FINANCIAL INSTRUMENTS DISCLOSURE PRACTICES: EVIDENCES FROM MALAYSIAN LISTED COMPANIES

BY

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A Dissertation submitted in fulfilment of the requirement for the degree of Masters of Science (Accounting)

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ABSTRACT

The current changes in business settings have directed companies to conduct business at international level, which requires the use of financial instruments. The mandatory MFRS 7, an-equivalent to the IFRS 7 standard shall be applied for annual financial periods beginning or after 1 Jan 2012. It caters for entities to disclose their involvement with financial instruments. Thus, the aim of this study is to investigate the financial instruments disclosure (FID) practices of Malaysian listed companies; specifically, their level of compliance with MFRS 7. The mean score for FID is 80.76%, which indicates that, in general, companies have complied with MFRS 7, although there are several requirements omitted by some companies. Furthermore, in light of the revision of MCCG in 2012, this study examines the association of corporate governance mechanisms with the extent of FID among companies. The corporate governance characteristics used in this study are board expertise, audit committee independence, audit fee, external and internal audit functions. This study applied the agency theory and formulated five hypotheses to test the extent of the relationship between FID and corporate governance characteristics. Based on a total sample of 319 Malaysian public listed companies for financial year end 2012, the analysis revealed that FID is significantly and positively associated with audit committee independence and external audit functions, while internal audit is negatively associated. The results suggest that audit committee members need to be independent to discharge their duties effectively; in addition, there should be an internal audit function that is independent, reliable and functioning in a timely manner. This is crucial in order to strengthen the role of the auditing function within the firm. Moreover, the results attest that, Big Four audit firms are more likely to ensure high compliance with applicable accounting standards compared to non-Big Four, as they are internationally recognised, and have more resources and expertise. Apart from contributing to the literature on financial reporting and corporate governance, this study may serve as a valuable input for regulators and standard setters to encourage strict enforcement of the incorporation of effective corporate governance practices in Malaysian listed companies, as this is likely to have some influence on the level of compliance with MFRS.

ملخص البحث

لمزاولة الشركات وجهت الأعمال مجال في الحالية التغييرات
استخدام يتطلب الذي الأمر ، الدولي المستوى على العمل
، IFRS7 المعيار يعادل الذي MFRS7 المعيار .المالية الأدوات
ممارسات في التحقيق هو الدراسة هذه من الهدف .المالية
يف المدرجة للشركات(FID) المالية الأدوات عن الإفصاح
نتيجة .MFRS7 مع إمتثالها درجة وخاصة ، الماليزية البورصة
، أنه على يدل مما ،80.76% الأدوات على الإفصاح متوسط
من الرغم على MFRS 7 مع الشركات امتثلت قد ، عامة وبصفة
بعض قبل من أهملت قد المتطلبات من العديد هناك أن
الماليزي نونالقا مراجعة ضوء وفي ، ذلك على علاوة .الشركات
تختبر الدراسة هذه ، 2012 عام في (MCCG) الشركات لحوكمة
الأدوات عن الإفصاح مدى و الشركات حوكمة آليات بين العلاقة
عينة إلى استنادا .الشركات حوكمة وخصائص (FID) المالية
كشفت ، الماليزية البورصة في مدرجة شركة 319 من مكونة
ملحوظ وبشكل (FID) المالية واتالأد عن الإفصاح أن التحاليل
عن فضلا ، التدقيق لجنة باستقلال مرتبط وإيجابي
النتائج وتشير .الداخلي التدقيق ووظيفة الخارجي التدقيق
لأداء مستقلين يكونوا أن يجب التدقيق لجنة أعضاء أن إلى
تكون أن ينبغي ، ذلك إلى بالإضافة .فعال نحو على واجباتهم
بها وموثوق مستقلة هي والتي الداخلي التدقيق وظيفة هناك
.المناسب الوقت في وتعمل

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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DECLARATION PAGE

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Syaima' binti Adznan

Signature……………………………… Date……………………………

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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Affirmed by Syaima' binti Adznan

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Signature　　　　　　　　　　　　　　　　　　Date

To the One who has taught me, inspired me and guided me throughout my life. I dedicate this humble endeavor to *Allah The Almighty* and to my beloved parents and family for their endless love and support.

May ALLAH’s blessing and mercy shower upon them always.

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AC	Audit Committee
BNM	Bank Negara Malaysia
CAPM	Capital Asset Pricing Model
CG	Corporate Governance
FID	Financial Instruments Disclosure
FRS	Financial Reporting Standard
GFC	Global Financial Crisis
IAF	Internal Audit Function
IAS	International Accounting Standard
IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standard
INED	Independent Non-Executive Directors
KLSE	Kuala Lumpur Stock Exchange
MASB	Malaysian Accounting Standards Board
MCCG	Malaysian Code of Corporate Governance
MFRS	Malaysian Financial Reporting Standard
MIA	Malaysian Institute of Accountants
SEC	Securities and Exchange Commission

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

This chapter serves as an introductory chapter for the study. It begins by presenting the background of the study, followed by the problem statement, research objectives and motivation for the study. Subsequently, the significance of the study will be discussed. This chapter concludes with a presentation of the structure of the study.

1.1 BACKGROUND OF THE STUDY

In recent years, there have been significant developments of more complex and innovative financial instruments to cater for the needs of current business world (Zadeh and Eskandari, 2012; Hunziker, 2013). Financial instruments, either equity -based (*i.e.* shares) or debt-based (*i.e.* derivatives) are widely used by companies as a medium to raise more capital (Ismail and Rahman, 2011). New risk management techniques and concepts have evolved for identifying, valuating and managing the exposure of risk arising from the financial instruments. Thus, there is a need for more relevant information on and greater transparency of an entity's exposure in managing and controlling those risks (Zaluki and Hussin, 2009). Potential stakeholders, particularly investors, are demanding such high quality information in order to make more informed decisions.

For this reason, in August 2005, the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) 7 on financial instruments to provide guidelines to the extent of the disclosure required for entities involved with financial instruments. Previously, financial instruments disclosure was catered for under either IAS 30 *Disclosure in the Financial Statements of Banks and similar Financial Institutions* or IAS 32 *Financial Instruments: Disclosure and Presentation*. However, the IASB removed these duplicated disclosures as part of their revision, and simplified them to a single concentration standard known as IFRS 7. IFRS 7 defines a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Generally, there are two main requirements proposed in IFRS 7; namely, 1) the need to disclose the significant level of the financial instruments to the entities; and 2) the qualitative and quantitative information on the exposure of risk faced by the entities' financial statements. In addition, IFRS 7 expands a number of existing disclosure requirements, including disclosure on fair value measurements and liquidity risk to address application issues as well as to provide sufficient information to users.

In line with international developments on this matter, Malaysian companies are also required to adhere to the regulation set by the Malaysian Accounting Standards Board (MASB). The MASB is the sole authority dealing with accounting standards in Malaysia. It has issued Malaysian Financial Reporting Standards (MFRS), fully IFRS-compliant standards, in order to be aligned with global accounting standardisation efforts. The full convergence process came into effect on 1 January 2012 and is to be applied by all Entities Other Than Private Entities (MASB, 2011). The convergence with IFRS, although challenging, will place Malaysian companies and the capital market at par with other international economies and markets (*The Accountant*, 2008). Thus, firms that comply with MFRS standards would be expected to produce high quality accounting information, as numerous studies (Liu *et. al*, 2011; Fifield *et al.*, 2011; Aubert and Grudnitski, 2012) have shown that, by adopting IFRS, the overall financial reporting prepared by firms improves significantly.

The MASB introduced MFRS 7 *Financial Instruments: Disclosure* and the requirement to use it came into force on 1st January 2012. It acts as a new standard to deal with the disclosure of financial instruments which were previously covered by FRS 132 *Financial Instruments: Disclosure and Presentation.* The decision to defer the implementation was made to give Malaysia a grace period to learn from other countries' experiences (MASB, 2005) as well as to provide a sufficient interval for companies to make necessary adjustments to their financial reporting (Zadeh and Eskandari, 2012). MFRS 7 is applicable to all financial instruments except:

a) Interest in subsidiaries, associates or joint ventures that are accounted for in accordance to MFRS 127 *Consolidated and Separate Financial Statements,* MFRS 128 *Investments in Associate* or MFRS 131 *Interest in Joint Ventures.* However, in some cases, MFRS 127, MFRS 128 or MFRS 131 permits entity to account using MFRS 139, in such cases, entities shall apply the requirements of this MFRS;

b) Employers' right and obligations arising from employee benefit plans as covered in MFRS 119 *Employee benefits;*

c) Insurance contracts as defined in MFRS 4 *Insurance Contracts;*

d) Financial instruments, contracts and obligations under share based payment transactions which governed by *MFRS 2 Share based payment;*

e) Instruments that are required to be classified as equity instruments in accordance to MFRS 132.

Furthermore, companies nowadays involved in a more sophisticated and advance business environment, which requires them to operate not only within its own country, but to expand at the international level, involving cross-country business activities. Consequently, the public or the affected stakeholders (*i.e.*, the potential investors) would demand for greater detail and more extensive accounting information to be disclosed in the companies' annual reports (Hassan and Salleh, 2010). Dobler (2008) claimed that among the information needed is for the company to sufficiently disclose their corporate risk information to enable the users to perform an evaluation of the company's financial position.

Corporate risk-related information presented in the annual report is expected to be adequately and transparently disclosed in a way that reflects the true financial position of the firms and can assist users (*i.e.* investors, shareholders) in decision making (Hassan and Salleh, 2010). This information includes the risk exposure arising from financial instrument transactions (Abraham and Cox, 2007; Hassan and Salleh, 2010), as financial instruments and derivatives are widely used by companies as a means of financing to raise more capital. For this reason, MFRS 7 is also concerned with the identification and the level of assessment of the financial instruments risk disclosure by companies in order to boost investors' confidence in the capital market. It focuses on risks that arise from financial instruments and how they manage those risks which include, but are not limited to, credit risk, liquidity risk and market risk.

Moreover, the revised Malaysian Code of Corporate Governance (MCCG, 2012) focuses on strengthening the board structure and its composition, and not only encouraging the company to abide with the laws and ethical values, but also maintaining an effective governance structure to ensure the appropriate management of risks and level of internal controls are in place. Specifically, among the recommendations of the MCCG code (MCCG, 2012) is that companies should ensure financial statements are prepared in such a way as to provide a reliable source of information, as per the excerpt below:

> **PRINCIPLE 5: Uphold Integrity in Financial Reporting**
> **The board should ensure financial statements are a reliable source of information.**
> **Recommendation 5.1**
> The Audit Committee should ensure financial statements comply with applicable financial reporting standards… (MCCG, 2012, p. 5-1)

This includes the need for companies to comply with applicable financial reporting standards as this is integral to the reliability of financial statements. In this context, Malaysian companies are required to comply fully with MFRS, as these are the basis of the financial reporting system in Malaysia (MASB, 2011)

Therefore, this study attempts to provide current evidence on disclosure practices among Malaysian companies; specifically, the study examines the level of compliance with MFRS 7 on financial instruments disclosure practices. Consistently, with the new revised MCCG (2012), this study also intends to examine the influence of corporate governance on the level of companies' compliance with MFRS 7.

1.2 PROBLEM STATEMENT

The adoption of IFRS, particularly among developing countries in the past few years, is considered to be one of the biggest metamorphoses witnessed in the development of the accounting field (Zeghal and Mhedhbi, 2012). Although some findings indicate that IFRS are not appropriate for adoption in certain settings (Bhattacharjee and Islam, 2009; Ballas, 2010), most researchers (Taylor, 2009; Jara *et. al*, 2011; Zeghal and Mhedhbi, 2012) agree that the implementation of IFRS can promote consistent practices and assist in the comparability of financial data among companies, which, in turn, can indirectly enhance the quality of financial reporting prepared. The convergence efforts to align

Malaysian standards to international standards efforts had already been initiated in 2006 (*Accountants Today,* 2012) and technically, the MASB has no power to exempt anyone (Malaysian Public Listed firms) from IFRS (*Accountants Today,* 2012). But, there are still variations in disclosure practice among companies, particularly in terms of the nature and level of compliance with the standard (Hassan *et al.,* 2008; Othman and Ameer, 2009; Zadeh and Eskandari, 2012). These scenario shows that having sound rules and regulation on paper is insufficient without proper practical enforcement and monitoring mechanisms being in place. Therefore, the regulators and relevant authorities need to take appropriate actions and find ways in order to achieve full IFRS convergence by year-2012. The lack of compliance in the adoption of these mandatory accounting standards is the main focus of this study.

Prior studies have examined risk-related disclosure in various settings, both mandatory and voluntary risk-related disclosure involving different market settings. In the Malaysian context, a few studies, e.g., Hassan *et al.* (2008), Othman and Ameer (2009), Hassan and Salleh (2010) and, Zadeh and Eskandari (2012) have examined financial instrument risk disclosure. Most of the studies measured the disclosure level or disclosure quality based on the disclosure index developed according to the respective accounting standard imposed at that period of time. For instance, Hassan *et al.* (2008) used MASB 24 *Financial Instruments: Disclosure and Presentation;* while Othman and Ameer (2009), Hassan and Salleh (2010) and Zadeh and Eskandari (2012) adopted the FRS 132 *Financial Instruments: Disclosure and Presentation.* In general, there were no major areas of difference between these two standards, as the MASB standards were simply renumbered and renamed (Lazar *et al.,* 2006) FRS for international convergence purposes (Othman and Ameer, 2009). The overall results revealed that there are disparities in disclosure practices among the companies, mainly associated with corporate structure and characteristics of a firm. As a consequence, Othman and Ameer (2009) suggest that there is a critical need to have some sort of standardised reporting format or guidelines to ensure that the financial information disclosed is valued by and relevant to its users. The differentiation in the disclosure practices among companies will be the next issue highlighted in this study.

Since 2012 marked the first year of MFRS adoption, this study aims to provide current evidence on MFRS disclosure practices among Malaysian companies; specifically, the study attempts to examine the level of compliance with MFRS 7 on financial instruments disclosure practices. In addition, this study seeks to make a contribution by investigating the association of corporate governance mechanisms with the extent of MFRS 7 disclosure practices among Malaysian companies. This is due to the fact it is not widely covered in the prior studies and to take into consideration the new amendment of MCCG in 2012. Conceptually, the findings from this study should be useful to the interested parties, such as the companies themselves, the MASB, the Bursa Malaysia, the Securities Commission and other regulatory bodies, as it empirically demonstrates the level of MFRS compliance among Malaysian listed companies. In addition, it highlights the influence of corporate governance on the level of companies' compliance with MFRS 7. This will give an additional input to them as, for instance, the regulators would benefit from this study as they would be able to assess the level of compliance of the companies and factors that could potentially influence the disclosure level. Consequently, appropriate monitoring and enforcement mechanisms should be in place to ensure that companies really comply with the required accounting standards and other appropriate regulations.

1.3 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS

The main objective of this study is to investigate the financial instruments disclosure practices among Malaysian listed companies. Specifically, it aims to examine the level of compliance with MFRS 7. Public listed companies were used as a sample as they are the companies affected and have been required to prepare their companies' financial statements in accordance with MFRS standards, beginning on 1 January 2012. Moreover, it is a requirement for companies that are listed in the Bursa Malaysia to ensure the availability of their annual reports; this provides an avenue for viable research related to MFRS standards.

Furthermore, this study attempts to contribute to the existing disclosure literature by examining the association between corporate governance and the extent of financial instruments disclosure level. This is also an attempt to provide additional empirical evidence to fill the gap highlighted by Zadeh and Eskandari (2012), who suggested that future research be carried out on the effect of corporate features and mechanisms in financial risk disclosure among Malaysian companies. Subsequently, they also recommended that a study be carried out on the effect of financial risk disclosure during the convergence period, which is the period of full compliance with FRS 7 (currently known as MFRS 7).

Moreover, the agency theory supports the view that effective corporate governance is in place when the board and its committees (*i.e.* the audit committee, internal audit function and external audit function) consist of balance composition with relevant knowledge and skills to exercise their roles effectively. Effective corporate governance subsequently influences financial reporting practices, including compliance with applicable financial reporting standards as this is integral to the reliability of financial statements prepared (MCCG, 2012). Similarly, Taylor *et al*. (2008) claim that firms with strong corporate governance structure is more effective in managing their financial reporting disclosure information, thus, promoting comprehensive, reliable and timely disclosure.

However, very few researchers (Taylor, 2008; Elzahar and Hussainey, 2012) have directly examined the relationship between governance mechanisms and financial instruments disclosure (using accounting standards), particularly in the Malaysian setting. Therefore, this study extends this research area and attempts to fill this gap by exploring the association between corporate governance and the extent of MFRS 7 disclosure practices among companies. In addition, this study complements a study conducted by Amran *et al*. (2009) which examined the factors associated with overall risk reporting, but did not cover the corporate governance elements. Thus, this study provides additional empirical evidence to the existing literature by investigating specific corporate governance elements (*i.e.* board expertise, audit committee independence, audit fees, external audit and internal audit functions) in association with the extent of a firm's level of compliance with the MFRS 7 required standard. This study assumes that effective corporate governance has a direct impact on the transparency of financial reporting, and hence, contributes to a high level of compliance with the MFRS standards. In line with the above research objectives, this study will provide answers to following research questions:-

1. Do Malaysian listed companies comply with MFRS 7 standard? What is their level of compliance to the MFRS 7?
2. Is there any relationship between the corporate governance structure of a firm and the extent of MFRS 7 disclosure practices?

To summarise, Table 1.1 provides an overview of the link between the problem statements, research objectives and research questions of the study.

Table 1.1 Problem Statement, Research Objectives and Research Questions

PROBLEM STATEMENT/ RESEARCH ISSUES	RESEARCH OBJECTIVES	RESEARCH QUESTIONS
1) The issue of the level of compliance to the mandatory standards, (specifically the level of compliance with MFRS 7) issued by the MASB among companies in Malaysia.	**RO1)** To investigate the financial instruments disclosure practices among Malaysian listed companies. Specifically, to examine the level of compliance with MFRS 7 *Financial Instruments: Disclosure*	**RQ1)** Do Malaysian listed companies comply with MFRS 7 standard? What is their level of compliance to the MFRS 7?
2) The differentiation in the disclosure practices among companies is partly driven by the corporate governance and how the firms manage those risks (Hassan and Salleh, 2010)	**RO2)** To examine the association between the level of financial instruments disclosure practices and corporate governance mechanisms	**RO2)** Is there any relationship between the corporate governance structure of a firm and the extent of MFRS 7 disclosure practices?

1.4 MOTIVATION FOR THE STUDY

A limited number of studies have examined the level of financial instruments disclosure practices, particularly in developing countries. This has motivated the researcher to investigate disclosure practices from the Malaysian perspective. Most prior studies were conducted in the developed countries, such as Abdelghany (2005) in the USA, Taylor *et al*. (2008) in Australia, and Hunziker (2013) in Switzerland. Further, Savvides and Savvidou (2012) conducted a cross-country study, investigating the financial instrument-risk-related disclosure practices with a focus on the banking sector. They selected 30 banks as the sample, representing different countries such as the USA, Canada, the UK, and Germany. The results showed that there are significant differences in disclosure practices among these countries, although they all use similar IFRS 7 standards.

In addition, Othman and Ammer (2009) in the context of the Malaysian market investigated the market risk disclosure practices of listed companies. However, they examine the level of compliance with FRS 132, which is an accounting standard that