCC have significantly higher earnings quality as they are significantly influenced by religion. Another related study by Abdul-Rahman, Rahman, and Courtenay (2012) found that the Islamic ethical framework affects earnings quality, proxied by accounting conservatism in Malaysian listed companies. From the study, SCC have higher accounting conservatism, suggesting religious ethical behavior mitigates managerial opportunistic and leads to higher earnings quality.

The current study extends the study of Wan et al. (2015) and Abdul-Rahman et al. (2012) who examined the accounting quality of SCC, by looking at the connection between accounting conservatism and SCC performance. Conservatism is well known as a safety concept in accounting that is more than 100 years old but there are some controversial issues regarding it. It is one of the most common accounting conventions in financial reporting and it has been researched as a fundamental feature of accounting quality by many researchers (Artiach & Clarkson, 2013; Ruch & Taylor, 2015).

The quality of financial reporting that refers to accounting conservatism is alike to the prudence concept in handling uncertainties in accounting treatment (Khan & Watts, 2009; Wang, 2007). It is held as a cautious treatment and dealing with uncertainties by methods of understating the income and assets while overstating losses as costs in the financial statements. In a seminal paper by Basu (1997) accounting conservatism is defined as a situation where managers recognize losses earlier, and later recognize the profit or income. This definition is widely used in many prior studies on accounting conservatism. Therefore, this study investigated whether accounting conservatism, which is a proxy for earnings quality, is a feature for Shariah-compliant companies' financial statements and investigated the association of accounting conservatism and the financial performance of SCC in Malaysia.

The next section, Section 2 reviews the literature; Section 3 describes the research methodology used for the study; Section 4 discusses the findings through a descriptive and statistical analysis; and Section 5 contains the conclusion.

2. LITERATURE REVIEW

2.1. Islamic Capital Market (ICM) and Shariah-Compliant Companies (SCC)

In 1992, the ICM was established in Malaysia, to operate the Islamic stocks trading, issued by the Securities Commission Malaysia (hereafter referred to as SC), where the products are Islamic indices, unit trusts and the permissible counters in the Kuala Lumpur Stock Exchange (KLSE), the former name of Bursa Malaysia (Mohd

Yusof & Abd, 2008). In particular, Mohd-Sanusi et al. (2015) pointed out that ICM is a capital market where transactions are conducted by following the Islamic law. Iqbal and Tsubota (2006) view that with the establishment of ICM, it may improve the stability of Islamic institutions and hence bring benefits not only to the borrowers but also to institutional investors.

Shariah as the religious law guides the activities in ICM. The main feature of ICM is the market is prohibited from involving riba (usury/interest), maisir (gambling) and gharar (uncertainties) elements as outlined by the SC, one of the regulating bodies that supervise ICM in Malaysia. As ICM plays vital role in the Muslim economy, quality and transparent information is undeniably critical for SCC to discharge its accountability to society.

Before the SC introduced a list of Shariah-compliant stocks in June 1997, Bank Islam Malaysia Bhd took the first initial efforts, back in 1983. This process facilitated the establishment of Islamic indices. The SC established the Shariah Advisory Council (hereafter referred to as SAC) with the role of advising the SC on Shariah matters of ICM. The SAC was established in May 1996 and comprises of qualified people who can deliver opinions on Shariah law such as Islamic scholars, academicians and Islamic finance experts, particularly in Islamic economics and finance (Wan et al., 2015). The SAC has its benchmark for a company to be listed as an SCC, where one of the criteria is the level of interest income received. If the financial contributions from non-permissible activities is less than from permissible activities, the securities are classified as Shariah-compliant and vice versa (Securities Commission, 2012). This is to encourage Muslims in engaging in trading in the stock market as trading and business activities are highly honored in Islam.

Identifying an SCC is an essential step in an investor's decision-making. Thus, the SAC gives an updated list of SCC from various perspectives, considering many points of view before categorizing the SCC companies (Securities Commission, 2012). The SCC play a vital role in the country's economic development as they represent a prospect in bridging the gap in the global markets. The qualities of fairness, justice and equity that are implanted in the SCC help in surviving the global economic crisis through its sustainability and growth. Those dynamic features of the SCC lead in various researches examining the issues related to them.

The significance of the SCC to the economy of the country explains the need for examining the reporting quality and financial performance. The low quality of reporting may lead to corporate failures, mismanagement, opportunities in engaging in fraud activities and corruption. Besides Bursa Malaysia and the SAC, the Malaysia Accounting Standard Board (hereafter referred to as MASB) is one of the regulating bodies that govern and supervise accounting transactions in Malaysia. As the study focuses on earnings quality for accounting transactions, the next section discusses the interest of MASB in adopting the International Financial Reporting Standards (IFRS).

2.2. International Financial Reporting Standards (IFRS) Adoption in Malaysia

The Financial Reporting Act 1997 established the Malaysian Accounting Standards Board (MASB) to mark a new milestone in the Malaysian financial reporting environment. The MASB issues approved accounting standards either by developing them on its own or implementing international accounting standards or adapting the accounting standards of another country. With the establishment of the MASB, twenty-four International Accounting Standards (IAS) and Malaysian Accounting Standards (MAS) were adopted and given the status as approved accounting standards (Tan, 2000). Malaysia started to adopt IFRSs, in 2008 when the chairman of MASB, Dato' Zainal Abidin Putih, announced that the country would be in accordance with the International Accounting Standard Board (IASB)'s accounting standards. Since then, MASB and the Malaysian Institute of Accountants (MIA) have carried out a great deal of activities to enlighten stakeholders alongside with the deadlines to converge, which was 31 December 2012 as the earliest financial year-end. Before the convergence, the accounting standards of Malaysia have consistently referred to the previous IAS and the present IFRS.

Conservatism was emphasized by Sterling (1967) as one of the most noteworthy accounting concepts, which has overwhelmed other concepts, for example, historical cost and the realization concepts (Basu, 1997). This accounting concept has long been discussed by both proponents and opponents. The barring of the conservatism concept is argued to influence managerial conduct and have negative economic results. The example of a negative outcome is the ascent of accounting scandals concerning the exaggerating of performance figures in getting more compensation for directors (Whittington, 2008).

The proponents argue that, should the conservatism concept remain, it figures out how to balance the management compulsion to overstate the performance figure by considering the pessimistic financial case. However, in 2010, the IASB has eliminated the idea of understatement and overstatement of assets and liabilities, respectively, which underlie the conservatism principle because of the argument that it results in biasness of reporting. In this case, the IASB argued the conservatism concept as clashing with the quality of neutrality (Madah & Abdul Wahab, 2018). The contention in the idea of conservatism is reasoned through the understatement of assets in a single period that may bring to the financial performance to be overstated in the later period. This view is also shared with some Islamic scholars that the understatement of assets may affect the valuation of Zakat (kind of Islamic tax) (Awang & Mokhtar, 2012).

Despite the controversy of conservatism, IFRS still applies conditional conservatism in various mechanisms such as in International Accounting Standards (IAS) 37, IAS 2 and IAS 36 in which the recognition of provision, contingent liabilities and non-recognition of contingent assets, lower cost or net realizable value of inventories and impairment of assets (IFRS, 2020). In addition, the importance of conservatism is irrefutable with the mountain of interest in researching conservatism as the fundamental feature of quality financial statements. Indeed, the effect is more harmful to society if the practice of conservatism is eliminated as the benefits outweigh the bad effects. This is evidenced by the recent move of the IASB (IASB, 2018).

Recently, IFRS has demonstrated the significance of accounting conservatism as one of the valuable attributes of financial statements through the prudence concept (IASB, 2018). In March 2018, IASB released a reexamined view on conservatism, supplanting the earlier version in 2010 as a comprehensive set of concepts for financial reporting that incorporates the prudence terms (IASB, 2018). The prudence concept is advanced through accounting conservatism as "a cautious response towards uncertainties and inherent risks in business courses" (IASB, 2018). Prudence is explained as "the exercise of caution when making judgments under conditions as one of the qualitative characteristics of useful financial information" (IASB, 2018). As it were, prudence rises from a safety cautious in dealing with uncertainty in recognizing expenses, liabilities and losses earlier rather than revenue, assets or any gains and income and is generally utilized used as an equivalent word (Barker, 2015). The comprehensive set of the IASB conceptual framework, which was revised in 2018 has proven that the boards have realized the importance of conservatism. Indeed, conservatism counteracts the over optimistic valuation of assets, which can limit the inappropriate distribution of dividends. This view is also supported by some Islamic scholars. Hence, the current study needs to look at the issues of accounting conservatism in an underexplored focus, which is in SCC.

2.3. Accounting Conservatism

In accounting, earnings quality defines as true and fair in reporting earnings with reasonableness in explaining firm performance (Mohd Radzi, Islam, & Ibrahim, 2011; Subramanyam, 2014). Ugwunta and Ugwuanyi (2018) that firms with better earnings quality seize more conservative financial reporting. According to Madah and Abdul Wahab (2018) one of the methods for estimating earnings quality is by examining the level of accounting conservatism since it is one of the proxies for earnings quality. A review of the literature proposes that accounting conservatism interests researchers because of its advantages to most stakeholders; for example: shareholders as owners, creditors, managers, regulatory bodies and researchers themselves (Aminu & Hassan, 2018).

Basu (1997) characterized conservatism as recognizing the inclination of accountants to demand for strict verification of financial statements to recognize good news rather than bad news. In this case, earnings reflect bad news or loss earlier than good news or gains. This asymmetric perception of good (gain) and bad news (loss) can constrain managerial opportunistic behaviour, thus increasing firm value to the advantages of a range of stakeholders. Such as, the consistent perception of bad news gives signs for the board of directors to investigate the reasons for the loss (Ball & Shivakumar, 2006). Conservative earnings improve contractual productivity by decreasing the likelihood of incorrect distribution of resources (Watts 2003). Also, Mohammed et al. (2017) contended that accounting conservatism encourages viable monitoring of managers and contracts in which it depicts that the part of corporate governance mechanisms is to improve the reliability and relevance of financial statements that acts as the primary trait of financial reporting quality.

Prior literature suggests that there are two types of accounting conservatism, namely conditional and unconditional conservatism (Aminu & Hassan, 2017; Ismail & Elbolok, 2011). As indicated by Beaver and Ryan (2005) conditional conservatism is commonly utilized and likewise accepted as news-dependent or ex-post conservatism. It is clarified as the quicker recognition of loss than gain. For instance, loss is recognized immediately in the case of impairment of assets, while good news in the form of gain is not recognized until it is realized (Aminu & Hassan, 2017; Ismail & Elbolok, 2011; Khan & Watts, 2009). For example, in treating goodwill, impairment of goodwill is to be expensed off immediately in the statement of profit or loss, resulting in the lower amount of goodwill recorded in the statement of financial position, while the increase in the value of goodwill is not recognized. In this manner, conditional accounting conservatism is described through the accounting treatment and policies that recognize bad news in earnings on a timelier basis than good news as compared to unconditional conservatism. This principle is widely applied in the accounting standards of the IASB.

Meanwhile, unconditional conservatism is contrary to conditional conservatism since it is news-independent or ex-ante conservatism (Alipour, Rabiee, & Alipour, 2013; Aminu & Hassan, 2017; Beaver & Ryan, 2005; Ismail & Elbolok, 2011; Khan & Watts, 2009). Unconditional conservatism practice is such as companies report understated book value of net assets at the end of accounting period. In that case, unconditional conservatism also represents balance-sheet conservatism. Prior literature has contended that conditional conservatism is a fundamental feature of accounting quality as it can upgrade the reliability of financial statements, thereby increasing public confidence (Mohammed et al., 2017). Measurement of asymmetric timeliness (AT) by Basu (1997) and C-Score by Khan and Watts (2009) are the two most common measurements utilized in prior studies, for example, in the studies of Aminu and Hassan (2017) and Mohammed et al. (2017). These studies have discovered that accounting conservatism positively affects companies' economic profit and corporate governance structure as a disciplinary device for managers.

Essentially, accounting quality is important for investors and stakeholders to make decisions based on the information provided by a company. The accounting quality of the SCC is believed to be higher quality because it relies on the Islamic values that underlie the concept of Maqasid Al Shariah (objective of Islamic law) (Wan et al., 2015). Additionally, the SCC consider the time value elements of money in their business transactions as they strictly prohibited from activities involving riba (interest), gharar (uncertainty), maisir (gambling). They are not permitted to engage into non-halal transactions, such as dealing with alcohol and pornography. The source of the fund must also be identified and fully disclosed as consistent with the Islamic concept of accountability to God (Allah) and social equity. Despite the abundant research of firm performance and accounting information used as a tool of monitoring, there is still a lack of empirical evidence on examining the relationship of earnings quality, proxied by accounting conservatism and firm performance, especially for SCC.

2.4. Financial Performance

Performance is measured through financial and non-financial measurement. Basically, in accounting, financial performance is widely used as its traditional quantitative approaches relate to financial information (Neely, 2002). For example, financial performance measures profit and return on investment to reflect the achievement of a company's objectives. Meanwhile, there are diversified methods of non-financial performance measurement. For example, in the context of accounting conservatism, Callen, Chen, Dou, and Xin (2016) measured performance in terms of the contractual features, which is debt covenants, in which it measures the performance of companies' efficiency in wealth appropriation. Besides that, García Lara, García Osmá, and Penalva (2016) measured performance with investment efficiency through corporate governance quality mechanism. For this study, financial performance is used rather than non-financial measurement as it suits the study better to fill in the gap of the literature.

Financial ratio is used to measure Shariah-compliant companies' financial performance. In this study, return on assets (ROA) is used to measure the profitability aspect ratio. According to a prior study by Nguyen (2001) the best measurement for firm efficiency in assets is ROA due to the independence of the financing methods. Generally, the profitability of a company describes its performance for the year. Hence, managers tend to disclose good news rather than bad news, and some are doing it for the sake of themselves (Bribesh, 2006). Hossain (2008) discovered a positive association between profitability and extent of disclosure in the case of Indian banking companies. Hussain Alkdai and Mohd Hanefah (2012) is one of the prior studies that focuses on Malaysian SCC. They found that profitability as the financial performance measurement is not significant with their study subject, which is earnings management. For this study, ROA is used as it is widely and recently used in prior studies to depict the performance of a company (Affes & Sardouk, 2016; Aminu. & Hassan, 2017).

2.5. Stewardship Theory

Stewardship theory is about the welfare of the organization's owner and the overall performance of company as opposed to self-interest (Donaldson & Davis, 1991) and this is in line with the purpose of the Islamic market in which the focus is on social benefits. As indicated by Boyd, Haynes, and Zona (2011) the management of the firms will run the firm with full exertion to accomplish the aims of the firm's owner. The fundamental idea of stewardship theory is the firm performance can be enhanced if the company empowers managers by giving them more trust and power to manage the company. The reasons are because they have better skills and technical knowledge in managing the firm's transactions relative to other stakeholders (Ntim, 2009) By delegating trust and power, it assists in boosting competence and efficiency, hence improve the company financial performance (Al Mamun, Yasser, & Rahman, 2013).

Hernandez (2012) argued that from the diverse interests of stakeholders, a steward has the capability of combining the different interests for other people. The main purpose of stewardship is to achieve the objective of the principal in a long term. In a real-life circumstances, executive directors are able to make a greater contribution in making better decisions on behalf of the board committees as they possess competence, professional expertise, and experience, given that they are rewarded well, as reward is one of impetuses toward effectiveness in upgrading financial performance (Kallamu & Saat, 2015). Therefore, the stewardship theory can be used to support accounting conservatism in Shariah-compliant companies' study setting as it brings in the element of Islam, such as khalifah.

The main principal in Islam is god (Allah). A man as the vicegerent of Allah has the duty to build this world in the best manner according to Islamic law. In this case, SCC firms play the role as khalifah or vicegerent have the feature of producing high-quality earnings, which is useful in generating better performance with the best ethical behavior in accordance to Shariah. By bounding to the duty of Khalifah of Allah, the return will be rewarded, not only in this world but also in the hereafter.

2.6. Islamic Accountability

In discussing the role of SCC in discharging accountability, it is essential to explain it from the view of Islam as the companies are characterised as Shariah compliant. Islam has seen Allah as the main guardian to whatever the behaviour that human take. Muslims are accountable first and foremost to Allah. If he is accountable to Allah, then he will be accountable to the society and the environment. Thus, with accountability to Allah as the main principal, human will not do harm to the society and the environment as their actions are watched by Allah and will be rewarded accordingly in this world and the hereafter.

Accountability refers to the execution of companies to be responsible and accountable as well as supplying feedback for the leaders in organization in discharging their role (Taufiq, 2015). The author further explains that, from the perspective of Islam, accountability is related to trust (*Amanah*) which indicates on how genuine a person in performing his responsibilities. Therefore, if they are consistent with Islamic accountability as the natural responsibilities to behave in accordance with Shariah, the SCC are then expected to be trusted (*Amanah*) in reporting, thus disclosing transparently with faithful representation.

Al-Humaidi (1999) states that, the standard of accountability in Islam can be categorized into two levels. The first level is where everyone is responsible for his behaviour, and the second level explains the responsibility of individuals and objects under their custody. Accountability for SCC is therefore imposed under the second level through accountability towards shareholders, investors and other third parties. In that case, SCC has the role to disclose accounting information which is useful and reliable for users to make decision. Prior study refers accountability as the actual performance of the necessary actions or the prevention of specific actions and reporting of the real performance (Ibrahim, 2000). However, the performance of company is observed through annual report especially for annual report or financial statement users such as investors, suppliers and also shareholders as they cannot observe the action directly. Therefore, this study assesses the accountability of SCC through the information disclosed in the financial statements by examining the feature of accounting quality and the performance.

Accounting information is a useful tool to maintain a good relationship between company and third party. Thus, it is necessary for SCC in Malaysia to comply with full disclosure concept in accordance to *Shariah* in order to prepare quality accounting information. The full disclosure concept is essential in enhancing public confidence and also for Muslim investors to identify investments that are *Shariah-compliant*. Maali, Casson, and Napier (2006) opined that, even such information could be unflattering to the company, the concept insists company's management to disclose all details about their actions to prove that its primary acts do not contradict with Islamic law. In addition, more information should be disclosed by the SCC that participating in prohibited actions, regarding non-permitted elements such as the source of income and their efforts to minimize the occurrence of such practices in the future. It is intended to make sure that the contribution of these non-permitted elements do not exceed the standards. Therefore, if SCC focuses more on practicing Islamic accountability to disclose its accounting information, it would be more reliable for shareholders and investors in helping to make decision.

2.7. Research Framework and Hypotheses Development

The proposed research framework designed is shown in Figure 1.

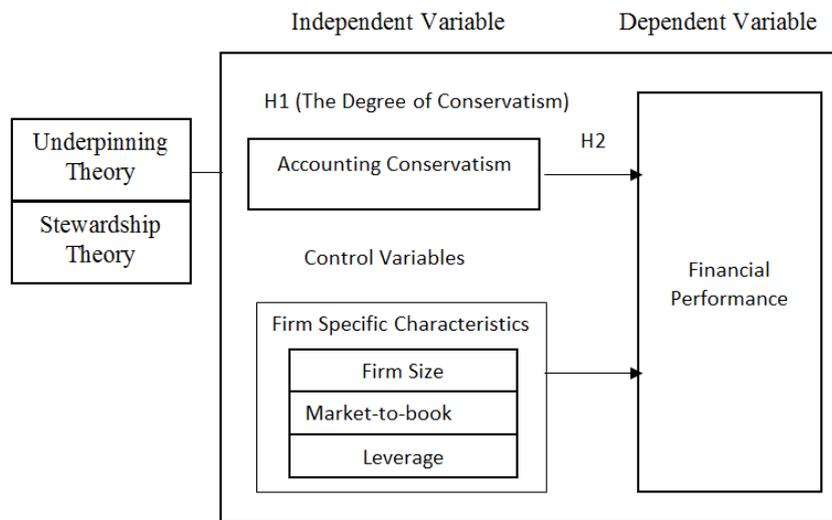


Figure-1. Research framework: Accounting conservatism and financial performance.

2.7.1. Accounting Conservatism and Shariah-Compliant Companies

According to Haniffa and Hudaib (2010) conservatism in Islamic accounting is the option of accounting approaches with the most favorable effect on society and not the option of the accounting approaches that have the least favorable effect on owners. The study carried out by Abdul-Rahman et al. (2012) investigated the association between religious ethical behaviour and accounting quality of conservatism in Malaysian listed companies. From the study, it was found that SCC have higher earnings conservatism rather than non-compliant companies. Religion is recognised as a potential source for business ethical behaviour in managerial conduct that can impact on the financial reporting quality (Wan et al., 2015). Since the firms are classified as SCC, they are expected to conduct ethical behaviour that is aligned with Shariah principles. Following the stewardship theory, SCC as vicegerent of Allah, perform in the best manner to produce high accounting quality, featured by accounting conservatism.

Additionally, convergence to IFRS is said to have the capability of enhancing conservatism in Asian Nations countries such as Malaysia (Madah Marzuki & Abdul Wahab, 2018). Previous related studies have examined the effects of IFRS on conservatism in Europe, Greece, New Zealand, Chile, Turkey (Balsari, Ozkan, & Durak, 2010; Bertin & Moya, 2013; Karampinis & Hevas, 2011; Piot, Dumontier, & Janin, 2010; Zhang, 2011). André, Filip, and Paugam (2015) asserts that IFRS are theoretically conditionally conservative whereby it must be enforced appropriately to achieve the level of conservatism aimed by IASB through their study conducted in Europe. Hence, the first hypothesis was proposed as follows:

H1: Accounting conservatism is a significant feature of Shariah-compliant companies' financial statements during the period of IFRS adoption. (The recognition of loss is timelier for Shariah-compliant companies).

2.7.2. Accounting Conservatism and Financial Performance

Accounting conservatism is found to give benefits to shareholder's value because it has a positive influence on a firm's economic profit (Aminu. & Hassan, 2017). The effect of mitigating agency problems is argued as being able to enhance firm value by improving investment decisions (Lambert, Leuz, & Verrecchia, 2007). Furthermore, Aminu and Hassan (2018) discovered a significant association between accounting conservatism and bank performance using ROA as a measurement in Nigeria. The prior study of Ugwunta and Ugwuanyi (2018) in Nigeria opposed the results because their findings show a non-significant positive effect between accounting conservatism and firm performance for the Consumer Goods sector. Larmande (2015) stated that the stewardship theory supports the idea that conservatism is helpful in depicting the good financial performance of a company. This is because it makes it harder for a vicegerent to influence and manipulate earnings because of the concept of fear of God for the better benefit not only in the world, but also in the hereafter. Prior study of Ramadan (2015) affirms that accounting

conservatism is significantly affecting firm and financial performance. Hence, the second hypothesis constructed was as follows:

H2: Accounting conservatism is positively associated with financial performance of Shariah-compliant companies in Malaysia.

2.7.2.1. Firm Size, Market-to-Book Ratio and Leverages (Control Variables)

Size, market-to-book ratio and leverage are firm-specific characteristics that act as the control variables for the study as they are supported and consistent with the empirical studies of [Mohammed, Fahmi, and Ahmad \(2019\)](#) and [Sana'a \(2016\)](#). Firm size is calculated by the Logarithm total assets ([Basu, 1997](#); [Khan & Watts, 2009](#); [Mohammed et al., 2017](#); [Sana'a, 2016](#); [Wan et al., 2015](#)). Larger firms are more mature, and they have more information that can attract more analysts compared to small firms. Hence, by having firm size as a control variable, it can mitigate the information asymmetries and uncertainties related to the reliability of projected gains.

Leverage is used as a financial indicator in measuring the companies' financial health while generating earnings simultaneously ([Basu, 1997](#); [Beaver & Ryan, 2005](#); [Khan & Watts, 2009](#); [Sana'a, 2016](#)). Hence, controlling the leverage in each company is persistent with the objective of the study because leverage may act as a cultivator for the results in growth as it functions as a multiplier in accounting the conservatism regression model. Lastly, many prior studies controlled market-to-book ratio (MTB) as a control variable in determining the significant relationship between accounting conservatism and financial performance ([Chen, Hu, Lee, & Lin, 2006](#); [Khan & Watts, 2009](#); [Mohammed et al., 2017](#)).

3. RESEARCH METHODOLOGY

For this study, the target population was the listed SCC that examined the association of accounting conservatism and financial performance. According to the [Securities Commission \(2017\)](#) 76% of public listed companies in Bursa Malaysia are recognized as Shariah-compliant. However, from the 76% of SCC, only those that are listed in the FTSE Bursa Malaysia 100 Index were part of the target sample as the companies are ranked by market capitalization. This was consistent with the prior study by [Sabrun, Muhamad, Yusoff, and Darus \(2018\)](#) on SCC that examined the performances and study of accounting conservatism by [Mohammed et al. \(2017\)](#).

To ensure consistency for the companies' categorization, one of the criteria was that a company was classified as Shariah-compliant if the company was listed as Shariah-compliant companies throughout the period of 2012 to 2017. From the 100 Index, 17 companies from the financial services sector were excluded because the measurement of the sector is complex and treated differently ([Grougiou, Leventis, Dedoulis, & Owusu-Ansah, 2014](#); [Mohammed et al., 2017](#); [Sabrun et al., 2018](#)). Following [Madah and Abdul Wahab \(2018\)](#); [Sabrun et al. \(2018\)](#) and [Wan et al. \(2015\)](#) that only use the same financial year-end, out of 83 companies, only 39 companies announced their financial year end on 31 December, the other 44 companies have different year-end such as March, June, July, August and September. Due to the main criteria, only 24 companies finally fulfilled the criteria as the final study sample. The final sample is shown in [Table 1](#). The total observations were 144 firms, consisting of 24 SCC for the period of six years from 2012 to 2017.

Table-1. Derivation of sample.

Sample of Study	No.
Companies listed in Bursa Malaysia, December 2017	902
Shariah-compliant companies listed by SC, November 2017	686
FTSE Bursa Malaysia 100 Index	100
Excluded companies in financial industry	(17)
Excluded companies with different financial year end	(44)
Excluded companies non-Shariah-compliant	(15)
Final sample	24

3.1. Variable Measurement

Accounting conservatism is the asymmetric timeliness of earnings in losses more than gains (Barker, 2015). Through the application of accounting methods and policies, accounting conservatism recognizes bad news in earnings on a timelier basis as compared to good news (Aminu & Hassan, 2017). There are two measurements of accounting conservatism in this study which are Basu (1997) model and C-Score (Khan & Watts, 2009).

The Basu model is a basic model developed by Basu (1997) in measuring conservatism. There are numerous studies that use the Basu model in measuring the extent of accounting conservatism such as André et al. (2015); Givoly, Hayn, and Natarajan (2007); Madah and Abdul Wahab (2018); Mohammed et al. (2017); Warganegara and Vionita (2010) and Watts and Zuo (2011). The Basu model cannot serve as independent variable due to the cross-sectional variables (Ugwunta & Ugwuanyi, 2018). Thus, the modified Basu model developed by Khan and Watts (2009) which is C-Score was applied to serve as an independent variable in line with the studies of Affes and Sardouk (2016); Callen et al. (2016) and Mohammed, Ahmed, and Ji (2017).

Align with those prior studies, for the first objective in this study, the Basu model was chosen to measure the degree of conservatism which arises from management reporting and the asymmetrical reaction of loss recognition (Basu, 1997).

$$NI_{it} = \beta_0 + \beta_1 DR_{it} + \beta_2 R_{it} + \beta_3 R_{it} \times DR_{it} + \varepsilon_{it} \quad (1)$$

Where:

- NI represents earnings yield or earnings per share divided by share price, both variables measured at the beginning of the fiscal year.
- β_0 is the coefficient calculated by the regression model.
- β_1 , β_2 and β_3 are coefficients of variables (slope).
- DR represents a dummy variable when $R > 0$ is 0 and is 1 when $R < 0$. The dummy variable has a value of 0 when R is not aggregating future bad news and has a value of 1 when R is aggregating future bad news. This is because of the assumptions of R aggregating bad news about the future when R is negative. Dummy variable is used to capture the differential impact of negative return sample and an associated interaction term (Vishnani & Misra, 2016).
- R represents the holding period returns of Shariah-compliant companies including dividends. For this study, stock return at the beginning of the fiscal year is used.
- ε represents a residual error.

According to Khan and Watts (2009) C-Score reflects the changes in accounting conservatism between companies (Affes & Sardouk, 2016). This firm-year conservatism score, C-Score, was used to study the empirical properties of conservatism by running the annual cross sectional data of Basu model and extending the estimated regression with firm-specific characteristics (Vishnani & Misra, 2016). Khan and Watts (2009) specify the asymmetric timeliness of bad news through C-Score and linear functions of firm-specific characteristics which include the firm's size, market-to-book, and leverage, which is as follows:

$$C\text{-Score} = b_{sit} = \lambda_1 + \lambda_2 \text{Size}_{it} + \lambda_3 \text{MTB}_{it} + \lambda_4 \text{Lev}_{it} \quad (2)$$

Where, λ_1 λ_2 λ_3 λ_4 are estimated from annual cross-sectional regression.

As C-Score is derived from the above equation, the model of annual cross-sectional regression, designed to estimate C-Score is given as:

$$\begin{aligned}
 NI_{it} = & \beta_0 + \beta_1 DR_{it} + \beta_2 R_{it} (\mu_1 + \mu_2 SIZE_{it} + \mu_3 MTB_{it} + \mu_4 LEV_{it}) + R_{it} \times DR_{it} (\lambda_1 + \lambda_2 SIZE_{it} + \lambda_3 MTB_{it} + \\
 & \lambda_4 LEV_{it}) + (\delta_1 SIZE_{it} + \delta_2 MTB_{it} + \delta_3 LEV_{it} + \delta_4 DR_{it} SIZE_{it} + \delta_5 DR_{it} MTB_{it} + \delta_6 DR_{it} LEV_{it}) + \epsilon_{it}
 \end{aligned}
 \tag{3}$$

Return on assets (ROA) was used as a measurement of financial performance that serves as dependent variable in finding the relation to accounting conservatism (Aminu & Hassan, 2018). According to PwC (2011) ROA is calculated with net income over average total assets and it measures the firm’s efficiency in producing gains from the assets and is calculated by dividing net income with average total assets. The model for the multiple regression analysis is as follows:

$$ROA = \alpha + \beta_1 C\text{-Score}_{it} + \beta_2 SIZE_{it} + \beta_3 MTB_{it} + \beta_4 LEV_{it} + \epsilon_{it}$$

Table 2 is the summarized table of variables measurement above.

4. FINDINGS

4.1. Descriptive Analysis

From the data analysis, all the variables appeared to be normally distributed. Based on the result, for the Basu (1997) model, earnings yield represented by NI had an average value of .4615 with a standard deviation of .58470, a minimum value of -1.42 and 2.75 as the maximum value. Table 3 shows that the average value for ROA was 9.3162 and the standard deviation was 6.10326. This result showed that the mean is greater than the standard deviation, hence this was an indication for normal data distribution and it was fit to produce a reliable result.

Table-2. Summary of study variables and measurement.

Variable	Measurement	Prevailing literature
Dependent Variable		
Financial Performance		
- Return on Assets (ROA)	Net Income/Average Total Assets	Aminu and Hassan (2017)
Independent Variable		
Accounting Conservatism	1. $NI_{it} = \beta_0 + \beta_1 DR_{it} + \beta_2 R_{it} + \beta_3 R_{it} \times DR_{it} + \epsilon_{it}$ (Basu, 1997) This model is used to answer hypothesis 1, the overall measurement of conservatism, consistent with most other studies.	Aminu and Hassan (2017)
	2. $C_Score = \lambda_1 + \lambda_2 Size + \lambda_3 M/B + \lambda_4 Lev$	Affes and Sardouk (2016); Khan and Watts (2009)
Control Variables		
Firm Size	SIZE = Log Total Assets	Aminu and Hassan (2017); Sana'a (2016)
Market-to-book Ratio	MTB = Market capitalization/ Total Book Value	Mohammed et al. (2017)
Leverage	Debt to ratio	Mohammed et al. (2017)

Table-3. Descriptive statistics.

Variable	Min.	Max.	Mean	Std. Dev.
NI	-1.42	2.75	.4615	.58470
ROA	-8.58	29.41	9.3162	6.10326
ROE	-29.34	45.18	13.2983	8.72484
CSCORE	-2.18	.45	-.4224	.36261
SIZE	11.71	18.07	15.6374	1.31638
MTB	-.46	1.46	.3251	.35019
LEV	-.36	.48	.0393	.20616

Notes: NI is earnings yield that is measured at the beginning of the fiscal year. ROA is return on assets. ROE is return on equity. C-SCORE is the firm-year measure of asymmetric timeliness for bad news based on Basu (1997). SIZE is log total assets. MTB is market-to-book ratio. LEV is debt to ratio.

Table 4 demonstrates Pearson correlation test and the results showed that the independent variables were not highly correlated. This was confirmed with the multicollinearity test as revealed in Table 5. The model appeared to have no multicollinearity problem.

Table-4. Pearson's correlation.

Variable		1	2	3	4	5
CSCORE	1	1.000	-.074	.428**	-.378**	.531**
SIZE	2	-.074	1.000	-.115	.368**	-.477**
MTB	3	.428**	-.115	1.000	.123	.476**
LEV	4	-.378**	.368**	.123	1.000	-.308**
ROA	5	.531**	-.477**	.476**	-.308**	1.000

Notes: ** and * represent significant statistical level at 1 and 5 percent respectively by using two-tailed tests. The number of observations made is 144 in the period of 2012 to 2017. C-SCORE is the firm-year measure of asymmetric timeliness for bad news based on Basu (1997). SIZE is the log total assets. MTB is market-to-book ratio. LEV is debt to ratio. ROA is return on assets.

Table-5. Multicollinearity test.

Variable	VIF	Tolerance (1/VIF)
C-SCORE	1.695	.590
SIZE	1.219	.820
MTB	1.521	.658
LEV	1.659	.603

Notes: C-SCORE is the firm-year measure of asymmetric timeliness for bad news based on Basu (1997). SIZE is log total assets. MTB is market-to-book ratio. LEV is debt to ratio.

4.2. Regression Analysis

This study examined accounting conservatism by using the Basu (1997) model and Khan and Watts (2009) model separately. The Basu (1997) model was used to analyze the feature of accounting conservatism in SCC. Meanwhile, Khan and Watts (2009) is a modified model of Basu (1997) and was used to examine the relationship between financial performance and accounting conservatism.

The result in Table 6 shows the regression model for Basu (1997) during the full sample period. A significant regression was found $F(3,140) = 3.647$, p-value less than 0.05, with R^2 of 7.2%. The adjusted R^2 was 5.3% for the full sample period, which represents the timeliness in financial reporting. Vichitsarawong, Eng, and Meek (2010) asserted that the incremental sensitivity of accounting income to the integration of bad news rather than good news is represented by a β_3 coefficient (DR*R) and it measures accounting conservatism. The β_3 coefficient of SCC in Malaysia was .018 (unstandardized) and 0.242(standardized) relatively positive and significant with the p-value less than .05.

This supports the literature on the existence of asymmetric earnings timeliness in which unrealized losses (bad news) are more likely recognized earlier than unrealized gains (good news). To this note, accounting conservatism is a significant feature of SCC's financial statements in Malaysia.

Table-6. Multiple linear regressions for Basu. (1997) model.

Variables	Unstandardized Coefficients (B)	Std. Error	Standardized Coefficients (β)
Constant	.587	.071	
DR	-.111	.149	-.087
R	-.002	.002	-.116
DR*R	.018*	.008	.242*
R ²			.072
Adjusted R ²			.053
F			3.647*

Notes: * p < .05, ** p < .01, *** p < .001.

Next, in examining the relationship between accounting conservatism and financial performance, the regression results are shown in Table 7 for ROA. According to Khan and Watts (2009) C-Score reflects the changes

in accounting conservatism between companies (Affes & Sardouk, 2016). This firm-year conservatism score, C-Score, was used to study the empirical properties of conservatism by running the annual cross sectional data of the Basu model and extending the estimated regression with firm-specific characteristics (Vishnani & Misra, 2016).

The regression for this relationship used C-Score in measuring accounting conservatism. ROA as the first proxy of financial performance showed that the $F(4, 139) = 34.399$ with a p-value less than .001 which means it was statistically significant. The R^2 of .518 indicated that the predictor variable, accounting conservatism, explained 51.8% of the variations in the financial performance of the listed Shariah-compliant companies in Malaysia. The results in Table 7 also showed that accounting conservatism has a statistically significant positive relationship with ROA as one of the proxies for financial performance. Thus, accounting conservatism significantly helps in enhancing the performance of Shariah-compliant companies during the IFRS adoption period.

Table-7. Regression result for the relationship of accounting conservatism and financial performance (ROA).

Variables	Unstandardized Coefficients		Standardized Coefficients
	B	Std. Error	B
Constant	37.153	5.216	
CSCORE	5.574	1.303	.342***
SIZE	-1.719	.318	-.367***
MTB	5.289	1.255	0.319***
LEV	-2.034	2.357	-.068
R^2			.518
Adjusted R^2			.503
F			34.399***

Notes: * p < .05, ** p < .01, *** p < .001.

4.3. Result and Discussion

The result illustrated that the existence of accounting conservatism as a feature of Shariah-compliant companies in Malaysia is evident from the coefficient of DR*R, which was positive and statistically significant. However, compared to the Basu (1997) model, it was relatively low. Hence, it was consistent with the earnings being timelier in financial reporting bad news than good news. This result supported the studies that emphasized the existence of accounting conservatism as one of the earnings quality proxy in recognizing bad news earlier than good news (Affes & Sardouk, 2016; Hamdan, Abzakh, & Al-Ataibi, 2011; Mohammed et al., 2017; Sana'a, 2016). Earnings recognize bad news earlier than good news in conjunction with accounting conservatism due to higher degree of verification of financial statements in good news are required by accountants compared to bad news (Vishnani & Misra, 2016). Based on the regression of the Basu (1997) model, it has been proven that accounting conservatism is a significant feature of earnings quality for Shariah-compliant companies during the adoption of IFRS

As Wan et al. (2015) stated, Shariah-compliant companies should have higher earnings quality compared to the other industries in providing high-quality financial reporting. The reason is that Shariah status requires adherence to the Islamic principles and guidelines that prohibits unethical conduct in business management. Hence, practicing accounting conservatism mitigates management problem in unethical conducts and helps in producing high-quality financial reporting based on the IFRS application.

The result for the relationship between accounting conservatism and financial performance depicted the expected results for ROA which has a positive significant relationship with accounting conservatism through the coefficient of C-Score. This implied that Shariah-compliant companies with high ROA were conservative during the IFRS adoption period. This was consistent with the studies of Affes and Sardouk (2016); Callen et al. (2016) and Sana'a (2016) that examined on company performances as well.

This result implied that listed Shariah-compliant companies which are considered as large companies with more profits and debts apply conservative accounting to mitigate the conflicts between stakeholders such as

creditors. In relation to the stewardship theory, it highlighted the concept of accountability to God, as humans are supposed to refrain from certain actions in managing the resources given in order to achieve certain goals and objectives (Hameed & Yaya, 2005). Lewis (2001) highlighted accountability as an obligation for businesses in providing an account to the Islamic community at large (ummah), which they have their right to know the effects of the operations on its well-being.

This supposes to impact the manner of managing business in Islamic communities and therefore, Islamic companies are responsible to deliver their fulfillment of such tasks (Aribi & Gao, 2010). Thus, Shariah-compliant companies carry Islamic values and are being accountable by producing high quality reporting to enhance the companies' performances. Stewardship theory also suggests that accounting conservatism plays an important role in managing conflicts between shareholders and other stakeholders such as creditors are accepted. In short, stewardship theory is accepted as Shariah-compliant companies conduct their business in accordance with Islamic law that suggests good ethical behavior. Thus, accounting conservatism is enhanced through the value of religion as an important role in the promotion of good ethical behavior.

5. CONCLUSION

The study complements the existing literature on accounting conservatism. Most of the previous studies focused on listed companies, but little of the views were on listed SCC. The study on the SCC allows conclusion to be drawn based on stewardship theory. This study shed light on financial performance in relation to conservatism that only a few prior studies have done. The results from this study supported the contention by stewardship theory that the SCC as vicegerent in managing Allah's properties have the tendency to produce high quality of financial statement, thus enhancing performance, which contributes to the well-being of society.

The results of the study attracted several interested parties such as academicians, regulators and practitioners as conservatism can mitigate the agency problem through best ethical behavior. This study contributes to the knowledge of accounting quality by explaining the ethical behavior of companies using the stewardship theory. Additionally, with the findings, regulators such as the MASB can play a role in promoting conservatism in developing and implementing accounting standards.

The results of the study can attract the interests of creditors and lenders because the management of debt and the distribution of profits are found to be significant with the existence of conservatism. This study is of interest to other stakeholders such as investors who are concerned on the quality of reporting in ICM. Finally, the results imply that IFRS is a set of high-quality accounting standards since the financial statements in ICM during the IFRS period are conservative.

This study is not without its limitations. One of the limitations was that the scope of the study was limited to only the Top 100 public listed companies from the years 2012 to 2017 in Malaysia. Second, the financial performance measurement was restricted to only ROA. Third, future research should consider extending this study to more industries rather than focusing on the SCC. This will give more comprehensive results.

In addition to ROA, as the financial performance measurement, considering another relevant variable such as earnings per share (EPS) and other non-financial performance measurement would be worthwhile to explore. Another recommendation is to consider extending the study to other quality of earnings such as accruals or finding a model that may offer the best possible solutions in detecting the existence of earnings quality for the industries. The inclusion of other detailed information on other relevant factors such as corporate governance and ownership structure to achieve conservatism in the contracting relationship could also be part of further research.

Funding: Authors acknowledge the financial assistance from the Accounting Research Institute, Universiti Teknologi MARA.

Competing Interests: The authors declare that they have no competing interests.

Acknowledgement: All authors contributed equally to the conception and design of the study.

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