

Thesis
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THE ROLE OF COMPANY ANNUAL REPORTS FOR INVESTMENT ANALYSIS
IN A DEVELOPING COUNTRY: THE CASE OF MALAYSIA.

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by

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DEDICATION

TO:

MY DEAREST WIFE AND CHILDREN
AND IN MEMORY OF MY BELOVED MOTHER,
SHARIFAH AMINAH BT SYED ALI ALGADRIE

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ABSTRACT

The main objectives of this study are: (1) to examine the role of the company annual reports in investment analysis in Malaysia; and (2) to evaluate the importance of the annual reports as a source of information for analysts to make investment decisions.

In order to achieve these research objectives, the study begins with a review of the uses and users of financial statements and it is pointed out that one of the important groups of users of the financial statements are the 'sophisticated' investors. Prior studies, using tests of the Efficient Market Hypothesis and investors survey, are presented and discussed. The review of prior studies concludes that the area of research into the importance of annual reports for investment decisions are important and that no similar studies involving developing countries had been carried out.

The accounting environment in Malaysia was presented to illustrate the regulations and statutes governing the preparation and presentation of

information in company annual reports. In the discussions regarding the investment situation in Malaysia, the major characteristics of the Kuala Lumpur Stock Exchange were introduced.

A two stage research methodology was adopted in the current research. The first stage involves a survey and analysis of a sample of annual reports of companies listed on the Kuala Lumpur Stock Exchange. This survey revealed instances of companies not complying with the International Accounting Standards adopted by the accounting profession in Malaysia.

The second stage consists of a postal questionnaire survey of investment analysts working in institutional investing firms, merchant banks and stockbrokers regarding their perceptions of the importance of the annual reports for investment analysis.

The results of the above surveys are presented together with recommendations to reduce the weaknesses of the annual reports of Malaysian companies. Finally, related areas for further research are suggested at the end of the thesis.

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CHAPTER I

INTRODUCTION

1.1 Statement of the Problem

The Financial Accounting Standards Board (FASB), in its Statement of Financial Accounting Concepts (SFAC)1 (1978) stated that the main objective of financial statements is to "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions"(p.8). This broad view of the objectives of financial statements is shared among professional accounting bodies in other countries such as the United Kingdom's Accounting Standards Committee [see for example, the Corporate Report (1975)].

It cannot be denied that there are many other existing and potential users or groups of users of financial statements. The Corporate Report, for example, identified seven separate group of users "as having a reasonable right to information and whose needs should be recognised" (paragraph 1.9), and briefly, they are:

- a. equity investor group: existing and potential shareholders, including holders of convertible securities, options or warrants.
-

- b. loan creditor group: existing and potential holders of debentures and loan stocks; and providers of short term loans.
- c. the employee group: existing, potential and past employees;
- d. the advisor group: analysts and journalists;
- e. the business contact group: customers, trade creditors and suppliers;
- f. the government: tax authorities and departments concerned with the regulation of business; and
- g. the public: tax payers, consumers and other community interest groups.

However, among the largest and most important group of users are the investors, either current or potential investors of the company. In the literature review (Chapter 2), it is suggested that within the group of investors, the annual reports should be aimed at the professional investment analysts.

This is because these "sophisticated" investors should have the necessary knowledge and expertise to read the increasingly complex financial statements of companies. In a country like Malaysia, the role of these analysts is particularly important in the financial analysis function. This is due to the comparatively low level of investment knowledge of its population (Neoh, 1985).

In the developed countries, especially those countries with large and established stock exchanges, the preparation and presentation of these annual reports are supervised by the regulatory and professional accounting bodies. For example, the professional accounting bodies in most developed countries not only formulated and recommended the accounting standards to be used in the preparation of these reports but also enforced them.

Therefore, it is expected that the annual reports of companies in these countries, although not satisfying every needs of the investor relating to the amount of information contained in these statements, are to a certain extent, still able to meet most of the information needs of the investors.

Many research studies (these will be discussed in Chapter 2) carried out in the developed countries, have shown that the financial statements are an important, if not the most important, source of accounting and other information to investors and potential investors in the developed countries.

In the developing countries, the situation is different from that of the developed countries. According to Enthoven (1977), private enterprise accounting in developing countries lacks relevance in

both its current practices and theory. He also suggests that reporting practices in these countries tend to be stewardship orientated and thus of limited use to financial statement users. Enthoven concluded that, generally, the amount of useful information contained in the financial statements of companies in developing countries is not useful for investment decision making.

In many developing countries, including Malaysia, there is also evidence to suggest that the professional accounting bodies do not seem to enforce either the accounting standards formulated locally nor the international standards which are adopted. An examination of the financial statements of a sample of companies listed on the Kuala Lumpur Stock Exchange (Chapter 5) showed instances of companies not complying with the standards adopted by the Malaysian Association of Certified Public Accountants.

In common with other developing countries, the investment environment in Malaysia is also different from that of the developed countries. Information sources for investment decisions, other than the financial statements of companies, are difficult to obtain. In addition, the Kuala Lumpur Stock Exchange (KLSE) is also very small in relation to the stock exchanges in the developed countries (for example

it is about 3% the size of the Tokyo Stock Exchange in terms of market value of quoted securities) and the KLSE is also subjected to wide fluctuations in trading volumes and values (see Chapter 5).

1.2 Objectives of the Study.

As will be demonstrated in Chapter 2, there are many studies that have been conducted into the usefulness of financial statements or corporate annual reports in developed countries. Similar research in the developing countries, specifically Malaysia, has not been carried out. Research into the role of company annual reports for investment analysts, as "sophisticated" users, in Malaysia will be a contribution to this important area of accounting.

The primary objectives of the study are to provide answers to the following questions:

- I. What is the role of corporate annual reports in investment analysis in Malaysia?
 - II. How useful are the company annual reports to the investment analysts in Malaysia?
-

In addition to the primary objectives, the following secondary objectives are set out in the questions below:

1. What is the current state of research into the usefulness of company annual reports for investment analysis (including studies into stock market efficiency)?
 2. What are the corporate accounting and disclosure requirements in Malaysia (including the requirements under the accounting standards formulated and adopted by the accounting profession and the statutory requirements in the Malaysian Companies Act)?
 3. What are the current accounting and disclosure practices of companies in Malaysia, as reflected by the information disclosed in the company annual reports?
 4. What are the major characteristics of the Kuala Lumpur Stock Exchange and what evidence is available relating to the efficiency of the the KLSE?
 5. To what extent do companies listed on the KLSE comply with the International Accounting Standards adopted by the professional accounting bodies in Malaysia?
 6. What are the major sources of information for investment decisions (other than corporate annual reports) in Malaysia?
-

7. To what extent do investment analysts in Malaysia adjust the figures appearing in the financial statements?
 8. What are the major similarities and differences in the results of this current study compared with previous studies that were carried out in the other countries?
 9. To what extent are investment analysts in Malaysia influenced by background characteristics (such as knowledge in accounting, knowledge in accounting, level of involvement in investment decisions and experience) in their perceptions of the importance of companies annual reports as a source of information for investment analysis?
 10. As a result of this study, what recommendations are necessary to improve the accounting and disclosure practices in Malaysia?
 11. What other areas of research into accounting and disclosure practices in Malaysia are suggested following the results and findings of this study?
-

1.3 Research Methodology.

In order to accomplish the objectives and sub-objectives of this study, a two-stage research methodology was adopted: firstly, an examination of the accounting and disclosure practices of a sample of companies listed on the Kuala Lumpur Stock Exchange and secondly, a questionnaire survey among the investment analysts working in the institutional investing firms, merchant banks and stockbrokers.

The first part of the study is concerned with evaluating the current state of accounting and disclosure practices in Malaysia. In this evaluation, a sample of the annual reports of companies listed on the Kuala Lumpur Stock exchange was analysed in detail. An analysis was undertaken to determine to what extent Malaysian companies complied with the accounting and reporting requirements of the International Accounting Standards adopted by the Malaysian Association of Certified Public Accountants.

The second part of the study involved the use of a questionnaire to survey the opinions of investment analysts regarding the importance and usefulness of corporate annual reports as a source of information for investment analysis. In addition to the corporate annual reports, other sources of information were also examined.

Investment analysts were chosen because they are the "sophisticated investors" and the organisations that they worked for, that is the institutional investors, (unit trusts companies, provident and pension funds and insurance companies), merchant banks and stockbrokers are an important and influential constituent of the investment sector in Malaysia (for details of these organisations please refer to Chapter 6).

1.4 Scope and Limitations of the Study

The scope of this study are as follows:

- (a) the study concentrates on the importance of one source of information only, the company annual reports of companies listed on the Kuala Lumpur Stock exchange; other information sources are not examined in detail;
 - (b) the extent of adjustment to ten individual items appearing in the annual reports of Malaysian companies are examined in this study (Chapter 8); these items were chosen as a result of the analysis of the annual reports of companies listed on the KLSE, (see Chapter 5); other items are not examined;
 - (c) the findings into the accounting and disclosure practices of Malaysian companies are limited
-

to the examination of the latest annual reports of 44 companies listed on the KLSE (that is, those companies which complied with requests for copies of their annual reports); there is a possibility that this sample may not be representative of the companies on the KLSE;

(d) this study reflects the views of the Malaysian investment analysts only; that is those analysts who are employed by the institutional investors, merchant banks and stockbrokers; investment analysts working in other areas are excluded from this study;

(e) in the questionnaire survey, the questionnaires were distributed to all the major institutional investors, merchant banks and stockbrokers; there is a possibility that certain types of organisations may be over represented in the sample (although tests had been performed to determine the level of non-response bias);

(f) although the investment analysts were instructed to give their personal views regarding the matters raised in the questionnaire, there is the possibility that the corporate views may be given rather than that of the individual analyst;

(g) the findings of this study is limited only to one developing country, Malaysia and is therefore not

capable of being extended to other developing countries because of differences that may exist in the accounting and investment environment; and

(h) the limitations inherent to research involving the use of questionnaire methodology.

1.5 Organisation of the Study

This study is divided into nine chapters. These are as follows:

Chapter 1, "Introduction", presents the statement of the problem, the objectives of the study, the research methodology, the scope and limitations of the study and the plan of the study.

Chapter II, "External Reporting and its Usefulness in Investment Analysis", reviews the current literature on the importance of the annual reports for investment analysis. The emphasis is on studies that analysed the views of professional analysts. This chapter discusses the development of financial reporting and the main group of users of financial statements, the investment analysts. Prior studies that either used survey of investors or testing the Efficient Market Hypothesis, together with the findings and conclusions, are also examined and discussed.

Chapter III , "Malaysian Accounting and Regulatory Framework" provides background information on the institutional and regulatory conditions affecting accounting practices in Malaysia. The major professional accounting associations and their role in the development of the accounting profession and financial reporting in Malaysia are examined. The statutory requirement for financial reporting are also discussed in the section on the Malaysian Companies Act.

Chapter IV, "Survey and Analysis of Company Annual Reports." Following the discussions on the accounting environment in Malaysia, this chapter then concentrates on the first stage of the study, to establish the current practice in Malaysia. In order to accomplish this objective, the annual reports of a sample of companies listed on the KLSE are examined. The methodology adopted in carrying out this examination is discussed, together with the limitations of this approach. The annual reports are evaluated on the basis of the presentation of information, statutory requirements and compliance with International Accounting Standards 1 to 17 adopted by the Malaysian Association of Certified Public Accountants. The examination reveals the current state of information disclosed in the annual reports of companies listed on

the KLSE and attempts to detail the weaknesses not only of the company annual reports but also in the enforcement of accounting standards.

Chapter V, "Investment Environment in Malaysia", focuses on the Kuala Lumpur Stock Exchange and the availability of information for investment decisions. The characteristics of the KLSE are described, including the size and volume of trading. In addition, published research into the efficiency of the KLSE, which suggests that it is not efficient in the semi-strong form, are briefly examined. The chapter provides background information for the survey carried out among investment analysts in Malaysia.

Chapter VI, "Questionnaire Methodology", discusses the possible methods to be adopted in the second stage of the study, that is, the investment analysts survey. Two alternative methods are considered: interview and postal questionnaires. It was decided that the postal questionnaire survey would be more suitable for the current study. The questionnaire design and development, the sample and the methods used in analysing and processing the data are also explained and discussed.
