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Research Report

Development of financial reporting environment in Malaysia

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ABSTRACT

The purpose of our paper is to examine the development of the financial reporting environment in Malaysia. We explore the influence of environmental factors such as social, political, economic, legal and cultural in the development of accounting and Malaysia's recent move towards the adoption of International Financial Reporting Standards (IFRS). We find that Malaysia's colonial past and the reformation of corporate governance have significantly influenced the country's financial reporting practices. Although there are a number of reforms in place more needs to be done in order to improve the transparency of corporate financial reporting practices in Malaysia. Our conclusion suggests the necessity to improve the quality of financial reporting practices and to build the confidence of stakeholders and potential investors. The findings of our study are particularly important to the standard-setters, regulators and accounting professionals to improve the financial reporting practices in Malaysia and other developing countries throughout the world.

Introduction

It is argued that the efficient and effective institutional framework and a favourable socio-economic and political climate improve the financial reporting practices of a country (Choi & Muller, 1984). Prior studies (see Ali & Ahmed, 2007; Ball, Robin, & Wu, 2003; Gray & Vint, 1995; Mueller & Meek 1997; Williams & Tower, 1998) have identified a number of environmental factors which influence corporate disclosure practices of a country. We examine the social, political, economic, legal and cultural factors which shape financial reporting practices in Malaysia.

With the globalization of capital markets and cross-border activities of companies, there is a need for improved corporate disclosure to ensure that transparency and the integrity of financial reporting are maintained. Potential investors including local and international, likely transfer resources in countries where their interests are protected through disclosure regulations. Since each country has its own unique environmental characteristics, recently, a number of studies in many emerging nations (see Ashraf & Ghani, 2005 on Pakistan; Ali & Ahmed, 2007 on South Asia; Mashayekhi & Mashayekh, 2008 on Iran; Al-Akra, Ali, & Marashdeh, 2009 on Jordan; Assenso, Ali, & Ahmed, 2011 on Ghana), have examined the accounting and reporting environment. However, there are limited studies in South East Asian countries, especially Malaysia, which has been under-researched despite the substantial growth in the economy and accounting regulatory change due to the globalisation. Since there has been a significant growth in the Malaysian economy, potential investors, market participants, financial institutions and regulators from developing countries would like to better understand the financial reporting environment of Malaysia. Our study fills the present research gap by examining the environmental factors which shape development of accounting practices in Malaysia.

Malaysia is one of the main business and financial centres in the Asia-Pacific region. Accounting is playing an important role in the growth of the corporate sector and

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has the potential to spearhead the development of capital market in Malaysia (Susela, 1999). The Malaysian government has attracted substantial foreign direct investment and participation in the securities markets and this has increased significantly in the last 30 years. In 2007, total foreign direct investment in Malaysia was US$8403 million, while the total market capitalization of the Malaysian stock exchange was US$326 million. The average annual growth of market capitalisation in Malaysia is 40% (Liew, 2007). In 2007, there were 1036 companies listed on the Kuala Lumpur Stock Exchange (KLSE), which is ranked 27th in terms of market capitalisation (US$325,663) in the world (Standard & Poors, 2008).

The strengths of Malaysia in the ranking can be seen in the obtaining of credit (ranked 3rd), protecting investors (ranked 4th) and engaging in trade across borders (ranked 21st). Malaysia is ranked 24th in the world for foreign direct investment (FDI). The growths in the market capitalization and inflow of capital have generated a need for the country to have sound financial reporting and disclosure of information. Additionally, Malaysia is of interest not only because of its strong capital market but also because it possesses considerable cultural diversity with regard to ethnicity, religion and language. This cultural diversity had also contributed to the policies underlying financial reporting (Nasir & Zainol, 2007). Another unique characteristic of Malaysia is the presence of a special form of political influence in the economy. This unique business practice is referred to as cronyism[2]. This paper contributes significantly to the accounting literature in that it will help accounting regulators and policy makers in the East Asian region and other developing countries to formulate accounting regulations in order to protect their stakeholders. It will also help to add value to many individuals, institutional investors and foreign investors to gain a better understanding of the transparency and quality of accounting disclosure in Malaysia.

The paper is structured as follows. Section 2 outlines background information pertaining to Malaysia. Section 3 describes the historical development of accounting regulations for financial reporting in Malaysia followed by a discussion of environmental factors influencing the country's financial reporting practices in Section 4. Section 5 reports on the role of International Financial Reporting Standards (IFRS) in Malaysia while Section 6 presents accounting standards due process. The enforcement of financial reporting regulations is described in Section 7. Section 8 concludes the paper.

Malaysia – an introduction

Malaysia is located in the heart of Southeast Asia and consists of two separate geographical segments known as West and East Malaysia. Geographically, Malaysia covers an area of about 329,758 sq km. Malaysia is a multi-racial, Islam-dominated nation (Suto, 2003). The Malaysian population consists of 66% Bumiputra (54% Malays and 12% indigenous ethnic groups), 26% Chinese and 8% Indians according to the 2005 census by the Department of Statistics of Malaysia (DOS., 2010). Bumiputra refers to Malaysian Malay and other indigenous ethnic groups (Haniffa & Cooke, 2002). Additionally, Bumiputra people also are known as "children of the land" (Suto, 2003). The definition of 'Malay' is enshrined in Article 160(2) of the Constitution of Malaysia, which specifies that the Malay is "a person, who professes the Muslim religion, habitually speaks the Malay language and conforms to the Malay custom" (Guan, 2007). Islam is the predominant religion in Malaysia; other religions are Buddhism, Hinduism and Christianity. The reason for the existence of a multi-racial population is the large inflow of immigrants from South Asia and China that occurred during the British colonial period. The arrival of immigrants also brought their religious practices to Malaysia and the country became multi-religious in character. The population of Malaysia in 1957 (the year of independence) was 6,279,000 while the current population in 2010 is 28,250,000 (DOS, 2010).

The nation attained its independence in 1957 and it has transformed since then from a predominantly agrarian society to a (quasi) modern, industrialised society within a relatively short space of time. The economy initially was commodity-based, with a heavy dependence on rubber and tin. Upon obtaining independence, the government has made progress in agriculture and manufacturing as well as in utilities, services and other sectors. The first phase of economic transformation took place in 1970 in the form of agricultural diversification, where timber and palm oil emerged as important export commodities. Later, the discovery of oil began to gain significance and lead to the production of crude petroleum.

The economic growth of the country was not fairly distributed, with a prevalence of poverty and income disparities between the various ethnic groups. This led to racial unrest being partly ascribed to the inequitable distribution of wealth among Malaysia's ethnic communities, especially the Malays and Chinese (Gomez, 1997). Consequently, the Malaysian government introduced the New Economic Policy (NEP) in 1970 for Malays locally known as "Bumiputra" (Haniffa & Cooke, 2002). The NEP institutionalised positive discrimination in favour of Bumiputra by offering concessions in terms of grants, trade, education and certain jobs (Haniffa & Cooke, 2002). The NEP caused a remarkable increase in Malay participation in corporate shareholding within 20 years. It further helped create a Malay business community (Gomez, 1997).

Accounting regulations for financial reporting practices in Malaysia

The corporate financial reporting practices of Malaysia are primarily governed by the Companies Act 1965, the Securities Commission Act 1993, the Kuala Lumpur Stock Exchange (KLSE) Listing Requirements and the Companies Commission of Malaysia. These laws and rules contribute significantly and influence corporate disclosure practices in Malaysia.

[2] The term "crony capitalism" frequently used to describe the close ties between governments and large corporations in East Asia (Ball, Robin, & Wu, 2003).