

Does foreign ownership impact accounting conservatism adoption in Vietnam?*

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Abstract:

This study investigates the effects of foreign ownership on accounting conservatism adoption in Vietnam. Although foreign ownership is found to have a positive relationship with accounting conservatism in Korea (An, 2015), there is still no general agreement on it. In this regard, the purpose of this study is to shed more light on the association between foreign ownership and accounting conservatism. Using data from Vietnamese firms listed on stock exchanges, the study finds that in contrast to the findings of An, foreign ownership is negatively associated with accounting conservatism. This result supports the transient hypothesis of foreign ownership, indicating that foreign investors with the low level of ownership do not have significant incentives to oversee managers, thus not influencing financial reporting quality.

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1. Introduction

Accounting conservatism is widely accepted to be a desirable qualitative characteristic of accounting information (Ball et al, 1968, Ruch & Taylor, 2015). Basu (1997) first operationalize the definition of accounting conservatism as an asymmetrically greater reflection of "bad news" over "good news" in accounting earnings recognition. Watts (2003) follows up on this definition to provide four explanations for accounting conservatism containing contracting, litigation, regulation, and taxation concerns. Basu's definition and Watts's explanations lay foundations for research on accounting conservatism (Francis, Hasan, and Wu, 2013). In the development of accounting conservatism literature, An (2015) is the first researcher to find the significant positive association between foreign ownership and accounting conservatism, supporting the active-monitoring hypothesis of foreign ownership. Since An conducted the research in Korea with the characteristics of one of the highest foreign-investor countries in the world, it is necessary to conduct more research in other countries to confirm this relationship. In this regard, the purpose of this study is to investigate the association between foreign ownership and accounting conservatism in Vietnam. There are several reasons for conducting this study. First, Vietnam is one of emerging markets but a

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transition country different from Korea, a developed country. Second, although foreign ownership is increasing in Vietnam but still rather low. Last, Bach (2016) provides an empirical evidence on the adoption of accounting conservatism in Vietnam. Therefore, this study has the base to conduct in Vietnam.

Using a sample of firm-year observations over the period of 2005 to 2015 obtained from firms listed on Hochiminh stock exchange (HSX) and HNX stock exchange, the study tests the relationship between foreign ownership and accounting conservatism using Basu model with inclusion of a variable measuring foreign ownership. The study finds that foreign ownership affects accounting conservatism. However, in contrast to the findings of An, foreign ownership is negatively associated with accounting conservatism. This result supports the transient hypothesis of foreign ownership, indicating that foreign investors with the low level of ownership do not have significant incentives to oversee managers, thus not influencing financial reporting quality.

The remainder of the study is organized as follows. The study outlines the overview of accounting conservatism and the hypothesis development in Section 2. Section 3 presents research design before empirical analysis will be shown in Section 4. The study ends with conclusions in Section 5.

2. Literature review and hypothesis development

2.1 Definition of accounting conservatism

There is no authoritative definition of accounting conservatism, although the accounting conservatism has influenced accounting practice and theory and has been a qualitative character of accounting information for centuries (Basu, 1997; Watts, 2003a; Xie, 2015). The traditional definition of accounting conservatism can be expressed by the rule "anticipate no profit, but anticipate all losses" (Bliss, 1924). The following definitions are based on that adage as the philosophy of conservatism. The International Accounting Standard Board (IASB) describes accounting conservatism as "a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or incomes are not overstated and liabilities or expenses are not understated" (IASB, 1989). The Financial Accounting Standard Board (FASB) provides a similar definition of accounting conservatism: "conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate." (FASB, 1980).

However, the standard-setters' definitions are vague and difficult to operationalize for research. Basu (1997) is the first person to operationalize accounting conservatism through asymmetric timeliness of earnings. He interprets accounting conservatism as the denoting accountants' inclination in the asymmetrical verification requirements for gains and losses. His research has been a seminal work on accounting conservatism since then. Following Basu (1997), Watts (2003) gives four explanation of the demand for accounting conservatism. With regard to the contracting explanation, accounting conservatism reduces moral hazard problems caused by contracting parties with asymmetric information, asymmetric payoffs, limited horizons, and limited liability. According to the litigation explanation, conservatism reduces the expected costs of litigation because the litigation is more likely when net assets and earnings are overstated than they are understated and the expected litigation costs of overstatement are higher than those of understatement. In terms of the income tax explanation, accounting conservatism reduces

the present value of tax liabilities when the taxable income is influenced by the reported income. As to the regulatory explanation, the accounting conservatism helps regulatory bodies to reduce political costs associated with overstatement of net assets and earnings.

2.2. Relationship between foreign ownership and accounting conservatism

An (2015) uses two conflicting hypotheses, active monitoring and transient, to explain the relationship between foreign ownership and accounting conservatism. According to the active-monitoring hypothesis, foreign investors as large institutional shareholders with strong incentives to actively monitor managers can increase financial reporting quality. On the other hand, foreign investors as transient investors without significant incentives to oversee managers cannot influence financial reporting quality. Using Korean firms' data, An (2015) finds the positive relationship between foreign ownership and accounting conservatism. There has been limited research on this relationship so far. Thus, there is much room to explore the effects of foreign ownership on accounting conservatism.

2.3. Foreign ownership and accounting conservatism in Vietnam

Vo (2017) suggests that foreign investors in the Vietnam stock market are subject to precautionary motive and agency motive. In particular, firms with foreign ownership tend to hold more cash. Le et al. (2016) find that foreign ownership has a negative impact on leverage. Further, foreign ownership helps to reduce risk-taking activities of a firm (Vo, 2016). Expressed another way, foreign ownership seems to drive firms more conservative in their performance. This would, in turn, be reflected in financial reporting.

With regard to the conservative accounting, Bach (2016) provides empirical evidence on the existence of accounting conservatism in financial reporting. In addition, An (2016) finds that foreign ownership is positively associated with the accounting conservatism. Therefore, the tendency of increasing foreign ownership in Vietnamese firms and reforms of reducing limitations on foreign ownership in most industries (KPMG, 2016) lead to the following hypothesis.

H₁: Foreign ownership affects the adoption of accounting conservatism in financial reporting in Vietnam.

3. Research design

3.1 Collecting and selecting sample data

To investigate the relationship between foreign ownership and accounting conservatism, this study uses Vietnamese firms listed on Hochiminh Stock Exchange (HSX) and Hanoi stock exchange (HNX). Data are for fiscal years 2005 to 2014. The 2005-2014 period was chosen because the adoption of accounting conservatism in Vietnamese financial statement was found in this period (Bach, 2016). The sample selection is based on the two following criteria. First, financial firms are ruled out due to their different accounting standards. Second, firms with missing data are excluded.

The data for this study are obtained from audited financial statements, annual reports, and stock prices published in stock exchanges. According to Christie (1987), earnings and stock returns, measured per share, are standardized by beginning-of-fiscal-year stock price to control heteroskedasticity. Besides, White-Huber standard errors are used to calculate heteroskedasticity-robust t statistic (White, 1980). Bach (2016) suggests that the research

on accounting conservatism in code law settings should determine holding-period stock returns in the period of information disclosure. Therefore, stock returns are computed to end three months after the fiscal year-end. Also, this study avoids potential influences of outliers on regression results by excluding observations falling in the top or bottom 1% of beginning-of-fiscal-year standardized earnings and stock returns.

3.2 Measuring accounting conservatism and building a model

3.2.1 Measurement of accounting conservatism with asymmetric news recognition timeliness specification

Basu (1997) proposes the model to test accounting conservatism as follows:

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

Where E_{it} - Earnings of the firm i in the year t ; R_{it} - Stock returns of the firm i in the year t ; D_{it} - Dummy variable equal to one if stock returns are negative, zero otherwise; P_{it} - Stock price of the firm i in the year $t - 1$, which is used to standardize earnings.

In the regression, the slope coefficients on stock returns, β_0 and $(\beta_0 + \beta_1)$, serve as the measures of the sensitivity of earnings to positive stock returns ("good news") and negative stock returns ("bad news"), respectively. The interactive slope coefficient (β_1) measures the difference in the sensitivity of earnings to negative stock returns and positive stock returns. They are expected to be positive. This indicates that the timeliness of earnings is asymmetrically greater for losses than for gains.

In order to investigate the impact of foreign ownership on accounting conservatism, some following adjustments are made to model (1).

$$\begin{aligned} \frac{E_{it}}{P_{it-1}} = & \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it} + \beta_2 Foreign_{it} + \beta_3 Foreign_{it} D_{it} \\ & + \beta_4 Foreign_{it} R_{it} + \beta_5 Foreign_{it} R_{it} D_{it} + \varepsilon_{it} \end{aligned} \quad (2)$$

$Foreign_{it}$ is a percentage of shares held by foreign shareholders. $Foreign_{it}$ is multiplied by each of variables in the model (1). Coefficient β_5 is expected to significantly positive. It means that there is a positive relationship between foreign ownership and accounting conservatism.

3.2.2 Alternative measurement of accounting conservatism with asymmetric persistence of earnings changes

Basu (1997) also notes alternative model measuring accounting conservatism as follows:

$$\frac{\Delta E_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 D_{it} + \beta_0 \frac{\Delta E_{it-1}}{P_{it-2}} + \beta_1 \frac{\Delta E_{it-1}}{P_{it-2}} D_{it} + \varepsilon_{it} \quad (3)$$

Where ΔE_{it} - Earnings changes of the firm i in the year t ; D_{it} - Dummy variable equal to one if earnings changes are negative, zero otherwise; P_{it} - Stock price of the firm i in the year $t - 1$, which is used to standardize earnings changes.

In regression (3), the slope coefficients on prior earnings change, β_0 and $(\beta_0 + \beta_1)$, serve as the measures of the reversal of "good news" earnings and "bad news" earnings, respectively. The interactive slope coefficient (β_1) measures the difference in the reversal of "bad news" earnings and "good news" earnings. These coefficients are expected to be negative. This indicates that the reversal of "bad news" period is asymmetrically greater than that of "good news" period. Differently phrased, earnings would be less persistent for bad news than good news.

Model (3) is added with variable $Foreign_{it}$ in the same way as model (2) in order to test the effect of foreign ownership on accounting conservatism.

$$\begin{aligned} \frac{\Delta E_{it}}{P_{it-1}} = & \alpha_0 + \alpha_1 D_{it} + \beta_0 \frac{\Delta E_{it-1}}{P_{it-2}} + \beta_1 \frac{\Delta E_{it-1}}{P_{it-2}} D_{it} + \beta_2 Foreign_{it} \\ & + \beta_3 Foreign_{it} D_{it} + \beta_4 Foreign_{it} \frac{\Delta E_{it-1}}{P_{it-2}} + \beta_5 Foreign_{it} \frac{\Delta E_{it-1}}{P_{it-2}} D_{it} + \varepsilon_{it} \end{aligned} \quad (4)$$

Coefficient β_5 is expected to significantly negative. It means that accounting conservatism is associated with higher levels of foreign ownership.

4. Empirical analyses

4.1 Descriptive Statistics

Table 1 presents the descriptive statistics for foreign ownership. The mean of foreign ownership is 7.91%. The minimum value is 0% while the maximum value is 49.01%. The data indicates that foreign ownership in Vietnam is still fairly low.

TABLE 1. DESCRIPTIVE STATISTICS FOR FOREIGN OWNERSHIP

Variable	Mean	Std. deviation	Min	Median	Max
Foreign	7.91	12.08	0	2.12	49.01

Source: Own computations based on resources mentioned in section 3.1.

4.1.1 Results of the relationship between foreign ownership and accounting conservatism

Table 2 presents the result of testing the hypothesis, which proposes the foreign ownership affects the adoption of accounting conservatism in financial reporting in Vietnam. The results of model 1 are consistent with those of the research on the adoption

of accounting conservatism in Vietnam conducted by Bach (2016). In the results of model 2, the slope coefficients of the R_{it} and $R_{it} \times D_{it}$ variables are still significantly positive at 1% level. The results are consistent with those of Bach (2016). Much attention is turned to the result for the $Foreign_{it} \times R_{it} \times D_{it}$ variable. This variable is significantly negative. This result confirms the impact of foreign ownership on accounting conservatism. However, the found negative relationship is inconsistent with the findings of An (2016).

TABLE 2. REGRESSION RESULTS OF THE EFFECT OF FOREIGN OWNERSHIP ON ACCOUNTING CONSERVATISM USING THE MODEL OF ASYMMETRIC NEWS RECOGNITION TIMELINESS SPECIFICATION

	Model 1	Model 2
Constant	0.131 (19.96)***	0.138 (15.74)***
D_{it}	0.006 (0.52)	0.007 (0.53)
R_{it}	0.064 (7.77)***	0.059 (5.28)***
$R_{it} \times D_{it}$	0.172 (7.91)***	0.223 (7.64)***
<i>Foreign</i>		-0.001 (-1.85) *
<i>Foreign</i> x D_{it}		0.000 (0.43)
<i>Foreign</i> x R_{it}		0.002 (2.59)***
<i>Foreign</i> x $R_{it} \times D_{it}$		-0.005 (-2.94)***
Observations	2,109	1,918
Adjusted R^2	22.42	23,75

Source: Own computations based on resources mentioned in section 3.1.

TABLE 3. REGRESSION RESULTS OF THE EFFECT OF FOREIGN OWNERSHIP ON ACCOUNTING CONSERVATISM USING THE MODEL OF ASYMMETRIC PERSISTENCE OF EARNINGS CHANGES

	Model 3	Model 4
Constant	-0.01 (-1.27)	-0.01 (-0.94)
D_{it}	-0.037 (-3)***	-0.048 (-3.09)***
$\Delta E_{it-1}/P_{it-2}$	-0.045 (-0.98)	-0.079 (-1.58)
$\Delta E_{it-1}/P_{it-2} \times D_{it}$	-0.463 (-4.11)***	-0.378 (-3.22)***
<i>Foreign</i>		0.000 (-0.05)
<i>Foreign</i> x D_{it}		0.005 (0.49)
<i>Foreign</i> x $\Delta E_{it-1}/P_{it-2}$		0.005 (2.37)**
<i>Foreign</i> x $\Delta E_{it-1}/P_{it-2} \times D_{it}$		-0.028 (-1.42)
Observations	2,153	2,115
Adjusted R^2	6.2	0.073

Source: Own computations based on resources mentioned in section 3.1.

Using the alternative measurement of accounting conservatism reflecting the asymmetric persistence of earnings changes, Table 3 presents the result of testing the hypothesis H_1 ,

which proposes the foreign ownership affects the adoption of accounting conservatism in financial reporting in Vietnam.

The results of model 3 are consistent with Bach (2016). In the results of model 4, the $\Delta E_{it-1}/P_{it-2} \times D_{it}$ variable is still significant. The results are consistent with those of Bach (2016). Much attention is turned to the result for the $Foreign_{it} \times \Delta E_{it-1}/P_{it-2} \times D_{it}$ variable. This variable is negative but insignificant. This result does not support the findings of An (2015).

5. Conclusion

Using data from a sample of listed firms in Vietnam for the period from 2005 to 2014, this study finds that foreign ownership affects accounting conservatism. However, while An (2016) finds that the association between foreign ownership and accounting conservatism is significantly positive, the results of this study finds the negative relationship. It is very likely that foreign ownership affects accounting conservatism positively as the level of foreign ownership is large enough that foreign investors are able to actively oversee the performance of a firm. In other words, the ownership structure with low levels of foreign ownership supports the transient hypothesis rather than the active-monitoring hypothesis. The findings contribute to the understanding of the relationship between ownership structure and financial information quality. In particular, foreign investors with the low level of ownership likely do not have significant incentives to oversee managers, thus not influencing financial reporting quality. Moreover, the findings are probably of potential interest to regulators and accounting standard-setters in the context of the increasing reforms to reducing barriers for foreign investors.

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