CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

5.1 Summary and Conclusion

The findings of this study suggested that the signs of financial distress can be conveyed through the Ratio Model and Market Return Model.

For Y-1, the findings of the Ratio Model were consistent with the outcome of past researches such as Altman (1968), Nuha (1996) and Ng (2000). Although only the result for Y-1 was statistically significant, it has not impaired the ability of the Ratio Model in differentiating between the distressed and solvent companies.

For the Market Return Model, the anomalous findings differs from theoretical expectation. Nevertheless, the results reflected the findings of the earlier studies by Dichev (1998) and Taftler (1999), whereby the distressed companies under-performed as compared to low-risk companies. There was distinctive difference between the CAR of financially distressed and viable companies.

There were several arguments that could possibly explain the weak results for Y-2 and Y-3 of the Ratio Model.

One of the probable explanations is that the Financial Reporting Act was only enacted in 1997. The Act, which led to the creation of Malaysia Accounting Standard Board (MASB), set out the first formal reporting framework for Malaysia. While the compliance with MASB accounting is mandated by law, it should be noted that the period from 1998 to 1999 was a transitory period which may have prejudiced the samples and therefore may have affected the findings.

Disclosure deficiencies are not uncommon. A study by Dr Wan Nordin Wan Hussein and his colleagues from Universiti Utara Malaysia on "The Determinants of Early Adoption of MASB 22 and the Comprehensiveness of
IAS 14 Disclosures in Malaysia" in the third quarter of 2002 revealed that more than half the sampled early adopters of MASB 22 have not adhered to the disclosure requirements, particularly with respect to providing segmented data on non-cash expenses other than depreciation and amortisation (The Edge, 2003). MASB 22 was introduced in 2002 which requires listed companies in Malaysia to disclose segment data in their financial statements for the period beginning from 1 January 2002. The findings also highlighted the important role played by the independent auditors in assisting and educating companies on a higher standard of reporting.

The introduction of MASB 23, which is effective for financial period beginning on or after 1 January 2002 on the impairment of assets, is another accounting standard which affects the health of the company. Although companies have always been required to revalue their assets and on prudence basis, to write down the value of the assets, specific guidelines to determine asset impairment had not been available until the introduction of MASB 23. The asset impairment review shall now be conducted in a more disciplined manner, which removes any subjectivity in the valuation of assets. The value of the asset value, under MASB 23, hinges on market sentiment and economic outlook. Any impairment of the asset will result in negative impact on earnings, especially on companies, which aggressively acquired major assets during the 1997 Asian Financial Crisis and still carry large goodwill figures in their books (Lee KP, 2003).

The investigations by the Securities Commission on the books of 31 PN4 companies over the past 2 years revealed the occurrence of offences such as purchasing assets at inflated price, selling assets at deflated values, submission of false or misleading information schemes to defraud and misutilisation of capital raising exercise. Companies such as CSM Corporation Bhd has been directed to reinstate their financial statements which were found to be misleading while the managing director of Tat Sang Holdings Bhd has been prosecuted for furnishing false information during the listing proposal (Securities Commission, 2002). Such incidences suggested that the
published financial statements may not represent a true picture for comparative analysis.

A survey on Corporate Governance of Public-Listed Companies in Malaysia in 1998 cited that information disclosure and dissemination needed to be improved further in the annual report. The survey findings suggest a disparity in the source of information which may have affected the calculation of financial ratios for comparability and decision-making. A review of the audited accounts of the samples confirmed that despite not qualifying the audited accounts, the auditors for nearly 90 percent of the PN4 samples pointed out maintaining the growing concern's assumptions may not be appropriate due to several reasons notably the pull back of loans by creditors as well as non-compliance of provisioning policy on some of the assets. Taking the above into consideration, the actual Z-Score for these samples could be worse-off if full compliance was adhered to.

The shortcomings on disclosure anomalies undermine the competency of any financial statements analysis. Based on the KLSE's Annual Report as at 30 June 2001, around 47 percent of the 481 cases under the Exchange's investigations involved non-compliance of corporate disclosure policy and immediate announcement requirements. The findings on the Ratio Model could be affected by these disclosure deficiencies.

The results obtained for the Ratio Model on one year prior to distress classification was in line with expectations. The Z-Score model correctly predicted 90 percent and 75 percent accuracy rate on the distress phenomenon for the Main Board and Second Board respectively. However, the model was not particularly reliable in discriminating more than one year prior to distress occurrence, due probably to the external shocks on the Malaysian economy in the aftermath of the 1997 Asian Financial Crisis.

Based on rational asset pricing model framework, risk should be appropriately priced. Investors assuming such risk such as shown by PN4 companies
should lead to higher not lower average returns, as revealed by the Market Return Model in this study. Nevertheless, the results were not unexpected.

Taffler (1999) found evidence that the premium recorded for financially distressed companies was time dependent with sign inversely related to the state of economy of the country. During the run up to stock market crash, the distressed companies out-performed positive firms but this pattern was very much reversed in the extended economic recession.

The same pattern was reflected in this study. For the Main Board, for the period covering the 29th month to 33rd month prior to distress classification, the PN4 companies out-performed the viable companies. This period corresponded with the period leading to the stock market crash in August 1998 as Malaysia imposed the capital control. As the economy started to move out of recession, there was a return premium for solvent companies. The premium however reduces instead of widening as distress period approaches. The solvent companies generally practice good disclosure and corporate governance as compared to distressed companies classified as the PN4 affected issuers. The premium accorded for solvent companies was consistent with the findings of surveys conducted by PricewaterhouseCoopers (2002) and McKinsey & Co (2001) which showed that local investors are willing to pay as high as 22 percent premium for companies that practices good corporate governance.

The other alternative plausible argument could be the behavioral explanation which suggested that the investors simply do not recognize the PN4 stocks. Certainly when the guidelines on PN4 was first introduced in February 2001, there was confusion even among the listed companies as to whether they were the affected issuer. Only lately through more transparent practices such as separate classification, restriction in trading as well as announcement by the authorities on this matter led to more awareness on these stocks.
As seen from graphs 5.1.1 and 5.1.2 which included the subsequent 12 months excess returns after distress classification, the expected return was not adjusted to commensurate the higher risk of distressed companies even after the occurrence of the event.

Graph 5.1.1: CAR for Main Board Covering 12 Months After Distress

Graph 5.1.2: CAR for Second Board Covering 12 Months After Distress
Therefore, it can be drawn that in the early stage, the ability to identify PN4 stocks may be viewed as privileged or 'inside information' in which case, it would not be correctly priced. A survey conducted by PricewaterhouseCoopers on Market Readiness for Disclosure-Based Regulation (2002) highlighted that institutional investors still lack awareness and understanding on legal remedies available to them against errant companies and directors. They do not undertake extensive merit assessment of investment offerings.

Another possible argument that might be made was that the stock market was not informationally efficient in its ability to appropriately process published accounting information. Investor activism in Malaysia is perceived to be relatively low. Insider trading and market manipulation have been acknowledged to have occurred on the KLSE. Based on KLSE’s annual report as at 30 June 2001, there were 141 cases of potential false trading or market rigging or market manipulation or insider trading, suggesting the stock market may not be efficient for the price to reflect a fair value of the stock. Under such circumstances, mispricing was a more likely explanation for these anomalous results. This was clearly apparent in the findings for the Second Board Companies.

5.2 Suggestion for Additional Research

Arising from the 1997 Asian Financial Crisis, Malaysia has embarked on a journey of enhancing its corporate governance in an effort to build a vigorous capital market. The revamped listing requirements together with an increased emphasis on minority shareholders as well as the government’s efforts to separate ownership from management and increased enforcement efforts were instrumental in Malaysia improving its rating as reported in the CLSA’s Corporate Governance Report (2001).

Recently, the Malaysian Institute of Accountants (MIA) has announced the implementation of Practice Review Programme, a move aimed at ensuring that its members practicing as auditors in Malaysia maintain and observe all
professional and ethical standards (Hasni Mohd Nasir, 2002). The programme will involve the auditing of procedures and methods practiced by auditing firms by an independent reviewer approved by MIA.

According to GAAP Convergence 2002 report, Malaysia is among the 59 countries surveyed that are in the process of converging their national standards of financial reporting with the International Financial Reporting Standards (IFRS). Although MASB followed closely IFSR, it has not fully adopted all the standards issued by International Accounting Standards Board. With the convergence in standards, there will be no comparability issues on financial information across national boundaries (Lee KP, 2003).

Through these efforts and the improvements to be carried out under the Financial Masterplan, the efficiency of the capital market will gradually develops. The enhancement will allow new studies on financial distress to be carried out by analyzing the stock price behavior. By combining the Z-Score and market return, a further study could be carried out to analyse the relationship between Z-Score and the other determinants of return generating process in order to formulate the premium attached to Z-Score and ultimately the pricing of financial distressed companies. The challenge for the new research is to make full use of the available data to derive a better model of the distress process.

5.3 Implications
The better understanding obtained through this study will assist the stakeholders in identifying the financially distressed companies in Malaysia. The findings suggest different uses for the models. Both models serve to reduce the expected losses arising from poor decision-making process.

While the Ratio Model is widely used by creditors in reviewing their exposure to these companies, the Market Return Model is mainly applied by investors in reviewing investments’ decision-making. A large shift in the accounting ratios could be a useful indicator of imminent financial collapse. A more detailed
analysis could then be carried out on the identified companies in order to weigh the risk of corporate failure so that the risk-return profile could be adjusted accordingly.

Due to a relatively low investors activism in Malaysia, the findings from the Market Return Model have not been conclusive. In future, with the enhancements in the capital market environment, the application of this model in distress determination is expected to gather momentum.