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DBA RESEARCH PAPER

***FINANCIAL ACCOUNTING DISCLOSURES AND CORPORATE GOVERNANCE
IN MALAYSIA***

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PREFACE

The paper is on Malaysia, an emerging market, which had enjoyed strong economic activity with growth of 8-9% p.a. for a decade before the Asian financial crisis hit the region in 1997. The local currencies in the region came under pressure as capital took flight from the region. Credit and trade receivables became difficult. Assets and share values plunged dramatically as demand fell. A number of companies which had expanded rapidly through acquisitions and diversification with heavy borrowings in the past became insolvent. Investors and other stakeholders lost money with the failure of the companies. Many blamed the inadequate financial information and poor corporate governance as agency issues for their loss.

The authorities reacted and introduced new regulations and measures to improve the quality of the financial disclosures and corporate governance following the Asian crisis. The government established the Malaysian Accounting Standards Board and the Securities Commission (SC) was given more powers with amendments to the legislation. A Code of Corporate Governance was adopted and the Kuala Lumpur Stock Exchange (KLSE) amended its Listing Requirements.

Concern for the quality of the financial statements increased at the time when the economy decreased with the Asian crisis. Accruals accounting requires management estimates and judgement, and is susceptible to earnings management. The study is to examine the effect of earnings on share values, and earnings management in Malaysia. The study using companies listed on the KLSE covered the period of the Asian crisis up to 2005.

Using the data of companies with poor earnings that were subsequently placed on the KLSE PN4 list, the study confirmed previous studies that earnings affect share prices. The share prices fell with negative earnings and remained low with declining earnings up to the PN4 announcements in 2001. Earnings management was evidenced by the use of the statistical model and the high standard deviation. There was, however, a marked change in 2005. Good management practices and transparency in financial information promotes growth.

Chapter 1. Introduction

1.1 Malaysia – An Emerging Market

Emerging markets in countries like Malaysia can be attractive because the potential for rapid economic growth is higher than in the more mature markets. However, there are risks, and the countries that are politically stable, economically open with sound monetary policies can provide significant gains from rises in their equity markets.

The term “emerging markets” is often used to describe developing economies. The International Finance Corporation (IFC), a subsidiary of the World Bank, characterizes an ‘emerging market’ as one which meets at least one of the two following criteria:¹

1. The equity market is located in a country which is classified as a ‘low’ or ‘middle income’ economy by the World Bank.
2. The market capitalization in relation to the most recent figures of the Gross National Income is relatively small

The World Bank estimates that almost US\$177 billion of foreign portfolio capital has moved into emerging markets' stocks over the course of the 1990s. Emerging markets distinguish themselves from the capital markets of developed economies with regard to the degree of information efficiency and institutional infrastructure. A market's institutional infrastructure is generally characterized by the taxation of dividends and capital gains, the restriction of capital flow and the quality of information available.

Malaysia, an emerging market country, is experiencing a growing population, a substantial increase in living standards and income, rapid economic growth, and a relatively stable currency. With a population of 25 million people, the country is situated in South East Asia with a land area of 330,200 sq. km. It has natural resources like gas

¹ See International Finance Corporation (IFC) Factbook (2000), S.2

and petroleum, and has a large production of palm oil, with products from the plantations largely supplied to China to meet its demand.

Malaysia enjoyed strong economic growth in the 1980s and 1990s with liberalisation, in the form of freeing up the market to international participants. Capital flows to the market were substantial due mainly to the emergence of portfolio flows (fixed income and equity) and foreign direct investment. The foreign direct investment had grown steadily over the years and had reached US\$7.3 billion by the end of 1996². This could have not happened without the country embarking on deep structural changes and reforms with a stable political environment. Indeed, to sustain the economic growth in particular and enhance the efficiency of the financial system in general, the country has been driven to track the international movement of reforming capital markets. The reforms of the financial and the banking systems were crucial for the potential benefit and their impact on the stock exchange market. Also, the flow of an important portion of the international investment contributed to the dynamism of the market.

1.2 History

The Malay States and the Straits Settlements in Peninsula Malaya were ruled by the British until 1957 when the Federation of Malaya gained independence. In 1963, the Federation was expanded with Sabah, Sarawak, and Singapore joining to become Malaysia. However, Singapore was to leave the Federation two years later.

The trading of shares in Malaysia and Singapore dates back to the British colonial days. This unorganised share trading continued at a low level until the rubber boom in 1910 and the growth of tin mining in Peninsula Malaysia. It was not until June 1930 that the stock-broking firms formed the Singapore Stockbrokers Association under the then Societies Ordinance of the Straits Settlements. The Association existed until 1960 when ten firms in Singapore and nine in Peninsula Malaysia joined to establish the Malayan

² Source: UNCTAD FID/TNC Database (1998).

Stock Exchange based on the scoreboard system. When Singapore joined the Federation of Malaysia in 1963, the Exchange was renamed the Stock Exchange of Malaysia. This Exchange continued even after the separation of Singapore in 1965 with a name change – the Stock Exchange of Malaysia and Singapore. The new Singapore dollar (S\$) was maintained at parity with the Malaysian ringgit (RM), and used interchangeably by the two countries. When the Malaysian government announced its intention to terminate the interchangeability of the two countries, the common Stock Exchange split.

The Kuala Lumpur Stock Exchange Berhad (KLSE) and the Singapore Stock Exchange Ltd (SES) were formed in 1973 to take over the common Exchange. Initially, the SES allowed new Malaysian issues to be listed provided the prospectus was also issued in Singapore, and the listing requirements met. The arrangement was terminated following the collapse of the Pan-Electric group of companies in 1985.

One of the main objects of the KLSE is to provide, regulate, and maintain facilities for conducting the stock-broking business. The KLSE has become an active component of the capital market in Malaysia. The market capitalization reached US\$12.0 billion in 1983, and had exceeded US\$100.0 billion at the end of 1999³. The number of companies listed on the KLSE had grown to 757 by the end of 1999. The bullish sentiment was driven by the economic recovery in the country from the financial crisis, improved company earnings, and the low interest rates.

1.3 Political System

The system of government in Malaysia is closely modelled on that of Westminster, a legacy of British colonial rule. Malaysia has an elected constitutional monarch, the *Yang di Pertuan Agung*, and the parliamentary democracy has an appointed Senate (*Dewan Negara*) and an elected House of Representatives (*Dewan Rakyat*). The Prime Minister,

³ International Monetary Fund, “Corporate Performance and Governance in Malaysia”, IMF Working Paper WP/02/152, p. 6

Abdullah Badawi, heads the *Barisan Nasional* (BN) coalition government, as well as the United Malays National Organisation (UMNO), the largest member of the coalition. . There have only been five prime ministers since independence, and the last one, Tun Dr. Mahathir Mohamad, held office from 1981 to 2003.

The Malaysian government has been controlled by the UMNO-led BN coalition since independence. The ruling coalition has maintained a two-thirds majority in the Parliament, except for a brief period in 1969.

Most of Malaysia's political parties are ideological or ethnic-based. The ruling coalition, BN (National Front), is composed of three large ethnic political parties (the Malay-based UMNO, the Chinese-based Malaysian Chinese Association, and the Malaysian Indian Congress) and a few other smaller parties. On the opposition side, the major opposition parties are the Chinese-based Democratic Action Party (DAP), and the Malay-based Parti Islam SeMalaysia (PAS). The DAP always campaigned on the issue of racial discrimination, especially in the commercial area. Its main base is in the Penang State. The PAS is noted for its Islamic fundamentalism, with the aim to turn Malaysia into an Islamic state. Its major constituency is in the Kelantan State.

The BN has been able to maintain its uninterrupted rule at the Federal level as a coalition of ethnic parties with development policies which have helped to improve a majority of the professional and middle class across ethnic lines. The opposition parties have been weak, plagued with internal squabbles and defections.

UMNO has maintained a tight control with strong discipline over its members. The leaders are known to have used federal and state government posts, parliamentary seats, and numerous state and quasi-state enterprises to reward faithful followers. Large campaign expenses for individual politicians have been covered by UMNO's rich investments - the Fleet Holdings, the Hatibudi Sendirian Berhad, and the Renong Berhad conglomerates, which have interests in hotels, television, retailing, real estate, construction, and banking at both national and local levels. The mass media, is also

owned or tightly controlled by UMNO, and has provided the best news image and advertisement for politicians during elections.

Despite its tight controls and strong discipline, UMNO experienced two major internal crises - in 1987 and in 1998. The party was split into two factions after the UMNO general assembly in 1987 when Prime Minister Mahathir's position was challenged by the then UMNO vice-president Tengku Razaleigh Hamzah. Two years later, Tengku Razaleigh Hamzah and his group left UMNO and established a new party, Semangat 46. However, the coalition of *Gagasan Rakyat Malaysia* (People's Might), formed by Semangat 46, the DAP, and the PAS, failed to reduce BN's two-third majority in the 1990 parliamentary election. By the 1995 election, *Gagasan Rakyat* had disappeared. Both the DAP and the Semangat 46 lost seats to the Barisan Nasional. The other crisis of UMNO occurred in 1998, in the midst of the financial crisis. The then Deputy Prime Minister Anwar Ibrahim and his supporters attempted to force Mahathir to take an early retirement. However, Mahathir retaliated by disclosing the names of hundreds of companies and individuals that won privatization contracts or had benefited from *bumiputra* (Malays) share allocations in recent years. Anwar and his supporters were among the names. Anwar was later removed from his posts as Deputy Prime Minister and Finance Minister, and sentenced to a six-year term on charges of corruption (a violation of the Internal Security Act) and homosexual behaviour (a violation of the Islamic Law). Anwar's supporters, rallying behind Anwar's wife, formed The National Justice Party to challenge BN in the 1999 general election. BN managed to hold its three-quarters majority in parliament although it lost some seats to the PAS. The National Justice Party won only five seats in that year.

Although UMNO championed the interests of the *bumiputras*, the Chinese and Indians have continued to support the BN. It is partly because the economic interests of the Chinese have never been seriously hurt. The promotion and improvement of *bumiputra* interests have been made through state-owned enterprises, government subsidies, and the requirement for *bumiputra* participation. However, the government promotion policies and the requirements for *bumiputra* participation were quite often circumvented through

the use of nominees that the Chinese business elite benefited as much as the Malays. Furthermore, the racial riots of 1969 serve to remind the Chinese that a stable and moderate UMNO-dominated BN government would better protect their interests and lives than other extremist communal parties.

UMNO's continued dominance over other political parties has been maintained through various control instruments of the government. The mass media such as television and the press are either owned by member parties of BN or tightly controlled by the government. Criticisms of the government often ended up with the charge of sedition or instigating racial conflicts prohibited by the Internal Security Act, which also allowed the police to detain political opponents without trial. The Malaysian government routinely resorted to these harassment techniques during election campaigns. The opposition could not depend on the legal system either, since the ruling coalition maintained two-thirds majority in the parliament, which allowed the government to frequently pass constitutional amendments to expand administrative powers at the expense of the opposition. In fact, the Supreme Court has become subordinated to the will of Mahathir since he removed some of the judges who opposed him during the UMNO split of 1988. In the same year, the Parliament passed a constitutional amendment permitting the Supreme Court to conduct judicial review only when the Parliament grants.

Furthermore, the British-style single-member constituencies combined with the government's partisan gerrymandering of electoral constituencies had favoured the centrist Barisan Nasional over the fundamentalist or extremist opposition parties. Finally, internal squabbles and defections plagued the opposition parties. Most of the Malaysian parties are organized in an authoritarian way. When factional divisions occur within a party, they usually ended up with a split of the party rather than going through democratic turnover of party leadership. After losing the 1990 election, many supporters of Semangat 46 returned to UMNO for more patronage and promising career future. The party won only six seats in 1995, and none in 1999. The DAP began serious infighting after it lost badly in the 1995 election. In the 1999 election, it increased its parliament seats by an additional one. It was nine in 1995.

1.4 Economy

1.4.1 Economic Development

Since Independence in 1957, the Malaysian economy has undergone profound structural changes, evolving from a dependence on tin and rubber into an increasingly broad-based and diversified economy with an expanding industrial base. In the early phase of development, agriculture was the main source of growth. Beginning in the 1970s, the manufacturing sector began to assume an increasingly important role in the expansion of the Malaysian economy. Within the sector, the shift from labour-intensive industries to capital-intensive industries took place in the 1980s in line with the national objectives. Manufacturing grew from 13.9% of GDP in 1970 to 30.9 % in 2003, while agriculture and mining, which together had accounted for 42.7% of GDP in 1970, dropped to 8.7% and 7.2 %, respectively⁴. The economy has been sustained through productivity and industrial upgrading to higher value-added industries with a new focus on information technology by the creation of the multi-media corridor.

The Malaysian economic policy framework is based upon the NEP, which was launched in 1974. The political and economic objectives of the NEP are to reduce poverty by increasing income levels for all Malaysians and to restructure the Malaysian society in order to erase all racial identification in economic terms. In other words, the NEP calls for a financial redistribution from the minority of wealthy non-Bumiputra (native Malaysians also known as "Princes of the Soil") racial groups to the Bumiputras.

Under the NEP, the government could order corporations to transfer up to 30% of their shares to government approved Malay individuals or companies. However, this had mainly provided instant profits to UMNO elites and their relatives, as the opposition in late 1994 exposed such scandals.

The economic performance of Malaysia for the past two decades before the Asian financial crisis was quite remarkable with annual growth of about 8 per cent.

⁴ Ministry of Finance (Kementerian Kewangan) Economic Report, 2003/04.

1.4.2 Asian Financial Crisis

Prior to 1997, the Indonesia, Korea, Malaysia, the Philippines, and Thailand were experiencing low inflation and a moderate level of fiscal and monetary imbalances. In 1995, the combined current account deficit of the five countries totalled the equivalent of US\$41 billion. In 1996, the current account deficit of these countries increased by 33% to US\$54.5 billion. At that time, the high current account deficits were not seen as a problem due to the significant inflow of foreign capital that more than offset the deficit of the respective countries' current accounts.

The foreign capital inflow into the five Asian countries was so enormous in 1995 and 1996 that not only were the countries able to finance their current account deficits, but they were also able to use the excess capital to invest overseas and add to reserves. The level of capital inflows into the mentioned Asian countries totalled US\$86.3 billion in 1995 and US\$91.2 billion in 1996⁵.

In 1995, US\$4.9 billion, or less than 6% of the total capital inflow of US\$86.3 billion, was for the purpose of foreign direct investment. Out of the balance of the total capital inflow provided, US\$11 billion was provided by private investors for portfolio type equity investment, and US\$67.9 billion was provided by private creditors, primarily commercial banks. In 1996, a similar picture was painted with 6.4% of the total capital inflow being invested for the purpose of foreign direct investment and the balance being provided by private equity investors and private creditors. Looking at 1995 and 1996 in aggregate, over 65% of the external capital provided to Indonesia, Korea, Malaysia, the Philippines, and Thailand took the form of foreign commercial bank loans. In essence, the countries were financing their excess of imports over exports with foreign bank credit. The inherent risk with this type of financing is that a change in the willingness of foreign banks to provide credit can result in economic disaster.

⁵ Source: UNCTAD FID/TNC Database (1998).

Similar to the Latin American crisis of 1980, prior to the crisis Thailand experienced a tremendous credit boom as foreign investors borrowed baht from Thai banks for the purchase of Thai equities and real estate. The over-extension of credit made Thailand vulnerable to either a drop in equity or real estate prices.

Thailand's vulnerability increased significantly as Thai banks were permitted to capitalise from Japan's low interest environment by borrowing on a short-term basis from Japanese banks and lending the proceeds in baht to the private sector. Since the baht had been relatively stable for many years preceding the crisis, this risky practice was permitted to continue. This practice would eventually encourage speculative attacks on the baht.

Underlying the unsustainable practice of Thailand's banks borrowing abroad and lending domestically was a fundamentally weak banking sector. The banks continued to provide troubled creditors with new loans to service existing loans. The practice of connected lending or more commonly known as "crony capitalism", and the Thai government directive for the banks to lend to weak industries stretched their reserves. The weakness in the banking sector was starting to become apparent. By early 1997, currency speculators began to sense the fundamentally weak banking and economic situation of Thailand.

The capital market by then had become fragile with deterioration in lender confidence. The outstanding stock of debt to OECD banks had risen to US\$103.1 billion in Korea, US\$28.5 billion in Malaysia, and US\$96.7 billion in Thailand. At market exchange rates, Korea's debt was 83.2% of its quarterly 1997 GDP, the Malaysian debt was 106.6% of its quarterly GDP, and the Thai debt was 220.9% of its GDP.

Many financial institutions in Thailand began to show signs of trouble as a result of their risky practices which included borrowing from foreign banks and lending domestically without hedging currency risk, and borrowing short-term and lending long-term. The news of the government's inability to bail out Thailand's largest financial institution, Finance One, in June 1997 caught the attention of the currency speculators. Speculators

attacked the baht believing that Thailand did not have enough reserves to maintain its currency peg to the U.S. dollar.

On 2 July 1997 Thailand could no longer support the baht. The Bank of Thailand announced it was allowing the baht to float and called the International Monetary Fund for assistance.

The decision to allow the Thai baht to trade freely in 1997 led to severe economic consequences for Thailand. For the six month period ended 31 December 1997 the Thai baht had devalued by 48.7%. On the equity side, Thailand's stock market had declined by 29.3% for the six month period ended 31 December 1997.

The devaluation of the Thai baht served as a wake-up call for foreign investors and creditors. Investors and creditors realised that other countries could be in a situation similar to that of Thailand and perhaps would be forced to devalue their currency at some point in the future. Investors and creditors targeted the Asian countries with the weakest fundamentals as potential candidates.

The depreciation of the baht resulted in the exports from Thailand being cheaper for foreign customers compared to identical products from Malaysia and Indonesia. Speculators did not believe that the Malaysian central bank could defend the ringgit, and moved against the ringgit.

On 14 July 1997 the Malaysian central bank announced that it could no longer defend the ringgit. For the six month period to 31 December 1997 the Malaysian ringgit had devalued by almost 50%. On the equity side, Malaysia's stock market had declined by 54% for the six month period ended 31 December 1997 wiping almost US\$225 billion off the share values. The effect on the country's economy was severe.

The Asian financial crisis in 1997-98 affected Korea, Indonesia, Malaysia, and Thailand with great severity. Different causes have been attributed for the crisis in the four

countries. At the same time, there are features common to all of them. In the case of Malaysia, there is unanimous agreement on the role of private debt, principally by companies, and that companies whose shares are listed for trading on the Kuala Lumpur Stock Exchange (KLSE) caused distress to the banking system, which triggered the collapse from July 1997.

The proportion of such private sector debt to GDP in 1997 was 170%⁶. A very large proportion of such debt was corporate debt, principally borrowings by public companies listed on the KLSE. The Malaysian stock market certainly took a beating when in September 1998 the KLSE Composite Index sank to a low of 262.7 points – a mere shadow of the mighty heights in the years prior to the crisis.

The Government initially introduced a series of pre-emptive measures between October 1997 and March 1998 designed to defend the value of the ringgit and strengthen the financial sector. An austerity program was announced, monetary policy was tightened and stricter prudential standards were imposed on the financial sector. Nevertheless, throughout the first half of 1998, economic conditions continued to deteriorate, as loan growth slowed sharply and non-performing loans increased. GDP contracted by 1.8% in the first quarter and by 6.8% in the second quarter on an annualized basis.

The weak link in the Malaysian financial crisis of 1997 seemed to be the Securities Commission. The Malaysian government established the Securities Commission in 1993, one year after its Thai counterpart. According to the Securities Commission Act of 1993, the Securities Commission reported to the Finance Minister, who also appointed all the nine members of the Commission, including the executive chairman, deputy chief executive, and seven private and government representatives. Therefore, like the Thai Securities Exchange Commission, the Malaysian statute of the Securities Commission did not allow it too much political independence from the Finance Ministry or from the pressure of private interests. Past Finance Ministers had used the position to benefit their

⁶ Bank Negara Annual Report, 1998.

relatives and proteges; Tun Daim Zainuddin, the Finance Minister from 1984 to 1991, is probably one of the more controversial one.

The Finance Minister has direct influence over the supposedly private regulatory body of the Kuala Lumpur Stock Exchanges (KLSE). By the Securities Industry Act of 1983, the Minister could “approve a stock exchange and to appoint any person to the stock exchange’s committee,” or to dismiss any committee members at any time.

During the 1997 crisis, the regulators of the security market, the KLSE and the Securities Commission, received many criticisms from the public and the government’s reviews. Both regulators were criticized for their lack of firm and decisive action against breaches of regulations. They were weak in monitoring and enforcement activities.

1.4.3 The Conglomerates

The Malaysian financial crisis in 1997 was partly caused by the failure of the market and the lack of government checks and action.

In the late 1980s and most of the 1990s, the Malaysian conglomerates expanded their holdings in subsidiaries in response to the booming economy and the expansion of the capital market. Both the state and private financial institutions overextended their loans to the real estate and capital markets. As savings lacked behind investment, these financial institutions supplemented their capital needs by resorting to mutual borrowing, dubious accounting procedures, and external borrowings.

The financial crisis in 1997 badly affected the conglomerates. The effect was further compounded by the close links among Malaysia's banks, finance companies, securities houses, and merchant banks. Banks controlled from 50 to 100% of the shares of their financial subsidiaries. Mutual borrowing was extensive among these financial institutions. Conglomerates like the Antah Holdings Group, the Melewar Group, the Arab Malaysian Group, the R.J. Reynolds and Land & General Groups, as well as the UMNO-

controlled Fleet Holdings, Hatibudi, and Renong Berhad, all exhibited such complex financial relationships among their subsidiaries and between conglomerates. Furthermore, many of the financial relationships were not linked to the competitive export sector but rather to the expansion of real estate and security markets of the 1980s and 1990s.

The expansion of the real estate and financial markets contributed to the rise of financial politics in Malaysia. Political elites found new ways of making instant profits by pricing their official responsibilities and privileged information related to these business activities. For instance, the Malaysian banking industry was dominated by two largely government-owned commercial banks, which provided frequent contact between the conglomerates and state officials. One such bank, Bank Bumiputra, was noted for its dubious loans to well-connected business people. When a Chinese investor lost his gamble in Hong Kong's real estate market in 1987, the bad loan almost wiped out the entire equity of Bank Bumiputra, which was supposed to lend money to *bumiputras* only.

UMNO candidates increasingly depended on conglomerates to raise funds. It was done through insider trading and manipulation of share prices of politically controlled conglomerates. Before UMNO convened its General Assembly, these conglomerates would generally launch a coordinated attack on the stock market to move the index. After the market plunged, they bought back their stocks and later distributed the profits to candidates who invested their campaign money at the "right time".

The collapses in the domestic stock market and the foreign exchange market were also accompanied by a large decline in aggregate demand. Private consumption and private investment, especially housing investment, plunged because of the abrupt withdrawal of foreign funds, the high interest rates, and the pessimism about quick economic recovery in East Asia. Furthermore, the positive effects from the depreciation of the Ringgit were more than offset by the depressed demand conditions in the region, making exports in the first half of 1998 (US\$35 billion) to be lower than in the first half of 1997 (US\$39 billion).

The fall in profits and in share prices rendered many large *bumiputra* conglomerates financially insolvent. The decline in their share prices reduced the value of the collateral pledged against their bank loans, and the drop in profits caused by the economic slowdown made them unable to service their bank loans.

Possibly, the most well known rescue attempt of a politically-connected conglomerate in 1997 was the November 17 announcement by United Engineers Berhad that it had just used borrowed funds to acquire 32.6 percent of the shares of its parent company, Renong Berhad.⁷ United Engineers had done this without consulting its minority shareholders. Furthermore, the government had to issue a waiver to exempt United Engineers from having to make a general offer for Renong shares that it did not own. Because United Engineers' move was widely seen as bailing out the indebted majority shareholders of Renong to the detriment of minority shareholders in both companies, the share prices of both companies plummeted after the announcement of the acquisition.

As matters turned out, the continued general downslide in profits and in share prices required that Renong be bailed out a second time. In October 1998, Renong defaulted on its debts, and the government paid off MR10.5 billion of Renong's short and medium-term bank debt by issuing an equivalent amount of long-term bonds. Renong promised to repay the government from its future earnings.

Other large *bumiputra* conglomerates also shared Renong's financial difficulties in that year. Quite a few of them, especially the politically connected ones, sought state assistance to overcome their financial difficulties. The difficulties of Malaysia's conglomerates (both *bumiputra* and non-*bumiputra* owned) in servicing their large bank debts severely damaged the balance sheets of Malaysia's banks. An estimate by Lehman Brothers in October 1998 put the extent of Malaysia's problem loans to be at the median of key Asian market economies experiencing banking crises. The proportion of problem

⁷ Asian Development Bank, 'The Capital Market in Malaysia', (1998), p.85.

loans in total bank loans was 13 percent for Japan, 33 percent for Malaysia and South Korea, 48 percent for Thailand and 61 percent for Indonesia.

Bank Bumiputra, a state bank, was pushed into near bankruptcy for the third time since its establishment in 1966. The government had to put in at least MYR2 billion as capital in order for Bank Bumiputra to meet the minimum risk-weighted capital adequacy ratio. Sime Bank and RHB Bank, two banks with strong ties to UMNO members, merged in mid-1998 and received an infusion of MYR1.5 billion from Danamodal, a state company established to recapitalise troubled banks. The steady deterioration of the bank sheets of Malaysia's banks has led Standard & Poor to predict that gross non-performing loans (NPLs) would exceed 30 percent of total bank loans at the end of 1999 and that the amount of required recapitalisation would exceed 40 percent of GDP.

1.4.4 Recovery

Malaysia suffered less and recovered better than Thailand from the 1997 crisis. Unlike Thailand, the country did not accept the rescue package with an infusion of funds and the stringent conditions imposed by the International Monetary Fund (IMF). The conditions on Thailand included:

- Floating of the baht
- Reform of the fiscal policy
- Ending the support for insolvent financial institutions
- Strengthening financial regulation and supervision

The Malaysian *ringgit* came under pressure as market confidence in the region had diminished with an outflow of funds there was also pressure on an interest rate hike. The country did the opposite of what the IMF had imposed on its Thai neighbour. It boldly imposed exchange controls on the *ringgit* and pegged the rate to the U.S. dollar. It also adopted an expansionary fiscal policy by lowering interest rates in an attempt to support the many struggling companies as demand fell in a contracted economy. With the rising

credit default and the non-performing loans, financial institutions were forced to merge as their financial strength became weakened.

The Malaysian financial politics, although inflamed by the conglomerates with a decline in profits and solvency problems, was kept in place by a relatively autonomous state, and the dominance of the BN in government. The Central Bank, Bank Negara, was able to maintain a relatively high efficiency and political autonomy, while the Securities Commission was relatively weak at the time of the Asian crisis as companies and the financial institutions were forced to re-structure with significant losses from the sharp falls in values of assets and property. Corporate re-structuring was slow as major debts had to be re-structured. The BN government was able to use various reward and punishment instruments to consolidate its cohesion and to suppress opposition parties in its efforts to handle the crisis. Due to the single-member constituencies, the communal base of political parties and the relatively clean elections, local factions did not play an active role in Malaysian financial politics.

The BN government was able to push through its sometimes controversial policies in its handling of the Asian crisis, and the Malaysian financial politics survived due to the stringent restrictions of direct foreign participation in the local financial markets. The policies enabled the country to recover better than the other affected countries in the region.

1.4.5 Danaharta

To avert a credit crunch or a possible systematic crisis, Danaharta was established by the government in 1998 as an asset management corporation (AMC) to acquire, manage, and sell non-performing loans (NPLs) as well as restructure and liquidate failed institutions. Its government-appointed Board comprises of two government representatives and five private sector representatives.

By the end of 1999, Danaharta had acquired and managed MYR45.5 billion in NPLs from various financial institutions. The total loans acquired and managed increased to MYR48.03 by mid-2001⁸. The financial institutions had the incentive to purge itself of its NPL expeditiously through a sale to Danaharta on account of the following considerations:

- Banks selling NPLs retained a right to receive at least 80% of any profits realised on subsequent sale or liquidation;
- Banks were allowed as much as five years to amortise the difference between the book value and the sale price when an asset is sold;
- Banks were able to exchange a non-earning, illiquid NPL for an income generating, readily marketable and zero-risk weighted bond;
- A bank that declined a Danaharta offer for a NPL purchase was to write-down the NPL to 80% of the offer price and immediately recognise any loss.

As the banks were able to avoid the immediate recognition of any losses, there was an element of accounting and regulatory forbearance from these loan sales.

1.5 The Stock Market

The securities market allows firms and investors to interact with dealings in stocks and shares. Share trading in Malaysia started in 1930 through the old Singapore Stockbrokers Association. The Association existed until 1960 when the Stock Exchange of Malaysia and Singapore was formed. Following the separation of Singapore, the KLSE was established in June 1973. One of the main objects of the KLSE is to provide, regulate, and maintain facilities for conducting the stock-broking business. The KLSE has become an active component of the capital market in Malaysia. The market capitalization reached US\$12.0 billion in 1983, and had exceeded US\$100.0 billion at the end of 1999. The number of companies listed on the KLSE has grown to 757 at the end of 1999. The

⁸ Pengurusan Danaharta Report, September 2005, p. 32.

bullish sentiment was driven by the economic recovery in the country from the financial crisis, improved company earnings, and the low interest.

Capital raising and investment are no longer constrained to national boundaries with advances in technology and the globalisation of markets. The international factors have become important, and the KLSE has over the years effected various changes and improvements to put it abreast of other overseas exchanges. The implementation of a computerised trading system with subsequent improvements has been one of those major changes.

It has been estimated by stock market analysts that by mid-1997, about a quarter of the stock in the Kuala Lumpur Stock Exchange was in foreign hands, another quarter was held by Malaysian institutions, with the rest constituting “retail trade” of price-takers. While most Malaysian shareholders only operate within the Malaysian stock market, foreign institutional investors see the Malaysian market as only one of many different types of financial markets in a global financial system including many national markets, i.e. the global financial system is hardly a market of equals. Although always in the minority, foreign investment institutions ‘made’ the stock markets in the region, shifting their assets among securities markets as well as among different types of financial investment options all over the world. In the face of limited transparency, the regional nature of their presence, the nature of fund managers’ incentives and remuneration and the short-term of their investment horizons, foreign financial institutions were much more prone to herd behaviour and contributed most to the regional spread of contagion.

1.6 Regulation And Reporting Requirements

Financial reporting and corporate disclosures for public listed companies in Malaysia are regulated by the Companies Act 1965, the Securities Commission which took over the role of the Capital Issues Committee (CIC), and the KLSE Listing requirements. The Companies Act imposes an obligation on the directors to keep accounting and other

records that will sufficiently explain the transactions and financial position of the company. The accounts must be audited with the auditor issuing a report certifying that the financial statements give a true and fair view.

Accounting standards approved by the Malaysian Accounting Standards Board and Financial Reporting Foundation are adaptations of the international accounting standards approved by the International Accounting Standards Committee. Companies listed on the KLSE, in addition, have to provide quarterly reports with a summary of key financial information as prescribed by MASB 26 - i.e. Balance Sheet, Income Statement, Statement showing either (i) all changes in equity or (ii) changes in equity other than those arising from capital transactions with owners and distributions to owners, Cash Flow Statement and the Selected Explanatory Notes.

The disclosure requirements were not enough to prevent 118 companies to obtain PN notices in the wake of the financial crisis⁹.

1.7 Market Efficiency

Investors are human and it is not surprising that financial markets reflect human frailties. While it is evident that human beings do not always behave rationally, it does not necessarily follow that markets will also be irrational. In fact, you could argue (as some believers in market efficiency do) that markets can be efficient even with irrational investors for several reasons. First, it is possible that there is a selection process that occurs in markets where irrational investors lose consistently to rational investors and eventually get pushed out of the market. Second, it is also possible that irrationalities cut in both directions – some leading investors to buy when they should not and others leading them to sell when they should not; if these actions offset each other.

If the capital market is efficient, stock prices must reflect quickly and fully any newly released information. Fama (1970) defined efficient market in terms of a ‘fair game’

⁹ Bursa Malaysia, Annual Report 2002 (Market Review), p. 11

where security prices fully reflect all available information that is relevant to the determination of values. In this case, all securities are correctly priced and investors will earn a normal return on their investment that is commensurate with the level of risk assumed. One important implication is that security prices will change only when new information or 'news' arrives that was not fully considered in forming current market prices. Even so, in an efficient market, agents will process this new information efficiently by immediately incorporate it into security prices. The central question that requires careful dissection here is what constitutes 'relevant information'. This is crucial because conclusions about market efficiency could differ according to what is included in, or omitted from the information set. Fama (1970) has outlined a standard classification for different compositions of information set, and with this, the EMH can be classified into weak form, semi-strong form and strong form. The author explained that such classification permits researchers to pinpoint the level of information at which the hypothesis breaks down.

The weak-form EMH, however, asserts that the only relevant information set to the determination of current security prices is the historical prices of that particular security¹. In this regard, investors cannot expect to find any patterns in the historical sequence of security prices that will provide insight into future price movements and allow them to earn abnormal rates of returns. In most of the empirical literature, the random walk behaviour of security prices is used as the basis to test for weak-form EMH. Since new information is deemed to come in a random fashion in an efficient market, changes in prices that occur as a consequence of that information will seem random. Thus, price movements in a weak-form efficient market occur randomly and successive price changes are independent of one another.

The body of literature on weak-form EMH can be considered as one of the most voluminous. A number of previous studies have investigated issues relating to the efficiency of the KLSE, although the overreaction issue is not investigated. Several early papers examine the randomness of price changes using serial correlation and runs tests. Using monthly price data, Lanjong (1983) and Barnes (1986) find results which are

generally supportive of weak form efficiency. Similar results are obtained by Laurence (1986) who used daily closing prices adjusted for cash and stock dividends, splits and rights issues, of 16 individual stocks most traded on the KLSE over the sample period of 1 June 1973 through to 31 December 1978. Results from serial correlation and runs tests suggest only slightly deviation from perfect weak-form efficiency. Yong (1987) uses weekly data for 170 stocks and finds a high degree of serial independence for most stocks.

Even emerging stock market like the Kuala Lumpur Stock Exchange (KLSE) of Malaysia has received considerable attention from researchers as the testing ground for EMH in those earlier years of 1980s. Barnes (1986) examined 30 companies and 6 sector indices for the six years ended 30 June 1980. Using monthly data, the serial correlation and runs tests results exhibit a high degree of efficiency in the weak form, with little departure from the random walk hypothesis. Further spectral analysis confirms the earlier findings that the KLSE is fairly efficient. Laurence (1986) used daily closing prices adjusted for cash and stock dividends, splits and rights issues, of 16 individual stocks traded on the KLSE over the sample period of 1 June 1973 through 31 December 1978. Results from serial correlation and runs tests suggest only slightly deviation from perfect weak-form efficiency. Using data for 6 sector indices and the all-share index from 1975 to 1982, Saw and Tan (1989) found that the Malaysian stock market is inefficient in the weak form when weakly data were used, but pockets of market efficiency existed when monthly data were used.

1.8 Objectives Of The Research

Earnings disclosures in the financial statements are the medium used by managers to show the performance results of their stewardship on the results entrusted to them. Financial disclosures provided by the company accounting and external reporting systems that include the publicly disclose audited, quantitative data on the financial position and performance of companies contribute to the information reflected in share prices.

This paper examines the agency theory on the separation of ownership and management in the companies, the effect of financial disclosures on share prices, and evidence of accounting distortions from management incentive contracts in Malaysia.

The objectives of the research are:

- To investigate whether financial accounting disclosures mitigate agency problems in Malaysia due to the separation of investors and managers.
- To determine the existence of earnings management in disclosures and the impact on the share market and its allocation of resources in the economy.
- To examine whether the disclosures possess information value that leads to investor confidence of stocks listed on the Kuala Lumpur Stock Exchange (KLSE).

Research Significance and Contribution to Knowledge

If the capital market is efficient, stock prices must reflect quickly and fully any newly released information. The paper makes several contributions with a study on the market behaviour following an economic crisis in an emerging market in Malaysia rather than a developed one, the performance of companies operating in difficult economic conditions over a prolonged period, and the likelihood of earnings management under those conditions.

The remainder of the research report is structured as follows – Chapter 2 covers the methodology and approach. Chapter 3 presents a literature review of previous research in the area of management incentives and motivation to earnings management, and in particular the use of accruals. Chapter 4 describes the local Malaysian environment and how the data was collected, the test for earnings management and interpretation of the results. Chapter 5 presents the analysis of the results and explanation. Chapter 6 summarises the study's key findings, examines the implications of those findings, and identifies questions for further research.

Chapter 2: Research Approach and Methodology

2.1 General Discussion

Financial disclosures by public-listed companies enhance transparency and help investors to make decisions. Investors can then buy or sell shares, and express their thoughts to management with such disclosures and information. However, such disclosures and information may not be adequate as many managers on performance incentive remuneration schemes may provide only those to their advantage.

2.2 Proposition and Questions

A public-listed company is generally characterised with the separation of share ownership and control. In Agency Theory terms, the owners or shareholders are principals and the managers are agents with one party (the principals) engaging the other party (the agent) to perform service on their behalf.

In the contract model, it is generally assumed that managers actively work to the interests and benefit of the shareholders – maximising shareholder value. However, that is not always the case.

The highly paid managers are responsible for the business operations. They make decisions and choices on the acquiring and use of company resources. They are also responsible for the accounting and reporting on the performance of the companies. However, there have been companies with seemingly good performance that have become insolvent leading to failures.

When companies fail, investors suffer with loss of their equity interest and money. The suppliers also suffer with loss of the business and uncollected debts. For the employees, the loss is their jobs and spending power. For the government, the loss is the foregone taxes and levies which in turn may affect the provision of services to the community and the standard of living.

Many of the failures, including WorldCom and Enron, have been attributed to the accounting system and the financial reports. In the case of WorldCom and Enron, the accounting system and the financial reports were independently checked and signed by external auditors.

Capital markets exist to efficiently allocate and use resources. Failures affect the efficiency and erode confidence in the market which can lead to a decline in financial and economic activity. The economic cost of company failures can also be high. Depending on the size, whilst investors and lenders may suffer monetary loss, employees lose their jobs which raises unemployment, dampens consumer spending and stretches government services.

The highly paid managers are often blamed for the company failures with the ever-present concern that they have not worked to fulfil their contract. The managers may have worked to support their own goals and interest. For example, they may have worked to maximise the size of the company and other managerial goals rather than the shareholder value.

Shareholders and investors have used remuneration as an incentive to motivate and drive managers to achieve the desired earnings and operating results for maximising share value. The financial statements prepared on the accrual basis using generally accepted accounting standards and conventions allow the parties to know, and to what extent, their expectation and contract have been fulfilled.

Since the Ball and Brown (1968) study on the relationship between accounting earnings and returns, it has drawn much interest with an increase in accounting research. Their study found that earnings have information content and was “useful” to investors. They reported a significant correlation of abnormal stock returns in the month of earnings announcements with the change over the previous year’s earnings. Kieso, et al. (2001) argued that financial statements should indicate the real situation of the company and provide information about the financial resources held, claims to those resources and

changes in them. However, companies with seemingly good performance and healthy profits have become insolvent leading to failure and closure.

Financial gains from incentives are known to affect the behaviour of individuals – especially when they face the right incentives. There is considerable literature that has shown agency conflicts can be reduced with remuneration plans tied to performance. The remuneration with bonus schemes and other short-term incentives depend on accounting measures. They have given rise to the incidence of managers using aggressive accounting on earnings in the financial statements to inflate share values. The generally accepted accounting standards and convention allow for some degree of interpretation and discretion. It is such interpretation and discretion that allow managers to make accounting choices or to design transactions to their advantage. An important work in this area was the paper by Watts and Zimmerman (1986), on accounting procedure choice and some underlying motivations: the remuneration package, debt covenants, and political costs.

There has been considerable work done on accounting choices and aggressive accounting on earnings by managers in several countries, particularly in the US and United Kingdom. However, there has been little previous research in Malaysia. The country went through significant political and economic changes following the Asian crisis. Annual gross earnings and the financial performance of a high proportion of the companies there were affected by the Asian crisis and the changes that followed. The management incentive and motivation to adopt accounting policies and treatment on transactions to reflect better performance would be high under those economic and financial conditions. The existence and use of earnings management in financial disclosures would not reveal the real position of the companies to the principals – the investors. In the relatively unsophisticated investment environment, the financial disclosures in the Annual Reports of companies are an important form of communication. The financial disclosures and reports that are supposed to mitigate the agency problem may in fact exacerbate it.

It is against this background that provides the premise for research. The purpose of the research is to test and move knowledge forward, and the methodology used should be sufficient to satisfy the stated objectives. The literature review leads to the study and test for the following:

1. That earnings management exist with executive bonus plans in Malaysia.

If managers adopt accounting policies and treatment on certain transactions to reflect better performance in financial disclosures, there should be a correspondingly higher share price with distortion in valuations to the stock. The paper also investigates whether earnings management enhances stock values and market activity:

2. Earnings management enhances stock values and sustained over the period of the study.

The collapse of major corporations like Enron and WorldCom and the passing of the Sarbaine-Oxley Act (2002) in the United States has led to new regulations and reporting requirements for better corporate governance. Other countries, including Australia and Malaysia, have followed with the requirement for greater disclosures and better corporate governance. The disclosures and management systems will be examined on reducing earnings management.

2.3 Methodology

The research design with the methodology and approach follows closely the established process for quality research. Kidder and Judd (1986) listed the following that should be considered in the research design:

- Construct Validity: establishing correct operational measures for the concepts being studied

- Internal Validity: establishing a causal relationship, whereby certain conditions are shown to lead to other conditions, as distinguished from spurious relationships
- External Validity: establishing the domain to which a study's findings can be generalised
- Reliability: demonstrating that the operations of a study such as the data collection procedures can be repeated, with the same results.

The methodology and approach for the paper has been designed to satisfy the four criteria.

2.3.1 Literature Review

There is a body of literature on the subject of financial disclosures and executive remuneration. The review is to gain familiarity, to explore and gain an understanding of the knowledge and issues from past research to form the framework for the proposed work.

Hart (1998) described the literature review as:

The use of knowledge in the existing literature is to justify the particular approach and method to be used in the selected topic of research to contribute something new.

Research has been known to be built on earlier work, and the literature review is to facilitate further advancing of knowledge. The review process with an exploratory approach has been instrumental in leading to further research which is hoped will contribute something new to the body of knowledge.

There is already a voluminous literature on agency theory and the principal-agent relationship. However, there is less on the accountability and the behaviour of managers remunerated with bonus-schemes and other incentives. Although the political system and

type of government may influence managerial behaviour, many of the individuals are driven by the remuneration and potential rewards. Quite often such remuneration and rewards are based on accounting data.

The accounting and financial statements are also an important vehicle for the shareholders and investors to know how the agent managers are performing. As such the financial statements are used by managers to report the results and performance of their stewardship from the resources entrusted to them by the shareholders and investors. These statements generally prepared using accrual accounting act as the most reliable and easily accessible vehicle for dissemination of company-level information to allow shareholders and users of the information to better understand the performance and financial position with the accrual estimates. A lack of adequate and reliable financial disclosures would prevent shareholders, investors and creditors from receiving necessary and timely information to make choices and decisions between companies.

The users of the financial information and disclosures can be misled when making decisions based on inaccurate or manipulated accounting numbers provided. The flexibility in accounting with the use of accruals allows managers to report more favourable financial statements.

For many years, the accounting profession would debate the merits of “flexibility” vs. “uniformity” in developing accounting standards. The current accounting framework is all about bringing uniform financial statements to the users of the information, including investors and creditors, which are understandable and comparable. The financial statements are quite often confused with the financial report. Financial reporting is the whole reporting package with the notes to the accounts whilst the financial statements are specifically the balance sheet, the profit and loss account, and the statement of cash flow.

The conceptual framework for financial reporting according to the Financial Accounting Standards Board (FASB) is:

‘.....a coherent system of inter-related objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements’. (p.1)

The conceptual framework has been the foundation for the development of generally accepted accounting standards. The financial accounting system using accrual, deferral, and allocation procedures is to relate revenues, expenses, gains and losses to reflect the performance during the period rather than just cash receipts and outlays. Accrual accounting provides information about a company's financial performance and the financial position to a variety of external users, including investors.

Many countries, like Malaysia, have developed their own accounting framework with their own set of accounting standards. Companies in Malaysia have to adhere to the accounting standards issued by the Malaysian Accounting Standards Board (MASB). With the globalisation of businesses and the economy there is a growing need for the harmonisation of accounting theories and standards to make financial reports more meaningful. The expectations of users, the investors in particular, have also influenced the perceived adequacy of financial reports.

Over the past years there has been a push for more disclosure of information in the financial reports to improve the market's ability to assess the firm's risk and value. An increase in disclosure should reduce stock volatility and increase efficiency in the market. However, disclosure is costly. The costs of disclosure include the direct costs of preparing, producing, and disseminating the financial information. The indirect costs arise when the company's competitors are able to exploit the information that is provided to the market.

The reporting framework with more disclosure has driven companies to improve their internal management control systems and the risk management practices. The disclosure requirements also provide better accountability and transparency to assess the performance of managers.

The financial disclosures have an impact on share prices with resultant movements which in turn affect the shareholders' value. The valuation relies on the hypothesis that current earnings provide information about expected future cash flows (eg. Watts and Zimmerman, 1986; Kormendi and Lipe, 1987; Ohlson, 1991). The general model that defines the relation between accounting information and market values is:

$$V = f(A, v)$$

V can be the current price of the firm, A can be any vector of accounting variable such as earnings per share, and v can be any vector of information other than accounting numbers.

The financial disclosures that are prepared in accordance with the accounting standards and disclosure requirements on an accrual basis are quite often subject to management estimates and decisions. As management remuneration with bonus schemes quite often depend on accounting measures, managers may make decisions and adopt accounting policies and treatments that benefit them. Accounting policy choice can refer to decisions that are as simple as the use of the depreciation method, or may be as complex as a set of judgements on the valuation of financial instruments. The use of non-traditional financial instruments for off-balance sheet financing, for example, has enabled managers to raise large amounts of debt without disclosing their impact in the financial statements.

Another item that is not disclosed in the financial statements is the contingent liability. A contingent liability is a potential future liability that may arise as a result of an event or transaction that has already occurred; however, its conversion to an effective liability is dependent upon the occurrence of one or more future events or transactions. Generally, a

contingent liability is not recorded in the accounts unless there is a high probability of loss. Management is responsible for deciding whether or not there is a high probability of loss from a contingent liability. In order to lower the reported liability of a company, the manager may avoid recognising a contingent liability even though there is a high probability of loss.

Extraordinary items have also been used by companies in their financial disclosures. The gains or losses are derived from events or transactions that are distinct from the ordinary activities and are therefore not expected to recur frequently or regularly. The extraordinary item transaction is generally presented below the line after taxes and is often not taken into consideration by analysts in determining the company's future potential earnings. The use of extraordinary items can give managers the opportunity to potentially inflate the reported earnings, and has given rise to inconsistency in reporting financial performance among companies.

A range of motivations surfaced in the literature potentially explaining why managers manipulate the financial information. For some transition countries, the shifts from command to free market economies have created opportunities for managers to pursue their self-interests with the appropriation of rents or excessive profits. A classic example of rents and rent-seeking behaviour is the existence of some government restriction such as the import quota and the issue of particular licences. The fees and payments to government officials can be exorbitant as business managers compete for the licences. However, the basic hypothesis is the bonus plan or executive compensation. The hypothesis is whether managers in companies with accounting-based bonus plans are more likely to adopt methods to increase reported earnings. The literature review on the executive remuneration and earnings management is covered in more detail in the following Chapter 3.

2.3.2 Empirical Study

From the literature, there have been studies on executive remuneration and earnings management in the past on the larger, developed capital markets, particularly the U.S. and European markets. However, the study is different as it is on an emerging market rather than a developed one, and is country specific – Malaysia.

After a decade of robust growth Malaysia was hit by the Asian financial crisis in 1997, followed by a recession and a slow economic recovery. Share values plunged dramatically during the Asian financial crisis. A number of companies listed on the Kuala Lumpur Stock Exchange had trading on their shares suspended during, and immediately after the crisis. Some 104 public-listed companies could not trade their way through the crisis and the recession that followed were placed with *Danaharta*, established by the government in 1998 to assist troubled companies.

In good economic times, companies expand with acquisitions and take-overs. Share values increase with the higher earnings. The managers are rewarded by the shareholders and investors holding higher portfolio values with bonus payments and other incentives to maintain the good results. It is during the period of the recession and stagnant growth that the managers struggle with the earnings and dividends to the shareholders. Managers are then more likely to adopt “discretionary” accounting policies and treatments in seeking to increase earnings and share prices for debt re-structuring to overcome the cash-flow problem, and for their own benefit. It is acknowledged companies that are less affected may not engage in earnings management.

The study on executive remuneration and earnings in Malaysia is for the period 1997-2005. The period is chosen as it was the time the country went through significant political and economic changes following the Asian crisis. The country pegged the local currency and introduced foreign exchange controls following the crisis, and Tun Dr. Mahathir Mohamad retired as prime minister in 2003 after 22 years in office.

2.3.3 Approach

The market price of a stock, like other economic goods, is a function of supply and demand. The demand for the stock depends on the price at which it could be bought and the information available. The efficient market theory assumes that investors are rational and hold the same information. The equilibrium price represents the market consensus about the intrinsic or fair value of the stock and is a reflection of all available information. In an efficient market, prices will adjust to new information instantaneously.

The market model in finance follows the efficient market theory and assumes that the rate of return on any stock is linearly related to the return on the overall stock market. The market model holds the notion that prices move with the aggregate market, and that a stock's return is a function of only one factor, the market index. The market model is commonly expressed as:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

where:

R_{it} = the return of stock i in period t

α_i = the expected return

β_i = sensitivity of stock i to the market return

R_{mt} = rate of market return in period t

ε_{it} = the random residual return on stock i

The coefficient β_i is a measure of how sensitive the stock's rate of return is to the overall market. If the coefficient is greater than 1, the stock's rate of return is more sensitive to changes in the market than the average stock. The market model using ordinary least squares regression highlights each stock's price relative to the market index in the period. It is then when the index has a zero return, that the stock i is expected to have a return of α_i . The stock returns that are not related to the market index are described as abnormal.

However, there may be several reasons for the abnormality such as industrial production, and shifts in the term structure.

The conditions necessary to have an efficiently priced market to exist are:

- Information is costless and available to all at the same time
- There is no transaction cost or barrier to trading.
- Investors are rational.

In the real world, the conditions are unlikely to exist. Information is quite often provided to the managers before others, and some financial analysts are more adept at creating new information by inter-relating previously available information. Also, all transactions incur fees and taxes. Some countries even have investment restrictions.

Actual stock prices reflect the type and the “noise information” known. The “noise information” such as extraordinary items is quite often used to not disclose the real earnings. Earnings management has been described as:

A purposeful intervention in the financial reporting process with the intent of obtaining some private gain.....

Schipper (1989)

The definition attribute reported financial statements to management intent. It is not always easy to distinguish between earnings management and the legitimate exercise of accounting discretion by managers.

Share offerings provide the direct incentive to manage earnings. Managers may report higher earnings to improve the terms on which the shares are sold to gain monetary benefits for themselves. The shares of initial public offerings (IPO) are known generally to be mispriced and under-perform in the market following the offering. Past studies (Rangan, 1998; Teoh et al., 1998) show that:

1. Reported earnings of IPOs are unusually high at time of offering.
2. The high earnings are attributed to unusually high accruals.
3. The earnings performance is poor following the offering.
4. The shares with higher accruals at time of offering tend to perform worse in the years after offering than others.

As earnings management at the time of offering become apparent through earnings disappointment in subsequent periods, the over-pricing of the shares reverses and these stocks under-perform in the market.

The study by Skinner and Sloan (1999) showed that the market penalises growth companies for negative earnings surprises. Burgstahler and Dichev (1997), and Degeorge, Patel, Zeckhauser (1999) showed that U.S. listed firms tend to avoid reporting losses and earnings declines. Degeorge, et al. (1999) argued that earnings management is generally used to meet two simple thresholds:

1. Avoid losses.
2. Maintain prior years' results.

Financial reports are prepared based on accruals accounting. It is accrual accounting to match income and expenditure for the reporting period that has given rise to earnings management. The use of accruals in earnings is susceptible to earnings management and has gained considerable attention.

Total accruals are the change in non-cash current assets less the change in current liabilities after excluding the current portion of long-term debt, depreciation and amortization with the adjustment for the non-current assets. The total accruals (TA) consist of both discretionary accruals (DA) and non-discretionary accruals (NDA). The NDA are required by the accounting rules and the discretionary portion of accruals is due to managerial discretion. The DA is generally viewed as the TA minus the NDA. The management choice on the DA may not match the expenses with the revenue generated.

For example, the research and development incurred in the period that is expensed decrease the current period income although it may be for generating future income and cash-flows. Management choices in the DA give rise to earnings management.

Many of the past studies use an indirect approach to calculate accruals. The balance sheet approach, for example, relies on the relationship between changes in working capital from the balance sheet and accrual components of revenue and expenses. The aggregate accruals method has also been used to evaluate the existence of earnings management. Several more sophisticated models have appeared to separate the NDA and the DA in the study of earnings management. Healey (1985) used the average of past total accruals to estimate the DA. The Jones (1991) model and its variants, however, have been used extensively from the literature to examine earnings management. The model is used to estimate the expected accruals while controlling for changes in a firm's economic conditions such as sales revenues. This model is generally used in a time-series manner and can be firm-specific. It has also been used in an annual cross-sectional fashion (DeFond and Jiambalvo, 1994). The model is known for its ease of use, and is based on the linear equation of the form:

$$ACC_{it} = \alpha_0 + \alpha_1 Y_{it} + \varepsilon_{it}$$

Where:

ACC = the aggregate measure of accruals,

Y = is a vector with one of components to explain the dependent variable,

ε = the residual of the regression,

t = the period

i = is the stock

α_0 and α_1 are the parameters.

In the study on the Malaysian market, the Jones model is used with historical reviews of selected companies for the period relying on secondary data held by the Kuala Lumpur Stock Exchange to test for the existence of earnings management. The use of secondary

data is appropriate as the research is based on historical accounting reports of selected samples. Using secondary data has the advantage of saving time and costs involved in data collection as outlined by Zikmund (2000).

There are several factors that affect share prices and valuations. The market volatility, interest rates, economic outlook, company earnings, performance, and growth are just some of the factors. However, as the interest is on the affect of earnings management, the data is then used in the ordinary least square (OLS) regression based on the model introduced by Bath *et al.* (1992) to test whether earnings management enhances the stock value. The model was modified with a dichotomous variable for earnings management – the residual obtained from the Jones model.

The model with the following equation is used in the study:

$$P_{it} = \beta_0 + \beta_1 PBIT_{it} + \beta_2 EM_{it} + e_{it}$$

Where:

P_{it} = Share price of stock i at year t

$PBIT_{it}$ = Profit before tax of stock i at year t

EM_{it} = 1 for earnings management; 0 for normal

β_0 = Intercept value

$\beta_1 \beta_2$ = Co-efficient for variable 1, 2

e = error

The data collected is analysed using models with the aid of the computer package. Although the data is quantified, the analysis itself is qualitative. Meaningful analysis of the data is hoped to provide more valid inference, and is covered in Chapter 4.

2.3.4 Sample and Data

Sampling allows information to be obtained from a subset of units in the population to draw inferences as a whole. Clearly, the validity of these inferences depends on the manner in which the sample is drawn and size. In contrast to complete coverage, sampling method can have several advantages. Restricting the collection of information to a sample reduces the scale of the operation with a lower cost. The results can also be produced more quickly with greater flexibility in terms of coverage, size, content, and other aspects of design and methodology.

The sample for the study is selected from the 444 companies listed on the Kuala Lumpur Stock Exchange (KLSE) Main Board in 1997. Sixty-one financial services companies (eg. banks, insurance companies and mutual funds) were excluded because their features and business activities are not directly comparable with those of other companies like in manufacturing and retail. Companies of which complete data were not available for any of the required variables were considered as missing data and eliminated from the sample. The companies that had been de-listed within the study period were also excluded. Companies listed in 1997 and during the study period were excluded as well. The usable sample was 365.

Selection criteria:

No of KLSE listed companies (Main Board) - 1997	444
Less: Bank, finance, insurance, mutual fund companies	61
Less: IPO companies	14
Less: Companies with incomplete data	6
Usable Sample	363

The final sample for the study consisted of 66 randomly selected non-financial companies representing roughly a fifth of the usable companies listed on the KLSE in 1997. The random sampling allows all in the population the same probability of being selected.

The sales revenue and accrual accounting data required for the study are obtained from the financial statements in the published Annual Reports of the sample companies which have been attested and certified by the independent, external auditors. Data on the market and the KLSE market indices are obtained from the KLSE Annual Handbook; the KLSE Digest, a monthly publication of the KLSE; the annual reports of the companies held at the Information Centre of Bursa Malaysia, and Datastream.

The data used were tested for internal validity using statistical methods and analysed. The use of historical data may not provide a fool-proof causal inference in the study but the quantitative method and interpretation are intended to make the analysis more robust.

The external validity is the generalisation and inferences that can be made from the study's findings. It is recognised that the use of the historical data may have a problem with low external validity. However, the study and the use of the data over a long, eight-year period is to overcome the problem.

2.4 Conclusion

The research design is consistent with the criteria outlined by Kidder (1986) which have been commonly used to establish the quality of any research study. The literature review and background information provided the motivation and the major objectives of the research.

The financial statements are used by managers to report the results and performance of their stewardship in the use of the resources entrusted to them by shareholders and investors. Accruals are an important part of accounting in the preparation of the financial

statements. The use of accruals by managers to adjust and manipulate accounting numbers to report more favourable financial statements have been prevalent. The subject has been of considerable interest and a majority of the empirical studies have used the balance sheet approach to calculate accruals. The Jones model (1991) is a popular model used in previous work by others and is used in the study on Malaysian companies in the paper.

The use of secondary data on the selected sample companies is sufficient for the study. The analysis of the data using statistical methods in the later chapter is to ensure that the internal validity is met, that is, the causal relationships of factors that create value are correctly analysed and explained. The external validity is the generalisation and inferences made from the study's findings. The criterion on reliability is that if the study is repeated using the same procedures, the results and findings would be the same.

Chapter 3: Literature Review

3.1 General Discussion

As the firm or company is viewed as an organisation with contracts between the share owners and the manager in agency theory terms, conflicts occur. The manager may have a different motive other than maximising share value - which give rise to problems and increase agency costs.

3.2 Agency Theory

3.2.1 Shareholder-Management Conflict

The company business operation that is managed by the owner will have the owner-manager undertaking actions to maximize the value. The owner-manager will probably measure utility by personal wealth, but may trade off other considerations, such as leisure and perquisites. If the owner-manager forgoes a portion of his or her ownership by selling some of the company stock to outside investors, he or she may prefer a more leisurely lifestyle and not work so hard to maximize shareholder wealth. A company business is generally characterised with the separation of share ownership and control.

In Agency Theory terms, the owners are principals and the managers are agents with one party (the principals) engaging the other party (the agent) to perform service on their behalf. The relationship is not always cordial and problems occur as the agents do not always act to the interests of the principals. Managers may seek to maximise their own wealth, power and prestige while the principals want to maximise the value of their assets. In the majority of large companies such agency conflicts or conflicts of interest between agents and principals can be quite significant because the managers may own a small proportion, if any, of the company shares. Other management goals may rank ahead of maximising shareholder wealth. For example, managers may seek to create a large,

rapidly growing organisation to increase their own status, create more opportunities for lower level managers, fend off any unfriendly takeover, and enhance their job security. The manager pursuing diversification is not likely to have maximised the share price and shareholder value and may deprive the shareholders the opportunity to diversify their individual portfolios by buying shares in other companies.

The manager acting for his self-interest could use the company resources in the form of perquisites, or being too risk-averse. The risk-averse manager may miss profitable opportunities which the shareholders would have preferred.

The problems arising from the conflict of interests are numerous, but research has recognised four key ones – adverse selection and moral-hazard, earnings retention, risk aversion, and time-horizon.

a) Adverse Selection And Moral Hazard

Managers have the ability to operate in their own self-interest rather than in the best interests of the shareholders because of asymmetric information as managers generally know better than shareholders whether they are meeting their objectives, and uncertainty. There is uncertainty in the business environment with a myriad of factors that can influence the resulting outcome and it is difficult to ascertain whether the agent directly contributed to the outcome. The Agency Theory argues that under conditions of incomplete information and uncertainty, which characterize most business settings, two agency problems arise: adverse selection and moral hazard. Adverse selection is the condition under which the principal cannot ascertain if the agent accurately represents his ability to do the work for which he is paid for. Moral hazard (or shirking) is the condition under which the principal cannot be sure if the agent has put forth maximum effort. In a situation where the manager owns the company, his or her incentive to consume private perquisites rather than investing in positive net present value (NPV) projects is less. The moral-hazard problem is more likely to occur in large companies with the complex contracting nexus.

With the adverse selection and moral hazard problems, the fixed wage contract is not always the optimal way to organize relationships between principals and agents.

b) Earnings Retention

Ambitious goals and over-investing can be a more significant problem than that of perquisite consumption and under-investment. Managers are generally rewarded on an increasing function of company size. They may focus on diversification and expansion to have a larger power base so as to have a higher prestige, and the opportunity for more reward. Managers who have been entrusted with the company assets have the option to retain the profits earned or distribute to the shareholders by way of dividends. However, managers generally prefer to retain the company earnings to reduce the need for outside financing for investment and diversification which also reduces firm specific risk.

However, such a strategy has been found not to be in the interest of shareholders. Lang and Stulz (1994) in their study reported that returns to shareholders in undiversified firms are greater than for those who had attempted to reduce their exposure to risk through diversification. Also, they found that the value of these firms is reduced as they diversified further.

c) Time-Horizon

Shareholders generally prefer higher levels of cash distribution to themselves by way of dividends. While shareholders may be concerned with the maintainable dividends and the future cash flows of the company, managers may only be concerned with the cash flows only for the duration of their employment which may lead to a bias for short-term returns rather than long term positive NPV projects. The problem worsens as the managers approach their retirement or is planning to leave the company.

Studies by Dechow and Sloan (1991) showed that research and development (R&D) expenditures declined as senior managers approach retirement. The findings can be explained as R&D expenditures reduce managers' remuneration in the short term, and retiring managers will not be around to reap the benefits of such investments.

Such a problem may also lead to managers manipulating earnings and performance with the use of subjective accounting practices in an attempt to maximise their rewards and incentive payments prior to retiring.

d) Risk Aversion

Managerial risk aversion is due to portfolio diversification constraints. Managers may seek to avoid any profitable, high-cost investment decision that increases company risk, and instead pursue diversification with lower cost investments that have a lower risk.

Managerial risk aversion also affects the financial policy and position of the company. Higher borrowings to finance investments increase risk but have the potential to provide tax breaks. However, Brennan (1986) contends that risk averse managers will prefer equity financing because debt increases the risk of default and bankruptcy. That may not be the preference of shareholders.

Despite the existence of the problems, the large public companies with the diffused share ownership continue in its present form.

3.2.2 Costs Of Shareholder-Management Conflict

There is an agency loss when returns to the owners fall below what they would be if the principals, the owners, exercise direct control. Agency costs can be viewed as the value

loss to shareholders arising from the agency conflict between the principals, and the managers. Agency costs are those costs borne by shareholders to encourage managers to maximize shareholder wealth rather than to their own self-interests. Jensen and Meckling (1976) wrote in their seminal paper that corporate debt levels and management equity levels are both influenced by a wish to contain agency costs. There are three major types of agency costs:

- a) Expenditures to monitor managerial activities
- b) Expenditures to bond the managers and limit undesirable behaviour, and
- c) Opportunity cost from the inability of managers to act.

Monitoring costs are expenditures paid by the principal to measure, observe and control the agent's behaviour. Certain aspects of monitoring may also be imposed by legislation. For example, large public companies are required to engage external auditors to provide statements of compliance and to report on the financial performance.

The company may have structures and systems to ensure managers act in the interests of shareholders with the acceptable compensation. Business units may be established and outside members with special knowledge may be appointed to the Board of Directors. The bonding costs are the costs associated with establishing these structures and systems. Bonding provides a means for making managers do the things that shareholders prefer.

Shareholders in trying to control management behaviour may place restrictions which limit the ability of the manager to take action or make decisions on profitable investments. Certain major investment decisions may require shareholders to vote. The delays may result in an opportunity loss.

Despite best efforts, the interests of shareholders and managers are unlikely to be fully aligned. There will be agency loss arising from the conflicts of interest, and inappropriate management action. These are known as residual loss. They arise because it is not possible to fully contract for every managerial action. The agency cost would be

excessive if shareholders attempt to enforce principal-agent contracts and ensure all the managerial action conforms to shareholder interests and preference.

3.2.3 Reducing Agency Conflicts And Cost

Despite the problems with the agency conflict and costs, companies with the diffused share ownership still exist in its present form. It may be due to the internal and external control systems, including executive remuneration, adopted by the shareholders to reduce the problems. For example, the shareholder-manager conflict and agency costs can be reduced if managers are remunerated entirely on the basis of stock price changes. That should encourage managers to maximise shareholder wealth. However, it would be extremely difficult to hire good, competent managers on such terms because the earnings and performance could be affected by economic and political events beyond their control.

The other ways in the literature that encourage managers to act in shareholders' interests are:

- a) performance-based incentive plans,
- b) direct intervention by shareholders,
- c) the threat of takeover.

With the large number and spread of shareholdings in most large, public companies the direct intervention by shareholders to replace the manager would be difficult and is hardly done. If the earnings and performance of the company is low with corresponding low share prices and value, the threat of a takeover by another company is real.

It is the remuneration contracts with performance-based incentives to align the interest of shareholders and managers that has drawn considerable attention with the amount of literature written. Linking performance to reward makes the basic assumption that reward is somehow a motivator that will encourage specific behaviours or result in higher performance levels. There is a greater likelihood to motivate managers through an integrated performance and reward strategy if more is known on what promotes their self

interest. Reward, both financial and non-monetary, is one of those self-interests. While recognizing that non-monetary rewards for performance can be important, economists tend to focus on monetary rewards because individuals are willing to substitute non-monetary for monetary rewards. Money represents a generalized claim on resources and is generally preferred over an equal dollar-value payment in kind.

In Maslow's 'hierarchy of needs' theory, financial reward only influences the lower of the needs in the hierarchy and the higher level needs are satisfied by non-monetary rewards. Herzberg later expanded on the work of Maslow, reporting on the hygiene factors that impact employee satisfaction and motivation.

Over time, many organisations have developed performance and reward systems for the managers linking performance and pay. With the contractual agreements there have to be consideration for the fundamental trade-off between incentive gain (increase in performance) and compensation costs. However, many of the performance and reward systems have been developed in isolation and fraught with issues. There have been some that require incentive payments to be made even when overall performance is disappointing. Continuing to reward poor performers through annual pay increases and incentive payments are just some of the more common issues.

3.3 Executive Contracts

3.3.1 Remuneration And Performance-Based Incentives

Many of the large, public companies now have some kind of executive contracts with remuneration linked to some performance-based incentives. The remuneration should be sufficient to attract good, competent managers, and the incentive to use their abilities to take actions that will enhance shareholder value.

The early literature focussed on the structure and level of executive compensation to maximise shareholder value. The early papers empirically examined the level of managerial pay and the profits of the firm (the shareholders objective) or sales (where size was assumed to be the opportunistic objective of managers). The studies had different specifications and produced a wide range of results. Some showed that the cross-sectional variation in compensation is linked to firm size rather than earnings, while others had the link to profits. It became difficult to draw strong inferences from these results. The early work had been plagued by multi-co linearity, and serious interpretation problems.

More recent executive compensation research has focussed on developments in the information economics, and the principal-agent theory. The classical principal-agent model uses the trade-off between risk sharing and incentives in the design of management contracts which has led to considerable empirical studies on establishing the economic determinants of observed incentive contracts. The availability of compensation data on top U.S. executives driven by the reporting requirements there has driven interest in examining implications of the theory.

The theory holds that executive compensation should be based on performance. The later studies addressed econometric concerns with the earlier work, and strongly established an empirical relation between pay and performance (eg. Murphy, 1985; Coughlin and Schmidt, 1985; Benston, 1985). More recent research focuses on the magnitude of pay-performance sensitivities. For example, Jensen and Murphy (1990) directly estimate the sensitivity of dollar changes in top executive pay in the U.S. to dollar changes in shareholder wealth. Using a comprehensive measure of top executive pay (cash compensation, salary revisions, outstanding stock options, share ownership and performance-related dismissals) they estimate that executive pay changes by roughly \$3.25 for every \$1,000 change in shareholder wealth, and argue that this is too low to provide adequate managerial incentives. However, as their critics note, it is difficult to evaluate the level of pay-performance sensitivity without considering the underlying economic determinants.

In response to Jensen and Murphy, Haubrich (1994) demonstrated that the documented pay-performance sensitivities can be optimal for large firms, given sufficient managerial risk aversion. Hall and Leibman (1998) expanded compensation to include changes in the value of executive's stock and option portfolio, and show through simulations that estimated pay-performance sensitivities impose substantial lifetime consumption risk on executives.

Baker and Hall (1998) questioned whether pay-performance sensitivity as estimated by Jensen and Murphy (1990) is the proper measure of the strength of executives' incentives, as it does not consider the marginal product of effort. They argued that small estimated pay-performance sensitivities do not necessarily imply low incentives for executives at large firms as the marginal product of managerial effort can increase with firm size. An executive's actual incentives are theoretically measured by Jensen and Murphy pay-performance times the executive's marginal product of effort. They document that the Jensen and Murphy pay-performance sensitivity measure (dollar change in executive compensation per dollar change in shareholder wealth) is strictly decreasing in firm size. An alternative incentive sensitivity measure is the value of the executive's equity stake which increases in firm size by roughly the same magnitude.

The validity of either as a sensitivity measure of the incentives depends on underlying assumptions about the elasticity of the executive's marginal product of effort with respect to firm size (i.e. Jensen and Murphy assume that marginal productivity is invariant to firm size (elasticity=0), while the value of equity stakes assumes that marginal productivity scales proportionately with size (elasticity=1)). From the study, it was reported that executives perform a variety of tasks that does not differ with size, and that smaller pay-performance sensitivities for large firms are substantially offset by larger marginal products of effort.

The debate surrounding Jensen and Murphy (1990), and the Haubrich (1994), Hall and Leibman (1998) and Baker and Hall (1998) studies illustrate the difficulties involved in

evaluating agency theory by examining the average size of estimated incentive coefficients.

An alternative approach examines comparative static predictions from principal-agent models. The trade-off between risk-sharing and incentive provision in optimal contract design forged these models. A number of comparative results have provided the basis for investigating the cross-sectional determinants of incentive contracts. The basic agency model predicts *ceteris paribus*, pay-performance sensitivity should decrease in the variance of noise in the performance measure. Using a variety of measures for compensation and performance, Aggarwal and Samwick (1999) extended Jensen and Murphy's work to document a strong, inverse relation between pay-performance sensitivity and the variance of the performance measure. They show that ignoring cross-sectional variation in the variance of performance can affect the estimate of pay-performance sensitivity towards zero. Incorporating variance, their estimates of pay-performance sensitivities were substantially larger than those of Jensen and Murphy.

The empirical research in accounting information and disclosures has been encouraged by comparative static predictions from principal-agent models. One approach cross-sectionally examined principal-agent expectations using observed or statistically estimated pay-performance sensitivities. The second approach was not to directly address the optimality of observed contracts but to take the contract as exogenous for the examination of earnings management behaviour motivated by the executive contract structure. The third approach examined the impact of the adoption of accounting-based incentive plans on firm performance.

The first approach relies primarily on implications of the "information principle" attributed to Holmstrom (1979). This principle (intuitively) states that any (costless) performance measure that is marginally informative about a manager's actions, given other available performance measures, should be included in the contract. However, this statement gives little direct guidance on which performance measures should be included in actual contracts.

3.3.2 Role Of Accounting In Executive Contracts

Accounting information can facilitate the information flow among investors and managers through the stock market. Bushman and Smith (2001) summarised that the accounting information is a direct input to corporate control mechanisms designed to discipline managers to guide resources toward projects identified as good and away from projects identified as bad.

The historical cost basis of accounting is fairly reliable and used by investors as an indicator of performance and the share value. The study of the role of accounting in executive contracts and performance incentive is driven by the prevalence of its use. The reward and performance incentive system are generally based on objective accounting measures such as sales, and profits. Organisations tend to prefer objective measurement systems because they generate fewer conflicts with managers than subjective systems. An objective performance-measurement system does not need justification with the assessment of performance.

Objective merit systems appear to have several disadvantages over systems where performance is evaluated subjectively. One disadvantage is that wrongly specifying the performance measure in an objective system results in resourceful employees “gaming the system” by optimizing with respect to actual instead of intended measures. For example, the managers with performance incentive based on annual accounting profits may sacrifice long-term profitability for short-term gains.

Murphy (1998) conducted a survey with detailed information on the annual bonus plans for 177 public traded companies in the U.S. From the survey, Murphy reported that 161 of the 177 sample firms explicitly use at least one measure of accounting profits in their annual bonus plans. Compensation tied to the overall financial performance of the organisation has been popular in U.S. corporations

It has been argued that performance should not be based on factors beyond the control of the management, and should therefore be measured relative to the performance of all firms or firms in the same industry rather than on absolute measures of firm performance (Holmstrom, 1979). The argument seems reasonable to base management rewards and incentives on relative instead of absolute performance. However, it will be difficult to obtain the industry information and there will be a time lag to collect and compute the performance data. Also, the managers of smaller organisations may react quicker to changes in the economic conditions or trading environment due to their structure.

The use of accounting profits in performance measurement has its limitations. The manager investing in a long, expensive research and development project is likely to incur costs in the current year. A manager who invested in such a project would increase firm value, but accounting profits would be reduced as the results from such research and development project may not materialise in the short term. The reward and incentive on the basis of accounting profits continues to be used with the amounts certified by the independent auditor.

While several recent papers attempt to explain explicit performance measure choice in contracts, most accounting research posits a set of performance measures, and then set out to examine the estimated incentive weights on the posited variables. The issues raised relate to measurement error and omitted variables. Despite limitations in the approach, interest remains.

3.4 Accounting For Earnings

In accounting terms, profit is income less expenses. Income is derived from the normal operating activities of the organisation recorded on an accrual basis in accordance with the generally accepted accounting standards. Accounting standards regulate the reporting choices available to managers in presenting the financial statements. Better accounting

regulation leads to higher levels of market monitoring by improving the soundness of the information of the stock market.

One of the most significant developments of recent times has been that the International Accounting Standards Committee (IASC) has moved away from the objective of 'harmonisation' of regulations, and towards an ultimate goal of global standardisation. If such standardisation is to be achieved it is likely to be through a combination of means. The European Union has adopted international accounting standards for listed companies from 2005 onwards. The process of convergence with US standards will, however, take longer. Nevertheless it is not overstating that the ultimate goal is one of standardising accounting regulation across the world. A uniform international accounting standard regime would encourage higher investments in the stock market with higher international capital mobility

Bushman and Smith (2001) summarised that the accounting information is a direct input to corporate control mechanisms designed to discipline managers to guide resources toward projects identified as good and away from projects identified as bad, and to prevent managers from expropriating the wealth of shareholders.

Studies on value relevance of earnings find that earnings are less timely and less conservative in code law countries than in common law countries. Ali and Hwang (2000), Ball, Kothari, and Robin (2000) and Guenther and Sun (2004) find that the usefulness of earnings in predicting returns or stock prices is lower in code law countries. Guenther and Young (2000) argue that in countries with better accounting quality, accounting earnings are more closely related to the underlying economic activity. They find that the association between the accounting measure of returns and GDP growth is high in the U.K. and the U.S., and low in France and Germany. Ball, Robin and Wu (2003) attribute these findings to the demand for financial reporting. In some common law countries, political influences and family control of businesses decrease the demand for high quality financial reporting. Earnings from Hong Kong, Malaysia, Singapore, and Thailand are no timelier than earnings from most of the code law countries.

Income, according to the accounting standards, is to be recognised in the income statement only when there is an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. The recognition of income should therefore occur simultaneously with the recognition of increases in assets or decreases in liabilities. To recognise the income from the sale of goods or services, there should be a corresponding net increase in assets arising from the transaction or the decrease in liabilities arising from the waiver of a debt payable.

The future economic benefits associated with the recognition criteria of income have a degree of uncertainty. The concept is in keeping with the uncertainty that characterises the business environment. An assessment of the degree of uncertainty on the flow of the future economic benefits is to be made on the basis of the information and evidence available at the time the financial statements are prepared. When, for example, that it is probable a receivable amount entity will be received, in the absence of any evidence to the contrary, it then becomes prudent to recognise the receivable as an asset.

The second criterion for the transaction to be recorded is the measurement which has to be reliable. For certain transactions the measurement may have to be estimated. The use of reasonable estimates is an essential part in the preparation of financial statements which should not undermine their reliability. If a reasonable estimate cannot be made, then the item should not be recognised and included in the balance sheet or income statement.

Earnings in the income statement refer to that part attributable to shareholders. In the efficient market theory, the market reacts to new information that comes to the market. Strong earnings generally result in the stock price moving up. As the stock prices react to earnings announcements, investors have used the accounting information. Following the work of Beaver (1968), and Ball and Brown (1968) numerous researchers have been investigating the market reaction to announcements of accounting information. The majority of the work in this field deals with the relationship between earnings and stock prices.

European studies which have investigated the stock price reaction to earnings announcements confirm the findings of Beaver (1968) in the US - earnings disclosures lead to significant stock price changes or trading volume increases. In the UK, Firth (1981) reported both abnormal absolute stock returns and significant trading volume increases at annual earnings announcement dates under the period 1976–78, for a sample of 120 companies. Similarly, Pope and Inyangete (1992) observed a strong increase in the volatility of security returns around announcement dates for a sample of 3,541 UK annual earnings announcements between 1985 and 1987. With a different approach, Hew et al. (1996) confirm that UK annual earnings have information content for investors, since positive (negative) unexpected annual earnings were found to cause significant positive (negative) returns. The earnings are important figures under accrual accounting.

The agency theory operates on the premise that management's primary goal is to maximise shareholder wealth. It requires managers to act to maximize the price of the firm's common stock. Stock price maximisation requires efficient, low-cost plants that produce high-quality goods and services at the lowest possible cost. In addition, stock price maximization requires the development of products that consumers want and need, so the profit motive leads to new technology, to new products, and to new jobs. Finally, stock price maximization necessitates efficient and courteous service, adequate holding of merchandise, and strategically located retail outlets. These factors are necessary to attract customers to generate sales, and thus profits.

The efficiency gains of more productive operations and a better re-allocation of resources should lead to increases in stock price and shareholder value. The market values the firm that increases the productive use of its assets with an increasing turnover ratio and profit margins. Consequently as a result, profits should increase.

Shareholder value has become a widely used term but creating shareholder value should be the goal. From the investors' perspective the value created is measured as the growth in the company's share price over a period together with dividends received from it, the

total shareholder return (TSR). If a stock market prices the shares efficiently, the efforts of management will be reflected with the value created in the period.

3.5 Corporate Financial Reporting

3.5.1 Framework And Accounting Information

Accounting information and the financial statements is a measure of management performance, and assumes that the user has knowledge of the business and economic activity. Expectations have a decided impact on the perceived adequacy of the financial statements and reports. Economic theory suggests an increase in disclosure should reduce stock volatility and increase efficiency in the market. Over the past years there has been a push for more disclosure of information in the financial reports to improve the market's ability to assess the firm's risk and value. However, the costs of the additional disclosure can be high. The firm's competitors will be able to exploit the information that the firm provides to the market.

The conceptual framework in accounting has been developed and used in the preparation of the financial statements to provide comparable, complete and consistent information to the investors. The main components of the IASC conceptual framework are:

- (i) The objective of financial statements,
- (ii) The qualitative characteristics of financial information,
- (iii) The elements of financial statements, and
- (iv) The criteria for the recognition and measurement of the elements of financial statements.

The IASC framework states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of

an enterprise that is useful to a wide range of users in making economic decisions (1989, para. 12).

The qualitative characteristics of the financial information is taken to mean understandable, relevance, reliability (substance over form), and comparability. The IASC framework also provides definitions of the elements of financial statements - assets, liabilities, equity, income and expenses. Defining the elements of the financial statements from an economic perspective has resulted in assets being defined in terms of future economic benefits, liabilities being defined of future dispositions of economic benefits in settlement of present obligations, revenues being defined in terms of inflows or enhancements or savings in economic benefits, and expenses being defined in terms of consumption of economic benefits. Items that meet the definition of an element should be recognised if:

- a) It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- b) The item has a cost or a value that can be measured with reliability.

Measurement of elements is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement.

The conceptual framework is not biased towards any particular financial statement included in a reporting entity's financial report. It is concerned with ensuring that the financial report as a whole conveys to the users of the report useful information about the impact on the reporting entity of transactions and other economic events affecting it. The framework focuses on the economic substance of performance, the financial position, the financing and investing that has been undertaken, and the compliance with rules and regulations. The framework, despite being criticised for not recognising the changing needs of some user groups, is meant to delineate the boundaries of financial reporting laying the requirements within the scope of the accounting concepts and the standards to increase the understanding and confidence in the financial statements.

3.5.2 Policy Choice In Accounting

The preparation of accounting information and financial statements on an accrual basis requires management judgement and estimates. There are concerns with the scope for subjectivity that the accounting standards allow. Certain accounting policies require management decisions and judgment in financial reporting. For example, judgment is required to estimate numerous future economic events such as expected lives and salvage values of long-term assets, obligations for retirement benefit, deferred taxes, and losses from bad debts and asset impairments. Managers must choose among acceptable accounting methods for reporting the same economic transactions, such as the straight-line or accelerated depreciation methods or the LIFO (last in, first out), FIFO (first in, first out), or weighted average inventory valuation methods. In addition, managers must exercise judgment in working capital management (such as inventory levels, the timing of inventory shipments or purchases, and receivable policies), which affects cost allocations and net revenues. Managers must also choose to make or defer expenditures, such as research and development (R&D), advertising, or maintenance. Finally, they must decide how to structure corporate transactions. For example, business combinations can be structured to qualify for pooling or group accounting, lease contracts can be structured so that lease obligations are on- or off-balance sheet, and equity investments can be structured to avoid or require consolidation.

The accounting information can contain a substantial level of policy choice with the manager's discretion that can significantly influence the reported earnings and net worth by choosing one or other accounting policy over another possible policy. The importance of earnings for shareholders and investors would encourage managers to favour decisions that maximize accounting measures of profit. Managers can report higher earnings

through their accrual estimates and choices of accounting methods available with the following:

- Estimations of asset valuation accounts such as the provision for doubtful debts and the provision for inventory obsolescence.
- Accruing less liabilities for items such as warranties, environmental clean-up costs, and corporate restructuring costs.
- Reporting lower expenses through assumptions and estimates such as the expected useful lives of the fixed assets.
- Reporting higher income through the choice of depreciation method, inventory cost flow assumption, and method of accounting for employee entitlements.

There has been considerable work done on accounting standards and the choice of permissible standards. Research on managers' reporting decisions has focused on two areas. The first area, often called positive accounting theory, focuses on management's financial reporting choices. The second area, the voluntary disclosure literature, focuses on management disclosure decisions.

It has been argued that more disclosure reduces the uncertainty about the stock value, which in turn reduces the potential information advantage that an informed trader might have. The management voluntary disclosure decision is best illustrated using an initial public offering (IPO) setting without corporate disclosures. Investors would be unable to determine whether the offer price reflects the value. However, those companies with the value above the average would be inclined to disclose more information to seek a higher price. If those companies disclose and the others do not, investors may stay away or value the non-disclosing ones lower. The market forces will eventually drive all public companies to voluntarily disclose.

The positive accounting theory, on the other hand, is based on the accounting policy choice for the financial statements in formal contracting arrangements. Many corporate contracts are tied to reported earnings, including debt covenants and executive

compensation agreements. Most public companies have debt that is protected by accounting based covenants such as maintaining a certain level of earnings and to limit the dividends paid to shareholders to ensure sufficient assets to repay the debt. Reported earnings are often factored into the executive compensation contracts as an element in the performance-based bonus calculations and as a ceiling on bonus payouts. Renegotiating these contracts to adjust for accounting changes can be costly, while failure to renegotiate in face of a purely accounting-driven change in earnings can be costly as well. In addition, if an accounting-driven increase in reported earnings is difficult to distinguish from an increase in profits arising from business fundamentals, the earnings bump could have political ramifications, such as increased exposure to tax hikes, surcharges, or reduced subsidies.

Much of the positive accounting theory literature centred on implications of the contract form for the earnings disclosure. The studies by Watts and Zimmerman (1986) examined observed nonlinearities in annual bonus plans, in particular, the existence of lower thresholds and upper limits on bonus payments. The focus is on isolating the existence of earnings management, while remaining silent on contract design issues and other efficiency issues relating to observed earnings management. Evidence of dysfunctional response to compensation schemes emerged. More recent literature in accounting, however, advocates equilibrium contracting demands with a credible reporting framework to reduce agency costs.

Managers are more likely to use accounting judgment to make financial reports more informative for investors if certain accounting choices or estimates are perceived to be credible and reflect improved financial performance. For instance, the manager's estimate of net receivables in the financial statements will be regarded as a fair and credible forecast of cash collections when endorsed and certified by the independent auditor.

3.6 Earnings Disclosures

If capital markets are efficient, stock prices will react quickly and fully to any newly released information. Consequently, a change in the level or in the variability of stock prices is expected when the financial results and earnings are announced. Accounting earnings are taken as a source of relevant information by investors in the process of assessing the value of a security.

Ball and Brown (1968) showed that prices anticipate earnings surprises and reported drift in stock returns after earnings announcements. At the firm level, stock prices react to earnings news but the market is slower to fully reflect the information in earnings. Earnings announcements may be more informative to investors where there is greater financial disclosure, and may have differing usefulness. There have been a number of papers that focus on the information content of the earnings by examining the price and volume reactions to earnings. Cross-sectional determinants of these reactions have also been examined by Atiase (1985), Bamber (1986), and El-Gazzar (1998) among others, while Landsman and Maydew (2002) investigate whether the information content of earnings has changed over time.

The information content of earnings is obtained from the mean abnormal returns around the announcement date. The mean abnormal return approach makes the assumption that earnings should cause a stock price increase if the news is good and a price decrease if the news is bad. Abnormal returns are defined as the difference between actual and market-adjusted predicted returns. As such the earnings figures are meaningless unless the amount is contrasted against the market's expectations about the earnings. Expected earnings are generally estimated in two different ways. Assuming that earnings follow a random process, some studies take earnings of a given year as the expected earnings of the following year. Other studies use the analysts' consensus forecast as the best available measure of expected earnings. Using the information-content argument, positive unexpected earnings should on average lead to positive abnormal returns, and negative unexpected earnings to negative abnormal returns. Earnings are supposed to convey

relevant information if abnormal stock returns are statistically positive for firms with positive unexpected earnings, and statistically negative for companies with negative unanticipated earnings.

Firms regularly release information through quarterly and half-year disclosures that may help investors anticipate the level of annual earnings. Following Foster (1977), several European studies have been devoted to the usefulness of these interim disclosures. In France, listed companies must disclose their quarterly turnovers and release half-year reports containing a six-month income statement and relevant information on their operations. Since interim disclosures are not audited and less abundant than semi-annual releases, Gajewski and Que're' (2001) hypothesized that the market reaction to quarterly disclosures should be lower than the one of half-year reports. Their results for the 1994–96 years indicate that turnover data disclosed by French quoted companies at the end of each quarter do not cause significant market reactions. This leads the authors to question the usefulness of these mandatory disclosures. In contrast, stock price reactions to half-year and annual releases are both statistically significant but, as expected the information content of half-year disclosures appears to be less than the one of annual reports. With regard to interim accounting information, Spanish firms are subject to more demanding requirements than French ones. They must disclose earnings quarterly and publish a half-year report containing a profit and loss account and a balance sheet. This is certainly why, unlike the French evidence, Pellicer and Rees (1999) did not notice any significant difference in the volatility of returns accompanying annual and interim releases in Spain. In contrast with the French and Spanish evidence, the information content hypothesis of interim reports appears to be rejected in Belgium. In this country, a law implemented in 1990 obliges listed firms to disclose semi-annual earnings. Van Huffel *et al.* (1996) have thus analysed the stock price reaction to half-year report releases just after the establishment of this new legal requirement. Although the sign of unexpected earnings was positively associated with the sign of abnormal returns at the disclosure dates, the authors did not detect any clear announcement effect.

Interim disclosures under study were not associated with statistically significant abnormal returns. Since accounting figures are reported continuously throughout the year, Firth (1981) proposed to examine the incremental information content of four accounting events in order to better understand how investors process accounting data. These events are the release of interim reports, the announcement of preliminary earnings, and the release of annual reports. The study covered the 1976–78 period and the sample consisted of 120 randomly selected UK companies listed on the London Stock Exchange. The information content of each event was determined by ranking by size the cross-sectional average of the absolute values of weekly abnormal returns around each announcement. Firth's results indicate that preliminary and interim announcements possess the highest information content. The annual reports also hold significant information content. The study also checked for correlation, and found that the preliminary earnings announcements had a positive relationship to abnormal returns at both interim disclosure and annual report dates. The study shed light on the accounting information in the interim and annual disclosures.

3.7 Earnings Management

3.7.1 Management Discretion and Motivation

The widespread use of accounting information by investors and financial analysts to help value stocks, and the importance of earnings can create an incentive for managers to manipulate financial disclosures in an attempt to influence short-term stock price performance. Although managerial actions affect the value of a firm's stock, external factors also influence stock prices. Included among these factors are legal constraints, the general level of economic activity, the tax laws, and conditions in the stock market.

Accounts manipulation is defined as the use of management discretion to make accounting choices or to design transactions so as to offset the possibilities of wealth transfer between the company and society (political costs), funds providers (cost of

capital), and managers (compensation plans). Copeland (1968) defined manipulation as an ability to increase or decrease reported earnings at will.

The expression “creative accounting” has been developed mainly by practitioners and people who report and comment on market activity. Creative accounting is motivated by the desire to mislead investors by presenting to them what they like to see. Matthews and Perera (1996) include under the term such activities as fiddling the books, cosmetic reporting, and window dressing. All the terms and descriptions have one commonality which is that they are all related to the actions management take with regards to financial reporting. The consequence of accounts manipulation is that the statement of financial position and the results may no longer be described as “true and fair”.

There are many reasons for why managers manipulate the accounts and manage earnings. One of the main reasons is related to the performance of the firm with respect to some expected benchmark. The benchmark could be the previous period’s performance (the desire to show an improving trend), analysts expectations (the desire to meet or beat expectations), “zero” (the desire to remain profitable), or whatever benchmark is specified in a manager’s compensation contract. Missing the benchmarks can be extremely costly because the relationship between stock price (or compensation) and earnings is very non-linear around the benchmarks. Missing an earnings target by a mere cent may see its stock price decline precipitously, while a firm that beats a target by a few cents may see a nice boost to its stock price.

Compliance with the accounting standards is also not an assurance that the financial statements present fairly the financial position and results of the company. Shah (1996) argued that those with the resources resist regulation, and will find ways to circumvent the regulations.

There is empirical evidence linking the character of executive compensation with earnings manipulation. Ke (2002) finds that firms where the managers have relatively high amounts of equity incentives, in the form of unrestricted stock and immediately

exercisable options, are more likely to engage in earnings management by reporting small earnings increases more than small earnings decreases, and also by reporting long strings of increasing earnings. Gao and Shrieves (2002) find that earnings management intensity, as measured by the absolute value of discretionary accruals, is increasing in the amount of options and bonuses and decreasing in salaries.

The accounting literature takes two perspectives on earnings management:

- (1) An information perspective and
- (2) An opportunistic perspective.

Under the opportunistic perspective, managers are assumed to manipulate earnings to mislead shareholders or for their own personal benefit. “Information perspective”, on the other hand, regards earnings management as a mechanism through which managers attempt to reveal their private information about future prospects of the company to the investors (see Holthausen and Leftwich, 1983). Most prior studies in accounting and finance have focused on the opportunistic perspective and the extent to which managers alter reported earnings for their own benefit. A range of motivations have been suggested in the literature potentially explaining why managers manipulate earnings. However, the main motivations for management to manipulate earnings are:

- 1. Debt contracts
- 2. Compensation agreements
- 3. Equity offerings
- 4. Insider trading

The motivations to engage in and manipulate earnings for their own benefit and monetary gain are strong. Managers have also become bolder as such actions and motivations are difficult to detect.

1. Debt contracts:

Lenders often use accounting numbers to regulate firm activity therefore debt contracts become an important theme in financial accounting research. One example of this theme is the imposition of limits on performance activity in investing and financing activity. Those firms that are approaching the limits of accounting-based covenants would be tempted to engage in earnings management.

The rationale behind the incentive for managers to increase earnings is to decrease the restrictiveness of accounting-based constraints in debt agreements or to avoid the costs of covenant breaches (Beneish, 2001, p. 8). Breaches of the debt agreements and covenant generally result in higher penalty rates, closer monitoring, or even the foreclosure of the business. The impact and economic consequences of default have been varied but can be severe. It is not surprising then that researchers have shifted their focus and study to the types of accounting choices and manipulation that firms who are experiencing technical default make. Although results are mixed with regards to whether managers make accounting choices to increase income, researchers argue that managers are more likely to make choices that avoid covenant default.

2. Compensation agreement:

Most companies tie managerial bonus awards to the reported earnings, and the literature suggests that managers are more likely to alter reported earnings to increase compensation. For example, the manager who earns no bonus if earnings are below a predetermined amount, no incremental bonus if earnings are above another predetermined amount and a predetermined percentage of earnings if earnings are between these two amounts. When earnings are below the lower amount or above the upper amount, there are incentives to manage earnings downward to improve future results. When earnings are between the two amounts, there are incentives to manage earnings upward to maximize current-period compensation. In other words evidence

suggests that managers are more likely to report a decrease in earnings when the bonus limits are not binding to increase future compensation (Healy, 1985 cited Beneish, 2001).

3. Equity:

In prior research information asymmetry is recognized particularly at the time of initial public offering between owners, managers and investors (Beneish, 2001). The various models based on researchers such as Leland and Pyle (1977) argue that private valuation can be seen by the amount of equity retained by insiders. Other models highlight the importance and role of auditor reputation on the offer price (Titman and Trueman, 1986; Datar et al. 1991 cited in Beneish, 2001). Researchers have also studied the importance of earnings management in the context of initial public offerings and others have looked at this area in the context of seasoned equity offerings. Therefore previous research has found that returns performance and subsequent earnings are negatively correlated with at-issue earnings management. Based on previous research findings, it can be said that market participants are unable to appreciate the full implications of unexpected accruals in terms of valuation. Therefore it is misleading to suggest that intentional earnings management at the time of a security issuance successfully misleads investors (Beneish, 2001).

4. Insider trading:

Insider trading is the use of private information for profit in share trading. Managers quite often hold private information not known to others to determine the appropriate accounting treatment for a transaction or event. Insider trading based on private information is a relatively newcomer as an incentive used by managers in earnings management and it is sometimes described as a trading related incentive. Beneish (1999) suggests that the most direct evidence connecting insider trading to financial statement manipulations is when managers of firms with earnings overstatements that violate GAAP are more likely to sell their stock appreciation (cited in Beneish, 2001, p. 10). Beneish (2001) formulated his hypothesis based on previous insider trading research

where he examines the issue of manipulation incentives that are related to insider trading. When previous research was examined it was found that managers held the view that by providing investors with insider (private) information in a timely fashion, managers were being compensated for this invaluable service by their ability to act as informed traders through the buying and selling of stock in advance of stock price increases. However, researchers are now examining the penalties faced by managers who have acted as insider traders and argue that if the penalties are not significant such as loss of reputation and employment that will not deter managers from engaging in earnings manipulation.

3.7.2 Management Judgement And Flexibility

Managers generally prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. Businesses operate in a dynamic environment. The volatility in performance may be interpreted as poor on the part of the managers who may be viewed as lacking foresight and flexibility in the dynamic business environment.

A steady trend can be achieved, for example, by making a higher provision for liabilities in good years, and reducing these provisions in lean years to improve reported profits. The potential for manipulating the accounts can be found in various situations such as regulatory flexibility, a dearth of regulation, a scope for managerial judgement in respect of assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers. Even in a highly regulated accounting environment such as the US, a great deal of flexibility is available (Largay, 2002; Mulford and Comiskey, 2002).

1. Regulatory flexibility.

Accounting regulation often permits a choice of policy. For example, in respect of asset valuation the International Accounting Standards allow a choice between carrying non-

current assets at either re-valued amounts or depreciated historical cost. As Schipper (1989) points out, such changes may be relatively easy to identify in the year of change, but are less obvious in subsequent years.

2. Dearth of regulation.

Some areas are simply not regulated. For example, there is as yet a mandatory requirement in respect of accounting for stock options. In the majority of countries, like Spain for example, accounting regulation in some areas is limited: for example the recognition and measurement of pension liabilities and certain aspects of accounting for financial instruments. It is not possible to regulate all financial transactions and more so those that are dependent on some outcome in the future which is uncertain.

3. Management has considerable scope for estimation in discretionary areas.

Most of this arises from the flexibility of the reporting framework and the accounting standards. McNichols and Wilson (1988), for example, examined the discretionary and nondiscretionary elements of the bad debts provision. Managers can also adjust depreciable lives periodically and justify it on the grounds that the change is to bring them in line with industry standards. An example of this is the case of Southwest Airlines which increased its depreciable life from 20 years to 25 years in 1999. The adjustment allowed the airlines to keep its record of always showing increases in earnings intact.

4. Timing of transactions

Transactions can be timed so as to give the desired impression in the accounts. Managers can accelerate revenue recognition just prior to the end of the financial year. In some cases, these last minute sales are genuine sales. In other cases, they are attempts to get inventory off a firm's books and have it booked as revenue. Such attempts are referred to as "channel loading". Firms that indulge in channel loading will typically show symptoms such as a large increase in receivables relative to sales.

5. Artificial transactions

Artificial transactions can be recorded to both manipulate the balance sheet amounts and to move profits between accounting periods. This is achieved by entering into two or more related transactions with an obliging third party, normally a bank. For example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a 'sale and leaseback' can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

6. Reclassification and presentation of financial items

Reclassification and presentation of the amounts are relatively under-explored in the literature. However, the study by Gramlich et al. (2001) suggests that firms may engage in balance sheet manipulation to reclassify liabilities in order to smooth reported liquidity and leverage ratios. A special type of creative accounting relates to the presentation of financial numbers, based on cognitive reference points. As explained by Niskanen and Keloharju (2000): 'the idea behind this behaviour is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million'. Their study and others (e.g. van Caneghem, 2002) have indicated that some minor massaging of figures does take place in order to reach significant reference points.

3.7.3 Accruals In Earnings Management

The accruals in accounting require management judgement and estimates in the preparation of financial statements. The flexibility from accrual accounting offers opportunities for managerial manipulation. Empirical evidence supporting the existence of managerial manipulation of earnings is provided in Degeorge, Patel and Zeckhauser (1999), and Teoh, Welch and Wong (1998). Quite often decisions have to be made on the

income figure. Income before extraordinary items, income before tax or net income may be chosen as the target.

Studies on the extent of earnings management are largely based on (1) aggregate accruals, (2) specific accruals, or (3) distribution of earnings after management (McNichols, 2000). Despite the numerous studies done, there is still insufficient understanding regarding the extent and the scope of earnings management (Healy and Wahlen, 1999). The difficulty is with the accruals and management choices in earnings management which are relatively low in cost and opaque in nature.

The earnings management literature posits that for managers to be able to manage earnings there must exist opportunities, in addition to incentives, to do so. Most accounting decisions involve some accruals. For example, sales on credit lead to an accrual with the creation of a receivable. The receivable disappears when cash is received. Most decisions involve accruals which affect accounting earnings that is often used in valuation, contracting and performance measurement. There is a general consensus that the judgment and flexibility allowed in accrual accounting provides opportunities to manage earnings.

Consider assets which are described as economic resources that provide future benefits to the company. If, for example, the manager is convinced that the marketing expenditure will result in future benefits the choice to report the transaction as an asset is correct. On the other hand, if the manager is trying to manipulate reported earnings using an accounting decision to meet an earnings target then the capitalization of the marketing expenditure is only to improve the earnings. The investor is usually not in a position to distinguish between the two alternative scenarios because doing so requires knowledge of the manager's judgement as to whether the expenditure will result in future benefits. While the earnings management decision increased reported earnings, it has also resulted in an accrual item in the balance sheet. The accrual is not a permanent item, and has to be reversed and amortised over time as an expense in future periods.

It is not always sufficient to rely on accruals alone in earnings management. The transactions can be complex as was the case with Enron requiring the formation of legal entities, and creation of financing arrangements between the company, its lenders and new outside investors. Enron had a venture with “special-purpose entities” to provide digitized video entertainment to customers’ television sets over an Enron-provided broadband fibre network. By late 2000, this venture had neither paying customers nor profit. Enron, however, reported a large gain from the “sale” of the unprofitable, start-up venture. The company had also used asset sales to actively engage in managing its earnings. Enron’s common stock closed at a high of US\$90 a share in September 2000. However, when Enron announced in November 2001 that it would restate its earnings the stocks traded at US\$0.26¹⁰. The restatement resulted in a US\$1.2 billion reduction to shareholders’ equity. The company filed for bankruptcy on 2nd December 2001.

Most accrual decisions can be planned and executed by the manager or a small group of individuals. Certain complex financial transactions like the ones undertaken by Enron required significant legal planning, the proper creation of legal entities, and the raising of new long-term capital in the form of loans or equity.

Another instance of earnings management are new equity offerings. Teoh, Welch, and Wong (1998a, 1998b) have shown with their study that managers manipulate earnings at the time of equity offering. Managers are opportunistic and manipulate accruals to increase earnings and mislead investors. Aggressive earnings management benefits the original shareholders of low-quality initial public offerings (IPO) because they tend to receive high cash receipts from the true value of their offerings. The operating performance peak at the time of equity issue due to high discretionary current accruals, and suffer subsequently with post-issue performance as the earnings management cannot be sustained in the long term. Accordingly, good companies with solid earnings streams and prospects have a lower incentive to manipulate accounting numbers with a lower degree of earnings management.

¹⁰ Georgetown Law Journal, ‘Corporation Law After Enron: The Possibility of a Capitalist Re-imagination’, Nov. 2003, p. 92.

In the U.S., the Securities and Exchange Commission (SEC) has taken action against several firms. One such firm is Micro-Strategy. Between January 1999 and January 2000, Micro-Strategy's stock price rose from US\$29 to US\$295. The company undertook a stock split 2:1 and rose to an intraday high of US\$333 on 10th March 2000. Ten days later, Micro-Strategy issued a press release announcing a downward restatement of revenues (by approximately 25%) for fiscal years 1998 and 1999. Micro-Strategy closed down US\$140, or 60%, on the day of the announcement. The SEC investigation alleged that premature revenue recognition led to overstated revenues and earnings during the periods in question and forced the company to issue the re-statement.

In one of the largest financial scandals, communications giant WorldCom which had bought MCI for US\$37 billion in one of the largest corporate mergers announced in 2002 that it had to issue a re-statement on its financial results due to accounting errors. An audit had showed transfers of about US\$3.06 billion for 2001 and US\$797 million for the first quarter of 2002 were not made in accordance with generally accepted accounting principles. The company disclosed in June 2002 that expenses had been wrongly declared as capital expenditure allowing for an overstatement of profits by several billion dollars. The shares which once traded at US\$64.00 tumbled to US\$0.21 and WorldCom filed for bankruptcy in July 2002.

The number of re-statements in the earnings as a result of SEC action or on the advice of auditors rose from 92 in 1997 to 225 in 2001. Previous research examining the re-statements has found that accrual information is a key determinant of the earnings manipulation (Bradshaw, Richardson and Sloan, 2001). Firms that were forced to issue re-statements have very large accruals in the years of alleged manipulation. Furthermore, the information in accruals is not limited to working capital accruals. Information about the likelihood of earnings restatements is also found in investing accruals and accruals relating to non-current assets.

The use of accruals in earnings management is well known, and companies with a high level of accruals are likely to be regarded to have inflated earnings. However, the high

total accruals should not always be considered as a proxy for earnings management. Companies can have high accruals for reasons such as growth in sales (increase in receivables) and additions to property plant and equipment (increase in depreciation). The prevalence and extent of earnings management is likely to be a function of the specific environment that the company operates in which includes the legislation and enforcement.

3.7.4 Economic Effect of Earnings Management

Research findings suggest that there are many different incentives for the manipulation of financial statements and earnings management. Earnings management with financial statements and income that are not fairly stated result in the wrong allocation of resources with high capital costs.

Managers who want to hide the low productivity of their firms must not only manage earnings, but also hire and invest as if productivity was high. It would not be sufficient to merely misreport performance. As expected, the hiring and investment by firms with earnings management has to be benchmarked to that of mimicked firms in the same industry with similar market value growth, and the characteristics are summarised below:

- a) Firms managing earnings hire and invest more than predicted by their technology.
- b) As firms manage earnings to be valued like successful firms, the excessive hiring and investment is not random but consistent with that of mimicked successful firms.
- c) The magnitude of earning manipulations should be related to the observed distortions in hiring and investment.
- d) Earning manipulation decreases with the expected cost of manipulation.

The firms shrink and the values drop when the earnings management is exposed. Earnings management is obviously undesirable from the investors' point of view. It

thwarts their efforts to make a correct assessment of the firm's fundamentals and determine the stock's fair value.

Worse, when companies fail investors not only lose their money and erode investment confidence but there is also the problem of unpaid creditors, loss of jobs, and plant and equipment left to waste. The economic cost of failure can be high. In response to recent corporate failures, the U.S. government through the Sarbanes-Oxley Act of 2002 introduced a number of provisions to close the gap between the degree of trustworthiness investors want and expect, and what they have received in the past regarding corporate reporting and governance.

3.7.5 Detecting Earnings Management

As earnings management has the propensity to deceive and mislead investors, it is difficult to detect. The degree of earnings management manifested by a firm is a function of the corporate culture, the probability and costs of getting caught, and the level of managerial ethics.

Market analysts and auditors have been criticised for not detecting earnings management and financial statement manipulation more so following the failures of Enron and WorldCom. The auditors are required to attest to the truth and fairness of the financial information and accounting disclosures in the financial report they audit. The main reasons for auditors from the technical side were the application of analytical review procedures as "sufficient audit evidence", weaknesses in the audit risk model, and risk assessment concerning internal control. The auditor paying attention to a broader range of risk factors and relevant external data may not be alluded to and necessarily ask the right questions about suspicious transactions. The direct costs to accountants who act as auditors are real and substantial when companies fail. Many have had early retirement forced on them with huge payouts.

Managers engage in different types of earnings management with the use of accruals. Accrual-based models have been developed and used in the detection and study of earnings management. Many of the models, however, require accruals to be separated into discretionary and non-discretionary accruals. The discretionary accruals reflect managerial choices while the non-discretionary component captures the impact of the business and the trading conditions. Healy (1985) described discretionary accruals as adjustments to cash-flows selected by the manager. The discretionary accruals have relevant information in accounting. Otherwise they will be considered as “noise” and long discarded by preparers and users of the accounting information. As discretionary accruals are generally determined by management, they have generated considerable interest in research studies on earnings management.

McNichols and Wilson (1988) outlined a general discretionary accruals framework that is the foundation for most earnings management studies. In the model, accruals are partitioned into a discretionary ($DACC^*$) and non-discretionary ($NDACC^*$) component, such that:

$$ACC^* = NDACC^* + DACC^*$$

Since $DACC^*$ is unobservable it is difficult to use on its own. Other models have been developed and used.

Other accruals-based models have evolved such as the the DeAngelo model (1986), the Jones model (1991), the modified Jones model (Dechow *et al.*, 1995), the industry model (Dechow and Sloan, 1991) and the margin model (Peasnell *et al.*, 2000). However, the more commonly used model is one based on a paper by Jones. The model is based on the suggestion made by Kaplan (1985) that changes in a firm’s economic condition and manager discretion results in accruals. In her work, she looked at the extent to which US companies claiming to be suffering from unfair foreign competition deliberately understated their profits to appear worse off than they actually were. Jones argued that there should be some corresponding relationship between a company’s financial position

and performance and its accounting “accruals”. For example, depreciation would be associated with the total fixed assets and working capital accruals such as changes in stocks, debtors, creditors and short-term accruals/prepayments would be closely associated with changes in sales turnover. If the “total accruals” derived from the reported balance sheet, income statement and cash flow statement appear to be out of line with the “normal accruals” for a particular period, the difference between “total accruals” and “normal accruals” needs to be explained. The implication is that accounting choices have been made that generate more (or less) reported earnings relative to operating cash flows than would have been expected under normal circumstances. A difference between “total accruals” and “normal accruals” may therefore be evidence that earnings management is taking place. This is consistent with the principles underlying ratio analysis, which often benchmarks a company’s financial ratios against prior periods and attempts to investigate any significant differences.

The Jones model involves estimating for each company in a particular accounting period the difference between total accrual and normal accruals which is referred to as “discretionary accruals”. Total accruals can be derived from disclosed accounting information (using cash flow statements, balance sheet changes or other methods). Determining the normal accrual can be a problem. Jones, however, used a time series model to estimate normal accruals.

Dechow et al. (1995) also test models for predicting non-discretionary accruals in order to estimate discretionary accruals in a period and find that these models appear well specified when applied to a random sample but generate tests of low power for earnings management of economically plausible magnitudes.

Many of the models provide little ability to predict total accruals. Conventional regression values from the actual accruals to predicted accruals are less than zero for a substantial majority of firms in those models. However, the Jones model is one that exhibits some predictive ability.

3.8 Conclusion

The Agency Theory with the separation of the principal and agent has its problems with the agent not always acting to the interests of the principal. Compensation plans have been devised as an incentive for the agents to more closely align their interests with the principals. The financial statements and earnings provide the communication channel between the two parties and allow the principal to monitor the performance of the agent. Auditors serve as an assurance to investors that the company's financial statements are true and fair, and mitigate the agency problem.

Due to information asymmetry, the agent who manages the firm has the opportunity to manipulate the financial statements and reported earnings for his benefit. It is difficult to develop an optimal compensation plan for managers where earnings can be manipulated. The literature has also shown that there are other incentives to manage earnings other than the higher reward to the manager.

The firm that engages in earnings management have to mimic other firms in the same industry with similar growth with the hiring of labour and higher investment. However, the firms shrink and the values drop significantly when exposed much to the disappointment and anger of the investors. Worse, when companies fail the cost can be high with investors losing their money, workers losing their jobs, and the plant and equipment left to waste.

It is thus imperative for corporations now to commit to developing and enforcing corporate governance systems that create a corporate climate of transparency and full disclosure to investors. Any structural weakness in corporate controls and governance could easily lead to large-scale management of earnings through dubious financial transactions, and ultimately to shareholder value destruction. This has happened with Enron and WorldCom.

Chapter 4: Malaysian Market and Evidence of Earnings Management

4.1 General Discussion

Malaysia which once depended on tin and rubber moved towards manufacturing with the discovery of oil in the late 1960s. The country enjoyed strong economic growth in the 1980s and 90s with a buoyant stock market until the Asian economic crisis of 1997. Stock prices plummeted and the value of the local currency fell markedly against the US dollar.

The corporate sector that had expanded in the good economic times with connected lending using the high share values then as collateral began to default with the Asian crisis. Many companies were unable to service the loans. Aggregate demand fell and the economy contracted by 7.5%. The government that initially increased interest rates and spent billions to support the MYR during the crisis later changed to lower the interest rates and pegged the MYR against the US dollar. The then Finance Minister and Deputy Prime Minister was dismissed.

Shareholders and other stakeholders suffered. The shareholders and investors lost a substantial amount of money when the company profits and their stock values declined. Questions were raised on the accounting information and the profession that prepared and provided the information. There were arguments that there had been a lack of proper disclosure and auditing.

The Asian economic crisis required measures to check investor confidence and the sliding market. The Malaysian government passed the Financial Reporting Act in 1997 establishing the Malaysian Accounting Standards Board (MASB) and the Financial Reporting Foundation. The MASB took over the standard setting process from the professional bodies and adopted the International Accounting Standards. Changes to the legislation and the Listing Requirements with continuous disclosure are to ensure greater efficiency, transparency and accountability with due diligence and corporate governance

for a sustainable economic growth. The strengthened reporting and regulatory framework is to deter false and misleading information issued by companies and managers.

4.2 Malaysian Stock Market

4.2.1 The Economy and The Market

Stock markets affect economic activity by mobilising savings to allocate to the corporate sector for productive investments. The stock markets allow savers to acquire equity or shares in public-listed companies that can be later sold quickly and cheaply to other investors.

The history of share trading dates back to the British colonial days. The Singapore Stockbrokers Association was formed in 1930 at the time that demand for rubber was high and tin mining was expanding. However, it was not until 1960 that the Malayan Stock Exchange was formed and public trading of shares began. In 1961, the Board system was introduced whereby two trading rooms, one each in Singapore and Kuala Lumpur, were linked by direct telephone lines into a single market with the same stocks and shares listed at a single set of prices. The Stock Exchange of Malaysia was officially formed in 1964 and in the following year, with the secession of Singapore from Malaysia, the common stock exchange continued to function under the name Stock Exchange of Malaysia and Singapore (SEMS). Following the cessation of currency inter-changeability between Malaysia and Singapore in 1973 the Board was divided into the Kuala Lumpur Stock Exchange Berhad (KLSEB) and the Stock Exchange of Singapore (SES). In 1989, the Malaysian government announced that Malaysian stocks would no longer be allowed to be listed on the SES. The authorities in Singapore reacted with the announcement that Singaporean stocks could no longer be listed on overseas Exchanges that did not allow their stocks to be listed on the SES. As a result of the split, Malaysia lost 53 quotations against Singapore's 133. The Central Limit Order Book (CLOB) was set up in January 1990 to trade Malaysian companies over-the-counter in Singapore after the Malaysian and Singaporean exchanges separated in 1990. The KLSB was later re-named the Kuala

Lumpur Stock Exchange in 1994. The Kuala Lumpur Stock Exchange became a de-mutualised exchange and was re-named Bursa Malaysia in 2004. At that time it consists of a Main Board, a Second Board and MESDAQ (Malaysian Exchange of Securities Dealing & Automated Quotation) with a total market capitalization estimated at MYR 700 billion (US\$189 billion).¹¹

Malaysia had depended on rubber and tin production for many years after independence in 1957. However, following the racial riots in 1969, the government introduced the New Economic Policy (NEP). The main aim of the NEP was the restructuring of the Malaysian socio-economy with the following aims:

- a) To redistribute corporate equity so that the *bumiputera* (local Malays) share would rise from around 2 percent to 30 percent.
- b) To eliminate the close link between race and economic function (a legacy of the colonial era) and restructure employment so that that the *bumiputera* share in each sector would reflect more accurately their proportion of the total population (roughly 55 percent).
- c) To eradicate poverty irrespective of race. In 1970 just under half of all households in Peninsular Malaysia had incomes below the official poverty line. Malays accounted for about 75 percent of these.

In 1970, the Chinese controlled a larger-than-proportional part of the corporate sector with the *bumiputeras* holding only 2%. Almost 70% of the jobs in the agricultural sector were performed by the *bumiputeras*, and a high proportion lived below the official poverty line. The NEP was designed to re-distribute wealth and eradicate poverty. Some *bumiputera* corporate groups emerged with soft loans from state-owned banks. They were awarded licenses and given preference in government projects. Rents were created by limiting competition in some areas.

¹¹ Bursa Malaysia, Annual Report 2004, p. 6.

When the NEP was introduced, the Chinese viewed the policy as limiting their business and economic opportunities. They developed strategies to contend with it. They allocated their company shares and formed partnerships with influential *bumiputeras* to forge ahead. A number of them also transferred their money overseas and diversified their business interests there.

Under the NEP, impetus was also given to the manufacturing sector by the creation of free-trade zones. The free-trade zones attracted multinational corporations (MNC) that led to the establishment of labour-intensive electronic component and garment industries. Job creation was rapid in the 1970s with economic growth averaging 7.6% per annum fuelled also by significant oil and gas findings and generally buoyant raw materials prices.

In the 1980s Malaysia attracted foreign direct investments, especially the multi-national semi-conductor and electronic companies to establish their production facilities there. Generous incentive packages such as investment credit, tax concessions, the fast-tracking of permits, and access to various infrastructure facilities were offered. The manufacturing sector grew and exports were promoted as the world market expanded. The government later ambitiously embarked on an ambitious heavy industrialisation programme and established the Heavy Industries Corporation of Malaysia (HICOM). The heavy industries that the government created and promoted included petrochemicals, iron and steel, cement and the national car manufacturing (*Proton*). The heavy industrialisation program, however, was at a time when the world economy was entering a recession with the “second oil shock”, and a decline in demand and prices for the export commodities. The government ran large budget and balance of payment deficits in 1981-84. The gross domestic product (GDP) growth rate declined from an annual average of 7 - 8 per cent in the seventies. The growth rate declined even further to 1.0 per cent in 1985. Regulations governing private investment under the NEP were relaxed in 1986 to exempt many companies from ownership and other requirements. The changes attracted much needed foreign investment into the country.

Over the period from 1970 to 1990, Malaysia with a growing foreign direct investment accomplished a transition from a primary product-dependent economy to one in which manufacturing had emerged as a significant, leading sector. The foreign direct investment by the multi-nationals created more jobs and generated exports. Foreign direct investment was estimated to have reached MYR6.2 billion by 1990¹². Rubber and tin which accounted for 54.3 percent of Malaysian export value in 1970 had dropped in relative terms to a mere 4.9 percent by 1990. The manufactured goods which accounted for 54.0% of the Malaysian export value in 1990 continued to grow, and accounted for 74.0% in 2004.

The stock market gained momentum in the late 1980s and early 1990s with the government's privatisation program and strong economic growth. During the 1991-96 period a total of 204 projects were privatised in all sectors of the economy, including infrastructure and government services. Approximately 55 were Federal projects, the remaining were State projects. The privatisation program included sale of equity, sale of assets, lease of assets, management contract, build-operate-transfer, build-operate-own, build-operate, build-transfer, land development, management buy-out, joint ventures and asset swap.

Managers retained earnings and borrowed heavily to meet their ambitious goals with new investments and the diversification of business operations. The favourable economic conditions enabled companies to borrow and expand. There are risks associated with outside financing and diversification. The expansion also gave rise to agency issues such as adverse selection and moral hazard. It was difficult to be sure that those managers have not shirked their duties and over-invested. Such strategies may not be to the interests of the shareholders and investors.

At the end of 1996, a total of 24 privatised companies, including *Tenaga Nasional* (National Electricity Power) and Malaysian Airlines, were listed on the KLSE with a total market value of MYR124.7 billion. The listings made a major contribution to the

¹² Ministry of Finance, *Economic Report 1990/91*, p. 6

turnover on the stock exchange. The stock market was also buoyed by the large foreign capital inflows. The Kuala Lumpur Stock Exchange Composite Index (KLSEI) went from 506 in 1990 to 1238 in 1996. The market capitalisation increased from MYR132 billion in 1990 to a peak of MYR807 billion in 1996¹³. The rise in the share prices allowed Malaysians to borrow more from the banks to acquire more assets. The state-owned banks were also used by the government for the wealth re-distribution policies of the NEP. The average growth rate from 1990-96 was 8.7% per annum and inflation was low at 3.8%. The outcome was that the domestic debt/GDP ratio in Malaysia in mid-1997 stood at 170 percent, which is among the highest in the world.

In July 1997, shortly after the Thai Baht was floated its value declined sharply creating the Asian economic crisis in the region with the “contagion effect”. There was a significant foreign capital outflow from the region. The acceleration at the end of 1997 precipitated the downward spiral of the Malaysian stock market. The Kuala Lumpur Stock Exchange Composite Index dropped from a high of 1271 at the end of February 1997 to 477 on 12th January 1998. The market capitalisation shrank by 54%. Besides causing turbulence in the stock market, the capital outflow also depreciated the Ringgit significantly against the US\$, from MYR2.5/US\$ in the 2nd Quarter of 1997 to MYR3.9/US\$ by the 4th Quarter of 1997, and then to MYR4.2/US\$ in early 1998¹⁴. The government initially reacted by raising interest rates and spending billions to check the slide of the MYR. In a departure from macroeconomic norm of free-market convention by floating the MYR, Malaysia boldly imposed capital controls on 1st September 1998, and later pegged the currency at MYR3.8/US\$. It has also been speculated that if the currency had not been pegged when the then Deputy Prime Minister was sacked, the currency would have been in freefall.

In 1998, when Malaysia imposed controls on its currency from the effects of the Asian economic crisis, about 172,000 Central Limit Order Book (CLOB) investors, mainly Singaporeans, had their shares frozen. The total shares had a value of approximately

¹³ Investors’ Digest, ‘Towering Above All ASEAN Marts’, KLSE July 1997, p.23

¹⁴ Bank Negara, Quarterly Statistics, 1997-2004.

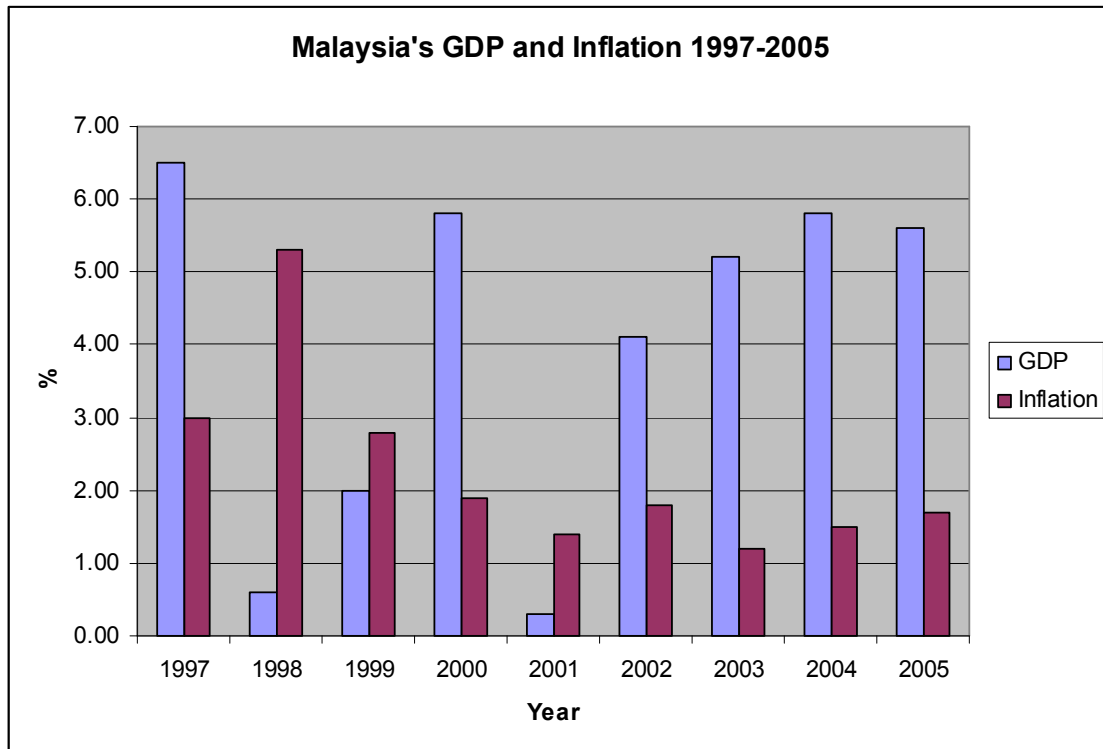
MYR17 billion (US\$4.47 billion). The issue dragged on for months before agreement was reached on 25th February 2000 whereby a third party, Effective Capital, a Malaysian private company owned by a Singaporean businessman, would acquire the shares on a staggered basis from 1st July 2000. The other option was a direct deal with a subsidiary company of the KLSE, Scans, and the staggered share release period was to be only from 1st January 2003 and lasting 9 months. The other option was obviously less favourable. The CLOB episode and the delayed resolution further have made many foreign investors, particularly Singaporeans, wary of investing in Malaysia, at least in the short term. The foreign direct investment (FDI) into Malaysia declined from US\$9 billion in 1996 to an annual average of US\$3 billion in 1998-2001. The government has taken steps to attract greater FDI into the country including the release of the Capital Markets Master Plan (2001). The government also adopted the Chinese-style managed floating rate for the currency in 2005.

The Malaysian economy which shrunk with a decline in aggregate demand and had fallen by 7.4% with negative growth in 1998 began to recover, recording economic growth of 6.1% and 8.3% in 1999 and 2000 respectively¹⁵. The countries in South-East Asia which had been affected by the Asian crisis called for greater co-operation through the Association of South East Asian Neighbours (ASEAN) which had been formed in 1967. Under the ASEAN free trade agreement (AFTA), there will be greater co-operation in certain service sectors with the lowering of tariffs to promote trade and investment in the region.

The manufacturing sector was the engine of growth in the Malaysian economy from the world demand of semi-conductors following the Asian crisis. However, the recovery was affected by the global economic downturn and the slump in the Information Technology (IT) sector in 2001. GDP in that year grew only 0.3% due to an 11.0% contraction in exports, but a substantial fiscal stimulus package mitigated the worst of the recession and the economy rebounded in 2002 with growth of 4.1%. There was continued improvement

¹⁵ Ministry of Finance, Economic Reports, 1997-2004.

in 2003 with economic growth of 5.3% in 2003 and 6.4% in 2004. The GDP growth was 5.4% in 2005. The economic performance and inflation for the period is illustrated below:



Source: Ministry of Finance, Economic Reports, 1997-2005

The economy which had shrunk affected the Malaysian stock market. There were 40 new listings on the KLSE Main Board in 1996. The number, however, dropped to 25 in 1997 and there were only 6 new listings on the KLSE Main Board in 1998. The Malaysian stock market had dropped to its lowest ebb with the Kuala Lumpur Stock Exchange Composite Index (KLCI) at 262.7 in September 1998.

The number of companies listed on the KLSE Main Board and the market valuation for the period are as follows:

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Main Board Listings	413	444	454	474	498	520	562	598	622	644
Market Valuation MYR bil.	746.0	354.1	353.4	527.6	423.9	444.3	464.5	610.3	692.5	689.8

(Source: Bursa Malaysia, 2005)

Many of the companies and individuals that had pledged shares and borrowed heavily to acquire properties or listed companies before the Asian crisis fell into serious trouble as the share prices and trading activity remained subdued for several months. A number defaulted on their repayments. With the number of non-performing loans increasing, the banks and financial institutions introduced tighter credit control. Many of the companies and individuals struggled with the tight financial conditions. By the end of 1998, the KLSE companies that filed for protection under Section 176 of the Companies Act 1965 included Time Engineering, Westmont Industries, MBF, and Wembley Industries.

It was not until February 2000 the more opportunistic investors returned and the stock market rebounded. The KLCI rose to 991 points, a remarkable performance then, before declining again. The KLSE amended its Listing Requirements in 2001 which allowed financially distressed companies to be placed on its PN4 (Public Notice 4) list. The PN4 companies are those with negative earnings and have become insolvent. The move was to ensure that only financially adequate companies remained on the KLSE board.

It was not until 23rd April 2002 that the KLCI climbed again to reach 808 on 23rd April 2002. However, by mid 2002 the stock market followed the slump in the major markets with the corporate scandals in the US. It was another year later before investor confidence returned and the KLCI reached 793.94 at the end of 2003. With greater investor

confidence and the return of foreign direct investment, the KLCI was pushed past 1200 in late 2005 and has remained high.

4.2.2 Executive Remuneration and Performance

Corporate earnings and financial performance were affected by the Asian economic crisis in 1997 and the aftermath. The fall in profits and share prices affected both individuals and companies as shares were used as collateral for bank loans. The decline in the share prices reduced the value of the collateral pledged against the bank loans, and the drop in profits reduced the ability to service the bank loans.

A well-publicised case is the attempt by United Engineers (UEM) in November 1997 to rescue its debt-laden parent company, Renong Holdings, allegedly connected to the ruling coalition partner United Malays National Organisation (UMNO). The company used borrowed funds to acquire 32.6% of Renong Holdings¹⁶. The purchase was not accompanied by the obligatory disclosures under the listing requirements and under the Companies Act 1965 concerning changes in substantial shareholdings. There was no disclosure as to who the shares were acquired from. No approval was sought by UEM from its shareholders prior to the acquisition despite the fact that the acquisition of the shares was a substantial enough transaction to warrant shareholder approval. The company sought and received a waiver in the “national interest” from the authorities to make a general offer for the other Renong Holdings shares that it did not own. The move was to the detriment of shareholders in both companies as the share prices of plummeted. The financial woes of Renong continued, and the executive head of the UEM-Renong Group was replaced in 2001. The cost of failure can be high.

The executive directors and chief executives as agents are responsible for the operations and direction of corporations. They have control of the assets and resources entrusted to them by the owners - the shareholders and investors – to maximise returns with strong

¹⁶ Wong, S.C., Jomo, K.S., Chin, K.F., ‘Malaysian Bail-Outs’, Singapore University Press, 2005, p.204.

financial results. The agency problem is that managers are individualistic and tend to act to their self-interests. The agency theory helps to explain the differing interests of the owners and the managers. However, the differences can be reduced and brought into check with closer monitoring and an appropriate reward system. It is not surprising then that many of the corporations have remuneration systems and incentives for the achievement of the desired outcomes.

Some managers can just be as equally concerned with the performance of their corporations as the owners. Such managers may perceive greater value in co-operative and rational behaviour. Koontz (1967) wrote that as the corporation is a separate legal entity from its owners, the directors and managers have to accept responsibility for the performance. The executive directors and chief executives are often engaged under contract and are expected to act in good faith at all times. The laws vest considerable powers on them to ensure the continuity and performance of the corporations. Their duties and responsibilities arising from the common law and statute can be summarised as follows:

- A director shall at all times act honestly and use reasonable diligence in the discharge of the office; and
- An officer or agent of the company or officer of the Stock Exchange shall not make improper use of any information acquired by virtue of his or her position to gain a direct or indirect advantage.

A breach of that particular section of the law may involve criminal liability. However, there are considerable hurdles in satisfying the criminal burden of proof.

Managers or agents have to be encouraged to act to the interests of the shareholders or principals in agency theory terms. The agency problem of the manager not acting to the interest of the shareholder has received much attention with the considerable literature. In corporate finance, the agency theory supports the use of high debt with the expectation of a high return. Moral-hazard and the assumption of bounded rationality can be a problem.

The agency cost from the problem can be high with substantial financial loss that can severely affect solvency and the normal business operating activities.

A well documented agency problem in Malaysia has been the Bumiputra Malaysia Finance (BMF) scandal involving the Chief Executive, Lorrain Esme Osman, and his top management team in which a sum of MYR2.4 billion was involved¹⁷. Here the chief executive and the management team who were entrusted with the sizeable assets of the company deliberately used them for their own personal advantage. Huge loans were approved to one single scrupulous businessman and his business empire leading to large amount of bad debts accumulated. The internal auditor, Jalil Ibrahim, was murdered during the investigation. The management team intentionally abused the trust of the shareholders to enrich themselves. The loss nearly crippled BMF, and led to Bank Bumiputra and its holdings, including BMF, being sold to Petronas. The former chief executive and most members of the management team were subsequently charged with criminal breach of trust. Self-interest had over-taken the duty and the responsibility assigned to the agents.

Managers who act to the interests of shareholders and who perform well have to be adequately rewarded and recognised. Otherwise they may change with the prospect of losing them to another organisation that offers better rewards and recognition. There is considerable literature on performance-based compensation to retain and motivate managers. However, much depends on the country and the culture. Malaysia still has the British influence in many of its management practices. While the Western practices have remained in Malaysia in varying degrees, the multi-national companies (MNC) quite often try to retain the way of the country of origin to strategically retain and enhance the performance of managers. It is generally known that the Asians have their culturally distinctive practice that emphasizes a harmonious work relationship and teamwork. The Western MNC, on the other hand, does not hesitate to terminate poor performing managers given the economic nature of the employment contract. The Western and particularly U.S. management systems are characterised by high individualism,

¹⁷ Malaysian Business, 'Malaysia's Financial Flops', 1 March, 2002.

impersonality in relationships, and emphasis on pay as a main motivator (money oriented).

The agency problem of managers not acting in the interests of the principal has led to the design and use of the executive compensation plans with the different bonuses and incentives. From the agency theory arguments there should be a close association between executive remuneration and company performance. The use of the performance-based remuneration is that it acts as a motivator through the use of incentives in the form of monetary rewards and by recognising achievements. A well-designed remuneration package with incentives should mitigate the agency problem. There is significant relevance to shareholders and investors who rely on the manager as an agent and hope to motivate the manager to act in their best interests. An increasing number of corporate and multi-national companies (MNC) are applying the incentive schemes to improve earnings and financial performance. The "Salary and Fringe Benefits Survey for Executives 2004" published by the Malaysian Employers Federation (MEF) disclosed that 90.5% of respondents from a sample of 304 companies in the country received bonus payment or some performance based reward. It may be a simple 13th month pay or the more complex combination of monetary and share option. The proportion of executive directors and chief executives in Malaysia who are on a performance-based compensation plan is high. The perceived generous compensation packages for the executive directors and chief executives remain topical and controversial

There has been no requirement for companies to disclose executive remuneration until new disclosure requirements were introduced in 2001 requiring listed companies to reveal the compensation bands of their top executives. Although those bands are disclosed, the executives are not named in annual reports. As such data on individual executive compensation is generally not available. The information on the nature of incentives is limited and mixed.

The perceived generous executive compensation with incentives is designed with the intention to align the interests of the manager with the shareholders for desired outcomes. However, there may still be agency loss from the conflicts of interest and inappropriate

management action. The conflict of interest could be the management tendency toward a short-term focus with lower risk to the neglect of more opportunistic long-term issues. Furthermore, the executive compensation and incentives are generally based on earnings and financial performance. However, the use of accounting numbers often requires certain management decisions and discretion. Such discretion allows managers to manipulate earnings and performance with the use of subjective accounting practices in an attempt to maximise their rewards and incentive payments.

An analysis of a sample of public companies listed on the KLSE comprising almost 50.0% of market capitalisation at the end of 1998 showed most are usually majority controlled by a small group of related parties and managed by owner-managers. About 85% of the sample had owner-managers with the Chief Executive, Chairman or Vice-Chairman of the Board belonging to a member of the controlling family or a nominee of the substantial and dominant shareholder¹⁸. With the high proportion of owner-managers, the agency cost and the problems such as shirking, accounts manipulation, and earnings management associated with the separation of the agent and principal would be minimal, if any, in line with the theory and abundant literature. Agency costs increase with a decrease in managerial ownership (Jensen and Meckling, 1976).

The other shareholders and investors generally rely on the financial reports and disclosures to monitor the performance of companies. There may be times when their interests may also be on the behaviour of the managers, the strategies and other activities of the company. When companies do not perform to shareholders expectations, they will sell their shares, sometimes even at a lower price than what had been paid, to buy a different portfolio. The monitoring role of the investors, especially the larger ones with their higher equity stake, can be significant. The market expectation can, and does affect share prices.

¹⁸ Claessens, S., Djankov, S., and Lang, L.H., (1999), 'Who Controls East Asian Corporations?' Washington D.C., World Bank Financial Sector Unit.

The company law requires the preparation of annual accounts, and public-listed companies are required to disclose their profit and loss accounts reflecting the performance on a continuous basis. For an effective executive compensation with incentives based on performance, there should be a consistent regulatory and reporting framework that allows shareholders and investors to monitor the performance of managers, the utilisation of assets, and to also evaluate the pay for performance issue.

In any performance-based compensation system, the monitoring and measurement of performance against the targets or set objectives are important. Otherwise it can lead to inappropriate management behaviour. A notable case is that of the Pan-Electric Group in the late 1980s. The executive director, Tan Koon Swan, was able to manipulate the accounts and earnings. The resultant high share prices allowed the group to expand through acquisitions with bank borrowings. The group appeared successful. However, when the shareholders and investors realised that the expanded group was short on potential, they began selling. The group defaulted on the bank loans and collapsed with substantial losses. Tan Koon Swan was subsequently charged and convicted for manipulating the market.

It has been argued that an adequate internal control and governance system with a robust independent audit would have uncovered the inappropriate management behaviour earlier, if not prevent it altogether, in the case of the Pan-Electric Group. Corporate governance is about organising the company in an effective manner towards the defined goals through a set of processes and policies with direction, control, transparency, and accountability. An effective internal control and governance system will reduce agency costs and inappropriate management behaviour including accounts manipulation and earnings management.

When the internal control and corporate governance systems are effective, the market confidence is higher. The confidence is often rewarded with debt and equity capital flowing to those companies which have good managers capable of investing in the most efficient manner for the production of goods and services for a high rate of return.

A strong regulatory framework with action on breaches will further strengthen the market confidence as the different companies, and even possibly the country, compete for domestic and foreign investment funds to maintain sustainable development and growth.

4.3 The Regulatory Framework In Malaysia

4.3.1 Legislation And Regulation

The regulatory framework is to protect investors and to provide confidence in the share market. The framework is based on the British system. The activities and reporting by Malaysian companies are governed by the Companies Act 1965 and the Securities Commission Act 1993. Public-listed companies are subject to three regulatory authorities:

- the Registrar of Companies (ROC),
- the KLSE (KLSE)
- Securities Commission (SC).

The incorporation or registration of every company, whether private or public, is effected with the ROC. Its jurisdiction thus extends to all companies incorporated in Malaysia. The principal duty of the ROC is to ensure that companies and their officers comply with the numerous provisions of the Companies Act and the subsidiary legislation, the Regulations. Documents pertaining to significant decisions or transactions of a company are filed with the ROC for public inspection. The ROC is accorded extensive powers of enforcement under the Companies Act, including the right to enter into premises, to seize documents and records, and to compel oral testimony of witnesses. The ROC reports to the Minister of Domestic Trade.

The KLSE is a self-regulating organization that governs the conduct of public companies whose shares are listed for trading on the Main Board or Second Board of the KLSE. The Main Board of the KLSE is for companies with a higher capitalisation above MYR60

million, and the Second Board is for those with a lower capitalisation. Public companies listed on the KLSE are classified into sectors based on their core businesses. The KLSE also enforces the listing and disclosure requirements. New listings are subject to the approval of the Securities Commission and other relevant authorities. The financial disclosures and contents of prospectuses are dealt with by Part 6 of the Listing Requirements. Listing entails an offer of share securities to the public. The continuous disclosure and reporting obligations imposed on public-listed companies (PLC) by the Listing Requirements of the KLSE are as follows:

- (a) To publish financial statements on a quarterly basis within two months after the end of each financial quarter.
- (b) To provide annual audited accounts, auditor's and directors' reports within 4 months from the end of the financial year.
- (c) To state the compliance with the Malaysian Code on Corporate Governance.
- (d) To make immediate public disclosure of all material information (irrespective of whether of a financial nature or not) concerning its affairs

In 1998, the KLSE reprimanded 5 public-listed companies for breaching the Listing Requirements in not complying with the disclosure requirements. UEM was also fined MYR 100,000 (approximately US\$26,316) by the KLSE for breach of the disclosure provisions under the Listing Requirements. There were 37 reprimands issued in 1999, and 9 reprimands issued in 2000 for not complying with the disclosure obligations in the Listing Requirements. Changes to the Listing Requirements were issued in January 2001 to improve corporate governance and the protection of minority shareholders. The changes included the requirement for board composition to have 1/3 independent directors, disclosure on state of internal controls and compliance with the Malaysian Code of Corporate Governance that had been developed and adopted a year earlier, and the obligation to provide clear, accurate and unambiguous information by both directors and advisors to the company. Some of the public-listed companies were slow to comply to the changes with the KLSE reporting that action was taken against 207 companies for breaches of the Listing Requirements from 1st July 2001 to 30th June 2002.

The SC was established under the Securities Commission Act which was passed in 1992 to oversee the securities and futures industry. The SC was established to take over the role of the Capital Issues Committee (CIC) which was controlled by the Central Bank and the panel on take-overs and mergers. The Act was amended in 2000 to enhance its powers to prosecute and enforce provisions in the legislation. The SC also monitors and regulates the affairs of the public-listed companies. Public companies applying for listing status with the KLSE also come under its purview. Under Section 33A of the Act, it has issued a code on take-overs and mergers. The code applies to companies with shareholders' equity of MYR10 million or more. The powers of the SC include:

- regulating take-overs, mergers and acquisitions of companies;
- ensuring proper conduct by companies and their officers;
- promoting the development of the securities and future markets;
- taking all necessary steps to protect the interests of investors;
- enforcing the compliance of relevant laws.

Under the authority of the Minister of Finance, the SC licences capital market players and oversees the activities of the several exchanges and institutions that comprise the Kuala Lumpur Stock Exchange (KLSE) Group. Although the SC has wide administrative powers it does not have the judicial power of a court. It is the responsibility of the Attorney General to initiate prosecution in court. In 1999 the SC investigated 54 cases and initiated 23 prosecutions for offences ranging from submission of false or misleading information, offering unacceptable schemes, engaging in acts to defraud and short-selling. More recent major cases included actions against Granasia Corporation Sdn Bhd and Hospitech Resources Bhd for misleading disclosures that led to the reimbursement of investors' funds amounting to MYR39 million. Hwa Tai Industries Bhd was reprimanded publicly and fines were imposed on its directors for failing to allocate shares fairly. The SC also took administrative actions against the Deloitte-Kassim Chan accounting firm, Hwang-DBS Securities and Affin Merchant Bank for not meeting their due diligence obligations.

The SC also advises the government and the Central Bank on policy matters. It also acts as the liaison agency for the Foreign Investments Committee (FIC), and Ministry of International Trade and Industry (MITI) when their approvals are required.

4.3.2 Financial Reporting Framework

Accounting information can facilitate market monitoring, increase the precision and volume of information flow, lower costs of financing, and increase market efficiency. Good accounting rules should provide information that is useful to investors.

The Malaysian Accounting Standards (MASB) established under the Financial Reporting Act 1997 together with the Financial Reporting Foundation makes up the framework for financial reporting in Malaysia. Prior to the establishment of the MASB, the professional bodies issued the accounting standards. The Malaysian Association of Certified Public Accountants (MACPA), dominated by the big international accounting firms, issued accounting standards, including the adoption of the International Accounting Standards, for use prior to the activation of the Malaysian Institute of Accountants (MIA) in 1987. MIA, established by statute in 1967, adopted all the standards issued by MACPA as mandatory standards to be complied with by its members. MACPA continued to develop standards through collaboration with MIA until the setting up of the Common Working Technical Committee (CWTC) in March 1989 consisting of members of MACPA and MIA. The two bodies worked jointly on the standards, and ensured that standards issued by both MACPA and MIA were the same. However, the CWTC was dissolved in 1992, and MACPA and MIA collaboration in respect of technical work ceased. Since the cessation of the CWTC, the two professional bodies have gone their separate ways in developing standards. However, members of MACPA will still have to comply with the standards of the MIA as all practising accountants have to belong to the statutory body.

There have been questions raised about standard setting by the accounting profession. The profession has been seen to act for self-interest with a view to formalise the “way of doing things” by accountants. The profession has focus and concerns on the technical aspects of the standard and the reporting issues only. The accounting setting process is seen to be too narrow as accountants do not, and are not expected to consider the socio-political implications of a standard. The technical aspect, though important, should not be the only consideration. There are other different aspects that need consideration. The government, for example, has a particular interest too as some of the standards may affect revenue and the income tax payable. The accounting standard must be acceptable to the users. Otherwise the financial information will not be used in the way they were intended. The accounting standard setting process has to involve other parties, the stakeholders, and not just accountants.

The accounting standards setting process by the profession was replaced by the current financial reporting framework established under the Financial Reporting Act 1997. The framework includes the Financial Reporting Foundation (FRF) and the Malaysian Accounting Standards Board (MASB). The FRF, as a trustee body, has accounting professionals, government and other regulatory authorities, banks, and the industry as members. The FRF has responsibility for the supervision of the performance, financing and funding arrangements, and as an initial source of views for the MASB on proposed standards and pronouncements. It has no direct responsibility with respect to standard setting. The responsibility rests solely with the MASB which is now the technical body responsible for the development, review, and the empowerment to issue legally binding standards in Malaysia.

The current financial reporting framework sets the pace and boundary for the development of accounting standards through wider participation from various sectors of the industry, government and the accounting profession. However, with the globalisation of markets and the competition for capital funds there is a need for the harmonisation of standards. Differences in national accounting standards have hindered investors to compare opportunities and formulate sound investment decisions across nations. The

MASB recognised the issue and problem with the different accounting standards and moved to revise the local accounting standards for convergence with the International Accounting Standards.

With globalisation and the need for comparable financial statements, the International Accounting Standards Board (IASB) assumed accounting standard-setting responsibilities from its predecessor body, the International Accounting Standards Committee, in 2001 as a result of a restructure from component members. The IASB is committed to financial governance through the development and dissemination, in the public interest, of a global set of accounting standards known as International Financial Reporting Standards (IFRS) that require transparent and comparable information in general purpose financial statements. The organization has an advisory body – the Standards Advisory Council (SAC) – to assist the Board. Though the SAC does not have any decision-making authority but only a consultative role, it is meant to include institutions and bodies representing those interests that might be indirectly affected by the work of the IASB without having a direct representation either at the level of the Trustees or the Board (they can be called ‘diffuse interests’).

Members of the SAC include the UN Conference on Trade and Development (UNCTAD), the Basel Committee on Banking Supervisors, the IMF and the World Bank together with a long list of national standard setters from different geographical regions. The SAC provides a forum where IASB members provide reasons for their decisions and express their suggestions, concerns and criticisms. IASB also liaises with national standard setters of the different countries, including from developing countries. The IASB co-operates with the accounting standard-setters in its efforts for convergence in accounting standards around the different parts of the world. In 2002, the European Union (EU) adopted the IFRS for listed companies from 2005. Many other countries like Australia, Canada, and Japan have also adopted the IFRS. China has pledged to follow. A significant influence for the adoption of the IFRS is the convergence project between the IASB and the U.S. Financial Accounting Standards Board to eliminate the U.S. Securities

and Exchange Commission (SEC) requirement for reconciliation to U.S. generally accepted accounting principles (GAAP) by EU companies that apply IFRS.

The widespread adoption of, or convergence with, IFRS has provided a single set of financial reporting standards that are understandable, transparent and comparable across nations. The uniform reporting by companies that have adopted the IFRS is to provide fairer competition with easier access to global capital markets, including the U.S., and the flow of funds. There are other advantages of the single set of global accounting standards and they include:-

- Cost savings from the elimination of different financial statements in the different countries for multinational companies, and the need for the tedious and expensive reconciliations.
- Comparability of financial reports across nations.
- Dissemination of quality accounting information to users throughout the different parts of the world.
- Financial statements that is similar across nations.
- Removing barriers to international capital flows by reducing the differences in the financial reporting requirements of companies in different foreign stock markets.

It is not surprising then that Malaysia adopted the IFRS for enhanced transparency and comparability in its efforts to compete and attract the domestic but more so the foreign investment in the global market. The MASB in revising the accounting standards towards convergence with the IFRS require companies to follow the adopted FRS commencing 1st January 2005 in the preparation and presentation of financial statements. The IFRS and the MASB equivalent are shown in Appendix II.

With IFRS, many of the multi-national companies (MNC) are no longer required to prepare financial statements differently from their home countries. The need for the tedious reconciliations to prepare the group accounts will be eliminated for many MNCs.

The IFRS also allows Malaysian companies to be listed in overseas markets without the need for a different set of financial statements.

There are, however, some parts of the capital-oriented IFRS are complicated and difficult to translate such as accounting for acquisitions and certain intangible assets. The implementation of IFRS is also expensive as staff and the preparers of the financial reports require training. The other costs include an appropriate internal system and resources to collect information to meet the FRS which may require creating computation models and employing valuation experts. Companies listed on the KLSE will also have to consider the impact of the new standards on other business areas such as risk management and operating strategy.

4.4 Malaysian Company Disclosures

4.4.1 Financial Reporting

Financial reporting in Malaysia is governed by the *Companies Act 1965*. The *Companies Act 1965* of Malaysia requires companies to prepare annual reports in accordance with its *Ninth Schedule*. Generally, the annual report of Malaysian based companies is made up of seven parts: 1) Directors' report, 2) Profit and loss account, 3) Balance sheet, 4) Statement of changes in financial position, 5) Notes to the financial statements, 6) Statement by directors, and 7) Auditor's report. The KLSE and the SC may impose additional disclosure requirements for public-listed companies. The accounts and notes disclose items considered to be relevant to investors, such as the level of turnover, the amount of investment and other income, directors' interest in the company (or related companies), details of shareholders and the value of their equity, particulars of properties held including address, description, existing use, tenure of holding and age of buildings, and an analysis of the shareholdings spread.

During the Asian economic crisis, shareholders and other stakeholders suffered substantial losses from the fall in profits and share prices as affected public-listed companies struggled to remain financially afloat. The fall in share prices reduced the value of the collateral pledged against bank loans, and the drop in performance and profits led to defaults in servicing those loans. There had been no prior warning signal for those companies in financial distress. By September 1998, thirty debt-burdened public-listed companies had sought protection from creditors under Section 176 of the Malaysian Companies Act 1965 to undertake a restructuring process. The KLSE amended its Listing Requirements in February 2001 and introduced PN4 (Public Notice 4) which allowed public-listed companies in financial distress that met its conditions to be placed in the list. The PN4 companies then had 6-12 months to submit their restructuring plans and regularize their financial condition to the relevant authorities for approval. The PN4 companies had to re-structure and sell their assets under arrangement and assistance from *Danaharta*, a government agency established for that purpose. If the companies fail to re-structure and regularize their financial condition, they faced de-listing from the KLSE. By the end of 2001, there were 93 PN4 companies with 46 from the main board.

The share market was in the doldrums. Shareholders and investors suffered financial losses. The investment confidence was badly shaken. The accounting information and disclosures in the financial reports made available by companies had seemingly failed them and other stakeholders.

Concerns were also raised on the role of the external auditors. Investors and other stakeholders rely on the work of the auditors. The law allow auditors to examine the accounting books and records of companies and perform such work as is necessary to enable them to issue their independent report. There had been no matters raised and unqualified audit reports had been given on the financial performance and position of those companies. However, several large public companies and financial institutions became insolvent a few months after their audit at the onset of the Asian financial crisis.

4.4.2 Disclosure Based Regulation

The Asian economic crisis highlighted the need to enhance corporate governance with a stronger reporting and regulatory framework. The lax and flexible approach to financial reporting was no longer acceptable. The Financial Reporting Act (1997) with the establishment of the Malaysian Accounting Standards Board and Financial Reporting Foundation was a milestone towards a stronger reporting and regulatory framework. The government issued the Capital Market Master Plan in 2001 which had corporate governance, transparency and disclosure as key objectives in the longer development of the corporate sector and the capital market. In line with the Plan, Malaysia adopted the International Accounting Standards, and followed with amendments to the legislation and the Listing Requirements of the KLSE. The accounting standards issued by the Malaysian Accounting Standards Board (MASB) have the force of law. Compliance is required by all public companies and companies that provide financial statements administered by the Securities Commission (SC), Registrar of Companies, and the Central Bank. Auditors, chief executive officers and directors are legally responsible for ensuring that the financial statements are in accordance with MASB standards. In addition, the directors responsible are required under the Companies Act (1967) to make a statutory declaration on the correctness of their financial statements. The accounting profession is also expected to ensure compliance of the standards by its members with disciplinary action for breaches.

The country has shifted to disclosure based regulation (DBR) following the Asian economic crisis. The shift to DBR is in line with the practice in the U.S. with the Sarbanes-Oxley Act, and other DBR countries to increase the efficiency of the market with higher standards of disclosure, transparency, and accountability. The increased regulation has focussed on accounting, auditing and corporate governance. The financial disclosure laws are based on the premise that they will improve the quality of financial information, and to lead to a fairer distribution of that information to investors for

decision making. Mandatory disclosure is to promote fairness and that purchasers will no longer pay for shares more than they are worth.

The DBR with the requirement for a continuous flow of relevant information for public-listed companies is aimed to have a high level of efficiency and transparency in the market. The information allows investors to judge the commercial merits of transactions based on the disclosures made by the companies. Investors can then decide to hold or sell their stocks based on the information available. There are laws governing information made available, and it is an offence for directors, advisors and any other person to issue information that is false and misleading. The laws also prohibit insider trading.

The government has recognised that strong corporate governance with transparency and accountability will make the market more efficient for a better allocation of resources to sustain economic growth. Public-listed companies are required to have independent directors and an audit committee as part of their corporate governance practice, and are also required to state that they have complied with the Code of Corporate Governance in the Annual Reports. For an effective DBR, there must also be a sound legal and regulatory infrastructure that promotes transparency and accountability with no opportunity to defraud investors and swift enforcement on all transgressions.

While most companies have worked to comply with the regulatory requirements, a number struggled with the need to obtain date extensions for their disclosures. However, a small number have even made voluntary disclosures over and above the mandatory requirements as part of their enhanced corporate reporting (ECR) in an attempt to gain a competitive advantage to attract investors, and possibly lift share prices. The voluntary disclosures may be non-financial such as efforts to address social and environmental issues in creating long-term shareholder value.

Whilst the legislators are concerned with mandatory disclosures for share price accuracy in the market to enhance the economy, financial economists, however, argue that disclosure is not necessary to protect investors against unfair prices. The efficient market

hypothesis (EMH) holds that a highly traded stock is unbiased and on average equals the actual stock value whether there is a great deal of information available or not.

The increased disclosure may only draw attention to the firm specific risk. Under the capital asset price model (CAPM) the level of firm specific risk has no effect on the market value of its shares. A security with higher firm risk will not necessarily be priced in the market to produce a higher return since there is no reward for holding a higher risk that can be diversified away.

The share price accuracy argument that mandatory disclosures will bring remain difficult to justify the higher costs involved since it will not increase the value of the shares.

4.5 Earnings Management

4.5.1 Disclosure Based Regulation, and Accruals

The liberalisation and privatisation policies in Malaysia encouraged the corporate sector to expand. New conglomerates emerged. Major projects and licences were awarded to those *bumiputera* conglomerates with political patronage or close ties with the government. However, the corporate sector was badly affected by the Asian economic crisis with a decline in profits and share values. Shareholders and investors, bankers, creditors and other stakeholders lost substantially when several companies became insolvent. The loss, many argued, had been attributed in part to the lack of proper disclosure and auditing. The efficiency and growth of the market relies heavily on the availability of information. Without changes, and good, reliable accounting information and disclosures investors may be reluctant to put their money at risk which in turn inhibits the growth of the market. To deal with these problems, new legislation has been introduced since the crisis and others amended with penalties for non-compliance to regulate the corporate sector and the disclosure requirements. However, efforts to understand the regulation are not aided by the existence of the different government

agencies with overlapping responsibilities, laws that are subject to administrative interpretation and actions that sometimes involve formal and informal implementations.

Companies are required to prepare financial statements based on MASB accounting standards and auditors are to certify on the truth and fairness of the financial performance and position. The tighter reporting and regulatory framework makes compliance with the MASB accounting standards mandatory. The MASB in adopting the international accounting standards is to mitigate the lack of disclosure in a number of areas to enhance transparency and accountability. The reporting and regulatory framework for financial statements is aimed at accrual accounting, which requires judgements and estimates, in an attempt to reduce accounting policy choices for uniform financial statement disclosures that are understandable and comparable. Regulations generally specify what is allowable and permissible, leaving only factual issues to be decided by professional judgment. There is no flexibility for case-specific circumstance.

Regulations on disclosure laws are supposed to lead to a more equal distribution of information among investors reducing the asymmetry problem that the less informed investors are at a disadvantage. However, the costs of conforming to the laws and the rules that have tightened the accounting system and financial disclosures are considerable. There is also the requirement to have independent directors to safeguard the interests of minority shareholders, and the establishment of audit committees under the Malaysian Code on Corporate Governance (2001). The Listing Requirements define an independent director as one who is not an officer of the company, and who is neither related to the officers nor represent concentrated or family shareholdings of the company. It is one who is independent from management and free from any relationship which could interfere with independent judgement. An independent Board will be more effective to oversee management and performance in a better perspective. Companies need to have adequate internal control, risk management, and corporate governance systems and structures in place to capture and make available all the necessary financial information to the different users.

Auditors and their firms are required to have the competencies, skills and knowledge to perform their work to attest and certify the financial reports. The work may sometimes require the use of specialist professionals such as in information technology. However, they are no longer allowed to perform other consulting services when they have acquired the relevant knowledge, skills, competence, and resources to do so. The rules are numerous and onerous, and the independent auditors are expected to ensure compliance.

Furthermore, there are costs involved with preparing and releasing information. Distribution costs can be substantial, especially if companies are required to send information by mail to all their shareholders. Certain disclosure items may also require the services of professionals, for example to determine the fair value of an asset or the revaluation of an investment plan under the impairment test. The measurement and reporting of some transactions can be complicated using the MASB standards and the IFRS equivalent.

The indirect cost that may arise from disclosure is that information provided to shareholders and investors may also be used by other parties such as competitors, the tax office, unions and employees. For example, information about the profitability of the different business segment can be competitively sensitive because it may reveal the operating margins and investments in other businesses.

The costs and benefits of rule-based disclosure differ for companies, as it is not possible to have one rule that is suitable for all. The larger companies have the resources to engage accountants, auditors, lawyers and investment bankers to ensure compliance whilst the smaller ones with limited resources struggle. The higher regulatory supervision by the SC and KLSE is to allow less room for professional judgement to obtain better quality accrual-based accounting information with little, if any, opportunity for manipulation and earnings management. Rule-based approaches to accounting are intended to constrain the application of principles and professional judgement by including a great deal of detailed specific guidance on exceptions, options and implementation.

The many laws and rules fly against free market fundamentalism. For companies to succeed in a competitive market, managers must be innovative and efficient with effective strategies to meet the ever changing business environment for desired outcomes. Quite often the managers have to make adjustments to the market expectations, including disclosures. For example, a company engaged in logging activities with no regard for the environmental impact may be punished by investors. Furthermore, the laws and rules can never be enough to control the manager when financial accounting measures such as profitability are extensively used in the compensation plans. Accounting information on an accrual basis requires management judgement and estimates.

Most accruals are a normal part of business and tend to reverse out over time. Accruals have been taken to be the difference between the net income and cash from operations and firms with high accruals have been considered to be more likely to have inflated or managed earnings. However, the high accruals may be for reasons such as an increase in receivables from higher sales, depreciation charges from new equipment, and outsourcing on long-term contracts. There are also financial products that have been introduced in the capital market that allows managers to develop strategies for better financial management with long-term contracts such as hedging with derivatives.

4.5.2 Accruals and Earnings

Accruals in accounting to match income and expenses to the reporting period offer a more accurate representation of financial performance than the cash basis. Accruals are known to have high information content on future performance. Erickson and Wang (1999) defined total accruals as net income minus operating cash flows. The accruals can be used to predict the future cash-flow as supported by Dechow (1994) who reported that the changes in cash-flows and changes in accruals are correlated. The results based on her work had a fairly significant relation of -0.55 for annual periods and -0.88 for quarterly periods. The accruals in accounting, however, require judgement and estimates which affect earnings.

The relationship between earnings and share prices has been well documented by Ball and Brown (1968) on the U.S. market. Later studies by Beaver (1968), Beaver, Lambert and Morse (1980), and others support the view that earnings reports possess information value that affect share prices. For the emerging market, Su (2003) examined share price reactions to earnings announcements in Hong Kong. Favourable earnings and financial performance to market expectations are generally rewarded with higher share prices. Negative earnings and poor financial performance, on the other hand, are punished by the market with lower share prices.

Accrual accounting requires choosing the appropriate method to disclose the earnings and performance of the business entity using judgement and estimates. Managers who are better informed about the business than others have to choose the appropriate accrual method amongst alternatives. However, the choice by the manager may be influenced by their performance-based incentive scheme, job security or their desire to achieve target earnings and meet market expectations. The flexibility allows for opportunistic behaviour with the choice of the accrual method that is more advantageous in the report on earnings and financial performance. Accrual accounting creates opportunities for earnings management.

Earnings management occurs with the discretion in reporting financial information. Some examples of such discretion in accruals include the deferment of asset write-offs and the under-provision of bad debts. Managers behave opportunistically to report earnings for a more favourable share price.

Accruals based earnings is susceptible to earnings management, and have been used for that purpose. Earnings management causes shares to be priced wrongly which can lead to an inefficient allocation of capital, and is difficult to detect. Managers may engage in earnings management to their own interests for a better reward under their executive incentive scheme and prestige. There are other different reasons and incentives for earnings management as outlined in the earlier chapter. However, the use of accruals in

earnings management is limited by the accounting standards and generally accepted accounting practice. Total accruals are the change in non-cash current assets less the change in current liabilities after excluding the current portion of long-term debt, depreciation and amortization with the adjustment for the non-current assets. The total accruals (TA) consist of both discretionary accruals (DA) and non-discretionary accruals (NDA), and are expressed as:

$$\text{Total Accruals} = \text{Discretionary Accruals} + \text{Non-discretionary Accruals}$$

Or

$$\text{TA} = \text{DA} + \text{NDA}$$

The non-discretionary accruals are required by the accounting rules and the discretionary portion of accruals is due to managerial discretion. Teoh et. al. (1998) described discretionary accruals as management intervention in the financial reporting process. An example is the change in the provision for doubtful debts by management acting to their own interests. The change in the accrual is discretionary.

Discretionary accruals can be viewed as total accruals minus non-discretionary accruals. Such accruals affect the quality of earnings and can be difficult even for auditors to separate for verification. From the literature review, earnings management arise from management choices on discretionary accruals. Accruals that differ from their normal amounts are considered discretionary accruals, and significant differences are an indication of poor earnings quality and likely proxy for earnings management.

4.5.3 Accrual Models

For users of accounting information and in the study of earnings management, it is important to be aware of the total accruals and the part attributable to managers or the discretionary component of total accruals. Total accruals, as defined by Dechow et.al. (1995), is the difference between the net income and the cash-flow from operations. It is,

however, approximated using the current accruals with the change in working capital and the non-current accruals with the depreciation and amortisation in several accrual prediction models. The discretionary component of the total accruals is required to be identified and separated to detect earnings management. Several models have appeared with the purpose of separating the discretionary and non-discretionary accruals. The models use some form of regression over a time period.

Healey (1985), for example, used the average of past total accruals over a ten-year period. De Angelo (1986) defined the non-discretionary part of accruals as the previous year's total amount using the random walk model over the selected period to detect earnings management. However, the Jones (1991) model and the modified Jones model in Dechow et al. (1995) and other variants such as Dechow, Richardson and Tuna (2003) have been used in empirical studies to examine earnings management. The Jones model which is widely used to separate discretionary accruals (DA) and non-discretionary accruals (NDA) stemmed from the import relief investigations in the U.S. where discretionary accruals were used as a measure of earnings management. The results demonstrated that management tended to make income-reducing accruals during the year of import relief.

The Jones model deduces the DA by first computing the total accruals (TA), then estimating the NDA by regression before deducting the NDA from the TA to obtain the DA.

With the Jones model, the total accruals is ascertained with the change in working capital as explained by the change in sales revenue and the value of the property, plant, and equipment. The depreciation to write-off the cost of the asset item over its useful life is assumed to be a fixed percentage determined by the matching principle and the future benefit it produces. The appropriate depreciation rate on a reducing balance is $1 - \gamma$. Depreciation expense is then as follows:

$$Dep_t = (1 - \gamma) PPE_{t-1}$$

The property, plant and equipment at time t equals the carrying balance at time $t-1$ plus the new additions. Working capital is the difference between the current assets and liabilities which includes accounts receivables and payables. Total accruals using the Jones model can then be expressed as:

$$TA_t = \beta_1 \Delta Rev_t + \beta_2 PPE_t + \varepsilon_t$$

where

ΔRev_t = the change in sales revenue from the previous period.

PPE_t = the value of the property, plant and equipment at time t .

In the model, $\beta_1 \Delta Rev_t + \beta_2 PPE_t$ are treated as non-discretionary or the normal accruals, and the error ε_t as discretionary. If the model correctly measures non-discretionary accruals, the β_1 and β_2 are specific market and year (which is influenced by $1 - \gamma$) parameters that are estimated using past data, and are constant terms. The model suggests that total accruals are determined by the change in sales, beginning property, plant and equipment, and the discretionary accruals.

The Jones model assumes that managers have no discretion over revenues, and that the working capital is very much influenced by the activity level which is the change in sales revenue, $\Delta Rev_t = Rev_t - Rev_{(t-1)}$. Sales revenue is affected by the economic conditions. The demand for goods and services can be expected to be high in a favourable, growing economy. The model captures the relationship between the accruals and sales over a period in a time series setting. The regression would provide the expected or non-discretionary accruals and the residual would be the discretionary accruals. Accordingly, the model requires samples with a long series of financial data and assumes that the level of accruals remain the same over time. Past empirical studies have found the assumption to be generally valid, and that discretionary accruals are indeed a valid proxy for earnings management (Dechow Sloan and Sweeney (1995); Bartov, Gul and Tsui (2000)).

4.5.4 Data and Results

Based on the literature review and past studies accruals have been used in earnings management. The study on accruals and earnings in Malaysia is for the period after the Asian financial crisis. The data was used to determine whether the same can be said for an emerging market like Malaysia. The Asian crisis badly affected many companies listed on the KLSE. Companies that suffered a decline in earnings and struggled to meet their commitments were used to test for the market reaction and share price movement. If the information is useful in affecting the share price, the market will respond quickly on its release. The share price movement reflects what investors think the shares are worth based on the information available.

There are several factors that influence share prices but the earnings have been an important one. There have been many studies on the relationship between earnings and share prices. The relationship has been well documented by Ball and Brown (1968) in their study on the U.S. market. Later studies by Beaver (1968) and others support the view that earnings reports possess information value that affect share prices. Favourable earnings and financial performance to market expectations are generally rewarded with higher share prices. Negative earnings and poor financial performance, on the other hand, are punished by the market with lower share prices. The efficiency of the market requires share prices to follow the information available.

Nasir and Mohamad (1993) in their studies on the effect of earnings announcements in the Malaysian market found that in the post-announcement period the abnormal returns exist and have not been significantly different from zero in its semi-strong form. Positive earnings announcements generally result in a spike in the share price. When earnings are negative a downward adjustment of expectation generally follows with a fall in the share price. The market expectations and announcements on the current performance by companies affect share prices. In a semi-strong efficiency market, the reaction to public information should be fairly quick. The extent of the change in share prices can, however, be softened by the type of management and future expectations.

Many of the studies on earnings and the effect on share prices have been done in robust markets with expected growth. However, for the period following the Asian financial crisis in 1997 to when the PN4 list was introduced in 2001, the KLSE was sluggish. The average return for the different sectors as computed from the KLSE data confirmed the state of affairs.

The average return and the standard deviation of dispersion for the different industry sectors computed using the KLSE data are as follows:

	<u>Avg. Returns</u>	<u>Standard Deviation of Dispersion</u>
Construction	-2.34	18.92
Trading/Services	-1.96	15.35
Hotels	-2.98	18.68
Consumer Products	-1.39	12.11
Finance	-1.94	16.71
Industrial Products	-2.07	14.29
Mining	-1.39	17.54
Plantations	-1.33	11.66
Properties	-2.34	16.60
Other	-1.91	14.58

For the period 1997 to 2001 when the PN4 list was introduced, all sectors had a negative return which is consistent with the downward movement of prices then. The construction sector, however, had the highest standard deviation of dispersion in that period as the investors reacted to several commercial and housing projects that were affected by the economic climate with price adjustments.

The study on the effect of earnings on share prices is to be done differently in this paper. The correlation is to be examined using the negative earnings data of those companies in

the preceding period up to the time of the PN4 announcement. Using the negative earnings in the sluggish KLSE market will confirm its semi-efficient form, and that the correlation with the price adjustment holds true.

The company law requires companies to publish their results within six months of the financial year-end but a majority of the announcements by companies listed on the KLSE are made after three months. The earnings announcement has become a regular and expected event even though managers prefer to defer the bad news. The market reaction to unexpected bad news can be large and asymmetric. Negative earnings tend to place downward pressure on share prices. Any PN4 announcement would be unexpected and drive the prices even lower. The cost of not meeting analysts forecast and the market expectation can be high.

A total of 93 public-listed companies were placed on the KLSE PN4 list by the end of 2001 as they struggled with the sluggish economy following the Asian financial crisis. The market capitalization of the 93 PN4 companies was estimated to be MYR4.42 billion or approximately 0.90% of the total market capitalisation then. The total included 46 from the main board. The PN4 list is for financially distressed companies that had become insolvent with qualified audit reports or an external administrator appointed.

PN4 Companies by Board Listing:-

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Main	46	5	4	2
Second	47	10	2	5

By the end of 2004, 67.0% of the PN4 companies have been successful in implementing their re-structuring plans with the assistance of the government agency, Danaharta, which had been charged with the non-performing loans. The re-structuring generally includes asset sales and the re-scheduling of loans. The weak market sentiment did not help. Some

16 companies, however, still remained in the PN4 list at the end of 2005 when Danaharta ceased operations.

Using the data of 21 PN4 companies from the 46 on the main board that complied with the conditions in 2001, it was observed that following the announcement of their poor earnings results in 1998 the already low share prices fell further. The post-announcement drop in share prices following the poor earnings results ranged from -3.12% to a massive -10.01% for the selected companies. The share prices remained low for the specific companies in the absence of positive results with earnings persistence up to the PN4 announcements.

The correlation of earnings and prices was computed using:

$$r_{yx2-x1} = \frac{r_{yx1} - r_{yx2} r_{x1x2}}{\sqrt{1-r_{x1x2}^2} \sqrt{1-r_{yx2}^2}}$$

In the above, r_{yx} is the simple correlation efficient where y is the price and x1 the earnings in period 1. With the data of the 21 companies for the period 1998 up to the PN4 announcement, the results using the average were as follows:

1. 1998 $r_{yx1} = 0.84$
2. 1999 $r_{yx2} = 0.91$
3. 2000 $r_{yx3} = 0.76$
4. 2001 $r_{yx4} = 0.43$

There was high correlation in the three years following the Asian financial crisis as share prices fell with the declining earnings. The correlation had dropped as the continued trend in the decline of the earnings had seemed to be expected. The negative earnings persistence had seemingly erased any expected change by investors as implied by the share prices. There was little, if any, market reaction to the PN4 announcements for those selected companies. The price fluctuation leading to the announcements was less than

1.0%. The information had only confirmed what investors had expected as they become aware of the financial distress conditions with the continuous decline in earnings.

The high borrowings, poor management and agency issues had caused the financial distress of the companies in the PN4 list. One notable PN4 company, TV3, had negative shareholders' equity of MYR193.5 million in 1999. The amount slipped to MYR337.5 million in 2000 before it was placed in the PN4 list.

There had been poor corporate governance in those companies as indicated by the high leverage in borrowings, an inadequate financial risk management and poor management practices to move to a financial position where the liabilities exceed the assets. A high proportion of the PN4 companies were also late in providing their annual reports.

The low share prices in response to the poor earnings of the PN4 companies, although the sample size was small, were expected and supported the literature that investors adjust their expectation to revalue and react to the earnings announcements. The results support the notion that investors are rational and share prices react to the information in the KLSE market in its semi-efficient form.

It is not surprising to learn that financially distressed companies were the biggest losers on the Main Board of the KLSE index in the first eleven months of 2002. Eight out of the ten biggest losers on the index were companies under the PN4 category.¹⁹

A fundamental incentive for a high share price is that it attracts equity and lowers the cost of capital. The earnings affect share price. It is a major factor that drives managers to try to avoid negative earnings surprises. Of course there are other factors such as interest rates, inflation and income tax that affect share prices but earnings have been a significant one. The reasons and motivation to engage in earnings management to support share prices are varied as described in Chapter 3. Managers with their private information are quite often drawn by the force of the reasons and motivation for earnings management. It

¹⁹ Malay Mail, 'PN4 Firms Biggest Losers on Emas Index', December 2, 2002.

is not surprising that large, public-listed companies like Promet and TV3 came under debt-servicing pressures and were placed in the PN4 list. Promet, a large property group which was also involved in oil-exploration in Sarawak and China, was subsequently de-listed and taken over by the Safuan Group, a large property developer.

Managers seek to avoid negative earnings surprises and tend to bundle the bad news with conditional optimistic forecasts. Many offer opportunistic disclosures to offset and reduce the likely impact of the negative earnings. The reasons and incentives for earnings management were numerous and considerable as many companies were unprepared and were badly affected by the economic shock of the Asian financial crisis.

Earnings management received considerable attention during the period and is the focus of the study on public-listed companies in Malaysia. The negative average returns of the stocks were a concern as managers try to provide opportunistic, and sometimes even optimistic information, to detract investors from the poor results.

Secondary data was used in the study for the period after the Asian financial crisis to 2005. Companies in the study have to be already listed on the KLSE in 1997. New listings during the period were excluded from the study. Collecting the necessary accounting data dating back to 1997, however, has not been easy. The data used in the study have been obtained from the KLSE Annual Handbook, the annual reports of the companies held at the Information Centre of Bursa Malaysia, and Datastream. Use of the Information Centre of Bursa Malaysia was charged by the hour. Other required data were sourced from the KLSE-RIAM database, and the Investors Digest, a monthly publication of the KLSE.

The study started with 120 randomly selected companies representing a quarter listed on the main Board of the KLSE in 1997 which were not in the banking and insurance sectors as they have different statutory requirements. As the study requires companies for the study period without replacement, those companies that have missing data or do not have sufficient data needed for the Jones model were removed. Companies with missing data

may be the result of being taken-over or even de-listed. Also, newly listed or new companies during the period are excluded from the study. The 66 companies that remained and used in the study are from the consumer, manufacturing, services, construction and engineering, mining, and plantation sectors. The companies and data used in the study are in Appendix V.

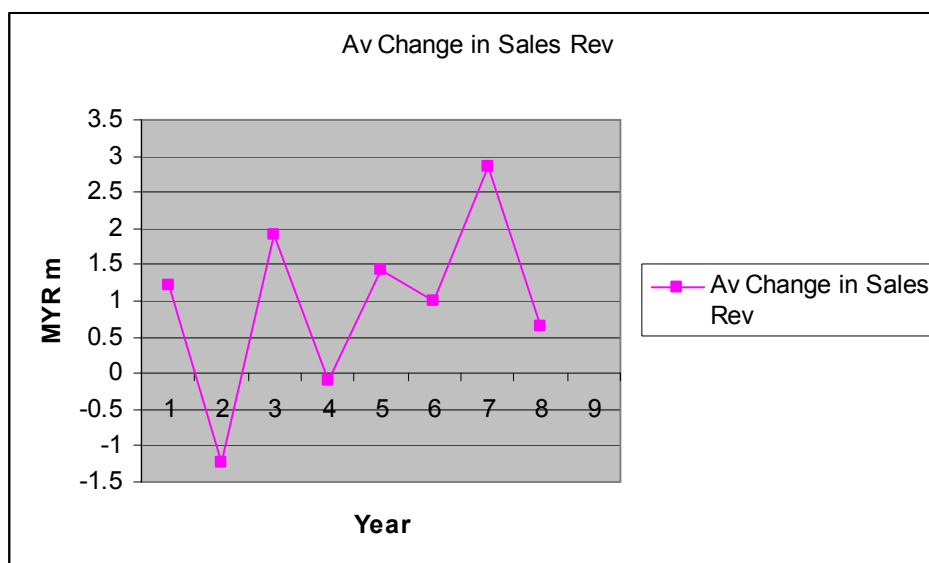
For each of the selected sample, the annual company reports were examined to obtain the required data. The significance of the mean discretionary accrual was assessed using the *t*-test. The test is useful to draw inference from the number of samples used in the study. The *t*-test is used to measure the significant difference in the mean between the samples. For the one-sample *t*-test, the mean and median of discretionary accruals are a positive 0.122 and 0.002 respectively which are not quite zero as the samples had been selected without regard to the size and the industry groups.

While companies in the same industry will generally have similar characteristics, the accruals for the samples selected would be more idiosyncratic. The expected differences allow earnings management to occur. Such practice generally goes unnoticed as it is not always easy to detect. The total accruals are the difference between the net accounting earnings and the operating cash flows. The discretionary accruals depend on management judgment and decisions. It is not surprising then that earnings management is often done through the manipulation of accruals with little need to change the cash flow. The accruals model has been widely used in the study of earnings management. Although the approach and use of the accruals model in the study may limit the ability to allow for differences between companies, it would provide an overall view that is sufficient for the purpose of the study.

The relation between accruals and changes in sales revenue is outlined and empirically summarised in the Jones (1991) accrual model used to examine earnings management. Like the study by Erickson and Wang (1999) using the Jones model, the change in revenues and fixed assets were used in the study of the expected part in total accruals. The revenue from credit sales affect and remain a function of total accruals. Teoh et. al.

(1998) separated the total accruals with the short-term accruals obtained using the regression based on the Jones (1991) model. Current accruals are expected to increase with sales and the corresponding co-efficient for the change of sales is then expected to be positive. The fixed assets were excluded as an explanatory variable in the model.

Using the Malaysian data, the significance of the mean discretionary accrual from the change in sales revenue is assessed with an estimate of the standard error and assuming independence in the accruals of the samples selected. In the study, the first year is treated as year 1 and the preceding one as year 0. To compute the change in revenue, for example, year 1 would be 1998 and the preceding year 0 would then be 1997. The average change in earnings measured by the sales revenue for the period of study as extracted from the annual reports for the sample companies and is illustrated as follows:



From the chart, there were substantial changes in years 2, 3 and 8. Total accruals include working capital accounts such as accounts receivable, inventory and accounts payable that are related to sales revenue to some degree. Working capital accruals are expected to increase revenues resulting in a positive coefficient for change in revenues. The co-efficient on change in revenues using the data was computed to be 0.143 (t -statistic =

3.495). The positive co-efficient is significant and expected in a way. It suggests that earnings have been managed upwards.

The liberal accounting policy choices and the limited disclosures required in the company annual reports affected the type and quality of information available which did not always reflect the economic reality. Opportunistic managers were able to modify and managed earnings through accruals for their purposes. The motivation to manage earnings was greater when the profitability had declined with the adverse economic and trading conditions. Failure to meet the analysts and market expectations can be costly.

For each of the years, the accrual measures for the samples are as follows:

	Year	Mean	Std Deviation	Std Error Mean
1	1997/98	0.110	0.364	0.109
2	1998/99	-0.112	0.269	0.081
3	1999/00	0.061	0.288	0.086
4	2000/01	-0.083	0.371	0.112
5	2001/02	0.129	0.347	0.105
6	2002/03	0.090	0.263	0.079
7	2003/04	0.160	0.306	0.123
8	2004/05	0.091	0.131	0.039

The high standard deviation and standard error mean raises questions on earnings quality and the persistence of discretionary accruals in those years. Earnings management exists. The political influence in the market and the politically-connected companies has brought about practices in disclosure and corporate governance that have been found to be wanting.

Some of the schemes that were observed to have been used in the company annual reports included the capitalization of period costs, the transfer of foreign exchange differences to reserves, and fixed asset revaluations.

There was, however, a marked change in 2005 with a lower standard deviation which indicates an improvement. In recent times the SC has become more aggressive in pursuing errant companies.

Although there is the potential of misspecification as the data was analysed without grouping the sample, for example by industry, the approach is sufficient for purposes of the study.

4.6 Conclusion

The financial strength and performance of many companies were badly affected by the Asian financial crisis. The company share prices declined raising the spectre of breaching the loan conditions. Many had borrowed to expand in the good economic times. The rapid expansion gave cause for agency issues such as adverse selection and moral hazard. It was hard to be sure that there had not been an over-investment. Also, a high proportion of the managers were on some kind of a reward system based on performance. The incentive and motivation to manipulate and manage earnings were there when the economic conditions changed.

The study for the period after the crisis is to determine the quality of earnings and the likelihood of earnings management. It was a period of uncertainty. The share market was in the doldrums, and the economy was slowly recovering before growth declined with world events in 2001. Managers were under pressure to perform to meet market expectations and keep share prices high.

The study on the effect of earnings on share prices was done differently as most had been done in a developed market with expected growth. The negative earnings of companies in

the period preceding the PN4 announcement were used and confirmed the notion that investors are rational. The share prices are adjusted by the market in its semi-efficient form. Earnings affect share prices and are positively correlated as disclosed with the results.

The reason and motivation for earnings management for the period of study when the market was sluggish was high. Failure to meet analysts and market expectations can be costly. The study on earnings management in Malaysia is for the period following the economic shock of the Asian financial crisis with share prices at a low ebb. The sample companies used in the study had a high level of accruals with the large movements in sales revenue during a period of low demand with a contracted economy activity. The results were an indication of poor earnings quality, and the existence of earnings management. The political influence in the market and the politically-connected companies has contributed to the managers' behaviour in earnings management. However, it was observed in the study that there was an improvement in 2005. The government has to do more if it is to change management behaviour and reduce the practice in earnings management further. The accounting standards and new laws without enforcement will do little to reduce, if not eliminate, opportunistic disclosures and earnings management.

Chapter 5. Discussion and Analysis

5.1 General Discussion

The accounting information is to facilitate market monitoring, lower the costs of financing, and increase market efficiency. The literature supports the argument that the quality of accounting information is an important proxy for the development of the securities markets.

The Malaysian authorities recognise the importance of the securities market and have taken steps to improve the accounting information since the Asian financial crisis with new legislation, new regulation, and new measures including the adoption of the International Financial Reporting Standards (IFRS). The better and more transparent accounting information will promote market and economic growth by reducing asymmetry, mobilise savings, increase market efficiency, and facilitate resource allocation to the benefit of all participants.

5.2 The Malaysian Securities Market

5.2.1 Period of Study

The Malaysian securities market has a long history dating back to the British colonial days. The study, however, covered the period from 1997 to 2005. The period is significant as Malaysia was badly affected by the Asian financial crisis in 1997 followed later by a political crisis with the ouster and subsequent conviction of the then Deputy Prime Minister, Anwar Ibrahim. It was also during this period that Malaysia's longest serving Prime Minister, Tun Dr. Mahatir Mohamad, retired after holding the position for 23 years.

The Malaysian securities market, an emerging one, was enjoying robust growth for more than a decade with new listings and a high level of activity with the voluminous

transactions before the Asian financial crisis hit the region. The Asian crisis caused an economic meltdown with currency values and share prices taking a sharp drop, and business activity shrunk which prompted a reversal in foreign investment. Many investors and market participants were caught in the downward spiral and suffered huge financial losses. Borrowers and creditors defaulted in their obligations. Those with overseas borrowings found their loans and interest payments had appreciated. Many who had pledged their shares struggled to provide additional security to satisfy the lending margins and remain financially afloat. The financial and banking sectors took a battering with the number of insolvencies.

When the Asian crisis hit Malaysia, the then Deputy Prime Minister and Finance Minister, Anwar Ibrahim directed the Central Bank (*Bank Negara*) to spend millions in an attempt to support the falling *ringgit* and at the same time raised interest rates. Several public sector projects were deferred and government expenditure was cut. His handling of the crisis caused serious differences with the then Prime Minister, Tun Dr. Mahatir Mohamad. He was dismissed and later jailed. Protests by his supporters that had threatened to lead to social unrest were quickly silenced. The government took drastic steps to shore up the contracting economy and rising unemployment that had reached 5.4% in August 1998. Interest rates that were raised in the wake of the crisis were reduced. The exchange controls were also introduced to stop the outflow of the currency with the *ringgit* pegged to the US dollar.

The Asian financial crisis in 1997, the political crisis with the dismissal of the then Deputy Prime Minister and Finance Minister, was followed by a crisis in confidence in the financial market. Many local and foreign investors stayed away in the aftermath of the tumultuous event of 1997. Questions and issues surfaced. Fund raising in the securities market became difficult and raised the cost of capital for new projects further reducing efficiency in the economy. Efforts to kick-start the economy, including tax incentives, a lower statutory reserve to be held by banks, and reducing the required level of *bumiputera* participation in some industry sectors, were starting to produce results with the gross domestic product (GDP) reaching 5.4% in 1999 from negative growth the

previous year. The government also eased the exchange controls with the economic recovery. However, the recovery took a turn in 2001 when the GDP dropped to about 2.0%. In 2002 the then Prime Minister, Tun Dr. Mahatir Mohamad, made the dramatic announcement of his retirement in the following year. He was replaced by the current Prime Minister, Datuk Seri Abdullah Ahmad Badawi.

5.2.2 Market Performance and Corporate Disclosure

The economic state of the country was also reflected in the Kuala Lumpur stock market. The Kuala Lumpur Stock Exchange Composite Index (KLCI) reached 1300 but lost 500 points within six months as a result of the Asian financial crisis in 1997 before sliding to its lowest ever at 262.70 in September 1998. The market made a recovery in 1999, and the KLCI topped 991.00 in February 2000.

The speed and magnitude of the crisis took many investors in Malaysia by surprise, even sending some broke, raising questions on the quality of the accounting information and management performance. Many felt that they did not receive any warning on the severe economic and financial conditions in the accounting reports or how managers had prepared for those conditions. Some argued that there had been deficiencies and a lack of proper disclosures in the accounting reports to enable them to adjust their investment decisions quickly. There are others who argued on the inadequate monitoring of the managers and their performance by the board of directors. Corporate governance and the role of auditors also came into question.

The Malaysian share market which once had a large number of Chinese family-controlled companies was starting to be dominated by the growing *bumiputera* groups with the assistance of the New Economic Policy (NEP) introduced in 1970 to distribute wealth to the local Malays. Such groups had preference in getting government contracts, and were able to borrow from the local banks such as Bank Bumiputera and Malayan Banking on favourable terms based on the expected profits.

The major parties in the coalition government, through their nominees or trust companies, also hold shares in several public-listed companies. The United Malays National Organisation (UMNO), for example, through the Fleet Group, have shares in the New Straits Times, TV3, and Malayan Banking. The coalition partner, the Malaysian Chinese Association (MCA), has interests in Multi-Purpose Holdings, the Star, and the private Tunku Abdul Rahman College (TARC). The other coalition partner, the Malaysian Indian Congress (MIC), have control and ownership of Maiko Holdings.

The share market allows the corporate sector to raise capital to meet the development goals of the country, and is an effective channel to allocate financial resources efficiently. Economic development and growth are thus related to the market. Companies listed on the KLSE have to provide their operating results twice a year in accordance with the Malaysian accounting standards. However, it is not possible to have standards to cover all the different types of financial transactions and products. Furthermore, some of the standards are ambiguous and subject to interpretation.

In the period before the Asian financial crisis, the Malaysian economy was strong and companies were reporting profits year after year. It was a period of optimism and growth. Acquisitions and mergers were common. There was a rapid expansion of credit as the investments and asset additions were made with bank borrowings, including off-shore loans. The off-shore loans with foreign-currency repayments were generally disclosed in the local currency. The volatility of the foreign-currency and the risk management policy, if any, were not disclosed. The existence and use of derivative instruments to hedge against financial risk were also not disclosed.

The debt levels of many companies increased, and were quite often done with cross guarantees by subsidiaries and related parties. A related party is when the company has control or ownership, and can influence management decisions. The standard on related party only requires the recording of transactions with the receivables or payables at balance date to be stated in the financial statements. The details of such guarantees and

cross guarantees provided to support the debt financing, and the extent of the risk were not disclosed in the accounting reports.

When asset and share values fell in the wake of the Asian crisis, many of the companies with high borrowings and gearing had solvency problems. Companies that had reported profits with substantial amounts in retained earnings defaulted with their loan repayments. It was difficult to comprehend that seemingly successful companies could be short of cash, forcing staff redundancies, selling assets, and reducing operations to remain financially afloat.

The concern for the quality of accounting reports increases as the economy decreases. Many of the companies had not adjusted for the decline in values of the company assets in the accounting reports. The accounting standard requires an adjustment or provision only if there is a permanent diminution in value. Many of the managers did not view the decline in values as a permanent diminution, and that the economic shock of the Asian crisis was treated as just an aberration. After all, Malaysia did recover from the last recession in 1986.

Accounting allows managers to make decisions and use their discretion on certain accounting policies and treatment. When the economy shrunk and the property and share values fell during the Asian crisis, trading conditions changed dramatically. Credit and accounts receivable became difficult and problematic. The cash cycle deteriorated and became stretched. Money was tight. Despite the adverse economic and financial conditions, many managers chose not to write-down or make provision for the declining asset values. Managers also chose to defer the recognition of potential claims against their companies.

There was an increase in credit defaults. The collateral pledged to the banks for loans had been based on expected increases in asset values. When the lending banks tried to enforce the corporate undertakings, the property assets and collateral provided as security could not satisfy the debts. The enforcement of the guarantees and cross-guarantees threatened

to expose the cosy arrangements and special relationships of some of the companies with the banks. The number of non-performing loans increased as the banks held off action. The non-performing loans reached MYR79.4 billion at the end of 1999 (Bank Negara, 1999-2000 Annual Report). Together with the depreciation of the *ringgit* the financial strength of the banks was considerably weakened undermining confidence. The institutions with the most non-performing loans were the local Sime Bank and Bank Bumiputera. Credit tightened as the banking system became distressed.

The government also had an interest to address the widespread losses and defaults to lenders from impaired assets in the balance sheets. Information that an asset is impaired represents a loss which may also affect the cash flow. Impairment against the revenue is subjective relative to the corporate assets such as property, plant and equipment, and is not determined solely on the basis of the accounting standard.

The accounting reports prepared in accordance with the accounting standards and certified by the independent auditor to give a true and fair view of the operating results and financial position became increasingly questioned. The Asian crisis had disclosed deficiencies and inadequate disclosures in the accounting reports with the reporting framework then. The managers who are involved in the operations of companies may have private information, for example on the cash flows, which could not be observed by auditors. The literature provides the opportunistic perspective of managers with incentives and motivation to not disclose all available information which is not symmetric. Timely recognition of gains or losses reduces the asymmetry.

The auditors are required to report on the financial statements provided by management. The professional standards only require auditors to detect material misstatements. Auditors then plan and work to that end. In a typical audit, they rely on the accounting records and information provided by management to verify the existence of tangible assets and confirm account balances. It is the responsibility of directors and management to provide adequate and accurate accounting information. The auditors' responsibility follows with the report whether the accounts provided by the directors are true and fair.

There is, however, much confusion on the role and responsibility of auditors. *In re Kingston Cotton Mill* (No. 2) [1896] 2 Ch 279 at 289, Lopes LJ described the auditor and his role as:

An auditor is not bound to be a detective or..... to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound.

That principle still holds for the statutory auditor although the market expectations and changes to the law have widened the scope of the audit in recent times.

The accounting reports and the role of the auditors, and the governance and management control systems failed investors and other stake-holders when trading of the company shares were suspended, companies placed on the watch list of the KLSE, or placed in placed in the hands of receivers and liquidators.

Wembley Industries Holdings and the SCK Group were the early public-listed to be placed in the hands of receivers and liquidators. Time Engineering, part of the large Renong conglomerate filed for protection under Section 176 of the Companies Act. The KLSE amended the listing requirements in the aftermath of the Asian crisis, and introduced PN4 (Public Notice 4) for financially weak or distressed companies. The number of PN4 companies for the first three years were as follows:

	2001	2002	2003
Main Board	46	5	4
Second Board	47	10	2

(Source: *Bursa Malaysia*)

Some 93 public-listed companies announced their distressed conditions under PN4 in 2001. By the end of 2004, 40 PN4 companies remained.

The government had to rescue some of the heavily indebted, financially weak strategic companies like Malaysian Airlines through government-controlled funds. A government-controlled organisation, *Danaharta*, was also established to help companies to restructure rather than to liquidate. The Securities Commission (SC) following its investigation reported in 2001 that many of the PN4 companies have been caused by mismanagement.

The share market allows the corporate sector to raise capital to meet the development goals of the country, and is an effective channel to allocate financial resources efficiently. Activity in the Malaysian share market has not reached pre-crisis levels as a significant number of local and foreign investors have not returned.

5.3 Post-Crisis

5.3.1 Regulations and Measures

The Malaysian government is always challenged to maintain economic and financial stability for growth. During the crisis of 1986 when the economy shrank and the share market declined the government privatised projects, and provided incentives to attract foreign investment. One ambitious government project was the MYR4.7 billion North-South Toll Expressway. The project was awarded to United Engineers Malaysia (UEM), an ailing public company with trading of its shares suspended by the KLSE for a long period. The company was then majority owned by Hatibudi, a *bumiputera* company which is alleged to have links to UMNO (Jomo, 1999). The parliamentary leader of the opposition party, Lim Kit Siang, challenged the award of the contract to an ailing company which has never built an expressway in the High Court but was rejected on the grounds that he had no *locus standi*. The North-South Toll Expressway project went ahead and boosted the economy with a construction-led recovery. Other publicly listed companies owned or controlled by UEM such as Time Engineering also benefited substantially from other privatisation projects. No new regulatory measure was introduced.

A different approach was taken with the 1997 Asian financial crisis as the local currency had depreciated. The government lifted interest rates, deferred several projects and cut back on expenditure. New legislation, regulations and measures were later introduced that included rationalisation of the weakened stock-broking industry with mergers, enhancing the market mechanism and competitiveness, improving corporate reporting and governance, and the protection of minority shareholders. The regulations and measures taken are to address the questions and issues that have surfaced during the Asian crisis.

Corporate governance is about internal control systems to monitor the management with the objective of enhancing shareholders' value. The U.K. Cadbury Report (1992) defined corporate governance as the system by which companies are controlled and directed (p.15). The Report also recommended the establishment of audit committees and the use of independent directors. The audit committee is a sub-committee of the board of directors. Following the Cadbury Report, the London Stock Exchange in 1993 made audit committees mandatory for public-listed companies.

Malaysia also followed with the KLSE requiring public-listed companies to establish audit committees by 1st August 1994. However, the effectiveness of the audit committees to carry out the financial reporting oversight has been mixed.

To improve corporate reporting and corporate governance, the government established the Malaysian Accounting Standards Board (MASB) under the Financial Reporting Act (1997). The MASB effectively took over the accounting standards development and setting process previously performed by the Malaysian Institute of Accountants (MIA) established under the Accountants Act (1967). Many accounting standards of the MIA had been based on the International Accounting Standards (IAS). It became mandatory for preparers and issuers of accounting reports to comply with the MASB approved accounting standards which were the existing standards of the MIA. Public-listed

companies have to also comply with the Companies Act and the KLSE Listing Requirements.

The Securities Commission (SC) is charged with the regulation and development of the securities industry, and the improvement of corporate governance amongst public listed companies. It oversees the operations of the KLSE, and it has powers under the Act to prosecute directors and companies for breaches. Investor protection is its priority, and it is also responsible for enforcing compliance with the MASB accounting standards. In 1999 the SC warned company directors and advisers against misleading information as the numerous announcements and statements on the future prospects and corporate proposals in that year. Recently, it has become more active and took action against company directors for deficiencies in the accounts. Oilcorp was directed to re-issue its 2003 accounts and Aktif Lifestyle its 2004 accounts. It has also charged Mr. Chin Chan Leong, the director of Fountain View, for manipulating the company shares in 2005. So far action has only been taken against the smaller public listed companies. The SC, however, continues to take action against errant directors but seem to be only scratching the surface.

The period after the Asian crisis has become more regulated with enforcement on account deficiencies and non-compliance of the law. Public-listed companies must have independent directors and a corporate governance system with the new KLSE Listing Requirements. The Malaysian Code of Corporate Governance issued by the SC in 2000 requires a third of the board to be independent directors. The KLSE define independent directors as those who are not officers of the company, not related to the officers or have family shareholding in the company, and are free of any relationship to exercise their judgement. They are required to disclose their compliance with the Malaysian Code on Corporate Governance, and the state of internal control to safeguard the shareholders' investment and company assets. Good corporate governance and internal control systems are expected to reduce vulnerability to financial crises and assist with market growth.

Malaysia has moved towards a disclosure based regulation. The changes are to provide better accountability and transparency with timely information and quality accounting reports for a more efficient market. The MASB has also moved to adopt the International Financial Reporting Standards (IFRS) to commence in January 2006.

5.3.2 Earnings and Quality of Reports

Investors buying shares in listed companies are driven by the expectation of the value increasing and profit. Under the efficient market hypothesis, share prices reflect all the information available. The strong form efficient market is when even private information is quickly incorporated in the share price and there is no likelihood of an abnormal gain or loss. However, in a semi-strong efficient market like Malaysia, the response to new information is expected to be sufficiently quick. According to the theory, no one earns abnormal returns or gains from trading based on information in a semi-strong market.

Analysts value company shares based on the earnings from its normal operating activities, and taking into consideration the future potential. However, the managerial opportunism and agency problems could lead to inadequate or inappropriate accounting measurements that affect share values. The practice and the poor quality of earnings are not new in the corporate sector, but when detected can increase the cost of capital considerably.

Disclosure in the context of Malaysian listed companies can be broken down into two broad areas, namely primary market disclosure and continuous disclosure. Primary disclosure is at its most vital in connection with initial public offerings. The disclosure obligations are contained in the Companies Act 1965 and the Securities Commission Act 1993.

The raft of regulatory changes and measures following the Asian crisis suggest that the quality of the corporate disclosures and reports in Malaysia have been poor. Those

disclosures and reports have been prepared using the applicable accounting standards. The practice of modifying the IAS to suit the local conditions has been subjective and ambiguous in several instances. The Cash Flow Statement, for example, can be prepared using the balance sheet or cash method. Also, deferred expenditure on research and expenditure in the balance sheet can be carried forward with little or no consideration for the potential future benefit and the impairment of the asset. Other account items which were not clear and subject to interpretation in disclosure include:

- Related party lending and borrowing.
- Foreign currency debt.
- Derivative financial instruments.

The reference to subsidiary and associated companies as related parties in the accounting standard was too simplistic. It was later extended to companies where directors have an interest. The foreign currency debts have to be disclosed in the local currency under the accounting standard but there was no clear direction on the repayment in the foreign currency. It was also not the practice then to report on the foreign exchange risk exposure as Malaysia had stable economy with a decade of growth before the Asian crisis. The derivative financial instruments are subject to future outcomes, and the future is never easy to predict. Many companies did not disclose guarantees given for loans.

The lack of uniformity and completeness in disclosure affected transparency. Companies are generally reluctant to disclose more than the minimum, afraid to divulge too much to competitors and possibly, the authorities. Neoh (1996) in his study of share movements in Malaysia had reported that there is no consistency in the corporate reports.

The Companies Act requires all companies, private and public, to have their accounts audited. The directors, with many involved in the management of the companies, are responsible for the preparation and presentation of the financial statements, and auditors attest to the truth and fairness. However, companies which had performed well with reported profits and had received unqualified reports from auditors became insolvent with

the Asian crisis. There was an estimated 800 companies that had receivers and liquidators appointed in 1996. The figure was almost 5,000 in 1998 (source: Corporate Debt Restructuring Committee, 1999).

Auditors had failed investors. Questions were raised on the role and responsibilities of auditors in many of the corporate failures. Had the auditors succumb to management pressure to accept misleading financial statements? However, there has never ever been a reported litigation case against auditors in the history of the country. The auditors generally attribute the failure of companies to the inadequate financial reporting framework as their defence.

The level of work performed and deemed sufficient by the auditor is different to that perceived by investors and users of financial statements. The audit expectation gap notion is not new and had been raised in the 1970s. The Cohen Commission was established in the U.S. in 1974 to consider whether a gap exists between what the public expects or needs and what auditors can and should reasonably accomplish. In Australia, the Australian CPA and the Institute of Chartered Accountants (ICAA) issued a major research paper in 1994 highlighting the need to address the expectation gap issue. Investors seem to have a higher expectation from an audit on disclosure, internal control, fraud and “illegal operations”.

Humphrey, Moizer and Turley (1993) in a survey study identified audit independence as a key element of the audit expectations gap. Although the performance of the auditor is expected to be higher, auditors are no longer able to provide consultancy services with the specialist staff that have the appropriate knowledge and skills. Auditors would struggle to retain the specialised staff in such areas as computer technology and actuarial science needed to perform complex audits. The high costs associated with keeping the specialist staff may be expensive to absorb if not fully charged out.

Changes to market expectations and the professional standards with Malaysia's adoption of the International Standards on Auditing (ISA) require auditors to extend their work

including a review of the risk management policies and the corporate governance system. The auditor has to also consider fraud and error in the audit of financial statements. It remains contentious whether better quality auditors are able to detect fraud and account irregularities including earnings management. Professional judgement with technical competence and leadership to handle situations form the basis for the auditor to fulfil his role and the general market expectation. It is no longer enough to state that there is no material misstatement in the accounts. The role and expectation from the work of the auditor has changed with the failures of companies, and more so with the collapse of Enron and WorldCom in the U.S. The passing of the Sarbanes-Oxley Act in the U.S. has made complying with accounting and auditing standards no longer an adequate defence.

Investors have seem to expect that an audit is an assurance of financial health. The audit expectation gap notion is not new. It was first raised thirty years ago and continues to dominate debate. It has been Defensive auditing. The US Courts and the SEC

Quality accounts reporting require accruals. However, accruals have been used in accounts manipulation and earnings management. Accruals are difficult to be observed by the auditor. The use of accruals in earnings management has received considerable interest in the past and is well documented in the literature. Archibald (1967) studied the use of depreciation, and Cushing (1969) on accounting changes. Beidelmen (1973) showed incentive compensation, research and development costs, retirement, and sales and marketing expenses were used by companies to manage earnings. Ronen and Sadan (1975) studied the use of extraordinary items.

Managers were under considerable pressure to perform during and in the aftermath of the Asian crisis under difficult economic and financial conditions. The study on earnings covered 71 companies selected at random listed on the KLSE. A brief review of the annual reports of the sample for the years 1997 to 2005 disclosed the widespread use of extraordinary or abnormal items in the two years immediately after the Asian crisis. An extraordinary item is a major transaction that is not likely to occur again whereas an abnormal item is a recurring one but is significantly different in amount against other

years. The use of those items indicates managers were struggling to adjust to the deteriorating financial position of the companies.

Managers under pressure to achieve the forecast or expected operating results and financial performance during the Asian crisis would be inclined to engage in earnings management. Managers of companies with debt-servicing problems were also likely to engage in earnings management. Accruals in accounting are susceptible to earnings management and are difficult to detect by the unassuming user of the financial information. The Jones accrual model which has been widely used in studies elsewhere was used to determine the existence of earnings management using the Malaysian data.

The Jones model is applied to the sample data to measure discretionary accruals. The discretionary accruals are regressed for the different companies for each of the years. The accruals were extracted from the balance sheet, and using the mean for the years 1998 to 2005 it is not surprising then that the results should have high standard deviations in the years following the Asian crisis. It was the period of anxiety and uncertainty as the economy shrunk, and company earnings suffered. The high standard deviations indicate that the quality of earning reports by companies were weak with the likely practice of earnings management. Although new regulations and measures had been introduced to improve the accounting information and reports, the high standard deviations continued to 2004. There was a noticeable improvement, however, in 2005.

The delayed improvement could be due to the listed companies adjusting to the regulatory regime. The regulations and measures require understanding. Some parts are unclear with the meaning subject to interpretation. Opinions and views were sought as companies struggle to comply with the requirements. New computers and systems had to be obtained in some cases further stretching the financial resources.

It is no easy task to adjust and comply with the changing reporting requirements. There are some companies that have expanded and grown large with the assistance of the NEP. The NEP was designed to advance the economic position of the *bumiputeras*, and the

accelerated ownership of companies with generous bank loans allowed entrepreneurs with political connections to invest and expand. The purchased assets were often pledged to the banks as collateral. The fall in share and asset values weakened the companies with some struggling to stay financially afloat.

Managers were developing a siege mentality as many had to fend off possible action by the banks, reduce operating activities to meet the lower demand, and comply with the increasing number of regulations and measures. Accounting disclosures require management judgement and estimates in a dynamic business environment. The managers responsible for the disclosures quite often inter-act in the market with suppliers and customers. They are likely to collect considerable information on the industry. However, they do not fully and accurately disclose all necessary information. The incentive and motivation for such behaviour could be their reputation, to save jobs, to avoid restrictions on accounting-based constraints in loan agreements or to avoid the costs of breaching borrowing terms, and market expectations. Such behaviour may affect the accounting disclosures and earnings which could be viewed as an attempt to manipulate reality to mislead external parties.

Although Malaysia adopted the IAS modified to suit the local conditions, the mixed findings on compliance with the required accounting and reporting practices suggest the absence of appropriate enforcement efforts in that country. A review of the sample companies, for example, disclosed the amounts of inter-company receivables and payables, but many had little or no disclosure on lending and borrowing activities with the associated companies. It may be that such companies do not form part of the consolidated group accounts. There did not seem to be a uniform practice on related party transactions.

Related party lending and borrowing could be difficult to follow in some cases with the clever use of nominee companies, cross-holdings and hybrid arrangements. Depending on how the transactions are structured, they might not even been recorded and reported.

It was also observed that those sample companies with foreign currency loans did not disclose their accounting policy on foreign currency risk management. It may be complacency after a long period of economic and financial stability. A high number of the sample companies use derivative financial instruments and whilst the amounts were disclosed, there was no note on the risk associated with the issuance of these.

The disclosures on contingent liabilities were often by way of a short note. They are not always quantified and were subject to some future outcome. Most of the sample companies had no disclosure of guarantees or cross-guarantees provided to related parties.

The inadequate disclosure and practice affected the dissemination of useful information and transparency in the financial statements. The users of the financial statements would have known of the financial performance and the weakening conditions of companies had all the generally accepted international accounting and valuation standards been used.

The new regulations and the adoption of the IFRS are to stop the inadequate and often differing practice in financial disclosures and reports. Compliance will ensure more meaningful and uniform reports are provided. The SC has been tasked with enforcement of the laws and standards in relation to accounting disclosures and reports. The enforcement actions and the penalties should act as a deterrent for inadequate and incorrect reports.

The enforcement provisions of the SC are outlined in the Act but it is only in recent years that those provisions have been publicised and used more actively. It may have been the enforcement actions by the SC that has contributed to an improvement in the quality of accounting information with less earnings management in 2005 as reflected in the study results. The SC has issued reprimands and requested several companies to re-state their accounts due to certain deficiencies. Actions that have reached the court are few, and mainly involved the smaller Chinese companies. The regulators often act to their self-interest with utility maximisation which may not always be to the public interest. The handling of the Renong-UEM deal is one such example.

The SC is under the purview of the Ministry of Finance. Senior officers have been known to be rewarded with company directorships and other public office upon retirement. It is therefore not to the interest of the bureaucrats to act against the large *bumiputera* companies connected to the government.

Under the IFRS, assets would have to be verified for impairment and liabilities recognised as they come due. The objective of the IFRS is to make accounting disclosures and reports comparable and understandable for users. There will also be no need to adjust the accounts from one country to another as companies compete in the global market. However, even with the IFRS management judgement and estimates are still required in accounting measurements. The human element remains. As it is not possible to have clad-iron rules and measures, the accounting standards and the requirements will be cleverly circumvented by accountants and practitioners. The SC and other authorities will continually be tested.

The SC and the authorities should also consider promoting the benefits of compliance rather than just wielding the big stick. There is the incentive for companies to abide by the rules and measures with better and more extensive disclosures. Such companies are quite often rewarded with higher prices and a lower cost of capital as their reputation and standing grows.

If the KLSE market is efficient, accounting information is circulated quickly and interpreted correctly. Such timely and useful information will assist investors and users in their decision-making. Whilst the financial statements cannot precipitate a regional crisis as happened in 1997, they should provide measurements and indications of the company performance and its ability to weather one.

The channels of communication and the dissemination of information in Malaysia remain disparate as access to information on the internet is limited to those who can afford the

technology. Many then rely on friends and the informal channels which may not be reliable.

5.3.3 Corporate Governance

Corporate governance received considerable attention after the Asian crisis. It is the way managers are responsible to the stakeholders, and how decisions are made that directly affects them. The management of a large company can be complex with dynamic processes that need to be attended to continuously under competitive conditions. Good corporate governance is linked to a high level of accountability and transparency in the processes and decisions made.

Both quality reporting and adequate corporate governance are critical in efforts to increase market confidence and participation by investors. Malaysia competes in the global market for foreign investment, and accordingly must adapt to internationally accepted standards and practice to be successful. There is also the need to continuously monitor and adjust for changes in the economic circumstances.

The government's involvement in business and the NEP have drawn much concern and consternation. The government support for selected *bumiputera* companies have allowed them to expand with easy loans. Many of these *bumiputera* companies have been awarded government privatisation projects on non-competitive terms. Such policies are neither effective nor efficient for the growth and development of the securities market and the national economy.

Several highly leveraged *bumiputera* companies such as the Malaysian Airlines System (MAS) with debt and solvency problems during the Asian crisis had to seek the assistance of the government. The government re-purchased the company shares and replaced the chief executive. A much publicised case is the Renong-UEM bail-out through government-controlled funds.

The share price of UEM, the company awarded the North-South Toll Expressway project years earlier, was MYR24 at the beginning of 1997. However, the company was embroiled in another controversy in November 1997 when it took a short-term loan to acquire a 32.6% stake in its holding company, Renong, at an inflated price of MYR2.34 billion without consulting its minority shareholders. No disclosure was made as required under the KLSE listing requirements even though the stake was more than 5%. There was also inconsistency in the announcements made by UEM to the KLSE. When the KLSE questioned UEM about the date of the acquisition, the reply was it had acquired the 722.9 million Renong shares on 17th November 1997. However, in January 1998 UEM announced that the said Renong shares had in fact been acquired over a period of time up to 17th November 1997. UEM was fined MYR 100,000 by the KLSE for breaching the disclosure provisions under the listing requirements. The government, through the SC, later issued a controversial waiver to exempt UEM from making a general offer for the other Renong shares it did not hold²⁰.

Renong is a large *bumiputera* conglomerate with diversified activities in engineering, toll-road operations, financial services, and gas projects. The company has a complicated structure of holdings and cross-holdings of other companies. It owns 37.1% of UEM. The company, however, carried substantial risk with its high level of leverage and wide business focus. It had debts estimated to be in excess of MYR20 billion.

The Renong-UEM deal was widely construed as a bail-out of Renong which was not a benefit to the other shareholders. The deal was a serious break-down of corporate governance. The general rules of transparency had not been followed and caused an outcry from minority shareholders and other investors. The market reaction was swift. The UEM share price dropped to MYR3.00, and Renong, once a favourite of investors, was also punished with the share price dropping to less than MYR1 in the week the deal was announced.

²⁰ Gomez, E.T., and Jomo, K.S., 'Malaysia's Political Economy: Politics, Patronage, and Profits', Cambridge University Press, 1997, p. 119-120.

The government had to subsequently bail-out the Renong-UEM group when the executive chairman, Halim Saad, failed to solve the mounting debts. Once again public funds had to be used when the government had to intervene. A more laissez-faire government would have allowed the group to seek other alternative solutions to stay afloat or sink. However, the government could not allow the group to sink with the toll concession and the guarantees given for the finance of the infrastructure projects. The group was subsequently re-structured and UEM World later took over Renong.

The bail-out was a setback for the NEP that had been used to accelerate the development and growth of *bumiputera* entrepreneurs and companies to narrow the income gap between the Chinese and Malays. The NEP which had helped *bumiputera* entrepreneurs and companies, especially with UMNO connections, obtain government infrastructure projects, concessions and licences had become costly with disappointing results. By the end of 2001, the government had, directly or indirectly, ownership of 7 of the 10 largest KLSE listed companies.

The political influence in the market with the corporate failures and government bail-outs did not sit comfortably with investors. There have been changes to improve corporate governance with the Malaysian Code of Corporate Governance, and for listed companies to issue statements that the code has been complied with. The laws and code are intended to check management behaviour and agency issues for better accountability and transparency. Whilst the law and the code require corporate governance systems to be in place, it is the practice by those involved that is important for the desired outcomes. The effectiveness of corporate governance is dependent on the people tasked with that role. Those with the right knowledge and experience can be expected to contribute more.

Openness with appropriate and timely reporting allows for better monitoring and control of performance which allows for specialisation with competitive advantages that can lead to growth in earnings. The effect in the stock market and to share prices is positive when there is growth.

5.4 Malaysian Market

5.4.1 The KLSE

The KLSE operates a fully integrated stock exchange with related activities that include trading, clearing, settlement and depository services. It has a statutory duty to act in the public interest, and is also responsible for the monitoring of the market and ensure adherence to its Listing Requirements by listed companies. KLSE listing requirements include minimum quantitative standards, admission procedures, a disclosure policy and, in some cases, a moratorium on disposal of shares. The continuous disclosure and reporting obligations required under the listing requirements are as follows:

- (a) To publish financial statements on a quarterly basis within two months after the end of each financial quarter.
- (b) To furnish annual audited accounts, auditor's and directors' reports within 4 months from the end of the financial year.
- (c) To state the extent to which they have complied with the Malaysian Code on Corporate Governance.
- (d) To make immediate public disclosure of all material information (irrespective of whether of a financial nature or not) concerning its affairs, and in particular concerning the following:

The powers of KLSE were strengthened with the amendments to the Securities Industry Act in 1999. The amendment allows KLSE to take action against not only the listed companies, but also the directors and any person involved with its listing requirements.

The KLSE is governed by a board of directors. The KLSE can hardly be described as autonomous and independent. The Ministry of Finance has representatives on the board of the KLSE, and appoints the chairman. The KLSE became a public company under the Demutualisation Act in 2004, and transferred the securities exchange business to its wholly-owned subsidiary, Bursa Malaysia. Even though the KLSE was re-structured, the Ministry of Finance still has an interest.

The government recognises the importance of the market as it functions to mobilise and allocate resources to support economic development and growth. The privatisation programs and the funding needs have dominated the market in the past. Several of the major privatisation programs have been awarded to *bumiputera* companies with alleged links to the government. The government representation at the KLSE too has been criticised as it is contrary to the objective for a free and efficient market. An objective that is difficult to support with the perceived control and involvement of the government with the NEP.

5.4.2 Performance

The share market promotes the allocation and distribution of economic resources through decisions based on the fair and competitive transactions. The free market system allows private companies to grow and create employment opportunities. The level of activity is an indication of confidence in the market and the economy.

The KLSE market had a rapid expansion in the years before 1997. The share market enjoyed a boom with new listings and increased market capitalisation until the Asian crisis hit as shown by the following table-

Table 5.1

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
New Listings (Main Board)	40	25	6	10	12	6	22	16	15	14
Market Capitalisation (MYR billion)	746.0	354.1	353.4	527.6	423.9	444.3	464.5	610.3	692.5	689.8

(Source: Bursa Malaysia)

The KLSE had 40 new listings and a market capitalisation of MYR746.0 billion in the year before the Asian financial crisis struck. New listings and activity dropped in 1997 and 1998 before recovering in 1999. It has been a roller-coaster ride for the KLSE, and has not reached the pre-crisis levels up to 2005.

The country needs both direct and indirect foreign investment to boost the economy. The share market is a reflection of the state of the economy, and the government has introduced various regulations and new measures to strengthen the share market industry. In addition to improving accounting information and corporate governance other measures included reducing the number of stock-broking firms through consolidation as many had been financially weakened with credit defaults, enhancing the market mechanism and competitiveness, and the protection of minority shareholders.

A strong financial accounting and disclosure system that supports the share price is needed for an active and vibrant market (Black, 2000). The regulations and measures to improve the accounting information and corporate governance are to promote an efficient market with company shares priced at fair value. Shares of companies with positive results and good management are often sought by investors. The demand attract higher prices. However, the regulations and measures are not enough to restore confidence. There should be enforcement with penalties for non-compliance. The inadequate enforcement system with cautions and reprimands in the five years after the Asian crisis did little to deter divergent behaviour. The government's waiver of rules and the bail-out of companies with close connections to the government, especially the Renong-UEM group which had several privatisation projects, was a serious break in the implementing and enforcing of the regulations and measures introduced. There is the belief and expectation that the support for connected companies remains, and the government may once again intervene for those in strife. It has invariably dented the market confidence and the perceived efforts to improve accounting information and financial transparency. Investors remain sceptical about the government intentions which have dampened the overall market.

The growing number of institutional investors in the market is expected to instil greater discipline in reporting to meet their expectations and requirements. However, an adequate and strict monitoring with enforcement of the regulations and measures are necessary to ensure compliance for a uniform reporting and practice in the country. Enforcement without bias and political influence would raise market confidence and safeguard minority shareholders. It would also keep managers in check with a swift response by the authorities to divergent and errant companies.

As Malaysia moves towards the global economy, it is clear that the old culture and management practice have to change for global standards. The local companies could benefit from the multi-national companies and investors that already have the experience and possess sound financial and management practices to provide adequate disclosures and quality financial reports. The multi-national companies are also likely to have effective corporate governance systems in place with their expertise to safeguard their assets and investment in the different countries.

Foreign investment, especially the direct investment has contributed to the development of the industrial and manufacturing sector in the country bolstering domestic capital, productivity and employment. The pull factors are available labour, raw materials, market, political stability, geographical position, and the incentives provided. The Malaysian government actively promotes and has taken several initiatives since the Asian crisis to attract foreign capital and investment to the country. Foreign direct investment promotes growth and has benefited the country. As such the government has adopted more liberal, market-based policies removing tariffs for several thousand items, and relaxed the rules for foreign equity holding in several industries. For example, foreign equity holding in the telecommunications sector has been increased to 61% from 49% previously allowed. It also offers exemptions, fiscal and tax incentives for selected industries as competition for a share of the global foreign investment from neighbouring and other countries are high. China, for example, has managed to attract substantial foreign direct investment with its low wages and abundant labour.

Despite the government initiatives and incentives, new foreign investment into Malaysia has been slow. The world events, the increased price of oil, and the prolonged uncertainty in the global economy have been contributing factors. Another factor is the government screening and control of direct foreign investments in the country as licences are required for all businesses. Such licenses may also have conditions on *bumiputera* equity and performance.

The table below illustrates the trend of net direct foreign investment:

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
MYR million	18,356	17,790	10,648	14,801	14,393	2,105	12,173	9,397	12,368	12,479

(Source: Bank Negara)

Net direct foreign investment is after taking into account the outflows resulting from liquidation and loan repayments. The indirect foreign investments in equities generally follow the pattern of direct investments as the incentives and motivation for profit are similar.

If investments and fair market-based competition drives progress, it is difficult to reconcile to the government's involvement and influence in the market and economy. The ruling coalition has a majority in government and is known to change policies quickly when the need arises. The exchange and currency controls are a reminder of how the government can make policy changes when the economy necessitates. Changes made abruptly or arbitrarily affect stability in growth and planning for new investments.

There must be productivity increases for investments to grow. The capital and equipment from foreign investment bring new technologies and better processes to the country. The new skills and knowledge acquired should improve productivity which in turn will further attract new investments. In the competitive market, most companies try to do more for less. However, the ongoing NEP that favours and requires *bumiputera* equity

participation and employment in companies has been a dampener. The NEP also runs against the principle of non-discrimination advocated by the World Trade Organisation (WTO) and also reduces efficiencies and productivity in the market and the economy. The public sector, dominated by one racial group, has the potential to raise tensions and frustrations with those who have received less attention to their social and economic needs.

5.5 Conclusion

The accounting reports and practice in Malaysia were inadequate when the Asian financial crisis struck the region. There had been no warning from the auditors who attested and certified the reports. The role and responsibility of the auditor in the financial failures of companies were questioned as the investors and stakeholders lost substantial amounts. The needs and expectation of the financial statement users is different to that perceived by the auditor.

The stock market has an important role and function in the allocation of capital resources for economic growth and development. The many regulations and measures to improve accounting reports and corporate governance are to resuscitate activity in the market and the economy. A vibrant and active market will bring social benefits with higher liquidity. However, recovery has been slow as the regulations and measures take time to be implemented and enforced.

The poor quality of accounting reports with the likelihood of earnings management continued for several years to 2004 before there was evidence of improvement from the study results. The quality and adequacy of disclosure has an effect on the share market. Enforcement is to encourage management behaviour and compliance. However, the enforcement action by the SC has been few but it is slowly getting noticed with some effect. The NEP and companies with connections to the government remain sensitive as enforcement action for non-compliance may appear to be compromised.

The disclosure and transparency in financial information with good corporate governance is to improve accountability and strengthen investor confidence. However, the disclosure and transparency so often repeated by the government, have not reached the levels of the International Monetary Fund (IMF) and other international agencies. Foreign investors have remained cautious and have not rushed back to the Malaysian market.

Chapter 6. Conclusion and Recommendations

6.1 Conclusion

6.1.1 Malaysia – An Emerging Market

Malaysia, strategically located in South-East Asia had a decade of strong growth before the Asian financial crisis struck the region. The local currency fell rapidly against the US dollar as investors moved their money elsewhere. The share prices plunged with the economy shrinking as unemployment rose and demand declined. The initial government reaction to the crisis was raising interest rates and reducing the public sector expenditure.

With the decline in share and asset values during the Asian crisis, many companies that were reporting profits with supposedly strong reserves had solvency problems. The high number of credit default and non-performing loans by companies and individuals eroded the financial strength of the banks. Many had borrowed heavily when the economy was strong and business conditions were good. Some had pledged shares of their public-listed companies as collateral to the banks. The lending practice and easy loans threatened the financial system.

Many companies including those listed on the Kuala Lumpur Stock Exchange (KLSE) struggled under the changed economic and financial conditions. Those which had taken out foreign currency loans suffered even more before the government controversially introduced the exchange controls and pegged the currency to the U.S. dollar.

The investors and lending banks that had relied on the financial statements and reports made available for their decisions were disappointed. There was no disclosure of the risk management policy and the exposure, and there was no warning of the deteriorating financial position of the companies.

The financial statements had been prepared and issued under the relevant legislation and the prevailing accounting standards then. Auditors have also attested and certified to the

truth and fairness of those statements. Those statements and the corporate governance system failed investors and other users during the crisis.

The stock exchange enables companies to raise funds for expansion, and has contributed to the growth and development of the economy. It had allowed the government to privatise several infrastructure projects. The KLSE which had been strong and vibrant in tandem with the economy became subdued following the Asian crisis. The intervention and the bail-out by the government of several *bumiputera* companies, including a large conglomerate, did little to restore confidence in the market.

6.1.2 Disclosure and Corporate Governance

The financial reporting and corporate governance came under close scrutiny as contributing factors to the crisis. The financial information and disclosures contained in the annual company reports were inadequate, ambiguous, and sometimes difficult to understand. The accounting standards used in preparing the reports had been issued by the professional bodies, the Malaysian Association of Certified Public Accountants (MACPA) and the Malaysian Institute of Accountants (MIA). Quite often the standards, such as on related party transactions and goodwill, were subject to interpretation and judgement which could produce very different results. The quality and usefulness of the financial information and disclosures were increasingly questioned.

A raft of new regulations and measures were introduced by the government to enhance reporting and corporate governance. The changes are to make financial information and disclosures more accurate with adequate, reliable data and information to enable investors and users to make decisions. Starting with the Financial Reporting Act that was legislated in 1997, the Malaysian Accounting Standards Board (MASB) was established. The Board replaced the standard setting by the professional bodies with a wider representation which included representatives from the government and industry. The KLSE amended its

Listing Requirements, and the Malaysian Code of Corporate Governance was later adopted.

The changes are intended to provide better quality and more timely financial information and disclosures to investors. Public-listed companies are required to have corporate governance systems to improve accountability and financial reporting. The changes also offer protection to minority shareholders. The share market has an important role in the economy and investor confidence has to be restored. The study is on the quality of the financial information and the likelihood of earnings management with the changes for the post-crisis period 1998-2005. It was also a significant period with world events that affected the local economy, and the resignation of Malaysia's longest serving Prime Minister, Tun Dr. Mahatir Mohamad, in 2003. His successor and current Prime Minister, Datuk Abdullah Badawi, has embarked on an anti-corruption drive with greater accountability and transparency to be competitive in the global market.

Accruals accounting used in accounting reports is susceptible to earnings management. Earnings affect share prices, and the incentives to engage in earnings management were strong following the Asian financial crisis. The Jones accrual model was used in the study on the quality of the financial information and earnings management with the raft of changes following the Asian crisis. The model was first used on companies seeking U.S. government grants to detect earnings management with the use of accruals. The model is on the basis that accruals are affected by changes in the sales revenue. However, it is a useful model and widely used by researchers.

The study using the Jones model was on KLSE companies selected at random which had data for the period. Newly listed and those that were de-listed during the period were excluded. The results showed a high level of discretionary accruals for the years 1998-2004 which reflect on the quality of earnings and the likelihood of earnings management. There was, however, a mark improvement in 2005.

The Asian financial crisis led to a recession and a slow economic recovery in the country. Activity in the once vibrant share market was subdued as listed companies struggled with their performance and earnings. The managers are involved in the normal operating activities of the company and have a good knowledge of the performance and the future cash-flow. The private information they hold may not be entirely disclosed which may affect the accounting measurements and values. There is a myriad of other reasons why managers with-hold private information. However, from the literature the incentive and motivation to engage in earnings management revolve around managers trying to safeguard their positions and to avoid debt covenant.

The results lend support the literature on agency theory and the conflict of interest. The agent does not always act to the interests of the principal – the shareholders. The principal may suffer from the adverse selection of the agent or moral hazard when the agent does not work with maximum effort. The management choices and opportunities in accounting allow them to report earnings to their benefit. If the shareholders know the true performance and position of their companies, they may decide differently and adjust their holdings accordingly.

The accounting information and reports are subject to management judgement and estimates. The use and choice of which depend on the individual's value, experience and knowledge. The auditor is only required to report that the financial statements are true and fair, and that there has been no material misstatement. Misstatements that are not material will therefore not be reported, and materiality is also subject to the individual judgement.

The role and responsibility of auditors became a concern with the number of company failures following the Asian crisis. A total of 93 companies listed on the main board of the KLSE had negative shareholders' equity or qualified audit reports in 2001. Investors and users of financial statements had expected better as there has been no earlier warning on the financial condition of those companies. Investors and other stakeholders suffered heavy losses as financially distressed companies folded.

The financial statements which depend on individual judgement and estimates had not been adequate. There has been a raft of changes to the standards and legislation to enhance the reports. However, the regulations and measures are no guarantee for better quality financial disclosures and earnings. Transactions can be structured around the rules and it is not possible to have rules for all the different types of transactions. The auditor and the internal corporate governance system are supposed to ensure compliance and curb the inappropriate behaviour of managers. The reprimands and the request by the Securities Commission (SC) to issue account re-statements indicate the continued existence of inadequate and deficient financial statements.

Enforcement actions by the SC have been limited to the small Chinese companies. The large *bumiputera* conglomerates, possibly with connections to the government, have escaped the wrath of the authorities. Corporate governance in those conglomerates has been suspect as seen by the Renong-UEM deal and the subsequent bail-out by the government.

The Malaysian Code of Corporate Governance that requires the appointment of independent directors, the need for an audit committee, and quarterly disclosures are steps towards better financial disclosure and transparency. The corporate structures with cross-holdings and the use of nominees make consolidations and related party transactions difficult to follow. The reporting culture and practice that has existed and been accepted by the market will be difficult to change in the short term.

6.1.3 Conclusion

The Asian crisis and the aftermath was a challenging period for the government as well as corporate managers. Asset and share prices dropped with many investors and other stakeholders suffered losses. Managers were under enormous pressure to shore up profits and share prices even during the period of low demand and a contracted economy. The

accounting standards and reporting framework allowed flexibility requiring management to make estimates and judgement in the financial information and disclosures. There were incentives to manipulate and choose the treatment and method of accounting for transactions to advantage. Companies struggled to remain financially afloat with the changed economic conditions. The number of defaults in borrowings increased. Managers under pressure with debt-servicing problems were more likely to manipulate and engage in earnings management to avoid the debt covenant. The reporting framework and accounting reports that had been based on the accounting standards issued by the local accounting bodies were found to be inadequate with the crisis. The inadequate accounting report disclosures with poor quality information were blamed by investors and users of financial statements as companies became insolvent and failed.

Companies (such as those mentioned in Chapter 4, p.117) that had reported profits became insolvent and were later placed in the PN4 list of the KLSE. The divergent accounting disclosures and practice from accounting choices on accruals, for example the capitalisation of expenditure and the disclosure of liabilities, with suspect corporate governance in Malaysia had dampened confidence in the market and the economy. The government reacted as investors stayed away. Regulations and measures were introduced by the government to change management behaviour in efforts to revive and instil confidence in the market. Changes were made to the reporting framework with new standards and legislation with the requirement for continuous reporting to keep investors better informed. It increased the burden and cost of compliance.

The inadequate accounting disclosures from poor corporate governance in companies, particularly those in the PN4 list, gave rise to agency issues like adverse selection and moral hazard. Large *Bumiputera* groups emerged under the New Economic Policy (NEP) and the granting of government projects with easy loans from state-controlled banks. Many of the financially troubled companies had expanded with borrowings, including from overseas, and had become saddled with a heavy debt burden.

Earnings affect share prices. The relationship was confirmed using data of companies that were later placed on the KLSE PN4 list. The declining earnings of those companies after the Asian crisis had their share prices falling and remained constantly low up to the PN4 announcement.

Managers under pressure to shore up earnings and the share prices are more likely to engage in earnings management. The study on the KLSE companies for the period after the Asian crisis to 2005 confirmed the existence of earnings management.

The country has adopted the International Financial Reporting Standards (IFRS) from 2005. The standards are used uniformly by more than 90 countries and are meant to make accounts understandable and comparable across the different countries as companies compete in the global economy. The IFRS removes the need for multi-national companies to prepare accounts differently in the countries they operate, and better facilitates capital flows between borders.

An appropriate corporate governance system in place improves accountability and the quality of financial reporting with adherence to the IFRS. Such a system with independent directors in place is to reduce the agency problems associated with management behaviour acting to their agenda and not to the interests of the principals, the shareholders.

The implementation and use of the IFRS with the appropriate governance system is to improve the quality of reporting and to increase investor confidence. However, it is time-consuming and expensive to implement and use. It is difficult to have one set of standards for all companies. Smaller companies without the necessary manpower and financial resources will struggle to satisfy those standards. There are a high number of small-sized companies and it would not make sense for every small-size company to use IFRS. The users of the financial information, for example, may be limited and known.

Furthermore, management with the executive incentives will invariably seek ways to circumvent the requirements of the IFRS. It is not possible to have a standard for every transaction. Individual judgement and estimates are required in the preparation of financial statements. As such IFRS will not eliminate opportunistic accounting choices and earnings management in the financial reports. The truth and fairness of financial statements will continue to be stretched by the managers of those companies at every possible opportunity.

Malaysia adopted the Code of Corporate Governance in 1999 to improve accountability and for the public-listed companies to have internal systems to provide better financial disclosures and reports. Public-listed companies are also required to have independent directors and an audit committee.

The effectiveness of corporate governance is dependent very much on the individuals tasked with providing an oversight on the performance of managers. The audit committee, formed initially to deal with matters raised by the auditors as part of the corporate governance system, has moved to provide a greater oversight role on managers and their performance to provide more timely and complete reports. However, the members may not necessarily have the financial skills and knowledge for the task which, in turn, could weaken the financial and management practices. The higher accountability sought with corporate governance may not be achieved.

The performance of the independent auditor and the scope of work have increased with more rigour as the needs and expectations of investors and users of financial statements have changed. It is no longer sufficient to report that there have been no material misstatements. The auditor is required to review the internal control and risk management systems needs the necessary skills and knowledge to ensure the disclosures are accurate and complete. Assets have also to be reviewed for possible impairment which may involve valuers. Other specialist staffs may have to be engaged for the more complex audits.

The changes to the standards and legislation in response to market expectations require auditors to perform more work with specialist staff as part of the audit function. However, the specialist staffs are no longer allowed to engage in consultancy services although they are better placed to provide such services with a greater economy of scale. Higher costs can be expected with the restriction.

The government's rhetoric of anti-corruption and greater transparency have not brought investors back. The regulations and measures to enhance reporting and corporate governance without strict enforcement would be difficult to achieve the desired results. The NEP that continues to favour the *bumiputeras* in the government's socio-economic engineering exercise, and the companies linked to the politicians remain daunting. The favoured group with preferential treatment may develop ideas that they are subject to a different set of regulations and measures. Enforcement actions by the SC remain sensitive and may be compromised. The enforcement and threat of punishment to reduce manipulation and earnings management for better quality accounting reports with sound corporate governance still have a way to go in Malaysia with the disparate treatment of the different racial groups.

More rules and regulations with the IFRS and corporate governance do not always offer satisfactory solutions to agency issues and raise market confidence. Market-driven solutions are generally better. Disclosures will be what the market wants rather than what is forced on to shareholders and investors. The disclosures and financial information should be disseminated quickly and without cost to users.

The openness in accountability and reporting will force companies to have strong financial and management practices with greater efficiency to reduce costs. Such companies with reputable managers will develop a competitive advantage that will attract shareholders and investors potentially leading to a lower cost of capital for growth. If the market views the company positively, then the shares would be in greater demand and prices would be higher. The law, however, should remain as the ultimate deterrent and enforced strictly without impartiality when breaches occur.

Activity on the share market has not reached the pre-crisis levels despite the efforts of the authorities. A strong and active share market promotes economic growth with benefits to the community. It remains a challenge to the authorities to regain market confidence to attract both the local and overseas investors. Accountability by management and the transparency of financial information are essential to have market efficiency and investor confidence. The country must adapt to the internal standards and practice to be able to successfully compete in the global market.

6.2 Recommendations

6.2.1 Government In Business

There is an estimated 47 government-linked companies listed on the KLSE in Malaysia. The government's continued involvement in business enterprises and the NEP that favours *bumiputeras* suggest that the government's resolve on the issue of improving financial disclosure and corporate governance may be fickle. The government has bailed out financially troubled *bumiputera* conglomerates before like UEM-Renong, and can be expected to do so in the future.

The government with all its rhetoric should divest its business interests to have a fair and open policy. The bureaucrats are then able to implement and enforce the regulations and measures strictly without interference from the politicians. Such a move will demonstrate its seriousness to increase transparency and increase investor confidence. However, it is unlikely that the government will divest its business interests as they have historically provided the much needed funds to the political parties for their activities especially during the national general elections. The coalition government has ruled the country since independence.

6.2.2 The Reporting Framework

The adoption of the International Financial Reporting Standards and continuous reporting increases the burden and cost of reporting. The one standard for all could be too much for the smaller companies that may just not have the resources to comply. Errors and omissions should not be construed as fraud and account manipulations.

More standards do not always translate to better disclosure. It is also not possible to have standards to cover all transactions. The market-based disclosure may have more merit. Companies will then have to disclose what the market wants rather than “noisy information” that is not used. The information needs of the stake-holders will drive the standards. The information processed and provided will be more effective and cheaper.

The stake-holders are not stupid. After a while, they are able to differentiate the type and reliability of the information provided together with the reputation of managers. Providing useful and needed information to the market allows investors to make decisions in a more accurate and timely way.

6.2.3 Future Research

Earnings management is and has been a subject of interest. The practice has existed for many years. It is hard to imagine that regulations and voluminous accounting standards will stop the practice. The international financial reporting standards have imposed a heavy burden with compliance issues and the high cost. The smaller companies with a limited number of users, possibly even known, have not been spared. The one set of standards for all does not make sense, and does not sit well with managers of the smaller companies.

The disclosures and financial information should be based on what the market wants rather than mandated by the authorities. From the perspective of an actual or potential

investor the financial information should be usable in generating indications of fair equity value.

Accrual accounting is used to measure performance over past periods. The current standard requires assets to be stated at cost and only to be re-stated when there is a permanent change in the value. There is also a tendency to delay the recognition of some transactions in accounting which provides a lag behind economic reality. Historical costs may lack relevance and it may be more appropriate to use market-based valuation for assets rather than being stated at cost, especially in times of changed economic conditions. When there are high profits from the historical cost basis, the market may be over optimistic and over-value the shares without considering the current economic conditions. The usefulness of accrual-based, historical accounting with the many standards to follow in equity valuation has its limitations. The market-based reporting may reflect fairer values under current, prevailing economic conditions. The market-based reporting framework with substance over form has merit and should be investigated further.

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Rates and KLSE Stock Market Index

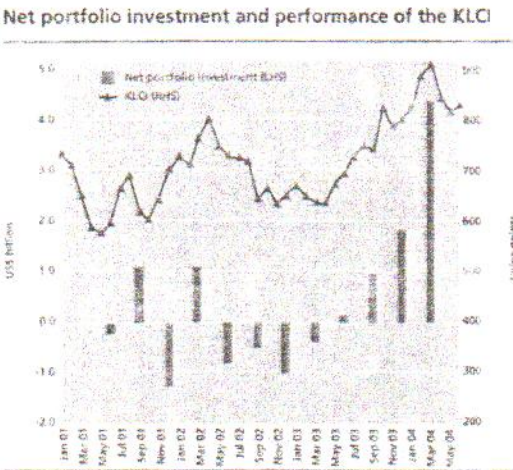
Table 1: Interest Rates, Exchange Rates and Stock Market Index (January 1997-March 1999)

1-wk interbank	1mthinterbank	3mthinterbank		Exchange rate	KLCI Index
Jan-97	7.21	7.30	7.33	2.492	1227.99
Feb-97	7.33	7.27	7.32	2.486	1254.90
Mar-97	6.96	7.32	7.35	2.477	1234.61
Apr-97	7.03	7.34	7.36	2.502	1121.10
May-97	8.45	7.79	7.77	2.506	1083.16
Jun-97	7.71	7.93	7.92	2.516	1094.91
Jul-97	9.43	9.07	8.31	2.575	1035.88
Aug-97	6.85	7.64	7.73	2.749	904.27
Sep-97	6.59	7.56	7.66	3.017	809.88
Oct-97	7.65	8.39	8.47	3.288	766.20
Nov-97	7.93	8.97	9.18	3.378	637.99
Dec-97	10.89	8.98	9.15	3.783	577.66
Jan-98	13.00	9.82	10.03	4.369	542.12
Feb-98	11.43	11.05	11.11	3.812	714.27
Mar-98	10.75	11.05	11.21	3.736	716.56
Apr-98	10.53	11.05	11.02	3.725	648.66
May-98	9.86	11.02	11.02	3.797	570.72
Jun-98	10.29	10.95	11.14	3.993	476.65
Jul-98	9.56	11.00	11.05	4.150	431.90
Aug-98	9.17	10.97	10.06	4.194	340.47
Sep-98	6.91	10.02	8.17	3.803	370.89
Oct-98	6.19	7.67	7.36	3.798	394.07
Nov-98	6.16	6.96	7.01	3.797	465.35
Dec-98	5.82	6.62	6.62	3.796	540.78
Jan-99	5.53	6.33	6.48	3.799	595.17
Feb-99	5.28	6.22	6.36	3.799	558.76
Mar-99	5.44	6.03	6.37	3.799	514.20

Source: Reuters

Portfolio Investment and Performance of the KLSE Stock Market Index

Jan 2001-June 2004



Source: Bank Negara Malaysia, Thomson Financial Datastream
Note: Net portfolio investment is based on quarterly data.

Sectors Represented on the KLSE

As of December 30, 1999, the market capitalization of the Kuala Lumpur Stock Exchange (KLSE) stood at MYR 553 billion (US\$ 145 billion), or 184 percent of 1999 GDP. Its turnover ratio was 34 percent. There were 757 companies listed, of which 474 on the main board and 283 on the second board.

Table 2: List of sectors represented on KLSE, December 30, 1999

Sectors	Market cap (RM mn)	Market cap %	Sectors	Market cap (RM mn)	Market cap %
Main board			Second board		
Consumer Products	42,724	7.73	Consumer Products	4,577	0.83
Industrial Products	68,668	12.42	Industrial Products	11,181	2.02
Construction	31,352	5.67	Construction	2,776	0.5
Trading/Services	185,048	33.48	Trading/Services	6,056	1.1
Infrastructure	13,842	2.5	Loans	157	0.03
Finance	109,872	19.88	TSR/Warrants	377	0.07
Hotels	1,795	0.32			
Properties	29,344	5.31	Sub-Total	25,124	4.55
Plantation	25,235	4.57			
Mining	2,654	0.48	Grand Total	552,691	100.00
Trusts	379	0.07			
Closed/Fund	340	0.06			
Loan	6,500	1.18			
TSR/Warrants	9,815	1.78			
Sub-Total	527,567	95.45			

Source: Kuala Lumpur Stock Exchange

Malaysian Accounting Standards

New name	Title	Old name
FRS1	First-time Adoption of Financial Reporting Standards	
FRS2	Share-based Payment	
FRS3	Business Combinations	
FRS4	Insurance Contracts	
FRS5	Non-Current Assets Held for Sale & Discontinued Operations	
FRS101	Presentation of Financial Statements	MASB1
FRS102	Inventories	MASB2
FRS104	Depreciation Accounting	MASB14
FRS107	Cash Flow Statements	MASB5
FRS108	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies	MASB3
FRS109	Research and Development Costs	MASB4
FRS110	Events After the Balance Sheet Date	MASB19
FRS111	Construction Contracts	MASB7
FRS112	Income Taxes	MASB25
FRS114	Segment Reporting	MASB22
FRS116	Property, Plant & Equipment	MASB15
FRS117	Leases	MASB10
FRS118	Revenue	MASB9
FRS119	Employee Benefits	MASB29
FRS120	Accounting for Government Grants and Disclosure of Government Assistance	MASB31
FRS121	The Effects of Changes in Foreign Exchange Rates	MASB6
FRS122	Business Combinations	MASB21
FRS123	Borrowing Costs	MASB27
FRS124	Related Party Disclosures	MASB8
FRS125	Accounting for Investments	IAS25
FRS126	Accounting and Reporting by Retirement Benefit Plans	MASB30
FRS127	Consolidated Financial Statements and Investments in Subsidiaries	MASB11
FRS128	Investments in Associates	MASB12
FRS129	Financial Reporting in Hyperinflationary Economies	IAS29
FRS130	Disclosures in the Financial Statements of Banks and Similar Financial Institutions	
FRS131	Financial Reporting of Interests in Joint Venture	MASB16
FRS132	Financial Instruments: Disclosure & Presentation	MASB24
FRS133	Earnings Per Share	MASB13
FRS134	Interim Financial Reporting	MASB26
FRS135	Discontinuing Operations	MASB28
FRS136	Impairment of Assets	MASB23
FRS137	Provisions, Contingent Liabilities & Contingent Assets	MASB20

KLSE PN4 Companies

The status of all PN4 companies, as at 31.10.2002 is as follows:

		Status of Regularisation		
Stage	Event	Classified as PN4 on or before 31.12.2001	Classified as PN4 after 31.12.2001	Total
1	Pending Requisite Announcement	21	8	29
2	Pending submission to authorities	9	1	10
3	Pending approval by authorities	29	2	31
4	Pending implementation	23	4	27
	Total as at 31.10.2002	82	15	97
	Already implemented (thus, out of PN4 category)	18	0	18
	Total from 15.2.2001 to 31.10.2002	100	15	115

Source: Securities Commission, Press release on 1 October 2002.

	1997		1998		1999		2000		2001		2002		2003		2004		2005	
	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000	Turnover 000	PBIT 000
Consumer																		
AMSTEEL	5,562,879	412,434	6,352,629	1,143,192	5,134,671	(934,697)	5,379,720	(662,357)	5,130,657	(747,899)	5,479,343	(551,557)	4,564,239	1,144,096	2,421,041	126,671	447,724	3,316
ANNJOO	409,459	36,527	240,287	10,465	237,987	24,796	356,750	27,264	376,687	23,984	348,185	33,281	443,406	53,915	528,566	96,959	565,539	30,943
APOLLO	55,466	15,486	64,026	13,149	76,384	17,685	107,782	24,538	100,779	22,223	93,429	17,925	113,409	18,629	119,473	19,930	124,442	17,227
CARLSBERG	655,600	160,045	669,500	151,854	842,330	157,935	851,984	152,208	841,113	161,670	838,783	126,830	876,005	106,675	796,000	113,300	867,230	112,400
CCM	568,961	66,775	521,850	59,276	544,756	69,019	571,697	39,132	497,563	12,819	518,359	58,281	578,713	58,242	696,941	189,966	814,219	130,306
DLADY	286,576	10,576	295,425	1,795	328,898	14,159	323,303	17,870	329,045	15,134	357,239	20,066	372,686	20,916	371,548	20,703	373,612	20,946
DRBHCOR	3,092,087	299,924	3,491,932	76,010	2,194,954	(183,560)	2,611,499	(292,998)	5,073,262	411,536	4,432,352	391,108	4,898,043	457,826	4,500,255	389,905	4,506,995	276,702
F&N	1,148,119	98,571	1,240,314	11,922	1,157,242	(68,297)	1,366,517	72,819	1,541,253	103,562	1,521,988	122,315	1,611,119	122,794	1,728,054	157,066	1,935,106	183,751
Faber Group	411,620	926	414,800	(330,700)	438,900	(119,900)	470,200	(114,900)	496,300	(103,300)	702,890	(237,120)	561,460	(471,030)	609,398	469,279	502,242	64,570
FFM	3,780,210	106,180	4,403,592	69,746	3,952,561	227,983	3,092,155	197,975	4,532,452	177,449	6,620,465	216,463	7,994,912	287,584	7,856,311	236,751	7,621,418	228,793
GOPENG	63,690	24,646	48,194	(21,245)	40,528	(30,209)	27,785	1,290	24,973	(1,990)	37,978	865	56,934	(7,290)	37,324	912	38,542	1,016
IOIOLEO	472,953	7,924	645,392	24,568	838,489	30,423	882,753	77,067	792,951	146,880	778,173	135,343	1,099,824	170,833	1,097,643	156,720	1,098,552	162,342
JIATAA	471,094	163,096	459,506	96,814	425,576	(55,716)	733,361	129,813	621,471	(19,157)	440,295	107,242	278,396	65,025	382,931	66,832	386,558	76,931
KIANJOO	438,151	85,357	425,012	76,345	425,517	52,607	494,536	33,034	494,028	41,907	479,091	40,215	505,068	52,492	575,684	56,510	654,957	69,594
LIONCOR			183,762	316	179,533	(288,889)	329,892	(267,733)	1,041,064	(330,744)	1,214,669	(138,260)	832,971	(89,543)	976,531	8,792	887,945	27,943
MIECO	128,593	16,397	130,667	10,231	134,439	21,011	147,863	26,676	139,788	22,108	164,591	26,856	141,932	21,897	152,106	24,621	156,932	26,418
MOX	413,332	95,330	389,070	69,771	358,871	99,885	434,742	110,992	476,087	133,937	499,733	129,984	554,527	141,753	586,932	152,683	591,684	163,829
MSC	374,934	17,503	701,075	25,327	742,136	24,809	575,023	27,483	582,647	33,694	719,457	39,666	783,377	53,249	763,448	42,637	781,960	52,087
MSHITA	783,328	78,007	786,403	63,900	724,378	46,895	806,602	71,105	752,247	73,693	806,374	27,935	809,893	72,860	806,783	56,821	809,764	61,873
MUDA	382,761	10,739	389,063	11,376	392,802	20,116	455,935	40,134	428,302	4,277	487,252	(4,360)	431,982	10,986	446,812	16,976	463,849	19,908
NESTLE	2,014,497	253,949	2,107,242	135,322	1,952,571	242,702	2,202,451	254,991	2,585,708	264,702	2,479,649	234,204	2,656,989	202,117	2,632,551	201,986	2,641,748	204,986
NYLEX	590,935	69,887	543,510	30,375	530,247	16,525	529,395	(65,837)	279,395	(65,837)	366,873	(53,274)	386,351	26,124	361,397	17,832	366,573	20,417
OYL	3,145,613	173,552	4,433,431	118,294	4,439,334	92,810	4,334	181,587	4,565,551	288,149	4,332,582	331,070	4,501,938	355,021	4,503,886	358,982	4,502,717	359,873
PPB	5,928,873	311,936	7,599,534	312,394	6,737,034	369,484	5,271,390	408,855	5,629,093	321,566	7,857,981	508,883	9,319,768	707,360	7,287,554	497,861	7,478,136	501,338
PROTON	6,222,202	1,029,117	6,788,472	724,617	4,075,040	98,958	6,496,724	141,318	8,301,238	378,297	10,307,663	1,511,820	9,267,996	1,361,941	8,790,369	820,743	8,986,301	728,593
SETRON			94,600	(5,928)	111,375	(1,510)	93,262	(678)	75,142	(364)	38,619	(79)	18,043	(1,324)	5,111	(2,218)	10,136	(2,906)
SHELL	2,903,582	77,449	2,433,141	74,107	3,187,388	93,110	5,183,516	157,490	4,601,402	3,928	4,458,227	197,964	5,496,898	249,624	5,186,339	210,986	5,368,911	238,962
SITATT	153,160	11,365	147,550	(42,568)	102,790	(23,722)	42,676	9,003	32,421	(4,255)	29,533	421	25,635	1,213	77,927	5,595	83,727	14,835
TCHONG	3,352,225	391,983	3,939,043	(3,462)	946,331	372,207	1,183,641	140,331	1,500,585	152,353	1,526,933	149,428	1,677,517	149,998	1,396,835	140,783	1,406,738	147,984
GAMUDA	792,187	131,033	681,175	110,033	510,428	143,033	815,833	206,062	831,283	260,690	1,042,752	384,966	1,442,069	406,002	1,183,964	326,337	1,383,792	367,743
HOUHUP	541,565	36,096	412,897	7,531	277,921	5,510	349,647	8,281	190,227	(23,543)	171,860	(61,554)	212,711	(252)	260,976	3,013	231,594	1,860
IJM	1,475,555	93,800	1,148,516	70,743	1,209,968	139,431	1,112,210	118,956	857,391	210,409	1,295,195	191,770	1,363,895	206,800	1,318,569	210,556	1,386,732	213,877
TRONOH	430	27,790	14,755	(86,368)	10,357	(20,336)	9,201	222,450	13,385	(81,543)	7,603	(6,082)	21,913	13,901	19,431	3,832	17,903	3,012
UEMWORLD	1,096,343	852,364	914,878	(811,998)	757,108	(1,246,376)	499,805	380,307	339,492	(1,185,029)	356,175	590,679	359,817	349,679	352,673	97,894	392,477	101,862
ANTAH	927,397	52,873	1,245,038	(30,973)	931,285	41,226	676,135	(151,546)	614,131	(12,710)	237,824	20,975	274,766	(238,914)	252,831	26,982	260,811	28,938
BJTOTO	1,832,510	343,691	2,188,238	453,925	2,195,411	438,206	2,339,894	384,724	2,333,339	400,858	1,986,543	367,992	2,013,594	372,511	2,132,863	398,532	2,317,699	401,605
GENTING	3,047,200	986,100	3,052,100	728,300	3,077,400	1,521,400	3,338,600	(322,700)	3,148,400	1,034,600	3,534,700	1,559,500	3,346,981	1,186,948	3,472,593	1,359,862	3,511,874	3,505,953
GKENT	164,358	11,263	130,890	2,599	139,754	(19,764)	126,723	(39,338)	125,593	(8,571)	191,418	(53,175)	111,440	2,943	126,832	3,017	129,568	4,306
HARRISONS	462,561	17,531	497,230	15,121	536,956	13,907	575,963	12,752	634,192	11,246	656,036	12,719	709,663	12,973	801,853	17,278	819,657	17,544
JUSCO	603,273	44,340	692,493	6,064	679,710	40,113	804,214	56,048	990,005	69,390	1,200,636	80,326	1,368,268	90,833	1,120,637	80,736	1,187,923	84,931
MAS	6,484,950	349,409	7,051,326	(225,362)	7,471,861	(669,735)	8,160,737	(236,890)	8,956,145	(1,303,030)	8,377,901	(846,493)	8,674,578	336,550	8,531,963	196,931	8,721,962	221,698
NSTP	843,359	208,642	755,444	(61,632)	684,211	62,316	693,144	2,007	680,188	(171,451)	768,673	344,281	1,127,118	(181,298)	720,863	96,782	782,958	112,672
SIME	13,236,000	1,683,000	12,075,800	(70,700)	9,910,500	1,018,200	10,971,500	1,199,100	11,959,900	1,130,500	12,053,100	1,148,100	13,717,800	1,284,100	14,903,500	1,343,600	18,645,700	1,364,200
TELEKOM	7,165,700	2,378,400	7,980,100	1,688,900	7,833,000	884,200	8,815,700	1,250,800	9,673,200	2,443,600	9,834,100	1,570,100	11,796,400	1,810,500	10,884,540	1,632,091	11,026,939	1,597,881
TENAGA	10,014,800	144,700	11,439,400	(2,788,400)	12,108,000	977,800	13,719,100	1,523,800	14,362,600	2,193,000	15,375,100	1,476,800	16,457,800	1,719,100	15,932,779	1,538,960	16,006,792	1,576,935
TIME	724,877	(119,739)	1,067,405	(2,321,019)	1,028,855	(115,566)	1,029,785	(93,761)	429,336	1,092,531	268,114	25,756	403,829	135,009	360,714	66,982	387,960	68,547
DIGI	240,192	(57,693)	397,614	(118,795)	475,271	(77,105)	655,821	23,204	907,803	189,985	1,289,564	145,770	1,713,529	201,536	1,265,842	132,698	1,298,394	143,521
SAPURA	349,844	13,428	370,099	206,984	317,473	(383,789)	379,663	6,113	443,914	289,947	367,455	4,621	629,841	(70,395)	582,661	26,983	598,763	36,928
GPERAK	67,382	22,781	213,266	12,589	131,715	(20,089)	40,033	(12,296)	25,637	(82,579)	24,530	(33,861)	34,292	(96,529)	28,736	(8,632)	33,982	2,187
SHANG	257,710	50,663	238,584	27,088	232,627	33,754	262,075	58,255	217,130	(14,348)	233,547	5,769	253,547	24,710	246,932	18,106	251,799	20,893
ANCOM	293,487	25,252	292,833	12,238	252,413	16,053	270,695	1,750	761,815	34,691	693,566	22,586	734,921	27,397	711,532	24,978	726,543	