

## Value Relevance of Financial Restatements: Malaysian Perspective

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**Abstract:** The purpose of this study is to examine whether the market perceives financial restatements as an important factor when it determines the value of the company. The sample comprises of 250 public listed companies on the Main Board or the Second Board of Bursa Malaysia for the years between 2005 and 2015. A multivariate regression analysis is used by employing the Ohlson's valuation model and it is based on the methodology developed by Davis-Friday, Eng and Liu. The study finds no significant relationship between financial restatement and firm value. However, the results highlight that the equity book value and earnings reported in the financial statement is value-relevant for investors in assessing Malaysian firm's value.

**Key words:** Value relevance, financial restatements, Malaysia, market, earnings, book

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### INTRODUCTION

Globally, financial restatements become a subject matter that had been discussed for decades. The issue behind it remains unresolved as the number of restatements continues to increase from year to year starting from the high profile corporate scandals in the United States (US) (i.e., Enron and World Com). In most cases, these restatements set off the disclosure of massive internal control and governance problems within the companies which caused significant damage to their reputation and market value and occasionally even prompt their bankruptcy. According to the US Government Accounting Office (GAO), there are about 2,705 financial restatement's cases reported from January 1997 until June 2006 that it makes the unadjusted losses in the market capitalization nearly \$18 billion. The Audit Analytics Report 2014 also specified that the number of restatements cases reported keep increasing over thirteen years from 2000 until 2013.

Financial restatements can be described as the process of reviewing and altering the errors in the formerly issued financial statement and such methods violate the Generally Accepted Accounting Principles (GAAP) (Abdullah *et al.*, 2010; Palmrose *et al.*, 2014). Primarily, financial restatements are inevitable to safeguard related parties' interest (i.e., shareholders and stakeholders) by providing them with accurate financial information for the decision making process. However, management is likely to employ their decisive influence by

using this opportunity for their interest that is they merely use their insider knowledge of the upcoming announcement to conceal data manipulation traces (Mohamed *et al.*, 2015). Such arrangements that are made by management could pose severe threats towards a company as the reported financial figures do not reflect the firm's actual condition. Therefore, restatements portray serious corporate reporting failures which cause investor's concerns about the credibility and reliability of restated firm's financial reporting quality.

Many studies on financial restatements that focused on the impact of restatements towards firm value have been done using the US capital market. For example, restatement events could deprive the condition of companies as significant losses on the market value (Anderson and Yohn, 2002) lead to the higher possibility of valuation degradation which in turn affects the company's stock price (Palmrose *et al.*, 2014). Hribar and Jenkins (2004) documented that restating companies might have suffered an intensifying cost of capital which eventually, the companies have to bear such massive losses. Apart from that, the incidence of restatements caused the directors to bear a significant reputational cost and experience massive market penalties from authorities (Srinivasan, 2005). Restatements also lead to the discovery of internal control weaknesses (Bizarro *et al.*, 2011), high likelihood of manager turnovers (Burks, 2010; Leone and Liu, 2010; Land, 2010; Srinivasan, 2005) and auditor turnover (Hennes *et al.*, 2013; Thompson and Coy, 2008; Srinivasan, 2005).

In the Malaysian context, however, there is lack of studies that discuss the impact of financial restatements, especially on firm value. The extent to which companies provide a fair view of their financial statements is a central issue of good financial reporting quality. The emergence of a sound financial statement by management is a necessary element since investors want to assess a company's future cash flows and conditions. Therefore, there is a need to highlight the impact of financial restatements towards investors since, it can affect investor's confidence in the credibility of financial reporting.

### Hypothesis development

**Financial restatements and firm value:** The occurrence of financial restatements is mainly due to the decision taken by the company whereby auditors revised public financial information that was previously reported. Studies on financial restatements have shown severe financial and non-financial impacts in turn, these effects have resulted in increased awareness of all market players towards the issue of financial restatements. Aggressive accounting method is one of the issues related to the incidence of financial restatements in which management decided to pursue such methods to ensure company's endurance. However, the aggressive accounting methods would result in relatively lower bonus compensation as well as higher turnovers of CEOs, CFOs and external auditor's post-restatements (Collins *et al.*, 2008; Anderson and Yohn, 2002).

Apart from that, the existence of financial restatements clearly signals that the prior financial statements were not reliable and relatively lower quality (Anderson and Yohn, 2002). These low financial reporting qualities exhibit inefficient allocation of economic resources and reflect a concerning internal controls weaknesses in which it subsequently leads to the economic implications (Chi and Sun, 2014; Bizarro *et al.*, 2011). The study by Anderson and Yohn (2002) has supported the statement in which the authors indicate that the restating firms suffer negative market returns for accounting problem announcements. The adverse impact on firm value would lessen company prospects and increased the uncertainty (Rajgopal and Venkatachalan, 2011; Palmrose *et al.*, 2014). In addition, restatements events also lead to a decline in expected future earnings, increment in the firm cost of equity capital, substantial fines and reputational loss for the firm (Karpoff *et al.*, 2008).

Moreover, the outbreak of the Asian financial crisis which has a great impact towards Malaysian economy has

eroded investor's confidence in the reasonableness of the financial information for equity valuation. This statement has been supported by the study by Davis *et al.* (2006) in which it is found that there is a deterioration in the value relevance of Malaysian firm's accounting information, i.e., book value and earnings during the crisis. In addition, the researchers further stated a weak corporate governance is normally due to the deviation in the value relevance of the equity book value and earnings. Thus, this study proposes the hypothesis as follows:

- H<sub>1</sub>: there is a significant negative relationship between financial restatement and firm value

### MATERIALS AND METHODS

The sample comprises of the public listed companies on the Main Board or the Second Board of Bursa Malaysia for the years between 2005 and 2015. Both of the financial and corporate data are obtained from the annual reports. A total of 250 firms meet the selection criteria included in the study. The selection criteria based on the step introduced by Abdullah *et al.* (2010) in which the keywords of "restate", "restated", "restatements" and "prior adjustment" are searched in each of the annual reports to find the incidents of financial restatements. Through the matching process introduced by Arthaud *et al.* (2006), the final sample for this study is 250 companies that consist of 125 restatement firms and 125 non-restatement firms. Table 1 presents a summary of industry classifications of the sample.

The model of the study is based on Ohlson (1995)'s valuation model in which market value as a function of book value and earnings. The study is conducted as an extension of the analysis made by Davis *et al.* (2006) in which, it tests the hypothesis of value relevance elements (i.e., market value of equity, book value of equity and earnings per share). The following regression model is used to examine whether the market perceives financial restatements as an important factor when it determines the value of the company:

$$MVS_{it} = \alpha_0 + \alpha_1 BVS_{it} + \alpha_2 EPS_{it} + \alpha_3 FR_{it} + e_{it}$$

Table 1: Sample distribution by industry

Industry	No. of		Total
	non-restatements firms	restatement firms	
Consumer product	17	18	35
Industrial product	30	31	61
Plantation	15	15	30
Properties	12	11	23
Construction	13	12	25
Trading and service	38	38	76
Total	125	125	250

Where:

$MVS_{it}$  = The market value of equity per share of firm  $i$ , year  $t$

$BVS_{it}$  = Book value per share of company  $i$ , year  $t$

$EPS_{it}$  = Earnings per share of firm  $i$ , year  $t$

FR = Dummy variable; 1 for the firms that restate their financial statements, otherwise coded 0 for firm  $i$ , year  $t$

$e_{it}$  = Error term in firm  $i$ , year  $t$

## RESULTS AND DISCUSSION

Table 2 shows the descriptive statistics analysis for all variables (i.e., market value per share, book value of equity per share, earnings per share and financial restatement) which consist of the mean, standard deviation, minimum and maximum values of the variables. As reported in Table 2, it appears that on average both share price and equity book value for 125 restatement and non-restatement companies are RM1.30 and 1.36, respectively. As for the earnings, on average, the results show accounting earnings of the sample is RM12.

The statistical results in Table 3 exhibit the Pearson's correlation analysis between all variables. As reported in Table 3, financial restatement is significantly and negatively correlated with Book Value of equity per Share (BVS) and negatively correlated with Market Value per Share (MVS) and Earnings Per Share (EPS);  $r = -0.207$ ;  $r = -0.115$  and  $r = -0.04$ , respectively. It is expected that financial restatement would adversely affect the firm value. These results imply that investors may find the priority issued financial statement is not reliable and the financial restatements could damage the quality of financial information provided. These results may also indicate that investor's trust towards the firm's aptitude to sustain its competitive advantage is eroded.

Furthermore, other variables are positively and significantly associated to each other. The correlation result indicates that the highest correlation is between market value per share and book value of equity per share ( $r = 0.602$ ;  $p = 0.05$ ). Further, earnings also shows a positively and significantly correlated to market value per share ( $r = 0.396$ ;  $p = 0.05$ ) and book value of equity per share ( $r = 0.352$ ;  $p = 0.05$ ). The results suggest that both equity book value and earnings are value relevance accounting information to investors in the valuation of the market value of shares. Overall, the effect of multicollinearity does not suggest any problems as the correlation coefficient of all the variables is small that is  $<0.80$ .

Table 4 presents the regression result of the effect of financial restatements on the relative value relevance of equity value and accounting earnings. As per Table 4, the results in the model indicate that  $R^2$  and the adjusted

Table 2: Descriptive statistics for all variables

Variables	N	Min.	Max.	Mean	SD
MVS	250	0.060	11.000	1.30363	1.520198
BVS	250	-7.406	7.044	1.36288	1.493147
EPS	250	-315.000	466.400	12.03724	44.861270
FR	250	0	1	0.50	0.501

Table 3: Pearson correlation matrix for all variables

Variables	MVS	BVS	EPS	FR
MVS	1	-	-	-
BVS	0.602	1	-	-
EPS	0.396	0.352	1	-
FR	-0.115	-0.207	-0.004	1

Correlation is significant at the 0.01 level (2-tailed)

Table 4: Regression of market value of equity on equity book value and accounting earnings, financial restatements

$MVS_{it} = \alpha_0 + \alpha_1 BVS_{it} + \alpha_2 EPS_{it} + \alpha_3 FR + e$			
Variables	Coefficients	t-statistics	p-values
Constant	0.494	3.613	0.000
BVS	0.536	9.748	0.000
EPS	0.007	3.978	0.000
FR	-0.014*	-0.094**	0.925***
$R^2$	0.401		
Adjusted $R^2$	0.393		
F-statistics		54.842	

\*\*\*Significant at 0.01 level, \*\*Significant at 0.05 level, \*Significant at 0.10 level. The samples consist of 250 observations during the year 2005 until the year 2015. MVS = The share prices at the end of the financial year in Malaysian currency (RM). BVS = The shareholders fund per-unit of shares in Malaysian currency (RM). EPS = The earnings before extraordinary items per unit of shares in Malaysian currency (RM). FR = Takes value "1" if firm restates previous financial statement, "0" otherwise

$R^2$  are 0.401 and 0.393, respectively. The adjusted  $R^2$  implies 39% of the variation in market value per share is explained by the variation in book value of equity per share, earnings per share and financial restatements as well as taking into account the sample size that is 250 companies and the number of variables. Table 4 analyses how financial restatement affects firm value.

The value for coefficient on book value per share ( $\alpha_1 = 0.536$ ;  $t = 9.748$ ) and earnings per share ( $\alpha_2 = 0.007$ ;  $t = 3.978$ ) are positive and are statistically significant. It, therefore, suggests that equity book value and accounting earnings are value relevance in determining a firm's market value. In other words, investors still rely on the accounting information to make their investment decisions. This statement consistent with the findings by Ahmad (2006) whereby both equity book value and accounting earnings are still of value relevance for the investors in the valuation of the market price after the financial crisis.

Although, the coefficient on financial restatement was statistically insignificant, it partially supports  $H_1$  in which it is expected that financial restatements give negative impact towards the firm value. The findings also suggest that there is a high probability for restating firms suffer a decline in its firm value and have to face negative market reaction. This consequence could be due to the

accounting concerns on investor's confidence in the stock market. GAO stated that investors are unlikely to invest in the problematic company which in this case is a firm that restated its previous financial statement. Management usually decides which accounting methods to choose in order to solve the accounting problems in these restatement companies. However, management takes a further action to choose an aggressive accounting method as to satisfy their interest and in turn, company is affected with the severity of restatements issue. Due to that reason, firms are unable to maintain investor's confidence in the management of the firms as management fails to exercise their duties in ensuring the preparation of the financial statement in accordance with accounting standards. Investors also believe their investment may not be worthwhile since firms are likely had to face future problems such as possible lawsuits because of restatements issue. Therefore, increase in market volatility and a decline in the quality of accounting information and corporate management are resulted from the restatements event and it definitely impairs investor's confidence towards company's information. The results of this study are consistent with the past literature (Ma and Zhang, 2011; Palmrose *et al.*, 2014; Anderson and Yohn, 2002).

### CONCLUSION

The issue of corporate scandals and financial restatements remains to be a concerning global problem. Recently, many restatement cases have been disclosed among Malaysian publicly traded companies and it has received extensive attention from the regulators. These restatements cases have a tremendous impact towards Malaysian capital market which indirectly undermined investor's confidence. In particular, the increase in the number of financial restatement cases provides the key motivation for the study to examine value relevance of financial restatements in Malaysia. From the findings, it is found that financial restatements do negatively influence the firm value which it suggests that financial restatements clearly signal a red flag concerning the company's credibility, integrity and the quality of financial information. The existence of restatements event represents the misconduct by management whereby their action endanger firm's endurance and stability in an open market.

Overall, the findings of the study help to establish a starting point to empirically explore further the importance of value relevance analysis in the area of financial restatements in Malaysia. This study provides a useful insight that may be beneficial to the users of financial statements, particularly investors to assess financial

restatements through its value relevance information. In addition, the findings may be used to prevent the long-term effects of financial restatements on the firm value. The findings also offer opportunities for future studies to explore other potential factors that can add value to the restatements and its value relevance. Indeed, the findings could be useful to regulators to find ways to improve the financial reporting framework and continue in cultivating the efficient and practical approach to mitigating the occurrence of financial restatements.

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