CHAPTER 1

INTRODUCTION

1.1 Background of the Study

The Institute of Certified Accountants and Auditors of Thailand (ICAAT) is a private sector that has an important role in setting the Thai accounting standards. After the Stock Exchange of Thailand (SET) was established in 1975, several laws controlled the listed companies. One of them is the act of Stock Exchange Committee (SEC) which is the public sector that controls all companies listed on the SET through regulating and monitoring their activities, including the financial disclosure.

At present, Thai accounting practice complies with 30 financial accounting standards. In general, if any accounting issue is not addressed by the Thai accounting standards, the International Accounting Standards (IAS) and the American General Accepted Accounting Standards will be used as guidance, respectively.

According to the SET's regulation announcement dated 30 April 1993, a change from the cost to equity method in accounting for equity investments is required for all listed companies, beginning the quarterly period ended 31 March 1994. Accounting Standard No.18 : Accounting for Investments in Subsidiaries and Associates states that investment in subsidiaries and associates should be either (1) accounted for using the equity method; or (2) carried at cost. In general, Thai companies use the cost method of accounting for investments in unconsolidated subsidiary and affiliated companies. Due to the SET's requirement, however, all listed companies are required to change from the cost to equity basis.

Thai Accounting Standard No.18 (TAS No. 18) provides the definitions; explanation of significant influence, accounting methods, choices of accounting method for consolidation, choices of accounting method in the financial statements of the investor, and disclosure. However, it does not address how a change from the cost to equity method of accounting method for investments should be accounted for. In particular, how the cumulative effect adjustment should be made remains unanswered, whether it be a retroactive or cumulative type of adjustment. To date, the ICAAT has not issued any GAAP guideline or statement in support of this accounting change while the SEC issued a practical guideline for this regulation but did not provide any suggestion for such adjustment. As a result, Thai companies tend to follow two diversed methods. On the other hand, a number of Thai companies apply TAS No.4 : Accounting Change which provides guidelines on how one should account for the cumulative effect as follows:

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14. For all changes in accounting principle ..... the following standards should be applied.

(a) Financial statements for prior periods included for comparative purposes should be presented as previously reported.

(b) The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change.......

Other companies tend to apply IAS or US GAAP whichever is available, respectively. IAS 28 - Accounting for Investments in Associates does not explicitly provide any guideline regarding the cumulative effect adjustment. It only mentions in paragraph 30 as follows.

30. *Investments in associates accounted for using the equity method should be classified as long-term assets and disclosed as a separate item in the balance sheet. The investor's share of the profits or losses of such investments should be disclosed as a separate item in the income statement. The investor's share of any unusual or prior period items should also be separately disclosed.*

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US GAAP, however clearly provides the method of accounting for the cumulative effect adjustment in FASB Interpretation-35 which is effective for fiscal years ended on , or after June 15, 1982. Specifically, the accounting changes required by FASB Interpretation-35 shall not be accounted for as accounting changes (APB-20). Instead, they shall be accounted for in accordance with the provisions of paragraph 19 (l) and (m) of APB-18 (Equity Method), as follows:

(1) If an investment in voting stock falls below the 20% level, or other factors indicate that the investor can no longer exercise significant influence, the presumption is that the investor has lost the ability to exercise significant influence and control, in which case the equity method should be discontinued.

The carrying amount at the date of discontinuance becomes the cost of investment. Subsequent dividends are accounted for by cost method from the date the equity method was discontinued.

(2) An investor who, because of other factors, obtains significant influence or who acquires more than 20% ownership in an investee after having had less than 20% must retroactively adjust its accounts to the equity method on the basis of a step-by-step acquisition of an investment. In this event, at the date of each step in the acquisition, the carrying value of the investment must be compared with the underlying net assets of the investee to determine whether goodwill (positive or negative) is involved.

TAS-4 and also APB-20 require that, in general, the cumulative effect of accounting change on the retained earnings for years prior to the year of change be computed and reported as part of the change year's income. The FASB has issued Interpretation No. 35 on the retroactively cumulative effect adjustment to the equity method while neither ICAAT nor SEC have issued any statement or guideline in support of this mandatory accounting change. As such, companies tend to follow the two alternative adjustment methods. It was found that the interim quarterly financial statements as at 31 March 1994 of all listed companies that met the SEC's requirement were separated into two major groups according to their accounting adjustment methods: (1) the retroactive restatement method for which the cumulative effect was adjusted to the beginning retained earnings or (2) the cumulative effect method for which the cumulative effect was included in net income.

1.2 Statement of the Problem

Since no specific guideline[1] existed for the accountants in practice, the accounting method for cumulative effect adjustment varied with two alternatives : ***the retroactive restatement*** and ***the cumulative effect*** method. Accordingly, the statements of problem can be expressed as follows:

(1) What was the investors' reaction to the changed accounting information ? This means:

(1.1) Does the mandated accounting change have information content?

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[1] During the observation period of the study, no authoritative accounting guideline was available. However, in March 1996 (two years later) the Security Exchange of Thailand had issued a guideline in support of the use of the retroactive method for ease of comparability of financial statements among companies.

(1.2) Does the retroactive restatement adjustment method have information content?

(1.3) Does the cumulative effect adjustment method have information content?

(2) Are there any other factors influence the change of the investors' decision making?

Other factors involved are considered in this study based on the past theory studies. The selected theoretical factors are as follows :

2.1 **Agency theory** concerns the contractual process and debt/equity ratio identified in the debt contract.

2.2 **Firm theory** concerns the firm size, one factor in the political process.

2.3 **Risk theory** concerns the systematic risk (β) that influences the investors in portfolio theory.

2.4 **Naive-investors theory** concerns the functional fixation in the accounting numbers of the investors.

2.5 Industry types concern the difference of industry types which influence the investors in making invesment decision.

1.3 Purpose of the Study

The purpose of this study is to investigate the impact of the mandatory accounting change on market reaction from the perspective of the investors. The results of the study should provide an answer of how the investors react or decide on the invesment in response to the accounting change information . An empirical research can also support the solutions of whether the accounting information has information content. Tests of the additional factors involved are also included in this study.

1.4 Statement of the Hypotheses

The study is separated into two parts. In part 1, is to investigate the information content of the mandated accounting change is investigated. In part 2, the additional theories involved will be tested. The proposed null hypotheses are as follows :

1. Hypotheses related to the test of information content :

1.1 Information content hypothesis :

the change from the cost to equity method of accounting for equity investment has no information content.

1.2 Information content hypothesis :

the Retroactive restatement method has no information content.

1.3 Information content hypothesis :

the Cumulative effect method has no information content.

2. Hypotheses related to the other factors involved :

2.1 Debt/equity hypothesis :

debt/equity ratio is not the factor involved.

2.2 Firm size hypothesis thesis :

firm size is not the factor involved.

2.3 Systematic risk hypothesis :

systematic risk of the securities (β) is not the factor involved.

2.4 Naive-investors hypothesis :

accounting numbers are not the factor influenced the investors.

2.5 Industry types hypothesis :

difference in the industry types is not the factor involved in affecting the investors' use of the changed accounting information.

1.5 Definitions of Key Terminology

The definitions of key terminology used in this study are as follows:

Cumulative Effect Method[1]

The cumulative effect method requires that the cumulative effect of accounting change on retained earnings for year prior to the year of change be computed and reported as part of change year's income. Pro forma income calculations, together with related earnings per share data, must be disclosed

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[1] D. Jacque Grinnell, and Corine T. Norgaard, Reporting Change in Accounting Principles- Time for a Change?, Journal of Accountancy, December 1979, pp. 64-72.

for all periods presented as if the newly adopted accounting principle had been applied retroactively. Disclosure of new principle's effect on change year's income and earnings per share must also been made. (APB-20)

Retroactive Restatement Method

The retroactive restatement method requires that the cumulative effect of accounting change be applied retroactively by an adjustment of retained earnings.

1.6 Scope of the Study

The study will utilize data collected from the SET. All listed companies as at 31 December 1993 excluding mutual funds are selected from the annually summarized information of the listed companies for the year 1993. The criteria for selection include (1) all companies which have subsidiaries and / or associates and (2) also all companies whose accounting period year ends 31 December. Two hundred and seventy eight companies are selected. For each company, the accounting change data are collected from the first quarterly report ended 31 March 1994. The movements of security prices and others are retreived from the SET's database documentation.

1.7 Organization of the Study

The remainder of the dissertation includes : chapter 2: theoretical framework and review of the literature, chapter 3: research methodology, chapter 4: results and analyses, and chapter 5: conclusion and directions for future research.