

Corporate Disclosure Quality in Malaysia

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Abstract

The objective of this study is to examine the quality of corporate disclosure in the annual reports of Malaysian public listed companies. It reviewed the reports published by the Malaysian Institute of Accountants from 2006-2012 on the common findings documented by the Financial Statements Review Committee (FSRC). It is found that there are common deficiencies in firms' annual reports or non-compliance with accounting standards among firms as reported by the FSRC. This finding indicates that although compliance with accounting standards is mandated by law, it does not necessarily mean that preparers will fully comply with such requirement. Similarly, the adoption of high quality accounting standards such as the International Financial Reporting Standards will not automatically lead to high quality financial reporting or increased transparency.

Keywords: Quality, Corporate Disclosure, Accounting Standards

1. Introduction

This paper aims to highlight the deficiencies of financial reporting in the annual reports of public listed companies in Malaysia. Annual report is a common medium used by the management of companies to disseminate information about their companies to various stakeholders. Disclosures in the annual reports can be voluntary or mandatory. Mandatory disclosure refers to the presentation of the minimum amount of information as required by law, stock exchange and the accounting standards setting body, which is enforced on applicable companies (Owusu-Ansah, 1998; Wallace and Naser, 1995). Voluntary disclosure, on the other hand, refers to any information disclosed in excess of mandatory disclosure which is achieved at the discretionary of management.

In this study, we focus on the presentation of mandatory disclosure i.e. disclosures required by the accounting standards in the financial statements. This is an interesting investigation because we expect that not all companies will fully comply with mandatory disclosure requirements due to weak institutional features such as inadequate regulatory framework or ineffective enforcement mechanisms and shortage of qualified accountants (Yeoh, 2005; Al-Razeen and Karbhari, 2004; Ahmed and Nicholls, 1994). Many researchers have indeed found evidence of non-compliance with mandatory disclosure requirements in the companies' annual reports in the context of both developed and developing countries (e.g. Al-Akra et al., 2010; Yeoh, 2005; Glaum and Street, 2003; Street and Gray, 2002). In addition, a study on mandatory disclosure may provide some useful insights about the extent of compliance, the effectiveness of independent auditors and enforcement bodies in the countries studied (Al-Shammiri et al., 2008).

Various terms were used in the literature to describe the quality of corporate disclosure such as 'adequate' (Singhvi and Desai, 1971), 'comprehensiveness' (Wallace et al., 1994), 'depth' (Naser et al., 2002), 'the extent of the number of items disclosed' (Palmer, 2008) and the degree of compliance with mandatory disclosure where "high degree of compliance and more disclosure are viewed as better quality" (Naser and Nuseibah, 2003, p.48). In the present study, corporate disclosure quality refers to the disclosure of information in annual report in accordance with the accounting standards. It is the requirement by the accounting standards that preparers or management of companies to provide adequate and relevant information to assist users of financial statements to make economic decision.

To achieve the objective of the present study, we review the reports published by the Financial Statements Review Committee (FSRC) of the Malaysian Institute of Accountants (MIA) from 2006 until 2012. The findings of the present study are of interest not only to preparers of financial statements and auditors but also to investors, policy-makers and regulatory bodies. It informs preparers and auditors of the reporting aspects that should be improved in the preparation of financial statement in order to improve the quality of disclosure. The findings also suggest that investors and regulators to be vigilant about the quality of disclosure in companies' annual reports although the reports have been audited and certified by auditors.

This paper is organised as follows. Section 2 presents the institutional background about the regulation of financial reporting in Malaysia. Section 3 presents the literature review on mandatory corporate disclosure. Section 4 describes the research method and Section 5 discusses the findings, followed by a conclusion in Section 6.

2. Financial Reporting Regulation in Malaysia

Malaysia had its first formal financial reporting framework when the Financial Reporting Act 1997 (FRA 1997) was passed in July 1997 (Susela, 1999). Under this reporting framework, the accounting standards issued and adopted by the Malaysian Accounting Standards Board (MASB) are mandated by law and the enforcement of the standards were entrusted to the three regulatory agencies, namely the Securities Commission (SC), the Central Bank of Malaysia (Bank Negara) and the Companies Commission of Malaysia (CCM). The SC is responsible to monitor compliance with accounting standards by public listed companies, the CCM monitors compliance by all registered companies and the Central Bank is responsible to monitor compliance by financial and banking companies. The Companies Act 1965 was also amended in September 1998, requiring all companies incorporated in Malaysia to comply with the approved accounting standards. The amended Companies Act 1965 requires directors to ensure that their company's accounts are prepared in accordance with the approved accounting standards. The Act also requires the directors to declare that the financial statements comply with the accounting standards and that they give true and fair view of the financial position and performance of the company.

Prior to 2005, the approved accounting standards in Malaysia were known as MASB standards. Following the worldwide convergence with International Financial Reporting Standards (IFRS)¹, particularly the adoption of IFRS by European countries in 2005, the Malaysian Accounting Standards Board (MASB) renamed the MASB standards as Financial Reporting Standards (FRS) and renumbered the standards to coincide closely with the numbering of IFRS. For example, FRS1 refers to IFRS1 and FRS2 refers to IFRS2. This was an initial step taken by the MASB to show its efforts toward convergence with IFRS. Since 2006, the FRS have been made identical to IFRS on a per standard basis and in 2008, the MASB declared to achieve full convergence with IFRS by 1 January 2012. Effective from 1 January 2012, the FRS were renamed as MFRS (Malaysian Financial Reporting Standards). Essentially, the MFRS are identical word to word with IFRS.

Additionally, the Malaysian Institute of Accountants (MIA) has also implemented self regulatory enforcement to ensure the MIA members comply with the MFRS in the preparation of

¹ International Financial Reporting Standards (IFRS) are accounting standards issued by the International Accounting Standards Board (IASB) since 1973. Among the objectives of IFRS are to increase transparency, comparability and reliability of financial statements.

financial statements for their companies. The MIA was established under the Accountants Act 1967 as a statutory body to regulate and develop the accountancy profession in Malaysia. To monitor the quality of financial statements that were prepared by the members of the MIA, the MIA has formed the Financial Statement Review Committee (FSRC). The FSRC does not only monitor compliance with accounting standards but also compliance with statutory and other requirements and approved auditing standards in Malaysia. The review process by the FSRC is based on random sampling and also referral cases by the Investigation Committee of the MIA, the Securities Commission, the Bursa Malaysia and the Central Bank of Malaysia. The FSRC may also review specific companies' financial statements when there are public interest issues involved. Table 1 shows the number of cases or financial statements reviewed by the FSRC from 2006 until 2012.

Table 1: Number of Cases Reviewed by the FSRC

Year End	Random selection	Referral	Public Interest	Brought forward	Total
June 2012	6	8	1	7	22
June 2011	10		8	9	27
June 2010	19		7	11	37
June 2009	19			9	28
June 2008	24	3			27
June 2007	34				34
June 2006	29				29

Source: MIA's annual reports (2006-2012)

The FSRC publishes the findings of their review on the MIA's webpage and also in the MIA's magazine 'Accountants Today' with the objective to inform and educate the MIA members about good presentation and disclosure practices, and consequently to improve the quality of financial reporting by companies. However, the FRSC does not disclose the names of companies, directors and auditors convicted of non-compliance with the mandatory requirements. This means the convicted entities have the benefit of avoiding negative publicity.

There are three types of penalty tariffs introduced by the MIA to deal with non-compliance with the approved accounting standards. The first category applies to minimal non-compliance issues (e.g. housekeeping issues), where the minimum action will be taken against the members, such as requiring them to tidy up their financial statements. The second category applies if there are substantial instances of non-compliance with disclosure requirements of the approved accounting standards. Several actions can be taken against members in this category such as: (1) members are required to take the necessary corrective action; (2) members are given a warning letter; and/or (3) the company's financial statements are placed under surveillance by the FSRC for up to two

consecutive years. The third category involves major non-compliance with the requirements of the approved accounting standards. Under this category, members would be referred to the Investigation Committee of MIA or other regulatory bodies for appropriate action or giving a warning letter or reprimanded. The company's financial statements could be put under surveillance by the FSRC for up to four consecutive years.

3. Literature Review

Prior studies have documented evidence of non-compliance with accounting standards or mandatory disclosure requirements among companies in both developed and developing countries. Street et al. (1999) examined 49 major companies from 12 countries that claimed to have complied with IFRS in their 1996 annual reports. Interestingly, they found that there was significant non-compliance with IFRS in many aspects. The main areas of non-compliance were observed in IAS2-Inventory, IAS8-Net Profit or Loss for the Period, IAS9-Research and Development Costs, IAS16- Property, Plant and Equipment, IAS18-Revenue, IAS19-Retirement Benefit Costs, IAS21-The Effect of Changes in Foreign Exchange Rates, IAS29- Hyper Inflationary Economies, IAS22-Business Combination and IAS23-Borrowing Costs.

Street and Bryant (2000) extended the work of Street et al. (1999) by examining the annual reports of 82 companies from 17 countries for the year 1998. Similar to Street et al. (1999), Street and Bryant (2000) also observed some degree of non-compliance with respect to IFRS, though the companies claimed that they had complied with IFRS. They observed compliance with IFRS was problematic in some areas, which are: IAS8-Net Profit or Loss for the Period, IAS14-Segment Reporting, IAS17-Leases, IAS19- Employee Benefit, IAS23-Borrowing Cost, IAS29-Financial Reporting in Hyperinflationary Economies and IAS31-Joint Ventures.

Street and Gray (2002) also assessed the extent of compliance with IFRS by companies claiming to have complied with IFRS in their annual reports for the year 1998. Based on a large sample size (i.e., 279 companies from 32 countries), they observed that the extent of compliance with each standard varies, and none of the companies achieved 100% compliance. In another study, Cairns (2001) assessed a sample of 165 companies that had adopted IFRS in their 1999-2000 financial statements. He revealed that 29% of the surveyed companies had practiced 'implied IFRS lite', which means companies claimed to have used IFRS but in fact had not complied fully with the requirements of the standards. In this study, Cairns (2001) identified problematic accounting standards including IAS12-Income Taxes, IAS14-Segment Reporting and IAS35- Discontinuing Operations. He also observed that some auditors issued unqualified audit reports for companies that did not comply with IFRS. A study by Glaum and Street (2003) has also examined the extent of compliance with both IASs and US GAAP for companies listed on the Germany New Market. The study found that compliance with IFRS was problematic with regard to disclosures associated to pensions, leasing, financial instruments, earnings per share, research and development, and provisions and contingencies.

Abdullah (2011) examined 225 Malaysian public listed firms' compliance with IFRS mandatory disclosure requirements during 2008. She found that none of the examined companies

fully complied with the mandatory disclosure requirements even though the management had declared that the preparation of financial statements were in accordance with the approved accounting standards. She also observed some poor reporting practices whereby several companies disclosed in the notes to the financial statements certain information that is irrelevant to the circumstances of the companies. For example, a few companies had reported in the accounting policy that they used segment reporting and has investment property. However, after detailed reading and examination of their annual reports, it was found that the disclosed information was irrelevant to such companies. She argued that although the usage of disclosure template prepared by auditors (i.e. boilerplate practice) can assist preparers in complying with IFRS, the practice becomes harmful when the preparers merely comply by ticking boxes instead of taking the initiatives to fully comprehend the requirements of IFRS as the information disclosed can mislead the users of financial statements.

In brief, all the abovementioned studies indicated that the adoption of high quality accounting standards such as the IFRS does not automatically lead to high quality financial reporting or an increase in transparency. This scenario is particularly relevant to countries with weak institutional features such as inadequate regulatory framework or ineffective enforcement mechanisms and experiencing shortage of qualified accountants (Yeoh, 2005; Al-Razeen and Karbhari, 2004; Ahmed and Nicholls, 1994).

4. Research Method

Using an archival approach, we review the FSRC's reports published by the MIA from 2006 to 2012. The FSRC has regularly reported their findings on companies' non-compliance with the statutory requirements and the approved accounting standards. The key objective is to create awareness and to educate the MIA members and accounts' preparers about the mandatory requirements so that the quality of companies' financial reports and disclosure practices can be improved. The FSRC reports are accessible from the 'Accountants Today', a monthly professional magazine published by the MIA. The magazine can be accessed from the MIA's library or can be downloaded from the MIA's webpage.

5. Findings

Our analysis shows that the main issue commonly raised by the FSRC in their reports from 2006 to 2012 relates to the going concern assumption and the adequacy of related disclosures in the companies' financial statements. It is noted from the reports that the FSRC had raised queries to the preparers on the appropriateness of the use of the going concern assumption in the preparation of financial statements. The queries were made when some preparers used the going concern assumption as the basis in the preparation of financial statements while their financial statements had shown signs of deteriorating financial position. Some examples of events and conditions that may cast significant doubt about the going concern assumption are critical level of net liability or

net current liability position, substantial operating losses, negative operating cash flows, indication of withdrawal of financial support by lenders due to breach of loan covenants, defaulted bank loans, and adverse key financial ratios.

It is important to note that the going concern assumption is a fundamental principle in the preparation of financial statements in which a company is assumed as continuing in business for the foreseeable future without the intention or the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. The accounting standard, MFRS101 "Presentation of Financial Statements" requires the management of a company to make an assessment of the company's ability to continue as a going concern when preparing the financial statements. According to the standard, when the management is aware of material uncertainties that may cast significant doubt upon the company's ability to continue as a going concern, the management must disclose those uncertainties in the financial statements. If the management did not prepare financial statements on a going concern basis, the management must disclose this fact, together with the basis used in the preparation of financial statements and the reason why the corporation is not regarded as a going concern.

The FSRC had also raised queries to auditors as to whether the auditors did comply with the auditing standards ISA570 "Going Concern". The auditors are required by the standard to obtain sufficient appropriate audit evidence about the appropriateness of the management's use of the going concern assumption in the preparation and presentation of the financial statements, and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. According to the ISA570, if auditors are of view that a going concern assumption is appropriate and there is adequate disclosure but a material uncertainty exists, the auditors should express an unmodified opinion but include an emphasis of matter paragraph in the auditor's report that highlights the existence of a material uncertainty relating to the event or conditions that may cast significant doubt on the company's ability to continue as a going concern, and draws attention to the note in the financial statements. However, if adequate disclosure is not made in the financial statements, the auditors should express a qualified or adverse opinion, as appropriate, in accordance with ISA705 "Modifications to the opinion in the Independent Auditors' Reports".

The findings of FSRC suggested that some auditors did not follow the requirements of ISA570 as mentioned above because there were cases that auditors expressed an unmodified opinion with an emphasis of matter paragraphs in the auditor's report when a material uncertainty exists and there was no disclosure of the management's plan to deal with the events or conditions that may cast significant doubt on the company's ability to continue as a going concern.

Apart from the going concern issue, the FSRC had also discovered common deficiencies or non-compliance issues in the financial statements such as inadequate disclosures on impairment of assets, deferred taxation, employee benefit, intangible assets, business combination, leases and segment reporting; and inappropriate classifications of items in cash flow statements. The FSRC had also highlighted that various errors were made by companies in their financial statements. The

errors include wrong cross-referencing from the financial statements to the notes of the financial statements; disclosures of accounting policies that are not applicable to the company; pagination error made in the Directors' statement and Auditor's report and typographical errors in the description of line items and figures. Although these errors are not within the requirements of accounting standards, it will impair the quality of disclosure and can mislead the users of financial statements. The deficiencies and common non-compliance with accounting standards are summarised in Table 2.

Table 2: Common non-compliance with accounting standards noted in the financial statements

No	Relevant accounting standards	Common non-compliance
1	Assessment to continue as going concern (MFRS101, para 23)	Management did not provide adequate disclosure on how they deal with material uncertainty on going concern
2	Judgements in applying accounting policy and key sources of estimation uncertainty (MFRS101, para120)	Key sources of estimation uncertainty are not provided to enable users understand the judgments management makes, for e.g. the management did not present sensitivity analysis; the expected resolution of an uncertainty are not stated.
3	Impairment of investments in subsidiary/associated company/goodwill (MFRS136)	Management did not provide adequate disclosure when there is material impairment loss recognised. For e.g. non-disclosure of whether recoverable amount is FV less cost to sell or Value in Use, basis of determining FV less cost to sell, discount rate (s) used in determining Value in Use
4	Deferred Taxation (MFRS112)	<ul style="list-style-type: none"> • Non-disclosure of deductible temporary differences, unused tax losses and unused tax credits of which no deferred tax assets are being recognised • Nature of evidence supporting recognition of deferred tax assets is not presented • Deferred tax assets are deemed probable to realise despite the current liabilities position.
5	Cash Flow Statements (MFRS107)	<ul style="list-style-type: none"> • Inappropriate cash flow classifications. For e.g. advances to/from subsidiaries were disclosed as 'operating cash flow' instead of 'investing/financing cash flow'

No	Relevant accounting standards	Common non-compliance
		<ul style="list-style-type: none"> • Inclusion of non-cash transactions in the cash flow statements • Major classes of gross cash receipts and gross cash payments from investing and financing activities are not disclosed.
6	Employee Benefit (MFRS119)	<ul style="list-style-type: none"> • Management did not provide adequate analysis on staff costs for e.g. non-disclosure on wages, bonuses, equity compensation benefit and other employee benefit. • Defined benefit plan was disclosed as defined contribution plan
7	Investment Property (MFRS140)	Errors in the significant accounting policies. For e.g. the company adopted fair value policy but used the revaluation value to reflect current market condition; did not disclose direct operating expenses arising from repair and maintenance of investment property
8	Income Statements (MFRS101)	<ul style="list-style-type: none"> • Companies that classify expenses by function did not disclose additional information on the nature of expenses particularly expenses in the cost of sales. • Unrealised profits from intercompany transactions are not fully eliminated
9	Presentation of financial statements (MFRS101)	<ul style="list-style-type: none"> • Non-disclosure of material components within other receivables and other payables • Non-disclosure of nature and purpose of each reserve within equity • Term loans are classified as non-current when it should be classified as current.
10	Business Combination (MFRS 3)	<ul style="list-style-type: none"> • Factors contributing to goodwill are not disclosed • Acquiree's identifiable assets, liabilities and contingent liabilities at acquisition date are not stated at fair value
11	Intangible assets (MFRS 138)	Reasons for supporting intangible assets as having indefinite useful life are not stated
12	Inventories (MFRS102)	Inventories were not segregated into cost and net realisable value

No	Relevant accounting standards	Common non-compliance
13	Property, plant and equipment (MFRS116)	Adjustment for impairment losses was not clearly stated in the accounting policy
14	Leases (MFRS117)	Reconciliation between total of minimum lease payments at the balance sheet date and their present value was not presented.
15	Segment Reporting (MFRS114)	Inadequate disclosure in accounting policy. For e.g. companies disclose segmental information reporting but did not disclose the accounting policy for segment reporting.

6. Conclusion

In this study, we focus on the presentation of mandatory disclosure among the Malaysian companies. This is an interesting investigation because we cannot assume that all companies will fully comply with mandatory disclosure requirements even though compliance is mandated by law, because weak institutional features such as ineffective enforcement mechanisms and shortage of qualified accountants may give them incentives for not to comply with the law. In summary, the present study documents the following which might be useful to various stakeholders including preparers and auditors.

Firstly, this study highlights the incidence of non-compliance with accounting standards among Malaysian companies as identified by the FSRC in their annual review of companies' financial statements from 2006 to 2012. In particular, the FSRC had reported evidence on the inappropriateness of the use of the going concern assumption by some companies in their preparation of financial statements, which indicates non-compliance with MFRS101 'Presentation of Financial Statements'. This incidence could be due to weak institutional features (for e.g. ineffective of enforcement) as FSRC had also interestingly identified cases whereby auditors did not comply with the auditing standards ISA570 "Going Concern".

Secondly, apart from the going concern issue, we note that the FSRC had also detected common non-compliance areas in the financial statements such as inadequate disclosures on impairment of assets, deferred taxation, employee benefit, intangible assets, business combination, leases and segment reporting; and inappropriate classification of items in cash flow statements. The FRSC had also highlighted that various errors were made by some companies in the financial statements which will definitely impair disclosure quality. These findings can inform preparers and

auditors of the reporting aspects that should be improved in the preparation of financial statement in order to improve the quality of disclosure.

Finally, the FSRC initiatives are designed to educate the preparers and auditors about good presentation and disclosure practices so that quality of financial reporting can be improved and consequently, comprehensive and credible information can be provided to users of financial statements. It is important to reflect on the extent that this aim has yet to be achieved given the fact that common non-compliance or deficiencies had been regularly detected from 2006 to 2012. The absence of negative publicity for the convicted non-complying entities may have not provided adequate disciplinary mechanism to fully comply with the accounting standards and other statutory requirements. This suggests that investors have to be vigilant about corporate disclosure quality although the companies' financial reports have been audited and certified by auditors. In terms of regulation, publicising the names of companies, directors and auditors convicted of non-compliance with the mandatory requirements can probably impose a more effective disciplinary mechanism to improve disclosure quality.

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