UNIVERSITI PUTRA MALAYSIA

EFFECT OF FAIR VALUE ACCOUNTING FOR FINANCIAL INSTRUMENTS ON THE DECISION USEFULNESS OF REPORTED EARNINGS

CHONG LEONG YEW

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By

CHONG LEONG YEW

Thesis Submitted to Putra Business School in Fulfilment of the Requirements for the Degree of Doctor of Philosophy

February 2018

DEDICATION

This thesis is dedicated to my family members who constantly supported and encouraged me throughout the whole journey. Thank you for standing beside me through the ups and downs. I also want to give glory to God for answering my prayer to make this journey a success.

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirement for the degree of Doctor of Philosophy

EFFECT OF FAIR VALUE ACCOUNTING FOR FINANCIAL INSTRUMENTS ON THE DECISION USEFULNESS OF REPORTED EARNINGS

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February 2018

Chairman : Associate Professor Ahmed Razman Abdul Latiff, PhD
Faculty : Putra Business School

At present, the decision usefulness of fair value accounting is still very much debated among academicians. Given the ongoing debates and the limited evidence available, it is still an open question as to whether Fair Value Accounting (FVA) for financial instruments enhances or impairs the decision usefulness of reported earnings. This study is undertaken to examine the effects of FVA for financial instruments on the decision usefulness of reported earnings for financial firms in the Asia Pacific region under IFRS environment. This study also examines whether corporate governance mechanisms moderate the relationship between FVA for financial instruments and reported earnings. Furthermore, the impact of country-level legal enforcement on the relationship between FVA for financial instruments and reported earnings is also examined. This study contributes to the literature on whether the shift from Historical Cost Accounting (HCA) to FVA enhances the decision usefulness of reported earnings.

Data for a sample of 480 firm-year observations were hand-collected from the listed financial firms from three countries namely Hong Kong, Singapore, and Malaysia in the Asia Pacific region over the 5-year period from 2012 to 2016. This study uses Panel Data and Hierarchical Regression Analysis Techniques to examine the objective of this study, which is the effects of fair value accounting for financial instruments on the decision usefulness of reported earnings.

Due to the statistically insignificant results, this study establishes that there is not enough evidence to conclude that the Adjusted Comprehensive Income (ACI) has more predictive power than Net Income (NI) on future Operating Cash Flows (CFO) and future NI. With regard to value relevance, the results also show that there is not

enough evidence to suggest that ACI is more value relevant than NI for both share prices and share returns as the results are statistically insignificant.

As for the strength of Corporate Governance mechanisms, the results show that the strength of CG mechanisms positively moderates the predictive power of financial instruments' fair values on future CFO. The results also show that the strength of CG mechanisms positively moderate the value relevance of financial instruments' fair values on share prices. As for the stronger country-level enforcement, the results, however, show that stronger country-legal enforcement in developed countries negatively moderates the predictive power of financial instruments' fair values on future CFO. The results also show that stronger country-legal enforcement in developed countries positively moderates the value relevance of financial instruments' fair values on share returns.

The findings of this study have implications on the investors, shareholders, standard setters, policy makers, and regulators. The reporting fair value changes in financial instrument components in Other Comprehensive Income can be regarded as decision useful information. This may imply that investors may need to pay attention to the fair value reporting for financial instrument components when making investment decisions. The results from the study may benefit the standard setter such as IASB as it provides empirical evidence on the use of accounting standards for countries in the Asia Pacific region where the institutional factors (e.g., ownership structures and legal enforcement) may be different from the developed countries such as US, UK, and Europe. In addition, the findings of this study may provide useful information and may benefit the policy makers and regulators.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi sebahaagian keperluan untuk ijazah Doktor Falsafah

KESAN PERAKAUNAN NILAI SAKSAMA UNTUK INSTRUMEN KEWANGAN KEATAS KEBERGUNAAN PERLABORAN PENDAPATAN TERHADAP FIRMA KEWANGAN

Oleh

CHONG LEONG YEW

Februari 2018

Pengerusi : Profesor Madya Ahmed Razman Abdul Latiff, PhD
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Pada masa ini, kegunaan keputusan perakaunan nilai wajar masih banyak dibahaskan di kalangan ahli akademik. Memandangkan perdebatan yang berterusan dan tiada bukti yang jelas, ia masih menjadi persoalan terbuka sama ada Perakaunan Nilai Saksama (PNS) untuk instrumen kewangan meningkatkan atau merosakkan kegunaan keputusan pendapatan yang dilaporkan. Kajian ini mengkaji kesan PNS untuk instrumen kewangan ke atas pelaporan pendapatan bagi firma kewangan di rantau Asia Pasifik di bawah persekitaran IFRS. Kajian ini juga mengkaji sama ada mekanisme tadbir urus korporat menyederhanakan hubungan antara PNS untuk instrumen kewangan dan pelaporan pendapatan. Selain itu, kesan penguatkuasaan undang-undang peringkat negara terhadap hubungan antara PNS untuk instrumen kewangan dan pelaporan pendapatan juga dikaji. Kajian ini memberi sumbangan kepada literatur samada peralihan dari Perakaunan Kos Sejarah (PKS) kepada PNS meningkatkan kebergunaan nilai pelaporan pendapatan.

Menggunakan data yang dikumpulkan secara tangan untuk sampel 480 pemerhatian tahun-firma dari firma kewangan tersenarai dari tiga negara iaitu Hong Kong, Singapura, dan Malaysia di rantau Asia Pasifik dalam tempoh 5 tahun dari 2012 hingga 2016. Kajian ini menggunakan teknik Panel Data dan Heirarki Analisa Regresi untuk menkaji objecktif kajian ini yang merupakan kesan PNS untuk intrumen kewangan mengenai kebergunaan keputusan pendapatan yang dilaporkan.

Oleh kerana keputusan statistik yang tidak signifikan, kajian ini menegaskan bahawa tidak ada bukti yang cukup untuk menyimpulkan bahawa Pendapatan Komprehensif Diselaraskan (PKD) mempunyai lebih kuasa ramalan berbanding Pendapatan Bersih (PB) pada Aliran Tunai Operasi (ATO) dan PB masa depan. Berhubung dengan

kerelevanan nilai, kajian ini juga menunjukan bahawa tidak ada bukti yang mencukupi untuk mencadangkan bahawa PKD mempunyai lebih kerelevanan nilai berbanding dengan PB untuk harga saham dan pulangan saham kerana keputusannya tidak signifikan secara statistik.

Bagi mekanisme Tadbir Urus Korporat (TUK), keputusan kajian ini menunjukkan bahawa mekanisme TUK yang lebih kukuh menyederhanakan positif kuasa ramalan untuk mengukur nilai saksama instrumen kewangan pada ATO masa depan. Hasilnya juga memperlihatkan bahawa mekanisme TUK yang lebih kukuh menyederhanakan positif kerelevanan nilai untuk nilai saksama instrumen kewangan pada harga saham. Bagi penguatkuasaan peringkat negara yang lebih kukuh, keputusan ini menunjukkan bahawa penguatkuasaan undang-undang negara yang lebih kukuh di negara-negara maju menyederhanakan secara negatif ke atas kuasa ramalan instrumen kewangan nilai saksama pada ATO masa depan. Keputusan ini juga menunjukkan bahawa penguatkuasaan undang-undang negara yang lebih kukuh di negara maju menyederhanakan positif kerelevenan nilai untuk nilai saksama instrumen kewangan ke atas pulangan saham.

Penemuan kajian ini mempunyai implikasi kepada pelabur, pemegang saham, penentu standard, penggubal dasar dan pengawal selia. Pelaporan perubahan nilai saksama dalam komponen instrumen kewangan dalam Pendapatan Komprehensif Lain boleh dianggap sebagai maklumat berguna untuk menbuat keputusan. Ini mungkin membayangkan bahawa pelabur mungkin perlu memberi perhatian kepada PNS untuk komponen instrumen kewangan apabila membuat keputusan pelaburan. Keputusan dari kajian ini boleh memberi manfaat kepada pengatur standard seperti IASB kerana ia memberikan bukti empirikal mengenai penggunaan piawai perakaunan bagi negara-negara di rantau Asia Pasifik di mana faktor-faktor institusi (misalnya struktur kepemilikan dan penguatkuasaan undang-undang) mungkin berbeza dari negara-negara yang maju seperti AS, UK, dan Eropah. Di samping itu, penemuan kajian ini boleh memberikan maklumat berguna dan boleh memberi manfaat kepada pembuat polisi dan pengawal selia.

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I certify that a Thesis Examination Committee has met on 28 February 2018 to conduct the final examination of Chong Leong Yew on his thesis entitled "Effect of Fair Value Accounting for Financial Instruments on the Decision Usefulness of Reported Earnings" in accordance with The Universities and University College Act 1971 and the Constitution of the Universiti Putra Malaysia [P. U. (A) 106] 15 March 1998. The Committee recommends that the student be awarded the Doctor of Philosophy.
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I hereby confirm that:

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This is to confirm that:

- the research conducted and the writing of this thesis was under our supervision;
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LIST OF ABBREVIATIONS

ACI	ADJUSTED COMPREHENSIVE INCOME
AFS	AVAILABLE-FOR-SALE
BHC	BANK HOLDING COMPANY
BPLM	BREUSCH-PAGAN LAGRANGIAN MULTIPLIER
CAS	COMPANIES ACT OF SINGAPORE
HKBO	HONG KONG BANKING ORDINANCE
HKCO	HONG KONG COMPANY ORDINANCE
CEO	CHIEF EXECUTIVE OFFICER
CFH	CASH FLOW HEDGE
CG	CORPORATE GOVERNANCE
FASB	FINANCIAL ACCOUNTING STANDARDS BOARD
FEM	FIXED EFFECTS MODEL
FV	FAIR VALUE
FVH	FAIR VALUE HIERARCHY
FVA	FAIR VALUE ACCOUNTING
FYE	FINANCIAL YEAR END
GAAP	GENERALLY ACCEPTED ACCOUNTING PRINCIPLES
G/L	GAINS OR LOSSES
HCA	HISTORICAL COST ACCOUNTING
HKEX	HONG KONG STOCK EXCHANGE
HKFRS	HONG KONG FINANCIAL REPORTING STANDARDS
IAS	INTERNATIONAL ACCOUNTING STANDARDS
IASB	INTERNATIONAL ACCOUNTING STANDARDS BOARD
IASC	INTERNATIONAL ACCOUNTING STANDARDS COUNCIL

IFRS	INTERNATIONAL FINANCIAL REPRORTING STANDARDS
MFRS	MALAYSIAN FINANCIAL REPORTING STANDARDS
HKMA	HONG KONG MONETARY AUTHORITY
MAS	MONETARY AUTHORITY OF SINGAPORE
NI	NET INCOME
NIH	NET INVESTMENT HEDGE
OCI	OTHER COMPREHENSIVE INCOME
REM	RANDOM EFFECTS MODEL
RM	RINGGIT MALAYSIA
SEC	SECURITIES EXCHANGE COMMISSION
SFAS	STATEMENT OF FINANCIAL ACCOUNTING STANDARDS
SFRS	SINGAPORE FINANCIAL REPORTING STANDARDS
SGX	SINGAPORE STOCK EXCHANGE
UK	UNITED KINGDOM
US	UNITED STATES
USD	US DOLLAR
£	STERLING POUND

CHAPTER 1

INTRODUCTION

1.1 Introduction

The vigorous characteristic of the financial markets has brought about different kinds of volatility, such as "share prices, bond prices, interest rates, commodity prices, and foreign exchange rates". As such, firms are exposed to various kinds of financial risks. The innovation in the financial markets has spearheaded the broad-based utilisation of financial instruments[1] whether in the forms of primary instruments (e.g., equities, bonds and loan stocks) or in the forms of derivative instruments (e.g., options, swap, futures, and forwards) (Tan, 2015).

With regard to derivative instruments, they are employed by firms to hedge their exposures to financial risks. However, others use them to speculate. Before the issuance of "International Accounting Standards" (IAS) 39 ("Financial Instruments: Recognition and Measurement") and "Statements of Financial Accounting Standards" (SFAS) 133 ("Accounting for Derivative Instruments and Hedging Activities") by the two most influential standard setters namely "International Accounting Standards Board" (IASB)[2] or "Financial Accounting Standards Board" (FASB)[3] respectively, most derivative instruments were not recognised in the financial statements and remained as off-balance sheet items. This was because derivatives instruments generally failed the recognition criteria using the conventional cost-based accounting model under the historical cost accounting (HCA) (Tan, 2015). When a derivative instrument contract is entered into, there is usually no initial cash outlay required (e.g., swaps and forwards), or if there is, the amount is very negligible (e.g., options and futures) (Duh, Hsu, & Alves, 2012; Johnson & Swieringa, 1996; Wilson & Smith, 1997). Thus, it rendered these derivative instruments unable to fulfill the recognition criteria to be recognised in the financial statements under the conventional cost-based accounting model. Therefore, exposure to these instruments was hidden in terms of HCA. Although these derivative instruments were not recognised in the financial statements, the changes in their values could have a great impact on the financial statements and the solvency position of a firm. In the past, there were instances firms had gone bankrupt or suffered huge losses due to high exposure to the derivative instruments (e.g., Gibson Greetings, Proctor & Gamble and Barings Bank) (Barnes, 2001; Beisland & Frestad, 2013; Hassan, 2004). As a result of these events, the IASB

[1] "International Accounting Standard" (IAS) 32 ("Financial Instruments: Presentation") defines a financial instrument as "any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity" (IAS 32 Para 11).

[2] IASB is the "IFRS Foundation's independent standard-setting body" that issues "International Accounting Standards (IAS/IFRS)". Being a not-for-profit organization, its principle objectives are "to develop a single set of high-quality, globally accepted IFRS which is understandable and enforceable based on principles that are clearly articulated" (www.ifrs.org).

[3] FASB is a "private, independent non-profit organization" that "establishes accounting and reporting standards and improves generally accepted accounting principles (GAAP) within the US in the public's interest" (www.fasb.org).

and FASB were under intense pressure to develop a more consistent and comprehensive standard for the reporting of derivative instruments (Barnes, 2002; Beisland & Frestad, 2013).

In respect of primary financial instruments where before the IAS 39 and SFAS 115 ("Accounting for Certain Investments in Debt and Equity Securities") came into effect, "certain debt and equity securities" were captured at "lower of cost or market" on the balance sheet (Lifschutz, 2011) with disclosure about the current market values as supplementary information (Barth, Landsman, & Wahlen, 1995; King, 2009). Under this treatment, gains would not be recognised and therefore, were hidden. If there were losses, write-down should be recognised immediately. However, write-downs would only be recognised when a drop in securities' market values was regarded as "other than temporary" (King, 2009). Owing to the weak definition of "temporary" drop in market value, most firms continued to keep the value of original cost on the balance sheet (King, 2009; Laux & Leuz, 2010; Linsmeier, 2011). As such, firms could avoid recognising gains and losses from fluctuations in the market value of securities until the time of settlement. This approach allowed firms to "cherry-pick" gains or losses (Butler, 2009; Hitz, 2007). By disposing of the investments which were profitable, a firm would be able to realize those profits and thereby, showed a rise in reported earnings and vice versa.

However, the limitations of this approach were manifested in the "Savings and Loan (S&L) crisis" which started in the US in the 1980s. The HCA with impairment estimates' approach has given an insufficient timely warning about the decline in assets' values held by the financial institutions (Linsmeier, 2011). According to the report by the Government Accounting Office (GAO) in 1991 on 39 failed institutions from 1988 to 1989, it was discovered that when the institutions were put in receivership, the investigators' of Federal Deposit Insurance Corporation (FDIC) estimated that these institutions' loan portfolios had suffered losses of up to USD 8.1 billion. However, up to the point of insolvency, only losses of USD 1.3 billion were reported to banking regulators in their call reports[4] (Government Accountability Office, 1991; Linsmeier, 2011).

Therefore, following the S&L crisis, HCA had proven to be inadequate (Hitz, 2007). The use of fair value approach would have highlighted the problem much earlier and therefore, this would have prompted more timely actions and less costly intervention from regulators (Barth et al., 1995; Glavan, 2010; Linsmeier, 2011; Plantin, Sapra, & Shin, 2008). Resulting from this crisis, an increased use of fair values in financial reporting was called for[5] (Epstein & Henderson, 2011; Gebhardt, 2012; Hitz, 2007).

[4] The respective regulators and other parties require all financial institutions that are regulated in the US to file periodic financial and other information.

[5] Among others, the SEC had recommended to the FASB to come out with a standard to estimate certain debt securities at fair value instead of amortised cost (Hitz, 2007).

Consequently, this has led to the shift in measurement paradigm from HCA to fair value accounting (FVA[6]) (Georgiou & Jack, 2011; Hitz, 2007).

In the past two decades, the financial reporting rules have moved towards more fair value based[7] (Barlev & Haddad, 2003; Duh et al., 2012; Emerson, Karim, & Rutledge, 2010; Hitz, 2007; Palea, 2014). The IASB and the FASB consider fair value[8] as a potential measurement basis in almost every decision they make as they believe that in many cases fair value meets the conceptual framework criteria better than other measurement bases (Barth, 2006, 2008, 2014). However, the increasing exposure to fair values in financial reporting has sparked an ongoing debate about the merits of FVA-based reporting system as opposed to the HCA (Barron, Chung, & Yong, 2016; Bratten, Causholli, & Khan, 2016). The proponents of fair value believe that fair value information is the only information relevant for financial decision-making as fair values provide the most current and up-to-date value of assets and obligations (Barth, 2014) as well as information about the timing and riskiness of future cash flows (CFA Institute, 2007). Therefore, FVA-based reporting system should provide more decision-useful information to the users of financial statements.

On the contrary, the opponents of fair value are concerned that the FVA impairs the decision usefulness of reported earnings[9]. This is because rather than representing economic events such as earning revenues or incurring expenses, opponents claim that the gains and losses recognized in a fair value reporting system is driven by short-term volatilities (Chisnall, 2001), which are transitory in nature, due to the recognition of unrealized fair value gains or losses under FVA (Ball, 2006; Gebhardt, 2012; Gray, 2003).

This study examines one of the most debated issues of accounting, and that is on the reporting of FVA for financial instruments and its effects on reported earnings. Studying FVA for financial instruments' effect on reported earnings is important,

[6] FVA is a "financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis certain assets and liabilities (generally financial instruments) at estimates of the prices they would receive if they were to sell the assets or would pay if they were to be relieved of the liabilities" (Ryan, 2008b). Under FVA, firms recognise gains when their assets' fair values increase or liabilities decrease and vice versa.

[7] The SFAS 105 ("Disclosures of information about Financial Instruments with Off-balance sheet Risk and Financial Instruments with Concentration of Credit Risk") was issued by FASB in 1990, SFAS 107 ("Disclosures about Fair Value of Financial Instruments") in 1991 and SFAS 119 ("Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments") in 1994. For the fair value recognition, SFAS 115 ("Accounting for Certain Investments in Debt and Equity Securities") was issued in 1993, SFAS 123R ("Share-based Payments") in 2004 and SFAS 133 ("Accounting for Derivative Instruments and Hedging Activities") in 1998. The IAS 32 and IFRS 7 were issued by the IASB on "presentation and disclosures on financial instruments", IFRS 2 on "share-based payments", IAS 39 on "the measurement and recognition of financial instruments" and IFRS 9 ("Financial Instrument") which superseded IAS 39 in 2018.

[8] Fair value is interpreted as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (IFRS 13 Para 9).

[9] For general discussion purposes, reported earnings refer to earnings that are captured in the "Income Statement" and "Statement of Comprehensive Income".

given that the earnings volatility was the major point of controversy surrounding the adoption of SFAS 133 in the US[10]. The same goes to the European Union where the introduction of International Financial Reporting Standards (IFRS) into Europe, particularly IAS 39, also caused strong objection from the banking industry (Larson & Street, 2004; Zeff, 2010).

One of the most cited reasons for corporate resistance to FVA is the concern that the recognition of unrealized fair value gains or losses, which are transitory in nature, would induce volatility[11] to the reported earnings (Gebhardt, 2012; Zeff, 2010). The public statements by representatives from the banking industry in the US (e.g., the American Bankers Association and the International Banking Federation) suggest that periodic revaluation of financial instruments are misleading because these revaluations are neither relevant nor reliable (Evans, Hodder, & Hopkins, 2010; Leone, 2008). As such, this volatility may reduce the decision usefulness of reported earnings as an indicator of management performance (Brüggemann, Hitz, & Sellhorn, 2013). In view that the emerging countries will eventually experience the similar impacts from the developed countries in this respect, it is timely, therefore, to conduct a study in emerging countries with much smaller and less efficient economies where the effects of these problems could be larger than in the developed countries.

Reporting financial instruments is complex as financial instruments themselves are complex[12]. This complexity has been compounded by the requirements of IAS 39, which are rule-based, complex, and difficult to apply in practice (Jermakowicz & Gornik-Tomaszewski, 2006; Paananen & Lin, 2009). In view of the complexity of the application of IAS 39, this has led to the development of IFRS 9 ("Financial Instruments") to simplify the measurement of financial instruments (Fiechter, 2011). At present, the development of IFRS 9 has been completed and has superseded IAS 39 on 1 January 2018. Even though IAS 39 has been superseded by IFRS 9, studying the FVA in reporting financial instruments (e.g., "Fair Value through Profit and Loss" (FVTPL) and "Fair Value through Other Comprehensive Income" (FVTOCI)) will still be relevant as the same approach has been carried over to IAS 39 from IFRS 9.

1.2 Effects of FVA for financial instruments on reported earnings

According to Bichof (2009), it is reported that financial instruments form over 90%, on average, of the banking sector's total assets and liabilities. Besides, the markets for financial instruments have also grown richer (Bhat, 2013) and expanded at an enormous rate over the years (Hodgkins, 2014). Therefore, the fluctuations in financial instruments' fair values may significantly impact the reported earnings of financial

[10] Barnes (2002) found that 61% of the 250 comment letters that came back following the exposure draft mentioned that earnings volatility impact as a major point of discussion.

[11] Fair value is conceptually interpreted as "the present value of a stream of expected future cash flows, and its changes reflect variations in the expectations associated with those future cash flows, which can lead to increased volatility in earnings" (Barth & Landsman, 1995; Hodder, Mayew, et al., 2006).

[12] The discussion paper of IASB is referred to on "Reducing Complexity in Reporting Financial Instruments" in 2008.

firms. One way to illustrate the significance of the impact of FVA for financial instruments on reported earnings of financial firms is shown in Figure 1.1. Figure 1.1, which is based on the 2013 Annual Report of Prudential Plc, shows that while a Net Income (NI) of £1,346 million was shown in the Income Statement, only £9 million was shown in the Comprehensive Income (CI) mainly resulting from the impact of accounting treatment of FVA for financial instruments presented under "Other Comprehensive Income" (OCI) items. In this regard, the NI was almost "wiped out" by the unrealized losses suffered by the financial instruments. This example demonstrates the significance of the impact of FVA for financial instruments on reported earnings for financial firms.

	31 Dec 2013 £ mil
Net Income	1,346
Other Comprehensive Income	
Net change in securities	(1,034)
Net change in derivatives	(255)
Others	(48)
Total Other Comprehensive Income	(1,337)
Comprehensive Income / (Loss)	9

Figure 1.1 : Statement of Comprehensive Income of Prudential Plc (listed in Singapore)
(Source: 2013 Annual Report of Prudential Plc)

Beside financial firms, the impact of FVA for financial instruments on reported earnings can also be significant for non-financial firms if they have high exposure to the utilisation of financial instruments as can be shown in Figure 1.2. Figure 1.2, which is based on the 2015 Annual Report of AirAsia Berhad, shows that while NI of RM 541 million was captured in the Income Statement, a Comprehensive Loss of RM 19 million was shown in the CI resulting from the similar impact of FVA for financial instruments. In this regard, the NI was entirely "wiped out" by the unrealized losses suffered by the financial instruments.

	31 Dec 2015 RM mil
Net Income	541
Other Comprehensive Income	
Net change in securities	(203)
Net change in derivatives	(336)
Others	(21)
Total Other Comprehensive Income	(560)
Comprehensive Income / (Loss)	(19)

Figure 1.2 : Statement of Comprehensive Income of AirAsia Berhad (listed in Malaysia)
(Source: 2015 Annual Report of AirAsia Bhd)

Furthermore, the impact of FVA for financial instruments on reported earnings is likely to be more significant for financial firms particularly during times of economic crisis (e.g. global financial crisis in 2008) where huge contrasting results can arise between NI and CI through the impact of accounting treatment of FVA for financial instruments as shown in Figure 1.3.Figure 1.3, which is based on the 2009 Annual Report of HSBC Holdings Plc, shows that while NI of USD 6.5 billion was shown on the Income Statement, there was a huge Comprehensive Loss of USD 29.1 billion recorded in the CI through the similar impact of FVA for financial instruments.

	31 Dec 2008 USD mil
Net Income	6,498
Other Comprehensive Income	
Net change in securities	(21,904)
Net change in derivatives	124
Others	(13,857)
Total Other Comprehensive Income	(35,637)
Comprehensive Income (Loss)	(29,139)

Figure 1.3 : Statement of Comprehensive Income of HSBC Holdings Plc (listed in Hong Kong)
(Source: 2009 Annual Report of HSBC Holdings Plc)

Therefore, in view of the potentially significant impacts of the FVA for financial instruments on CI as can be seen from the examples above, this raises a question as to which accounting metric is more decision-useful, NI[13] or CI[14].

Traditionally, NI, which mainly comprises of historical cost, is an important performance measure (Tsujiyama, 2007). Traditional performance measures such as "return on assets" (ROA), "return on equity" (ROE) and "earnings per share" (EPS), which are based on NI, are still commonly used measures by the investors to analyse the performance of a firm. However, CI can offer "more objective and useful information" because of the "periodical change in net assets, given that assets and liabilities held by an entity are objectively observable" (Tsujiyama, 2007). This means that CI, which includes more reporting of fair value for financial instruments under the OCI items, can provide a more comprehensive measure of earnings and therefore, reflects a better economic reality of a firm's performance (Bradshaw & Sloan, 2002). As such, it is an unresolved issue whether the reporting of FVA for financial instruments enhances or impairs the decision usefulness of reported earnings.

1.3 Background of the Research

In the last two decades, IASB and FASB, being the international standard setters, have started supporting the FVA usage as compared to HCA in financial reporting (Barth, 2006, 2008). The main purpose behind this movement in measurement paradigms is to enhance the accounting information's relevancy in financial reports following the "Savings and Loan crisis (S&L)" which happened in the US in the 1980s (Hitz, 2007). The primary cause for this move is that the FVA is able to present more "relevant" and "up-to-date" information that can improve the abilities of investors and regulators in making more timely decisions. This is because financial statements compiled under historical cost are incapable of presenting a timely reflection of the true value of financial instruments (Hitz, 2007; Linsmeier, 2011). Consequently, this had resulted in an expansion of various standards by FASB to ensure that financial instruments' accounting treatment is regulated. For example, FASB had issued SFAS 105 ("Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk") to oversee the information disclosure on financial instruments involving "off-balance-sheet risk and concentrations of credit risk", SFAS 107 ("Disclosures about Fair Value of Financial Instruments") to regulate the financial instruments' fair value disclosure, SFAS 115 ("Accounting for Certain Investments in Debt and Equity Securities") to oversee the measurement of debt and equity securities' investments and SFAS 119 ("Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments") to regulate the "fair value disclosure of financial instruments and derivatives" (Bloom & Fuglister, 1999). Later, SFAS 133 ("Accounting for Derivative Instruments and

[13] Even though NI includes some fair value gains or losses from financial instruments (e.g. "Fair Value through Profit and Loss" and "ineffective portion of Cash Flow Hedge" and "Net Investment Hedge"), it is mainly comprised of historical cost (Bhat, 2013; Sodan, 2015).

[14] CI, which includes components of OCI, has more exposure to fair value adjustments for financial instruments (Sodan, 2015; Bratten et al., 2016).

Hedging Activities") was made effective from 1998 to deal with fair value and govern financial derivatives and hedging accounting treatment and demands that all financial instruments be captured in the balance sheet including the derivative instruments (Rasch & Wilson, 1998).

Meanwhile, with the purpose of reaching convergence with FASB, the "International Accounting Standards Council" (IASC) ("the predecessor of IASB") has issued the original IAS 32 ("Financial Instruments: Disclosure and Presentation") in 1995 to regulate financial instrument presentation and disclosure. In 1998, IAS 39 ("Financial Instruments: Recognition and Measurement") was issued but was later amended in 2003 to outline the recognition, measurement and disclosures' principles of information regarding financial instruments (Tan, 2015).

Before the issuance of IAS 39 and SFAS 133, most of the derivative instruments were carried "off-balance sheet" and were not captured in the financial statements, as well as no uniformity was presented in the footnote's disclosures (if any) (Feay & Abdullah, 2001; Li & Stammerjohan, 2005). In the financial statements, these derivatives' market value changes were not accounted for until the time of their settlement where their cash flows were impacted by these financial instruments' contracts. As such, firms could avoid recognising the gains or losses of these financial instruments until the time of settlement.

As for the primary financial instruments where prior to IAS 39 and SFAS 115, certain debts and equities were captured at "lower of cost or market" on the balance sheet (Lifschutz, 2011) with disclosure about the current market values as supplementary information (Barth et al., 1995; King, 2009). Under this treatment, gains would not be recognised and therefore, were hidden. If there were losses, write-down should be recognised immediately. However, write-downs would only be recognised if a reduction in the securities' market value were regarded as "other than temporary" (King, 2009). Owing to the weak definition of "temporary" reduction in market value, many firms retained the value of original cost on the balance sheet (King, 2009; Laux & Leuz, 2010; Linsmeier, 2011). As such, the firm could avoid recognising gains and losses from fluctuations in the securities' market value until the time of settlement. This approach allowed the firms to "cherry-pick" gains or losses (Butler, 2009; Hitz, 2007). By disposing of the investments which were profitable, the firm would be able to realize those profits and thereby, showed an increase in reported earnings. On the contrary, if the firm was profitable and wanted to reduce the profit, they could choose to dispose of those losing investments that were below the actual cost.

The introduction of IAS 39 by the IASB and SFAS 115 & SFAS 133 by the FASB has standardized the accounting treatment for financial instruments. In regard to derivative instruments, IAS 39 and SFAS 133 demand the recognition at fair value on the balance sheet of all derivative financial instruments (Finnerty & Grant, 2002; Gray, 2003) and the unrealised gains or losses from the fair value changes are to be recognised in earnings (Beisland & Frestad, 2013). With regard to the primary instruments, the adoption of IAS 39 and SFAS 115 have resulted that certain debts

and equity securities (e.g., FVTPL and "available-for-sale" (AFS)) that are not kept to maturity are captured at fair values in the balance sheet, and the unrealized gains or losses resulting from the fair value changes are recognised in earnings (Epstein & Henderson, 2011; Lifschutz, 2011). In this regard, the treatment of "lower of cost and market" for certain debt and equity securities will no longer be in use.

However, these accounting treatments have given rise to another set of problems. The adoption of fair value financial reporting would lead to the short-term volatilities in the reported earnings mainly due to the recognition of unrealized fair value gains or losses under FVA (Ball, 2006; Gebhardt, 2012; Gray, 2003). According to Barth (2004), there are three sources of volatility of FVA. The first volatility is the real economic volatility captured in the fair values. This volatility needs to be reflected in order to be informative for investors. The second source is the volatility arising from the use of a mixed measurement model. This means that certain assets are valued at fair value, while other assets are valued at historical costs. The third source of volatility is the measurement error in fair value assets. This measurement error in fair value assets is caused by the use of estimates for fair values. This is because not all financial instruments have quoted prices in active markets[15] (Ball, 2006; Gray, 2003; Khurana & Kim, 2003). In the absence of actively quoted prices, estimation of fair values has to be made which involves subjective judgement (Khurana & Kim, 2003) particularly for those assets that are very difficult to value (Butler, 2009). Therefore, the reliability of fair value estimates remains a concern (Hitz, 2007) as it is open to both the intentional or unintentional biases. Consequently, this may impair the decision usefulness of reported earnings.

1.4 Evidence of Increasing Financial Instruments Utilisation by both Financial Firms and Non-Financial Firms

The banking and finance had experienced tremendous advancement in terms of economics and technology. This had triggered a widespread utilisation of financial and derivative instruments (Gebhardt, Reichardt, & Wittenbrink, 2004). As a result, there has been an expansion of the derivative markets at an enormous rate over the years (Hodgkins, 2014). It has been observed that the growth of derivatives' utilisations for the past two decades has been expeditious in both developed and emerging markets (Sundaram, 2013). Financial instruments, particularly the derivative instruments (e.g., forwards, futures, swaps, and options), are getting more broadly used by firms to minimise exposure from volatility in commodity prices, interest rates and currency (Tan, 2015). As corporate practices of risk management become more complex, these instruments' design has also shown apparent signs of creativity and flexibility. As a consequence, not only the transactions' value has increased tremendously in the past, the derivative instruments have also played an increasingly

[15] An active market "is a market in which securities as a whole are trading at a high volume" (Ryan, 2008b).

vital role in managing risk in the financial markets over the past two decades (Nguyen & Faff, 2002).

There is also evidence of increasing financial instruments' utilisation by non-financial firms. "Weiss Center for International Financial Research" has, in 1995, conducted one of the prominent studies of the use of derivatives across the world. By examining the US non-financial firms' use of derivatives, Bodnar et al. (1995) find that based on their full sample, the derivative usage had increased from 35% to 41% between 1994 and 1995. By 1998, a financial risk management practice's third series surveys, together with the non-financial firms' use of derivatives were conducted in the US (Bodnar, Hayt, & Marston, 1998). This survey is in response to the survey conducted in 1996 pertaining to the utilisation of derivative among non-financial firms in the US. No evidence is found that the use of derivatives has reduced over time. On the contrary, it is reported that, among firms using derivatives, 42% have actually increased in their usage.

Alkeback et al. (2006) investigate the usage of derivatives in Sweden in 2003 among non-financial firms with the aim of comparing with the earlier findings conducted in 1996. It is reported that in 2003, 59% of the firms in Sweden use derivatives as compared to only 52% in 1996. A number of factors, such as improved knowledge about derivatives, more stringent demand from legislators, creditors, and shareholders, and higher volatility in the market, have resulted in an increase in demand for financial derivative instruments. Lantara (2012) conducted an empirical study in Indonesia on non-financial firms with the aim of finding out what firm-specific factors deciding the use of derivatives and the usage level. The results indicate that the percentage of derivative users has grown to 20.9% in 2008 from 9.8% in 2005 but only decreased marginally in 2009 to 18.4%.

Gebhardt (2012) conducts a study on the STOXX Europe 600 index on the non-financial firms with regard to the relevancy of financial instrument. It was reported that, on average, financial assets form about 32.2% of total assets (that is about one-third of the total assets) from 2001 to 2009. The results show that substantial amounts of financial assets are held in their books. Therefore, financial assets are considered a significant part of the total assets for non-financial firms. It also discovers that out of the non-financial firms' sample in Europe in 2005, less than 10% of them display derivative assets or liabilities in their balance sheet. However, by 2008, the percentage of them displaying the derivative assets and liabilities have risen to more than 75%.

According to Bichof (2009), it is reported that financial instruments form over 90%, on average, of the banking sector's total assets and liabilities. Therefore, in view of the significant amount of financial instruments carried in their accounts, the fluctuations in values of these financial instruments are likely to have enormous impacts on reported earnings particularly for financial firms (Chea, 2011).

Moreover, the markets for derivative financial instruments have also grown richer (Bhat, 2013) and expanded at an enormous rate in recent years (Hodgkins, 2014). It has been observed that the growth of derivative instruments utilisation for the past two decades has been expeditious in both developed[16] and emerging markets[17] (Sundaram, 2013), particularly in the Asia Pacific region (Yong, Faff, & Chalmers, 2009) which warrant a study in this region. The growth of world derivatives market from 1998 to 2011 by type of market is shown in Table 1.1 below. Both the world "Over-the-Counter" (OTC) markets and exchange markets have grown significantly, with double-digit annual growth in each market. The market for world OTC in 2011 registered a USD 647 trillion worth of notional value. This market, on its own, is bigger than the rest of the financial world[18] (Sundaram, 2013). These findings are also supported by Hodgkins (2014), who reports that the notional value outstanding in the world derivative market exceeds the world's GDP, equity market, and bond market. As such, the effects of FVA for these financial instruments on the reported earnings are potentially significant, which warrant a study in this aspect.

Table 1.1 : World Derivative Market Growth from 1998-2011

World Derivative Market Growth from 1998-2011			
(in billion USD)	1998	2011	Annual Growth
Over-the-Counter Markets	80,309	647,762	17.42%
Exchange Markets	13,615	58,332	11.84%

Source: Sundaram (2013)

1.5 The Importance of Reported Earnings' Study

Reported earnings have always been an important performance measure of a business. However, policy makers and users of financial statements have always faced a challenging task in measuring the periodic performance of a firm (Kanagaretnam, Mathieu, & Shehata, 2009). This study focuses on reported earnings as they provide an important key indicator of profitability and financial information to the capital markets (Schipper & Vincent, 2003). Earnings offer useful information regarding a firm's performance and also a good indicator of future cash flows (Dechow, Kothari, & Watts, 1998). Earnings also offer information pertaining to the firm's value and firm use them as a means to convey that information to the external users about the financial and specific accounting aspects of the firm (Wild, 1994). Earnings are also used as a performance measure by external shareholders to monitor the managers.

[16] Due to significant growth of derivatives in the developed country such as US, it is reported that the "notional amount of total derivatives" held by the 25 biggest US banks expanded eighteen times from US 16.6 trillion in 1995 to US 308 trillion in 2012 (Abdel-khalik & Chen, 2015).

[17] Over the period from 2001 to 2010, the emerging markets expanded slightly faster, recording a growth of 300%, compared with 250% for the developed markets (Sundaram, 2013).

[18] As at December 2011, the total world equity market capitalization amounted to about USD47 trillion, the world's face value of bond markets amounted to about USD95 trillion, and GDP of the world was estimated to be about USD65 trillion in 2011 (Sundaram, 2013).

The study of reported earnings is also important from the viewpoint of financial reporting. Market participants have high interests on the issue of quality of earnings and its decision usefulness. Investors place a lot of emphasis on the earnings for determining the performance and value of a firm in order to achieve superior decisions on investments (Gaio & Raposo, 2011). In addition, financial analysts are making use of earnings in order to forecast the future outcomes of security investments (Pronobis & Zülch, 2010; Siegel, 1982). Earnings also used by the corporate boards and institutional investors to assess the management's quality and firm's performance (Lev, 2003). To determine the quality of financial reporting standards, standard setters are relying on the financial reports' earnings quality as an indirect indicator and feedback (Schipper & Vincent, 2003). As stated by Peasnell, Pope, and Young (2000), earnings are being employed by shareholders as a point of reference for awarding senior managers with executive stock options and also as a ground for bonuses allocation.

From the viewpoint of valuation, earnings are regarded in term of performance measure summary of firms as well as an important piece of information for public listed firms to convey to the investors. Reported earnings are used as the main criteria for deciding whether a firm could go public, to be de-listed or is eligible to go for rights issues to raise more capital (Ding & Su, 2008). Moreover, accounting earnings are often used in the evaluation models in financial theory to forecast and analyze the firm's value. As investors are relying on the reported earnings to make investment decisions, maintaining investors' confidence on earnings' decision usefulness is of utmost importance in valuing securities. On the other hand, according to Pergola (2005), manipulated earnings not only can bring huge losses to investment but also can bring damages to an economy through the effect of low earnings' quality.

In respect to capital markets, the financial accounting information ought to be "relevant and faithfully represented" (IASB, 2010) to be useful for the capital markets to rely on. The term relevant here refers to the information which has the ability to impact the decision-making of the users (Soderstrom & Sun, 2007). Whereas, the faithfully represented here refers to the information which must be "complete, neutral and free from material errors" so that it truly represents the financial position of a firm. The information quality must be strongly connected to how a firm's performance is determined. As such, any quality improvement in the accounting information (i.e., fair value reporting for financial instruments) ought to be able to offer better valuation tools for firm valuation and subsequently, improve the capital markets' efficiency and reliability (Bertin & Iturriaga, 2010).

The above discussions show that the reported earnings are of great relevance to various financial statements' users, particularly the investors. As such, it is vital to investigate whether the reporting of FVA for financial instruments enhances the decision usefulness of reported earnings to assist investors in achieving superior investment decisions.

1.6 Corporate Governance and FVA

Fair value is referred to as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (IFRS 13 Para 9). Fair value is often assigned as market value when the active market is present (Cairns, 2006). If an active market is unavailable, then the fair value estimation is made by way of inputs provided by the management (i.e., mark-to-model). Hence, if an active market is unavailable, fair value estimation can give rise to less reliable information due to estimation error (unintentional bias) (Ball, 2006; Hodder, Mayew, McAnally, & Weaver, 2006). Furthermore, when management is permitted to use their judgement in the fair value estimation, opportunities are also opened for manipulation (intentional bias) that could reduce the accounting information's decision usefulness and quality (Ball, 2006; Chen et al., 2010; Dechow et al., 2010; Hitz, 2007; Nissim, 2003; Ryan, 2008a). Previous studies have revealed the presence of intentional biases in FVA by management (Danbolt & Rees, 2008; Dietrich, Harris, & Muller, 2000; Hodder, Mayew, et al., 2006; Ramanna, 2008). For example, Enron took advantage of the discretion permitted under the FVA to overstate the assets' value (i.e., energy contracts) on the balance sheet and reported earnings in order to deceive and to misinform investors and financial statements' users which eventually resulted in its demise (Benston, 2006; Gwilliam & Jackson, 2008).

Critics of FVA state that the estimation of fair value information using "mark-to-model" may not be reliable. This is mainly due to the fact that these estimates cannot be proven and are opened to manipulation by management (Watts, 2003). Song et al. (2010) discover the "Corporate Governance" (CG) mechanisms can influence the value relevance of financial statements' "Fair Value Hierarchy" (FVH) disclosure. Song et al. (2010) also reveal that the valuation estimated under the FVH disclosure for Level 2 and 3 could be influenced by the subjectivity of the management.

A prior study such as He et al. (2012) has shown that the successfulness implementation of the FVA can be influenced by the company's level of CG as CG could have a significant role to play in implementing FVA particularly with regards to enhancing the fair value estimates' reliability. The previous literature finds that even though managers can utilise the information that they hold in order to report the fair value in a credible way (Barth, Landsman, & Rendleman, 1998), managers can manipulate for their own interest the inputs used for fair value valuation (Bartov, Mohanram, & Nissim, 2007; Benston, 2006). Past studies have indicated that the presence of strong CG mechanisms could constraint the earnings management activities (Cornett et al., 2007; Lin & Hwang, 2010; Liu & Lu, 2007; Xie et al., 2003) and thus, may enhance the reliability of fair value estimates of financial instruments, thereby enhancing the decision usefulness of the reported earnings. However, at present, research on the impact of CG mechanisms on FVA so far have been limited.

1.7 Impacts of Institutional Factors on FVA

The fundamental objective of the IASB is to achieve IFRS harmonization [19] by "developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements" (Ball, 2006; Iatridis, 2010). In this regard, one purpose of IASB is to strengthen the comparability and transparency of accounting information across different countries. This evidence is useful particularly to the international investors and security analysts who need reliable and comparable financial information across borders as they seek to diversify their investments in other countries. They would want to know whether after having adopted the same IFRS standards (i.e., financial instruments standards), the accounting numbers would provide a similar meaning for firms irrespective of which countries they are from (Rahman, 2006).

With regard to cross-border investment in the region of Asia Pacific, the amounts involved are significant. The Asia Pacific countries consist of Hong Kong SAR, Singapore, Malaysia, Japan, Vietnam, Thailand, Myanmar, China, Cambodia, Brunei, Korea (Dem), Korea (Rep), Indonesia, Philippines, New Zealand, and Australia (Stone et al., 2015). Stone et al. (2015) report that the Asia Pacific region has attracted significant inflows of Foreign Direct Investment (FDI) amounting to USD 533 billion in 2014, representing 43% of the world's FDI inflows, an increase from 38.7% in 2013 (Figure 1.4). Moreover, besides emerging as a major investment destination for inflows of FDI, this region has also been growing as a leading outflows of FDI since 2010, with the outflows of FDI in 2014 amounting to USD 563 billion, which represents 41.6% of the world's FDI outflows (Figure 1.5) (Stone et al., 2015). Therefore, the financial information's comparability across borders in this region is of great relevance to the international investors and security analysts in order to achieve superior decisions on capital allocations.

[19] Harmonization means local accounting standards are adopting the IFRS. There will still be "national differences" between IFRS and local accounting standards. Convergence means "word-by-word" implementation as local accounting standards. When full convergence is achieved, there will be no national difference (Lau, 2010).

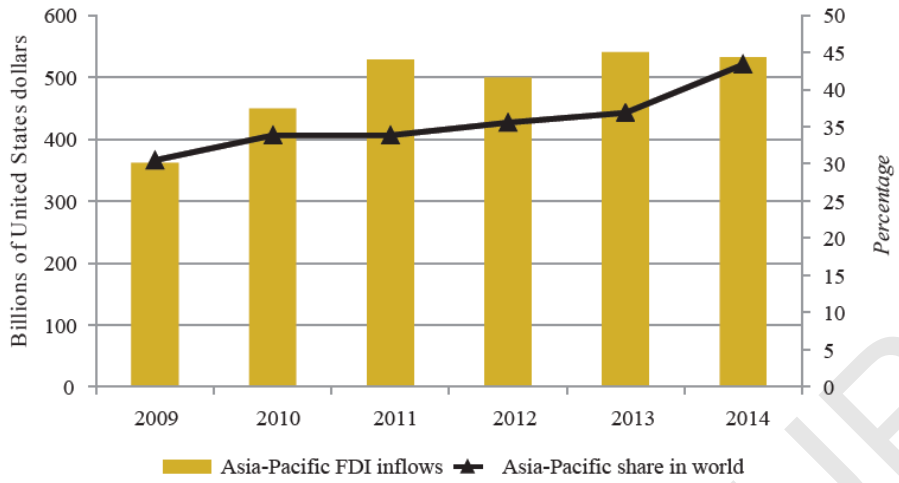

Figure 1.4 : Asia Pacific region's FDI inflows and their share in world FDI inflows, 2009-2014
Source: Stone et al. (2015)

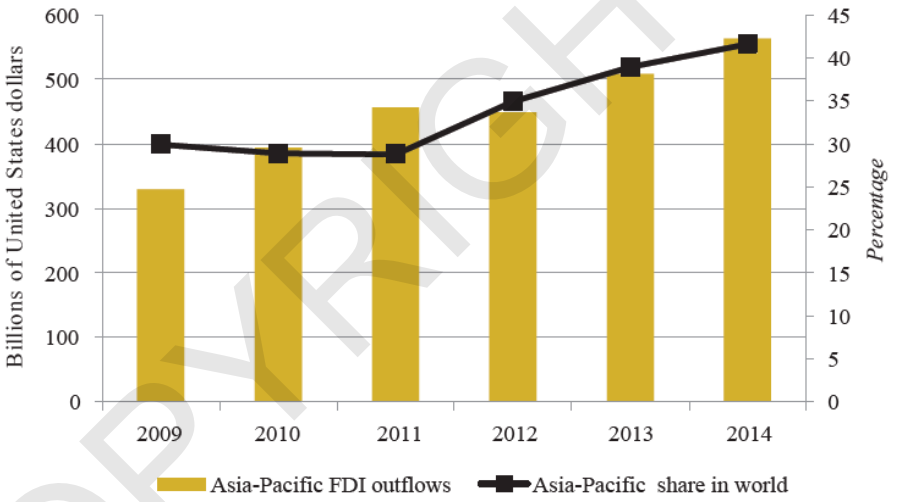

Figure 1.5 : Asia Pacific region's FDI outflows and their share in the world FDI outflows, 2009-2014
Source: Stone et al. (2015)

Over the last two decades, market globalization has resulted in an upsurge in international convergence in the IFRS and as such, resulted in the adoption of IFRS by more than one hundred countries in both the developed and emerging countries (Daske, Hail, Leuz, & Verdi, 2008; He et al., 2012). By utilising a uniform set of standards, the accounting information across countries may be more comparable and enhanced and thus, may enable investors to achieve superior decisions in funds allocation. However, this objective may not be achieved because past studies (e.g., Carlin & Finch, 2011; Nichols et al., 2012) have revealed that financial reports can become less comparable after the implementation of IFRS. There has also been a concern recently whether it is truly possible for full convergence of national standards with IFRS to take place (Ball, 2006; Holthausen, 2009). Peng and Bewley (2009) state

that the current IASB standard-setting has not focused sufficiently on whether FVA will be implemented successfully in emerging countries when compared with the developed countries. Moreover, there is also limited empirical evidence on whether emerging countries have the capabilities to adapt to FVA (Peng & Bewley, 2009).

Past literature (He et al., 2012; Peng & Bewley, 2009; Šodan, 2015) has provided some evidence that there are some difficulties in implementing FVA in some emerging countries. The current IASB's chairman, Hans Hoogervorst, had also acknowledged the challenges of implementing FVA in emerging countries during a speech on 8 March 2016, mentioning the challenges of implementing FVA when the "emerging economies markets are often not fully mature" (Chairman's Speech, 2016). This shows that the harmonization of IFRS pertaining to FVA for financial instruments may be difficult for emerging countries even though these emerging countries may have adopted the same uniform set of financial instruments' standards.

Past studies (Ball, 2006; Leuz, Nanda, & Wysocki, 2003; Soderstrom & Sun, 2007) have shown that the accounting standards on their own may not be able to determine financial reporting quality. This in no way means that accounting standards are not relevant at all, but rather, other institutional factors can too affect the financial reporting quality. As such, using a uniform set of standards may unlikely to bring about a similar financial reporting quality across countries because of different institutional factors namely legal environment, political systems, ownership structure and financial reporting incentives that may affect earnings quality (Holthausen, 2009; Leuz et al., 2003; Pronobis & Zülch, 2010; Soderstrom & Sun, 2007). This also indicates that the findings for FVA for financial instruments based on developed countries (e.g., US, UK, and Europe) may not be generalized to other jurisdictions such as in Asia Pacific region due to the considerable differences in institutional factors such as different legal environments and ownership structures.

Past studies have identified that legal enforcement environment[20] is an important institutional factor that causes differences in financial reporting quality (Burgstahler, Hail, & Leuz, 2006; Cai, Rahman, & Courtenay, 2008; Leuz et al., 2003). This is mainly due to the fact that IASB has no power to enforce the standards it promulgates (Ball, 2006; Ball, Robin, & Wu, 2003; Soderstrom & Sun, 2007) because enforcers (e.g., politicians, regulators, courts, auditors) remain primarily local, and inevitably will create differences in financial reporting quality. Wustemann and Kierzek (2006) find that the accounting practice is impacted more strongly by enforcing the rules than the content of the rules itself. Hence, a country with weak legal enforcement mechanisms can limit the harmonization of the IFRS standards (Barlev & Haddad, 2007; Georgiou & Jack, 2011) which includes financial reporting for financial instruments' standards. He et al. (2012) find that firms that are operated in regions with weaker institutions (i.e., poor legal environment) have more FVA-induced

[20] In this study, the terms of legal enforcement environment, legal enforcement and investor protection are used interchangeably. Leuz et al. (2003) did not study the effect of "legal enforcement" directly, but conclude that countries with "strong investor protection" would impose laws that can restrict earnings management.

earnings management[21] activities. Peng and Bewley (2009) find several unintended effects of mandatory IFRS adoption in China, where firms have strong earnings management incentives, and institutions are in many aspects incompatible with IFRS. As such, they find that earnings management and smoothing activities compromise the intended benefit of FVA for this purpose. Hence, the implementation of FVA in both the emerging and developed countries in the Asia Pacific region might lead to different financial reporting outcomes when compared with developed countries like the US due to differences in the legal enforcement environment.

As for the differences in legal enforcement between developed countries and emerging countries in Asia Pacific region, past studies (Cahan, Emanuel, & Sun, 2009; Cai et al., 2008; DeFond, Hung, & Trezevant, 2007; La Porta, Lopez-de-Silanes, & Shleifer, 2006; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997; Leuz et al., 2003; Shen & Chih, 2005) find that the legal enforcement for developed countries (e.g., Hong Kong and Singapore) is stronger than emerging country (e.g., Malaysia). Past studies (Burgstahler et al., 2006; Cai et al., 2008; Leuz et al., 2003) have also discovered that legal enforcement's strength reduces earnings management activities. Francis and Wang (2008) discover that earnings quality is higher for countries that have stronger legal enforcement environment. Hope (2003) discovered that strong enforcement compels managers to comply with the necessary rules and therefore, will result in a reduction of earnings management. Other past studies also find that in countries that have stronger legal enforcement environment, earnings are less managed and more value relevant (Ball, Kothari, & Robin, 2000; Hung, 2000; Leuz et al., 2003). Therefore, the presence of stronger legal enforcement in the developed countries may reduce earnings management and improve the reliability of financial instruments' fair value estimates, thereby enhancing the comparability and decision usefulness of the reported earnings. As such, the decision usefulness of reported earnings arising from FVA in developed countries may likely to be higher than emerging countries. However, at present, studies on the impact of legal enforcement on FVA are still scarce.

1.8 Motivation for this study

As mentioned earlier, the financial reporting rules have moved towards fair value based over the past two decades (Hitz, 2007; Palea, 2014). The IASB and FASB have started supporting the FVA usage over HCA in financial reporting (Barth, 2006, 2008). The main purpose of this movement in measurement paradigms is to enhance the information relevancy included in financial reports (Hitz, 2007).

The motivation behind this study comes from the IFRS conceptual framework (2010) which sets out that "the objective of financial reporting is to provide decision-useful financial information to capital providers to assist providers in making investment decisions" (IASB, 2010). This research is driven by the need to produce empirical

[21] Beattie et al. (1994) define earnings management as "as a process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings".

evidence whether the shift from HCA to FVA will be able to offer decision useful information. The supporters of FVA state that the FVA are more current as compared to the HCA and therefore, more relevant than HCA (Allen & Carletti, 2008; Hitz, 2007; Laux & Leuz, 2009; Palea, 2014). On the contrary, the critics of FVA state that FVA induces volatility in earnings if fair values' changes are recognized in earnings (Allen & Carletti, 2008; Laux & Leuz, 2010). They claim that the short-term volatilities of reported earnings may reduce their predictive power (Poon, 2004; Wilson & Rasch, 1998) and may even mislead the users of financial statement (Blankespoor, Linsmeier, Petroni, & Shakespeare, 2013; Palea, 2014). This volatility may not correspond with the performance of management, and it would be more difficult to predict future performance for the users. As such, earnings which are premised on fair value could not be employed to forecast future earnings in a similar way due to the future events which are uncertain and this can be seen as a huge setback in budgets and forecasts preparation and to manage the expectations of the analysts (Hague, 2002).

Therefore, given the ongoing debates (Barron et al., 2016; Bratten et al., 2016) and the little evident available (Gebhardt, 2012), it is still unresolved (Hitz, 2007) whether FVA for financial instruments enhances or impairs the reported earnings' decision usefulness. Such finding is crucial to the standard setters because it would contribute to the literature whether the shift from HCA to FVA meets the financial reporting's goal of providing information that is decision useful. In this regard, it is essential to establish evidence on the impacts of FVA for financial instruments on the decision usefulness of reported earnings' numbers particularly in the Asia Pacific region where limited attention has been given by past researchers.

In addition, the successfulness of FVA implementation can be affected by the company's level of CG (He et al., 2012) as CG could have a significant role to play in implementing FVA particularly with regard to enhancing the fair value estimates' reliability (Song et al., 2010). This is due to the fact that not all financial instruments have actively quoted prices (Ball, 2006; Gray, 2003). The estimation of fair value, where the active quoted price is not available, requires the exercising of management judgement. This can give rise to both intentional and unintentional biases, which can reduce the financial reporting quality and its decision usefulness (Hitz, 2007; Nissim, 2003; Ryan, 2008b). The previous literature find that although in some cases managers can use the information that they hold to report the fair value in a credible way (Barth et al., 1998), managers can manipulate for their own interest the inputs used for fair value valuation (Aboody, Barth, & Kasznik, 2006; Bartov et al., 2007). However, at present, studies on the CG's impact on the decision usefulness of fair values are still scarce (Song et al., 2010). As such, this research is undertaken to fill this void.

With effect from 2005, the IFRS's adoption took effect in many countries (i.e., the European Union, effective from 1 January 2005) with the key purposes of achieving accounting standards' harmonization and enhancing the quality of accounting information throughout the world (Soderstrom & Sun, 2007).

With respect to the harmonization of the IFRS by the IASB, the predominance of FVA over HCA has been achieving wide-based approval among standard setters and professional accountants (Barth, 1994; Barth & Landsman, 1995; Cherry & Hague, 2009; Mosso & Sack, 2010). However, the theoretical foundation that supports such approval assumes that the implementation of FVA is carried out in well-functioning financial reporting environments (Ball, 2006; Penman, 2007), where earlier prior studies supporting this finding are based on samples from developed countries (Danbolt & Rees, 2008; Niu & Xu, 2009; So & Smith, 2009). There are limited as well as in-depth discussions on the capability of FVA adoption in emerging countries (Peng & Bewley, 2009). Previous FVA studies were mostly undertaken in developed countries, i.e., the US (Hassan & Saleh, 2010). The results from these developed countries, therefore, may not be generalized to other jurisdictions, especially in the Asia Pacific region, where institutional factors differ considerably. Moreover, studies on the effects of institutional factors such as legal enforcement on reported earnings among countries that are operating under the same common law system have been scarce, particularly on the implementation of FVA. Therefore, this study is undertaken to fill this void from the Asia Pacific region's standpoint, which has been largely overlooked by previous researchers.

1.9 Problem Statement

The supporters of FVA state that the FVA are more current and up-to-date as compared to the HCA and therefore, more relevant than HCA (Allen & Carletti, 2008; Hitz, 2007; Laux & Leuz, 2010). This is because the changes in market conditions are reflected in fair value. Therefore, fair value numbers should be able to provide more decision useful information as they contain more up-to-date and current information when compared with the outdated historical cost numbers which are based on outdated market expectations and conditions (Poon, 2004). On the contrary, the critics of FVA state that FVA induces volatility in earnings if fair values' changes are reported in earnings (Allen & Carletti, 2008; Laux & Leuz, 2010). They claim that the short-term volatilities of reported earnings will not be useful and may even confuse the financial statements' users (Blankespoor et al., 2013). This volatility may not correspond with the performance of the management and that this would be harder to predict the future performance for the users. Therefore, given the ongoing debates (Barron et al., 2016; Bratten et al., 2016) and the little evidence available (Gebhardt, 2012), it is still unresolved (Hitz, 2007) whether FVA for financial instruments enhances or impairs the decision usefulness of reported earnings. This finding is essential to investors in helping them achieve better decisions.

Furthermore, according to Bichof (2009), financial instruments form greater than 90%, on average, of the banking's sector total assets and liabilities. In addition, the markets for financial instruments have also grown richer (Bhat, 2013) and expanded at an enormous rate over the years (Hodgkins, 2014). It has been observed that the growth of derivative instruments' utilisations for the past two decades has been quick in both emerging and developed markets (Sundaram, 2013), particularly in the region of Asia Pacific (Yong et al., 2009) which warrant a study in this region. In view of the tremendous growth of financial instruments coupled with high financial instruments'

carrying value in the balance sheets of financial firms, the value changes in financial instruments may likely to impact substantially on reported earnings of financial firms. As such, it is important to examine whether this impact enhances the decision usefulness of reported earnings. However, at present, the examination on the effect of FVA for financial instruments on reported earnings so far have been limited, particularly in the Asia Pacific region.

In addition, one particular problem with the valuation of financial instruments is that not all financial instruments have quoted prices in active markets (Ball, 2006; Gray, 2003; Khurana & Kim, 2003). Without actively quoted prices, the estimation of fair values has to be made (e.g., Level 2 and 3), which requires subjective judgement (Khurana & Kim, 2003). Even though the proponents of FVA argue that more relevant information can be provided using FVA as compared to HCA, the reliability of fair value estimates remains an issue (Hitz, 2007). The previous literature finds that although in some cases managers can use the information that they hold to report the fair value in a credible way (Barth et al., 1998), managers can manipulate for their own interest the inputs used for fair value valuation (Bartov et al., 2007; Benston, 2006).

Critics of FVA state that the current value estimation may not be able to generate reliable information (Barth, 1994; Hitz, 2007). They claim that these estimates cannot be proven and can subject to management's manipulation (Watts, 2003). Past studies find that the presence of strong CG mechanisms could constraint the earnings management activities (Cornett et al., 2007; Lin & Hwang, 2010; Liu & Lu, 2007; Xie et al., 2003) and thus, may strengthen the reliability of financial instruments' fair value estimates, thereby enhancing the decision usefulness the reported earnings. However, at present, studies on the impact of CG on decision usefulness of fair values are still scarce (Song et al., 2010).

The fundamental aim of the IASB is to achieve IFRS harmonization (Ball, 2006; Iatridis, 2010). In this regard, one objective of IASB is to strengthen the "comparability and transparency" of accounting information across different countries. Nevertheless, this objective may not be achieved because a number of past studies (e.g., Carlin & Finch, 2011; Nichols, Street, & Cereola, 2012) have revealed that financial reports can become less comparable after the implementation of IFRS. There has also been a concern recently whether it is truly possible for the full convergence with IFRS with regard to national accounting standards (Ball, 2006; Holthausen, 2009). The current IASB standard-setting has not focused sufficiently on the capability of the FVA adoption in the emerging countries where institutional factors vary considerably from developed countries (Peng & Bewley, 2009). This evidence is particularly useful to the international investors and security analysts who need reliable and comparable financial information across borders as they seek to diversify their investments in other countries. Therefore, a higher quality of comparable financial information across borders is of utmost importance to the international investors and security analysts in helping them to achieve superior decisions on capital allocations.

Past studies have also shown the legal enforcement environment is an essential institutional factor that causes differences in financial reporting quality (Burgstahler et al., 2006; Leuz et al., 2003) mainly because IASB does not possess authority to regulate the standards it promulgates (Ball, 2006; Ball et al., 2003; Soderstrom & Sun, 2007) as enforcers (e.g., politicians, regulators, courts, auditors) will consist of local, thereby creating unavoidable financial reporting quality differences. Wustemann and Kierzek (2006) find that the accounting practice is impacted more strongly by enforcing the rules than the content of the rules itself. Hence, a country with weak legal enforcement mechanisms can limit the harmonization of the IFRS standards (Barlev & Haddad, 2007; Georgiou & Jack, 2011) which includes financial reporting for financial instruments' standards.

With regard to the differences in legal enforcement between developed and emerging countries in the region of Asia Pacific, numerous past studies (Cahan et al., 2009; Cai et al., 2008; DeFond et al., 2007; La Porta et al., 2006, 1997; Leuz et al., 2003; Shen & Chih, 2005) find that the legal enforcement for developed countries (e.g., Hong Kong and Singapore) is stronger than emerging country (e.g., Malaysia). The findings from past studies (Ball et al., 2000; Burgstahler et al., 2006; Cai et al., 2008; Francis & Wang, 2008; Hope, 2003; Leuz et al., 2003) also discover that the legal enforcement's strength reduces the earnings management activities. Therefore, the existence of stronger legal enforcement in the developed countries may curtail earnings management and strengthen the reliability of financial instruments' fair value estimates, thereby enhancing the comparability and the reported earnings' decision usefulness. As such, the reported earnings' decision usefulness arising from FVA in developed countries may likely to be higher as compared to emerging countries. However, at present, studies on the impact of legal enforcement on decision usefulness of fair values so far have been limited.

1.10 Research Questions

This study focuses on the financial firms of selected countries in the Asia Pacific region such as Hong Kong, Singapore, and Malaysia. The reasons for the selection of these three countries are discussed in detail in Chapter 2 under Section 2.12.1 "Rationale for Selecting These Three Countries". The research questions for this study are as follows:-

1. Does the FVA for financial instruments enhance the predictive power of the reported earnings[22] on the future cash flows/earnings?
2. Does the FVA for financial instruments enhance the value relevance of the reported earnings?

[22] For research questions, research objectives and hypotheses, the reported earnings refer to as "adjusted CI" (which also forms part of reported earnings). The reported earnings are used instead of adjusted CI in order to maintain the consistency of the term used throughout the text. Adjusted CI is defined in the methodology in Chapter 4 as NI plus OCI items for financial instruments only (e.g. "available-for-sale", "cash flow hedge" and "net investment hedge").

3. Do the strength of CG mechanisms moderate the relationship between the FVA for financial instruments and predictive power of reported earnings on future cash flows/earnings?
4. Do the strength of CG mechanisms moderate the relationship between the FVA for financial instruments and value relevance of reported earnings?
5. Does the legal enforcement's strength moderate the relationship between the FVA for financial instruments and predictive power of reported earnings on future cash flows/earnings?
6. Does the legal enforcement's strength moderate the relationship between the FVA for financial instruments and value relevance of reported earnings?

1.11 Objectives of the Study

This study's research objectives are to examine the effects of FVA for financial instruments on reported earnings for financial firms in the Asia Pacific region as follows:-

1. To examine whether the FVA for financial instruments enhances the predictive power and value relevance of the reported earnings.
2. To examine whether the strength of CG mechanisms moderates the relationship between the FVA for financial instruments and the predictive power and value relevance of the reported earnings.
3. To examine whether the legal enforcement's strength in the developed countries moderates the relationship between the FVA for financial instruments and the predictive power and value relevance of reported earnings.

1.12 Contributions of the Study

1.12.1 Practical Contributions

The contributions of this study can be made in several ways. With respect to the practical contribution, this study offers empirical evidence whether the financial reporting of FVA for financial instruments enhances the reported earnings' decision usefulness. This can help investors in making better decisions on investments. Moreover, it will also enlighten the standard setters whether the switch to FVA from HCA meets the financial reporting's goal of presenting decision useful information. Besides, this empirical study also intends to offer evidence on the informational benefits of fair value reporting for financial instruments under OCI components in the "Statement of Comprehensive Income".

Besides, this study will offer empirical evidence of whether institutional factor such as legal enforcement moderates the relationship between FVA for financial instruments and reported earnings. At present, studies on the impact of institutional factor such as legal enforcement on financial reporting quality are very limited,

particularly on FVA for financial instruments, for countries that are operating under the same common law system. This will provide the enforcers and regulators with greater knowledge and insights into the impact of legal enforcement on FVA for financial instruments on reported earnings.

1.12.2 Theoretical Contributions

With regard to the theoretical contribution, this research contributes to theory by using Agency Theory and Market Efficient Theory to determine the moderating effect on the relationship between FVA for financial instruments and reported earnings. The Agency Theory is employed to explain that the strength of CG mechanisms may act as a moderating variable between the FVA for financial instruments and reported earnings on predictive power. As such, this study can advance our understanding of the agency theory with respect to CG in the context of FVA for financial instruments.

Meanwhile, the Market Efficient Theory is used to explain that the legal enforcement's strength may act as a moderating variable between the FVA for financial instruments and reported earnings on share prices and share returns. In this aspect, this study can advance our understanding of the market efficient theory with respect to value relevance in the context of FVA for financial instruments.

1.12.3 Methodological Contributions

As for methodological contribution, this research employs the panel data analysis techniques. The "Pooled Ordinary Least Square" (POLS) method is generally employed in the past studies (Biddle & Choi, 2006; Choi, Das, & Zang, 2007; Choi & Zang, 2006; Dhaliwal, Subramanyam, & Trezevant, 1999; Goncharov & Hodgson, 2011; Kanagaretnam et al., 2009). As the pooled OLS assumes only a single intercept for all firms, these assumptions may be restrictive. As such, the results may be less robust or may even be questionable.

This study uses Panel Data Analysis techniques where they can control the unobserved firm-level heterogeneity biases (Baltagi, 2008). In addition, the use of panel data fixed effects model approach also mitigates the omitted variables biases arising from unobserved firm-level heterogeneity that is time-invariant (Ball, Jayaraman, & Shivakumar, 2012; Baltagi, 2008). Hence, the "Panel Data Analysis" techniques may be able to offer a "more robust result" as compared to pooled OLS. Therefore, with this unique methodological approach, this research can contribute to the accounting research in investigating the effect of FVA for financial instruments on reported earnings.

1.12.4 Other Contributions

By focusing on the three countries (Hong Kong[23], Singapore and Malaysia) in the region of Asia Pacific, a better insights and understanding can be gained about the relationship between FVA and reported earnings in this region where they have received little attention from past researchers as most prior studies relating to FVA have centred on developed countries namely the US (Hassan & Saleh, 2010). The financial reporting quality in the region of Asia Pacific may differ as compared to developed countries (i.e., US) because of the influence of various institutional factors namely legal environment, political systems, ownership structure, and financial reporting's incentives (Leuz et al., 2003; Soderstrom & Sun, 2007).

1.13 Outline of this Study

The followings are the planned outlines for this research. Chapter 2 put forth the institutional background of the development of financial instruments' standards, while Chapter 3 consists of a literature review, hypothesis development, and proposed research framework. Chapter 4 outlines the methodology for this study, which includes the data collection and the methods employed. Chapter 5 reports as well as discusses the findings. Lastly, Chapter 6 presents the conclusions, the study's implications, limitations, and followed by suggestions for future research.

[23] Hong Kong is a "Special Administrative Region" under Republic of China. As for his study, Hong Kong is regarded as a country for simplicity of comparison purposes. This is supported by past studies (Ball et al., 2003; Cahan et al., 2009; Cai et al., 2008; DeFond et al., 2007; Houqe et al., 2012; Leuz et al., 2003) which have treated Hong Kong as a country for comparison purposes.

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Chong Leong Yew was born in Seremban, Negeri Sembilan. He did his primary education at Sekolah Rendah Kebangsaan St. Paul, Seremban. Then he continued his secondary education at Sekolah Menengah St. Paul, Seremban until STPM.

He graduated with a Bachelor of Accountancy from Universiti Pertanian Malaysia. In 2001, he pursued the ACCA qualification. He obtained his ACCA qualification in 2002 and then became a member in the same year. Thereafter, he pursued and obtained his MICPA qualification in 2004 and became a member in the same year. In 2011, he enrolled his MBA programme with Graduate School of Management (GSM) and obtained his MBA in Finance in 2013. In 2013, he obtained his CIMA qualification and became a member in the same year. He also obtained his MAICSA qualification and became a member in 2014. Due to his interest in pursuing a career in the academia, he enrolled his Ph.D. in Accounting programme with Putra Business School in 2014.

He has many years of working experience as a Group Accountant and Finance Manager with a few listed companies such as LB Aluminium Berhad, Industronics Berhad, Jotech Holdings Berhad and Seremban Engineering Berhad. Prior to joining the private sector, he had a short stint working in an international audit firm, BDO Binder as an audit assistant and then as a tax assistant. Currently, he is a member of MIA, ACCA, MICPA, and CIMA. Equipped with both academic and professional qualifications, he wishes to join the academia and become a full-time lecturer after completing his Ph.D. programme to share his knowledge and experiences gained throughout his career to enable students to become better and competent accountants.

PUBLICATION

Chong, L. Y., Annuar, M., & Zariyawati, M. (2015). The Wealth Effect of Share Buybacks: Evidence from Malaysia. *International Journal of Economics & Management*, *9*(2), 312-340.

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