Understanding

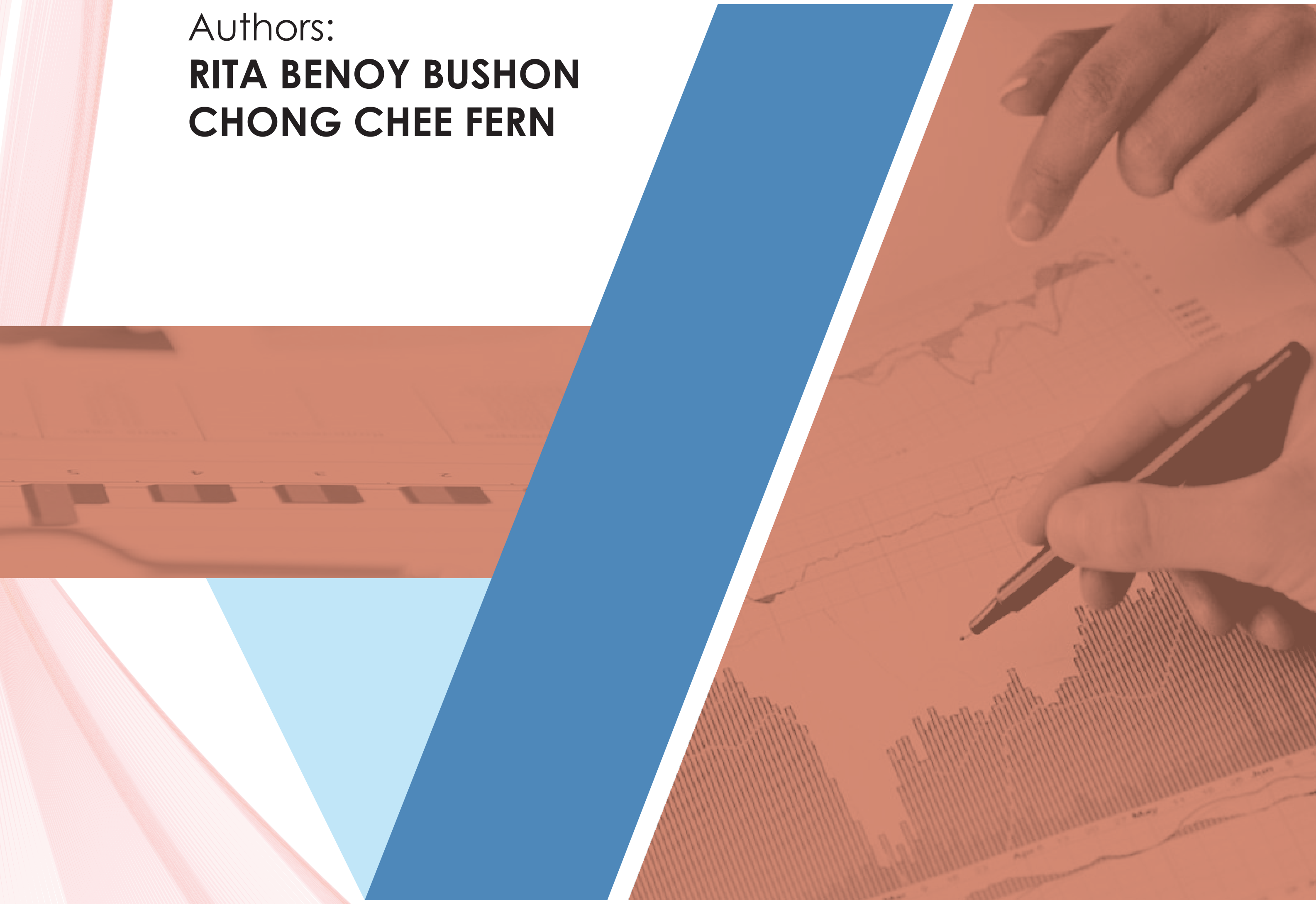
Key Information In An Annual Report

- From A Minority Shareholder's Perspective

Authors:

RITA BENOY BUSHON

CHONG CHEE FERN



MSWG

MINORITY SHAREHOLDER WATCHDOG GROUP

Shareholder Activism and Protection of Minority Interest

DISCLAIMER

This publication on "**Understanding Key Information In An Annual Report From A Minority Shareholder's Perspective**" is written by Ms. Rita Benoy Bushon and Mr. Chong Chee Fern and issued by the Minority Shareholder Watchdog Group to facilitate users of annual reports, in particular, minority shareholders and investors, to understand and analyse the document. The main reason is for investors to understand some basics of what an annual report can provide investors and how they can engage with the management and boards of companies on concerns they have, so that they can bring about added value to them.

This publication serves as a guide for information purpose only and is not exhaustive in its coverage. Preparers of Annual Reports can also use the information derived from this publication to enhance their reports.

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PREFACE

An Annual Report is an essential means by which corporations communicate with stakeholders as part of their accountability and stewardship obligations. Over the years, reporting via annual reports had witnessed dynamic changes and attracted considerable attention and scrutiny particularly after the global financial crisis.

There has been increasing disclosure of information in annual reports and improvements are evident.

This publication has been written to assist retail minority shareholders to understand some basic tools on how to use and analyse key areas in an annual report so that they will know their company better.

We have noted that many retail shareholders, the "moms and pops" buy and sell shares normally relying on rumours. These actions could cause them dearly, I believe.

In the many AGMs that I had attended, some retail minority shareholders and others alike, had requested me to help them understand the basics on investments and how to evaluate companies' fundamentals using an annual report. My motivation, thus, to write this report.

The terms "investors" and "shareholders" are used interchangeably throughout this publication.

I look forward to receiving feedback on this publication and other areas that shareholders require inputs on.

Rita Benoy Bushon

Chief Executive Officer
Minority Shareholder Watchdog Group
December 2016

Chapter 1

Overview and Value of Annual Report

This Chapter gives an overview of the features of annual reports of public listed companies and the main guidelines and regulations that govern them.

As the name suggests, annual reports are published yearly for the annual general meeting (AGM) of the company. An annual report is regarded as the accompanying document normally provided with the notice of the company's AGM and the resolutions tabled at such meetings for presentation to shareholders.

The disclosures in an annual report are needed to fulfil:

The statutory requirements

under the Companies Act 1965 such as the audited accounts and directors' report.

The regulatory requirements

under Bursa Malaysia Listing Requirements (LR) for listed entities.

Thus, listed companies must issue the Annual Audited Financial Statements and Annual Report within 4 months from the close of the financial year of the company. They include the Statement of Financial Position, Statement of Profit and Loss and Other Comprehensive Income, Statement of Cash Flows and Statement of Changes in Equity.

Companies must send the annual reports whether in hard copies or in electronic form to their shareholders at least 21 days before the AGMs, together with the notices of the agenda items including the election of directors.

Companies must also include in their annual reports the Audit Committee Report, Corporate Governance Statement and Statement on Risk Management and Internal Control.

(For a full list of the items, see Part A of Appendix 9C of the LR)

The newly amended LR has also made it mandatory for PLCs to provide a Management Discussion and Analysis (MDA) statement where the company management is required to provide an overview of the Group's business and operations, analysis of the financial results and conditions, review of operating activities, risks and forward-looking statements.

Apart from the above mandatory information (statutory and regulatory), the voluntary or non-mandatory information may include information such as group structure, share price performance, achievements, awards and recognition.

The disclosures in the annual reports form an important element of corporate governance which aids shareholders in making informed decisions on their company.

Companies can be considered transparent only when the information provided in the annual reports are made available in a timely manner depicting the accurate state of affairs of the company and explaining them so that it is easily understood. In a disclosure-based regime for minority shareholders to make decisions about their investments, the integrity of the information provided by the company is indeed crucial. It is the key ingredient for investor protection and market confidence overall.

The importance of quality corporate reporting is further underscored by the G20/OECD Principles of Corporate Governance as follows:

"A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their shareholder rights on an informed basis. Experience shows that disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in the capital markets.

By contrast, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in a poor allocation of resources.

Disclosure also helps improve public understanding of the structure and activities of enterprises, corporate policies and performance with respect to environmental and ethical standards, and companies' relationships with the communities in which they operate."

The purpose of an annual report is to fulfil the wide-ranging needs of the company and amongst them are:

a. complying with the statutory requirements

b. attesting that the financial statements were prepared in a true and fair manner

c. providing material information about the company to shareholders for them to make informed decisions

d. communicating key messages to stakeholders

e. using the report as a marketing tool

f. communicating specific intentions of the board e.g. strategies

g. reporting on performance and financials

h. explaining the material risks and factors that could influence performance

i. providing clarity on material matters and corporate governance issues

j. providing explanations on the corporate responsibility and sustainability-related activities.

Although the annual report is not the only source of information to assist investors to make investment decisions, it is one of the major sources and a useful one. Investors have to also rely on many other sources including quarterly financial results, investment analysts' reports, Bursa announcements, media reports and even some investment blogs which are reliable. Attending AGMs and EGMs would also enable investors to gather more useful information on the board and management of the company.

Annual reports are normally made available in electronic formats such as CDs, company websites, Bursa's website and sometimes as hard copy documents when requested.

Annual reports have become more voluminous since the last decade, containing more information and data, both financial and non-financial.

Having stated the above, many still view annual reports as backward-looking and dated.

From our observations, overall, companies, especially larger capitalised companies, have attempted to provide the relevant information for their shareholders. This is normally because such companies are covered by many analysts and followed by institutional investors. There are, however, many small and mid-sized companies where the annual reports do not give much information. We noted that material points in these reports were poorly connected and not easily understood making it difficult to want to invest in such companies.

Whilst it is laudable that the introduction of the International Financial Reporting Standards (IFRS) has led to a global language for financial statements and increased comparability, financial statements are only one element of the corporate reporting chain. There is a limit to which financial statements can convey the other important messages. It is, therefore, hoped that a narrative of key areas will provide a broader more meaningful understanding of a company's business, risks, market position, performance and prospects as well as its corporate responsibility and sustainability objectives.

Against this backdrop, a new reporting framework called Integrated Reporting (IR) has also been introduced by the International Integrated Reporting Council (IIRC), which essentially integrates financial performance with the non-financial elements of environment, social and governance (ESG) in a single report.

For completeness, this Chapter will attempt to provide the value of annual reports, assessing its benefits and shortcomings mainly based upon secondary studies conducted globally.

In June 2013, the survey report entitled "Understanding investors: directions for corporate reporting" by ACCA highlighted the following findings:

50% of users felt that the annual report was still their primary or only source of information.

47% felt that the report was too long.

35% were of the opinion that the report was too backward-facing.

40% opined that it was too general purpose to meet their needs.

35% felt that it was too complex in its current form.

71% thought that the companies should be reporting more on potential risks that could affect their performance.

70% said that a company's key risks and how they intended to manage or mitigate them was the most pressing issue for them following the economic crisis. The other areas that investors were significantly more interested in post-crisis included-

63% who were more focused on future plans and prospects, 59% who wanted to know about key performance indicators, and 58% were more interested in the financial statements themselves.

The emergence of integrated reporting was also welcomed. 59% said that the inclusion of social and environmental data through an integrated report would add value.

The survey strongly suggested that the annual report had not diminished in importance as the findings showed that the annual report is the most valuable source of input for making investment decisions.

Globalisation of markets, cross-border investment flows and the internationalisation of reporting standards had resulted in an overall improvement of reporting practices and a larger degree of homogenisation of annual reports over the years. However, we have noted that many reports tend to look and sound similar to boilerplate reporting.

More than two out of five investors believe that integrated reporting would provide a better explanation of the linkage between sustainability and long-term corporate performance; and a similar number believed that it would provide greater information on how long-term risks, such as climate change could affect a company's business model. Integrated reporting could help put the concept of stewardship right at the heart of the corporate reporting system.

Key Requirements and Good Practices/Recommendations on Disclosures in Annual Reports

As stated earlier, the contents of an annual report comprise mandatory and non-mandatory information. To have a better insight into the contents, it is necessary to consider the key requirements and good practices/recommendations on disclosures in an annual report. They are as follows:

1. Companies Act 1965
2. Bursa Malaysia Listing Requirements
3. Malaysian Code on Corporate Governance 2012
4. Bursa Malaysia CG Guide
5. Bursa Malaysia Corporate Disclosure Guide
6. Statement on Risk Management & Internal Control-Guidelines for Directors of Listed Issuers
7. Sustainability Reporting Guide
8. Sustainability Toolkits
9. ASEAN CG Scorecard

Refer to Appendix 1 for the relevant links

Since we are commenting on this topic of key requirements and good practices/recommendations, it is pertinent to have an insight into the areas of weaknesses or inadequacies in disclosures. In this regard, MSWG has annually carried out surveys of PLCs since 2009 and highlighted the observations/recommendations in disclosures in the area of corporate governance.

A summary of some observations is shown in Appendix 2: ***Malaysia-ASEAN Corporate Governance Report 2015 (some observations).***

Typical Contents of an Annual Report

A comprehensive annual report should, apart from the mandatory items, contain non-mandatory information, reflecting good corporate governance principles/practices and also information useful to shareholders, potential investors and various stakeholders. A sample set of comprehensive contents to be included in an annual report is shown below:

Sample of Contents of an Annual Report

- Vision and Mission
- Corporate Information
- Group Structure
- Organisation/Company Structure
- Financial Highlights
- List of Properties/Plantation Statistics/Vessels
- Chairman's Statement/Message
- CEO's Review/Message
- Management Discussion & Analysis (MD&A)
- Directors' Profile
- Senior Management Team
- Standards of Business Conduct Statement
- Achievements, Awards and Recognition
- Segmental Analysis
- Statement of Value Added & Distribution
- Share Price Chart
- Total Shareholder Return
- Statement on Corporate Governance
- Corporate Social Responsibility/ Sustainability Statement
- Organisation/Company Structure
- Statement on Risk Management and Internal Control
- Audit Committee Report
- Directors' Report
- Statement by Directors
- Financial Statements
- Notes to Financial Statements
- Independent Auditors' Report
- Analysis of Shareholdings
- Notice of AGM
- Statement Accompanying Notice of AGM
- Proxy form

Whilst it is a good practice to have the contents which are comprehensive, we note that there are a few items which we feel are useful but not included in some annual reports. We recommend that, where relevant, these items be included in the annual reports:

- Vision and Mission Statement
- Financial Highlights

By highlighting its vision and mission statement, the company can promote its brand and image and reinforce how it can achieve its corporate objectives. It can be a powerful statement that sets the direction of the company.

The 5-year financial highlights disclosures in the annual reports can provide investors useful and value added information. Further explanations are given under Chapter 2 on "Financial Highlights and Key Performance Indicators".

For guidance, please refer to "Contents list for the annual report of a UK company" issued by ICSA (January 2015):
https://www.icsa.org.uk/assets/files/free-guidance-notes/contents-list-for-the-annual-report-of-a-uk-company.pdf

Chapter 2

Financial Highlights and Key Performance Indicators

The Bursa Malaysia Corporate Disclosure Guide prescribes the minimum disclosure requirements for certain transactions. Nevertheless, the quality of disclosure depends, to a large extent, on the information provided by listed companies. To be meaningful, disclosures should be aimed at providing shareholders and investors with quality information on a timely basis.

In this regard, financial highlights, though not a mandatory item in an annual report, should be disclosed as they are useful and can enhance the quality of disclosure. An annual report contains voluminous information and in particular, the financial statements with so much data, can be intimidating to investors and more so to users who have limited accounting knowledge.

To facilitate better understanding and to have a more user-friendly presentation, disclosing financial highlights showing the key financial indicators for the last 5 years would be very useful to shareholders and investors.

To further add value, it would be useful to also present the last few quarters' financial data. For best practices, listed issuers are also encouraged to disclose some key statistics unique to certain industries, for example, the plantation industry which has some unique information peculiar to the industry, such as the tree-age profile.

For clearer illustrations, visual presentations of the financial highlights can be disclosed by including bar charts, graphs, pie charts and other pictorials, where applicable. This will also enable a better appreciation of trends for meaningful analysis.

An example of key financial data and indicators is illustrated below:

Group Financial Highlights

Statement of Comprehensive Income (RM '000)	2011	2012	2013	2014	2015
Revenue					
EBITDA					
Profit before tax					
Profit after tax					
Net profit attributable to equity holders					
Statement of Financial Position					
Paid-up share capital					
Shareholders' equity					
Total assets					
Total borrowings					
Total cash					

Key Indicators	2011	2012	2013	2014	2015
Return on Equity (ROE) (%)					
Return on total assets (pre-tax) (%)					
Price earnings ratio (PER) (times)					
Net gearing ratio (%)					
Interest cover (times)					
Earnings per share (EPS) (sen)					
Net assets per share (NAPS) (RM)					
Price to book value (PBV) (%)					
Dividend per share (DPS) (sen)					
Dividend yield (DY) (%)					
Dividend payout ratio (%)					
Cost-income ratio (CIR) (%)					
Impaired loans ratio (%)					
Share price at financial year end (RM)					

An example of key industry specific statistics such as for the plantation sector is shown below:

Oil Palm	2011	2012	2013	2014	2015
FFB production – own estates (mt), purchased (mt)					
Yield per mature hectare (mt FFB)					
CPO yield per mature hectare (mt)					
Palm oil extraction rate (OER) (%)					
Palm kernel extraction rate (KER) (%)					
Average selling prices: Refined palm products (RM/mt ex-refinery) Crude palm oil (RM/mt ex-mill) Palm kernel oil (RM/mt ex-mill) FFB (RM/mt)					
Planted area (hectares): Mature, Immature					
Cost of production (RM/mt) – Palm oil, Palm kernel					

Key Performance Indicators (KPIs) and Achievements

Closely associated with financial highlights is the disclosure of KPIs together with the targets and achievements. KPIs are the indicators or parameters such as return on equity (ROE), impaired loans ratio, cost-income ratio (CIR) while the respective targets to be achieved, for example, are ROE of 15%, impaired loans ratio of 1% and CIR of 35%.

Such disclosure will enable investors to assess how successful the company is in achieving its set targets and to what extent it is on track in meeting its corporate objectives.

To provide better insights and for benchmarking purposes, it would be useful if the PLC could also show the KPIs and achievements of other domestic and regional peers and even across industries, where possible.

At AGMs we noted that shareholders have begun to question why companies are not disclosing such indicators when some of their peers were able to. Shareholders were interested to see not only how a company fared against its own KPIs and targets but also how its performance was benchmarked against other players.

Benefits in Summary

The benefits can be summed up as follows:

- At a glance, you are able to quickly get a flavour of the company's past performances over a few years, its track record, trend, etc. and benchmarking against peers.

The information will certainly facilitate easier informed decision-making by shareholders or potential investors.

1. Apart from the audited financial statements, the section on financial highlights and KPIs are very useful to investors.

2. The 5-Year Financial Highlights and KPIs are important as investors can see at a glance the trend of performance and the key indicators over a 5-year period. Although past good performance may not necessarily be an indication of good future performance, it serves as a good guide.

3. Apart from achieving the targets set for the KPIs, how does the company benchmark against its peers, domestically or regionally and the industry? This will give further added value.

Chapter 3

Some Basics on Audited Financial Statements

Understanding the fundamentals of financial statements would be important for prudent investors. Do not be intimidated by the jargon and its calculations. It is relatively uncomplicated if you look for the relevant figures. There are many articles and books that are available in the web to aid you.

The standardisation of financial reporting terminologies has made it easier to understand the company. The maxim is that if the company has made it difficult for you to understand their statements or you have little knowledge of the product or the industry it is in, do not part with your money to buy into such companies.

We will try to take you through some basics of understanding financial statements from our perspective and focus on some common ratios that can be derived from the financial statements in an annual report. They can guide you to interpret the basic information.

Auditors' Report and Types of Opinions

First things first!

Before even delving into the interpretation of the company's financial reports, look into the Auditors' Report and determine whether the company has a clean report.

Audited financial statements prepared for inclusion in the annual report are as follows:

1. Statement of Financial Position
2. Statement of Profit or Loss and Other Comprehensive Income
3. Statement of Cash Flows
4. Statement of Changes in Equity

For each of the above statements, the respective consolidated statements are prepared. The accompanying notes form an integral part of the financial statements.

The financial statements must be audited by an independent external auditor approved by the Audit Oversight Board (AOB).

- See whether the independent auditors' report has an opinion on the accounts.

If there is an opinion, determine whether there is a need to further analyse the company or request for further explanation in the shareholders' meeting.

Likewise, a red flag is raised if the external auditor resigns or requests not to be re-elected or is changed frequently.

You would like to see a clean and unmodified opinion from the external auditor who concludesthat the financial statements give a true and fair view of the financial position of the company and the group in accordance with Malaysian Financial Reporting Standards, International Financial Reporting Standards and the requirements of the Companies Act, 1965.

Sometimes, although the auditors' opinion is that the accounts are appropriately presented in the financial statements, it still could draw a user's attention to a specific matter of importance that the auditors believe is fundamental to users' understanding of the financial statements. In this case, an Emphasis of Matter paragraph would be included in the auditors' report. This is considered unmodified.

Apart from an unmodified opinion, other opinions expressed by auditors are modified opinions categorised as follows:

- Adverse opinion
- Qualified or "except for" opinion
- Disclaimer of opinion

For a description and basis for such opinions, see Appendix 3.

Shareholders should note that for audits of financial statements for periods ending on or after 15 December 2016, there will be a new and enhanced auditor reporting. An important feature is the communication of key audit matters in the auditors' report and this is intended to:

a. provide greater transparency about the audit that was performed;

b. provide additional information to assist users of the financial statements in understanding those matters that, in the auditors' professional judgement, are of most significance in the audit of the financial statements of the current period;

c. assist users in understanding the entity and areas of significant management judgment in the audited financial statements.

d. provide users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.

Key Accounting Principles That A Minority Shareholder Needs To Understand

After going through the Auditors' Report and being satisfied with the content, the next area that shareholders should get familiar with are some key accounting principles and conventions. There are numerous concepts, principles and conventions in accounting. Understanding key ones can be very useful and we will go through these concepts briefly.

Generally Accepted Accounting Principles (GAAP) are used to prepare financial statements to ensure standardisation on the understanding of these numbers.

- We will look into the historical cost concept, realisation concept and profit measures:

Historical cost concept

According to GAAP, assets, especially illiquid assets, are recorded in the balance sheet at their original purchase price, which is known as historical cost. Illiquid assets include land and buildings.

The historical cost value may be significantly different compared to their current market value and normally for land, the market value can be very high, as land would appreciate in value over the long term.

Liquid assets such as marketable securities, for example, quoted shares are recorded at market prices.

During corporate exercises such as privatisation, shareholders need to be given back the proper value of the company's assets. The historical cost may not reflect the true value of the company. Thus a proper valuation by independent valuers needs to be conducted to give the fair and reasonable value of the company.

In Malaysia, we have many plantation companies where the assets are mainly oil palm trees. The oil palm trees on these lands have a useful life and the value depends on the age profile of the trees. The accounting convention for biological assets are still being perfected.

There have been actual cases of privatisation proposals in the past where shareholders, including MSWG, had complained to the regulators that the companies in question had not revalued their properties and, therefore, the offer price was grossly unfair as they had not taken into account any likely revaluation surplus. The companies were instructed by the regulators to carry out the revaluations. Hitherto, privatisation proposals were required to have independent valuations made when assets have not been revalued.

An example is depicted below:

- Assuming that in the case of a privatisation exercise, the price offered is RM2.50 per share.
- Net assets per share is RM3.00 and the company has substantial properties not revalued for a long time.
- If a revaluation were to be carried out and if there is a surplus which translates to an increase in the net assets by, say, RM0.60, the revalued net assets value (RNAV) per share will become RM3.60.
- Thus the offer price of RM2.50 per share will be at a big discount of RM1.10 (i.e. RM3.60 – RM2.50) or 30.5% (RM1.10/RM3.60) to the RNAV of RM3.60.
- The offer price is thus deemed unfair.
- Therefore, in any privatisation exercise, investors should watch out for those companies which have substantial properties which have not been revalued for a long time and, should insist on revaluation to be conducted.

Realisation and accruals concepts

The realisation concept in accounting refers to the application of accruals towards the recognition of revenue.

Under this principle, revenue is recognized by the seller when it is earned irrespective of whether cash from the transaction has been received or not. Revenues are recorded when goods or services are delivered and expenses recorded when incurred.

Profit is not a measure of how much cash a company earned during a given period. This is because the income statement includes a lot of non-cash expenses such as depreciation and amortization and non-cash revenue which will be booked in as they are based on the accruals concept where payment has not been received.

For example, in a hypothetical case of an engineering consultant company that rendered services to a client amounting to RM10m in November and was given 3 months to pay for the services.

At the end of the year the company had not received the payment. As the company had delivered the services and incurred an expenditure relating to this service amounting to RM9m, the company would need to book in the accounts for the RM10m revenue and RM9m in expenses based on the accrual concept and the matching concept.

Therefore, the profit for the company as at end of the year is RM1m.

At the year end, the RM9m had gone out in terms of expenses, but the RM10m had not been received. This means the company has depleted its cash by RM9m while waiting for the RM10m to come in.

This RM1m in profit is not a cash item but only an accounting entry.

The money is assumed to be collected the following year. It is all right if the money is indeed received and the accounts can be squared-off.

A problem occurs if this amount is not collected and becomes a bad debt.

Therefore, investors need to pay attention to the cash inflow and outflow as depicted through the cashflow statements.

The flow of actual receipt and disbursement of cash usually does not coincide and that is why the cash flow becomes so important. It can gauge whether a company, despite having profits, can have liquidity issues and be rendered insolvent like the example above.

A modified Auditors' Report or Report with "Emphasis of Matter" would be an important red flag for investment decision making by any potential investor.

Chapter 4

Key Ratio Analysis and Other Financial Considerations

After noting that the auditors' report is unmodified as discussed in the previous Chapter, we can further analyse the well-being of the company from the financial statements. In this Chapter, we will try to analyse some financial information in summary form.

As shareholders, you can keep a scorecard of how events had impacted the company you have invested in. They are easier to understand if you can visualise the underlying realities from the numbers such as what and how the company is doing, its products and services as well as the industry in which it operates. This is because there are peculiarities in each industry which you need to be familiar with.

Shareholders need to recognise that financial statement insight, though very important, is only one piece of the larger investment information. The numbers in a company's financials, nevertheless, do reflect real world events translated into Ringgit.

Overall Financial Performance

Prudent investing practices dictate that we seek out quality companies with strong balance sheets, solid earnings and positive cash flows.

The next area of interest would be the financial position of the Group.

The absolute numbers in financial statements need to be looked together with relative ratios to give a more meaningful interpretation to judge a company's financial performance and condition.

The resulting ratios and indicators should be viewed together across industries and across time periods, company size and stage of development.

We will analyse in brief some of the financial indicators and ratios.

Let us get started on getting the numbers with respect to a real example which we have extracted from an Annual Report of a company listed in Bursa Malaysia (please refer to illustrations depicted at the end of this Chapter as per **Attachment I**)

(i) The financial results for the last three years in graphic form and in **Table A** below are extracted from **Attachment I** at the end of the Chapter. This will provide some indicators of the trend of profits whether upwards or downwards.

FINANCIAL RESULTS

Financial Indicators (RM'm)

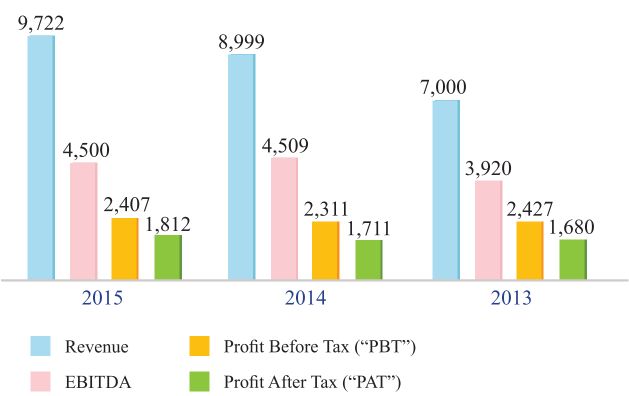


Table A: Financial Position

	2015 RM million
Total Revenue	9,722
Operating Expenses:	
Salaries	
Rent	
Utilities	
Total Operating Expenses	(5,222)
EBITDA	4,500
Interest Expense	(800)
Depreciation	(1,293)
Taxes	(595)
Net Profit (PAT)	**1,812**
PAT margin	**18.6%**

Extracted partly from Attachment I

Profit Numbers

Investors would like to know whether the profit numbers have increased or decreased.

Profits are normally gauged by looking at profit after tax (PAT). Profit after tax and minority interest (PATAMI) numbers too are used by analysts. For simplicity we will use PAT numbers for profits.

Net profit represents the number of sales dollars remaining after all operating expenses, interest and taxes have been deducted from a company's total revenue.

Changes in net profit need to be scrutinised too. In general, when a company's net profit is low or if there is a loss, a myriad of problems may be the reason, ranging from decreasing sales to poor customer experience to inadequate expense management.

The net profit is found on the last line of the income statement, which is why it is often referred to as the bottom-line numbers and the total revenue or turnover is referred to as top-line numbers because it is the first line in the income statement.

(ii) Net Profit = Total Revenue -Total Expenses

First, analyse the factors that contributed significantly to the increase or decrease in the profit numbers and whether they were recurring items or one-off items.

Where the increase is unusually high, coupled with high increase in revenue and receivables without substantive basis, try to establish the credibility. Question needs to be asked is whether the increase is sustainable or is it a "*too good to be true*" situation that warrants further probing?

A situation where the increase in trade receivables or debtors far exceeds the increase in revenue, it may also be a concern as it may be a sign that the company has problems in collecting its debts and may result in impairments and non-recoverability of the debts. The company could be facing liquidity issues.

Investors should also establish whether gross profit and net profit margins are improving or deteriorating and reasons thereof. Declining margins could be affected by increasing competition and/or escalating costs of goods or production or both.

Net profit margin or sometimes referred to as the profit after tax margin, which is net profit divided by revenue.

From the example, the PAT margin was 18.6%. It seems to indicate that the margins were declining, especially from 2013 at 24%.

After analysis of the sector, we noted that the sector had become very competitive in the past few years as more players entered the business, eroding the incumbent's margins.

When analysed further, EBITDA margins were high at almost 50% but because of huge depreciation charges and interest charges, the net margins were in the teens (18.6%).

The depreciation charges occurred because of the huge capital expenditure that was needed in such an industry and that it was largely through borrowings, thus, the interest charges were also high.

The investors would need to look at the industry as a whole to get a clearer picture and whether the company can stay ahead of its competitors.

High concentration of revenue and receivables in only a few customers may also pose undue risks. A sharp decline in revenue can occur if a few of the big customers were to quit doing business with the company. Investors would, therefore, need to analyse the customers' profiles and turnover rates.

There is also a fear of high impairment of receivables if a few of these customers were to default in payment of their debts.

- If there was any concentration of credit risk, this should be disclosed in the notes to the financial statements.

As such, investors should refer to the back pages of the annual report to see the notes to the accounts.

Share Price Performance and Total Shareholder Return

Investors would be keen to know how the company's share had performed and the total shareholder return. This is derived from the share price increase/decrease plus dividends received.

Total shareholder return (%) = {(Increase/Decrease) in share price + Total Dividends Received} / Purchased Price of Share

A company with a good track record of profitability especially over a sustainable long period of time has a higher probability of maintaining its good performance.

Investors would then be able to evaluate the compounded annual growth rate (CAGR) over the years from the annual reports.

From the example, we noted that share price was RM4.98 a share at the end of the year compared to RM4.00 the previous year whereas the total dividend received per share was RM0.207, thus the total shareholder return, assuming that the investor bought the share at RM4.00, would be 29.7% based on the following calculation:

{(RM4.98 – RM4.00) + RM0.207}/RM4.00 = 29.7%

As an investor, you would need to evaluate whether this total return is reasonable and fair to you, taking into consideration your risk-return profile.

Return On Equity

Closely associated with financial performance and one that is used very often in the investment community, is the return on equity (ROE).

It measures the amount of profits a company can generate from the amount of funds that belong to the shareholders, commonly referred to as equity or shareholders' funds.

ROE = (PAT/Shareholders' Equity) x 100

Why ROE Matters

ROE is sometimes also called “return on net worth”.

It is a measure of efficiency on how a company can deploy its resources using the shareholders’ monies to generate profits.

In this case, the company generated a profit of RM0.37 for every RM1 of shareholders’ equity in 2015, giving the company an ROE of 37%.

The investors can gauge the trends, namely, whether it is going up or coming down and the reasons why.

Return on equity numbers should be compared amongst companies within the same industry. Some industries tend to have higher average numbers compared to others. The numbers would need to be scrutinised further to see whether companies are artificially trying to boost these figures such as by share buy-backs, huge dividend payouts and keeping reserves low, which can boost ROE.

As such the numbers need to be seen in the context of a longer term.

Price Earnings Ratio (PER)

As net profit is measured in ringgit terms and companies vary in size, it is often appropriate to consider a common ratio as a yardstick to measure against other companies, such as the PER, which tells investors how much they are paying for the share for each dollar of net profit the company is able to generate.

The calculations of the PE ratio or sometimes referred to as PER multiple is as follows:

PER = Price of share/EPS

where P is the price of the share trading in the market and EPS is the earnings per share.

- The multiple (PER) also measures the number of times the share price trades over the earnings per share.
- It can be deemed a break-even number of years or a payback period in terms of number of years to recover your investment.

In general, it is better to have a lower PER multiple as it simply means a shorter time to recoup your investments.

It may also indicate that the share may be undervalued and has potential to appreciate, especially if the PER is significantly below the industry PER. It is always better to compare the company’s PER against other similar companies and the average industry PER.

First we have to calculate the EPS numbers which is earnings per share.

EPS is the part of a company's distributable profit allocated to each outstanding share and serves as an important indicator of profitability. It is generally considered to be a very important variable in determining share price.

- The diluted earnings per share (Diluted EPS) include the shares of all convertible securities such as stock options, warrants and convertible preferred shares, as if they were exercised.

- If a company issues new shares and has share buy-back in the year, the weighted average common shares are used in the calculation. The weighted average common shares outstanding can be simplified by adding the beginning and ending outstanding shares and dividing by two.

From the example, the PER is 498 sen / 21.3 sen= 23.4x

Ballpark numbers indicate that you would be getting back your money in 23.4 years' time. This may not necessarily be bad or high as the forward earnings of the company next year and the following years could be better depending on the growth factors and, thus, you need to evaluate the growth prospects of the company.

Whether the PER is high or low, you would also need to look at the average in the industry to determine whether you would consider the price as steep when buying the share.

PEG = PER/Annual EPS Growth

where PEG is price/earnings to growth.

Following from the above, the PEG ratio is one of the common valuation tools used by analysts.

The PEG ratio can provide some indicative value of the share while taking the company's earnings growth into account.

To distinguish between calculation methods using future growth and historical growth, the terms "forward PEG" and "trailing PEG" are sometimes used.

Even though the PER can be very high and seems to be expensive like the above calculations indicate, if the future growth of the company is viewed as tremendous, the share could still be considered undervalued and cheap.

Thus, the PEG ratio provides a relative number between the price and earnings of the share with that of its future potential.

Shareholders can evaluate the growth rates of the company's earnings by talking to analysts or going to the AGMs and asking the company's board to provide some indication of the company's revenue and earnings growth rates and whether achievable.

This information needs to be evaluated and analysed before you churn out the numbers to get the forward bottom-line numbers and calculating the forward EPS figures.

Do not be intimidated as it is simpler to understand compared to the more elaborate methods such as the discounted cash flow, free cash flow and other complicated methods.

- As a rule of thumb, with a PEG around 1, a company may be deemed to have reached its fair value when you compare it with the current price of the share. A PEG much higher than 1 indicates an overvalued company while one lower than 1 indicates an undervalued company.

PBV = Price/Net Assets Per Share (NAPS)

The price to book value ratio (PBV), also called the P/B ratio, is another valuation tool to evaluate whether the current company share price is undervalued or overvalued. It compares the share price with the net assets per share of the company.

PBV gives investors an indication of whether the share price is traded below (at a discount) or above (at a premium) the net assets per share.

If the share price is traded at a discount, it may be deemed as being undervalued and if it is at a premium, it may be deemed to be overvalued. The greater the discount, the more attractive would be the share, all other things remaining equal.

A P/B ratio above 1 indicates that the investors are willing to pay a premium for the company perhaps because the investors feel that the future holds good potential or possibilities and /or the company's assets are worth much more.

If the ratio is less than 1, it means the company could be undervalued for some reason. Investors may perceive that the company's assets may not be worth that much and/or the company's financial performance is poor and the future bleak.

The ratio has its limitations, especially for high technology companies with high levels of intangible assets and low fixed assets. However, during evaluation of takeovers and mergers, minority shareholders can also use ratios such as this as a guide to give them a rough idea as to whether the price is close to what it should be, based on industry norms.

In the example, the PBV ratio is 8.86 times
Price to Book Value (PBV) = Market price per share / Net assets per share attributable to equity holders of the Company
= RM4.98/RM0.562
= 8.86 times

Dividend Policy and Dividend Reinvestment Plan/Scheme (DRP)

Where a company has an explicit dividend policy being spelt out, investors, especially pensioners, can plan their own earnings stream. It also provides an indication of the company's ability to balance the various stakeholders' requirements such as its equity and debt holders as well as its own internal funds that will be required for its future growth.

Dividend payout ratio is the total dividends paid for a share in a year out of its earnings. It can range from about 10% to as high as 90% and some even exceeding 100%. A company with a high dividend payout policy and with sustainable high payouts over the years tends to indicate that the company is financially sound and has a strong cash position and would normally attract investors. There are some companies which are also able to consistently pay dividends quarterly, thus, making their shares even more attractive to investors.

Assuming that a company's profit after tax is consistent over the years, a higher dividend payout in any particular year would give rise to a higher return on equity (ROE).

An interesting scheme which has been gaining popularity among PLCs is the Dividend Reinvestment Plan/Scheme (DRP) whereupon any declaration of dividends, shareholders are given the option to reinvest a portion of their dividend entitlement in the PLC's shares instead of receiving the entire dividends in cash. This seems to be a "win-win" situation for both parties as shareholders are given the opportunity to increase their shareholdings in the PLC at a slight discount to the market price whilst at the same time the PLC is also able to conserve some cash instead of paying out dividends fully in cash.

Dividend Yield (DY) = Total dividends received per share in a year/price of share

- Dividend yield is one important factor for income seeking shareholders. It refers to the annual dividend payments per share to shareholders, expressed as a percentage of the stock's current price.

A good indication of the attractiveness of the dividend yield is to benchmark it against the industry yields and the return of other alternative investments such as the interest rate earned on fixed deposits placed with banks.

In times of uncertainties or when the market is depressed, investors may want to move to more defensive shares which have better dividend yields and lower price volatility.

From the calculations,

DY = 4.2%

i.e. Dividends Per Share (DPS) / Market price per share = RM0.207/RM4.98

Whether it would be safer to put the money into this company or into fixed deposits, yielding 3 percent, would be something the investors need to decide, as investment into shares is also about the capital appreciation.

Net gearing ratio = {(Total Borrowings less Cash)/Equity}

Gearing is a measure of a company's financial leverage and provides an indication of the extent to which its operations are funded by lenders compared to company's shareholders. Sometimes known as debt-to-equity ratio, the appropriate level of gearing for a company would depend on the company's ability to service it.

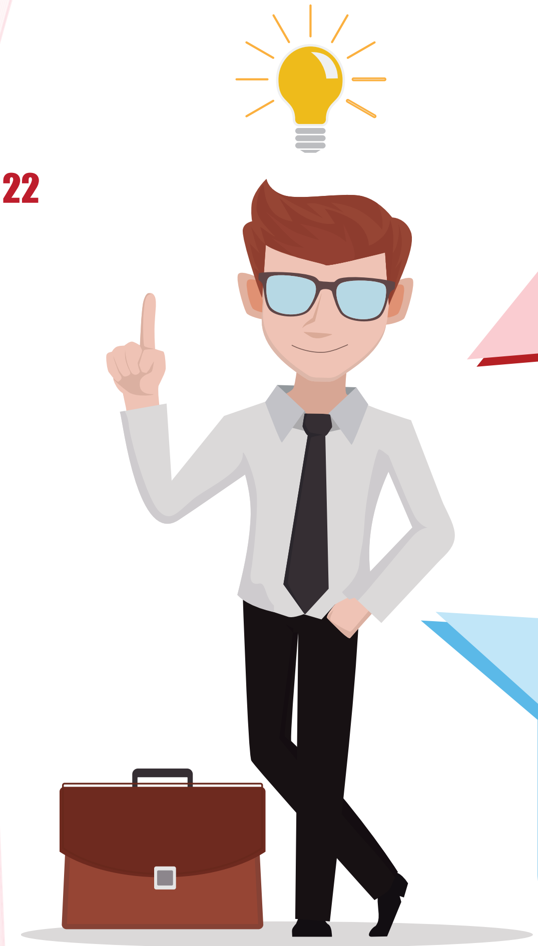
A modest amount of debt is often seen as a positive indicator and sometimes it is used to reduce a company's tax bill. Nevertheless, too much of debt can be bad news. You can look at industry norms as an indicator to gauge whether the gearing level of the company is high or low.

The higher the ratio, the higher is the risk exposed to vagaries of interest rate hikes which will lead to higher interest costs. The level of domestic or foreign debts would also be a consideration that is needed to be scrutinised, as exposures to foreign currency risk would be higher if borrowings are in foreign currencies.

In an economic downturn, the risk of a downward spiral of our exchange rate against major currencies could pose a severe strain on the company's finances.

From the calculations;
Net Gearing Ratio (Net GR) = {Total borrowings – Total cash} / Equity attributable to equity holders of the Company
= (RM9,231m - RM1,311m)/RM4,335m
= 1.83 times

Summary of Financial Analysis



Ratio analysis is certainly crucial and among the important ratios are:

- Return on equity
- Net gearing ratio
- Earnings per share
- Price earnings ratio
- Net assets per share
- Price to book value
- Dividend yield
- Dividend payout ratio

- Analyse the accounts and determine what contributed to the increase/decrease of revenue and profit.
- Is the increase sustainable and are there any one-off items?
- In there any unusual "*too good to be true*" spark in revenue or profit?
- Are borrowings substantial, resulting in very high gearing?
- Is the increase in trade receivables far exceeding the increase in revenue?
- Is there any high concentration of revenue or receivables in only a few customers?
- Is gross or net profit margin declining?

When we talk about creation of shareholder value, what is important to investors is the total shareholder return they can derive from their share investment.

ATTACHMENT 1 – AN ILLUSTRATION OF A COMPANY'S FINANCIALS

We illustrate below how some of the key financial information and ratios are shown or extracted from the financial highlights and other disclosures in an annual report.

FINANCIAL RESULTS

Financial Indicators (RM'm)		Financial Highlights		
		2015	2014	2013
	Revenue	9,722	8,999	7,000
	EBITDA	4,500	4,509	3,920
	Profit before Tax ("PBT")	2,407	2,311	2,427
	Profit after Tax ("PAT")	1,812	1,711	1,680
(1)	Profit attributable to equity holders of the Company	1,638	1,817	1,537

Financial Ratios		Financial Highlights		
		2015	2014	2013
	EBITDA margin (%)	46.3	50.1	56.0
	PBT margin (%)	24.7	25.7	34.7
	PAT margin (%)	18.6	20.2	21.9
(A) EPS = (1)/(2)	Earnings per share (sen)	21.3	23.8	20.2
	Dividends per share (sen)	20.7	31.3	30.3

FINANCIAL POSITIONS

Financial Indicators (RM'm)		Financial Highlights		
		2015	2014	2013
(4)	Equity attributable to equity holders of the Company	4,335	5,801	7,180
	Total assets	18,132	17,876	16,991
(5)	Total cash	1,311	1,420	1,221
(6)	Total borrowings	9,231	7,862	6,918

Financial Ratios		Financial Highlights		
		2015	2014	2013
(C) ROAE = (1) /{Av. of (4)}	Return on Average Equity (%)	32.3	28.0	21.4
(D) Net GR = {(6) – (5)}/(4)	Net Gearing ratio	1.83	1.11	0.79
(F) NAPS = (4)/(2)	Net assets per share attributable to equity holders of the Company (RM)	0.56	0.56	0.94

Share Price Performance

1 January 2015 to 31 Dec 2015
(7) RM4.98 per share as at 31 Dec 2015.

	2013	2014	2015
Dividends (RM'm) Interim	2,310	2,388	1,600
Final	500	560	-
Total (3)	2,810	2,948	1,600
Div. Per Share (sen) Interim	30.3	31.3	20.7
Final Div. Per Share	6.6	7.3	-
Total Div. Per Share (B)	36.9	38.6	20.7
Earnings Per Share (sen)	20.2	23.8	21.3
Payout Ratio (%) (H)	182.7	162.2	97.2
Dividend Yield (%) (I)	5.5	5.8	4.5

Notes to the Financial Statements

	Group	
	2015	2014
Profit attributable to the equity holders of the Company (RM'000)	1,638,100	1,817, 411
(2) Weighted average number of issued ordinary shares ('000)	7,706, 222	7,624,813
Basic earnings per share	21.3	23.8

(B) DPS = (3)/(2)
(E) PER = (7)/(A)
(G) PBV = (7)/(F)
(H) DPR = (B)/(A)
(I) DY = (B)/(7)

Legend
(A) : *Earnings Per Share (EPS)*
(B) : *Dividends Per Share (DPS)*
(C) : *Return on Average Equity (ROAE)*
(D) : *Net Gearing Ratio (Net GR)*
(E) : *Price Earnings Ratio (PER)*
(F) : *Net assets per share (NAPS)*
(G) : *Price to Book Value (PBV)*
(H) : *Dividend Payout Ratio (DPR)*
(I) : *Dividend Yield (DY)*

(1) : *Profit attributable to equity holders of the Company*
(2) : *Weighted av. no. of issued ordinary shares*
(3) : *Total dividends per year*
(4) : *Equity attributable to equity holders of the Company*
(5) : *Total cash*
(6) : *Total borrowings*
(7) : *Market price of RM4.98 per share as at 31 December 2015*

Illustrations of Ratio Calculations based on 2015 Figures

(A): Earnings Per Share (EPS)
= (1) Profit attributable to equity holders of the Company/(2) Weighted av. no. of issued ordinary shares
= RM1,638m/ 7,706m
= RM0.213

(B): Dividends Per Share (DPS)
= (3) Total dividends per year/(2) Weighted av. no. of issued ordinary shares
= RM1,600m / 7,706m
= RM0.207

(C): Return on Average Equity (ROAE)
= (1) Profit attributable to equity holders of the Company / Average of (4) Equity attributable to equity holders of the Company
= RM1,638m/RM5,068m
= 32.3%

(D): Net Gearing Ratio (Net GR)
= {(6) Total borrowings – (5) Total cash} / (4) Equity attributable to equity holders of the Company
= {RM9,231m - RM1,311m}/RM4,335m
=1.83 times

(E): Price Earnings Ratio (PER)
= (7) Market price per share / (A) Earnings Per Share
= RM4.98/RM0.213
= 23.4 times

(F): Net Assets Per Share (NAPS)
= (4) Equity attributable to equity holders of the Company / (2) Weighted av. no. of issued ordinary shares
= RM4,335m/7,706m
= RM0.562

(G): Price to Book Value (PBV)
= (7) Market price per share / (F) Net assets per share attributable to equity holders of the Company
= RM4.98/RM0.562
= 8.86 times

(H): Dividend Payout Ratio (DPR)
= (B) Dividends Per Share (DPS) / (A) Earnings Per Share (EPS)
= RM0.207/ RM0.213
= 97.2%

(I): Dividend Yield (DY)
= (B) Dividends Per Share (DPS) / (7) Market price per share
= RM0.207/ RM4.98
= 4.2%

Chapter 5

Management Quality

Quality of Management

Financial statements showcasing the financial results and position of the company help in assessing the health or well-being of a company from the quantitative aspects while the assessment via management is more from the qualitative aspect.

We believe that good management is a precursor to good financial performance.

The level of corporate governance, integrity and transparency are among factors that determine the quality of management.

- We have seen that in some companies the management had produced remarkable financial results in the short term but at the same time, their corporate governance practices such as transparency was not to the desirable level expected.

  After monitoring them for a few years they were put into PN17 status (a status that their shareholders' funds dwindled to such levels that they were not able to support their operation) and needed to be rescued. The company's value was destroyed through the management's bad practices.

The quality of management, to an extent, can be assessed via the annual report by going through the relevant information and various statements disclosed. These include the following:

1. Directors' Profiles and Management
2. Chairman's Statement
3. CEO's Review/Message
4. Management Discussion and Analysis (MD&A)
5. Statement on Corporate Governance
6. Sustainability Statement
7. Statement on Risk Management and Internal Control
8. Audit Committee Report

The key elements are growth and governance.

The composition and quality of the company's Board of Directors and Management is crucial to implement company strategies effectively.

The diversity of the board in terms of skills, experience and gender would be relevant in terms of assessing how the board thinks and sees what is important for the company and how they assess risks.

Such information can, to a great degree, be extracted from the directors' profiles and management staff's qualifications and experience disclosed in the annual report.

The annual report can provide such information which normally should include:

- Board directors, including details of their experience, qualifications, terms of appointment and remuneration
- Diversity Policy
- Key staff members, including details of their experience, qualifications and responsibilities
- Organisation or corporate structure showing lines of responsibility and the links between the various units and/or divisions of the organisation
- Key personnel matters including human resource and productivity, improvement in workforce details and employee incentive schemes

In addition to the Board members, it is also good practice to disclose the profiles of the senior management.

As regards governance, it is mandatory for PLCs, as required under the LR, to include in their annual report a narrative statement of their corporate governance practices with reference to the Malaysian Code on Corporate Governance 2012 ("MCCG 2012").

A reasonably good feel about management quality can also be deduced from the Statement on Corporate Governance as disclosures are made on some or all the following relevant areas such as Board Charter, Code of Ethics, roles and responsibilities of the Board, assessment, conduct, Board committees, management committees, remuneration, training, company secretary's roles and responsibilities, directors' access to information, relationship with external and internal auditors, and communication with shareholders and investors and management.

By reading the Chairman's Statement and CEO's Review, shareholders can also gather some knowledge on pertinent areas such as strategies and plans, corporate developments and management's intentions and commitments. There could also be commentaries on management, succession planning, diversity and values as well as any achievements, accolades and recognition. Other pertinent areas include commentaries on management of assets, capacity, utilisation, capex and expansion plans.

It would be good if the Chairman's statement is more personalised and exudes zeal and passion and commitment, carrying a strong message as if he/she is together with all shareholders and stakeholders.

Moving forward, the Chairman's Statement will no longer be mandatory as it will be replaced by the MD&A to be implemented for annual reports for FYE on or after 31 December 2016.

Investors should examine the CEO's comments in the previous annual report and see if the goals set and promises made have been fulfilled this year. This should be compared with the CEO's comments in this year's report for consistency and credibility.

Whether KPI targets have been achieved or not is another good indicator of management quality. An extra value-added measure is benchmarking the company's KPIs or financial indicators against the industry, domestic and even regional peers.

Management Discussion and Analysis (MDA)

One newly introduced disclosure in an annual report is the Management Discussion and Analysis (MD&A) statement which will be mandatory for annual reports for financial year ending on or after 31 December 2016. MD&A requires the disclosures on the group's business, operations and performance (including financial performance) during the financial year and includes at least the following information:

(a) Overview of the group's business and operations including its objectives and strategies for achieving the objectives;

(b) Discussion and analysis of the financial results and financial condition;

(c) Review of operating activities including each principal business segment;

(d) Any identified, anticipated or known risks; and

(e) Forward - looking statement.

The MD&A should be signed off by the CEO and dated.

The required information will provide shareholders with a good insight on how the group's business and operations, risks and challenges are being managed.

The MD&A is also the management's opportunity to provide the investors with its view on both the financial and non-financial information of the business and the various limitations. It also provides the platform to highlight important trends, business prospects and risks that have affected the past performances and which will help shape the company's future.

Talking about CG scandals, one prominent case which shook the corporate scene was the Volkswagen (VW) emissions scandal in September 2015.

> Briefly, the auto giant was found to have equipped its vehicles with software that cheated on emission tests. When that happened, globally, politicians, regulators and environmental groups were questioning the legitimacy of VW's emissions testing.
>
> VW had to recall millions of cars worldwide, incurring astronomical costs resulting in the company suffering financial losses. Other consequences were fines, investigations, lawsuits, brand damage, loss in trust and crisis of consumer confidence. As in the words of the Group CEO who had resigned,..… "company had broken the trust of our customers and the public". Unsurprisingly, VW's share price also succumbed to the scandal and plummeted.

The scandal basically "brings out" almost all the risks of not embracing sustainability as listed earlier. This case also clearly shows that the quality of management is affected by its level of governance and here VW's shareholder value was eroded or destroyed by its management's questionable governance practices. It also illustrates how important it is for a company to be a good and responsible corporate citizen.

Risk Management and Audit Committee Report

Investors are also able to learn something about the management by going through the Statement on Risk Management and Internal Control and the Audit Committee Report. Among the relevant information are the process of how the management identifies, assesses and manages risks, the internal control framework, duties and responsibilities and activities of the Audit Committee and dealings with internal and external auditors.

Having gone through the global financial crisis, it can be said without doubt that the quality and robustness of risk management plays a significant role in determining the management quality. Risk management acts as a check on indiscriminate, aggressive growth with a short-termism horizon and is also a key to sustainability.

The quality of the Audit Committee Report will reveal, to a certain degree, the effectiveness of the internal and external audit functions and demonstrate the commitment of management towards these crucial areas.

An area of increasing importance is sustainability and investors need to know whether the Board seriously embeds sustainability in the company's strategy.

Investors should watch out for undesirable practices which could impact the shareholder value in the longer term.

Key sustainability events/ issues include:

- Climate change
- Natural resource depletion
- Pollution
- Increase in waste, and the related cost of material, energy, water and transport
- Environmental disasters
- Poor safety arrangements and outcomes
- Corporate governance scandals resulting in loss of shareholder value

Risks of not embracing sustainability include:

- Environmental
- Reputational
- Confidence, trust, loyalty, brand value
- Regulatory - to protect the organisation's licence to operate
- Losing business
- Inability to secure financing
- Securing financing at unattractive rates
- Inability to attract certain investors

One other area which investors may possibly overlook is information on litigation cases, if any, where the company may be embroiled in legal suits and may potentially suffer huge losses. How the company is exposed to such suits and whether there is negligence and how the management manages the cases may, to a certain extent, reflect on the quality of management.

- Apart from producing good financial performance and numbers, it is important that a company must have quality management.
- A reasonably high weightage is assigned to the qualitative aspects of a company
- Risk has always been a part of running a business, but it becomes increasingly a major concern, particularly after the global financial crisis.
- Investors should be mindful of companies which are too aggressive in expanding their business without due regard for risk mitigation.
- Inadequate or poor risk management reflects poorly on management.

Among the red flags raising doubts on the quality of management are:

- Frequent changes in Board composition
- Board tussles
- Frequent reprimand of company and directors by the regulators
- High attrition rates amongst senior management staff
- Questionable related party transactions

The following should be of concern to investors or require thorough explanations:

- Key staff risk where company is too dependent on the CEO and certain key staff without any proper succession plan in place
- Consecutive years of declining revenue and profits
- Unusual sharp spark in revenue and receivables
- Consistently declining market share
- Consistent acute underutilisation of its capacity
- Acute competition, threats and high risks
- High concentration of revenue and receivables in a few customers
- Unusually high gearing
- Liquidity problems
- Consistent inability to achieve KPI targets

Chapter 6

Other Relevant Information

This chapter provides additional information in the annual report for shareholders to see if there are other areas that can impact their decision on the company and make some valued judgements regarding it.

This information could include the following:

- Investor relations
- Related party transactions
- Bonus shares issues and rights issues and other fund raising exercises
- Share buy-backs and subsequent disposals, distribution or cancellations
- Stakeholders' engagement/management policy
- Top 30 largest shareholders
- Shares liquidity and public shareholding spread

Investor Relations

A PLC should not underestimate the importance and the role of investor relations.

The Investor Relations Unit should be active in enhancing the profile of the company in conducting analysts' briefings, carrying out investors' roadshows, engaging with shareholders and stakeholders including investment analysts and fund managers.

The annual report should also disclose the contact number and email address of the person in charge of investor relations matters.

- We noted at an AGM of a PLC, a shareholder commented that the Group had been recording good financial performance but despite that, its share price had not performed for quite a long time. He alluded that the Group's investor relations unit had not been active and suggested that it should lift the Group's profile and showcase its achievements. Since then, the investor relations unit had carried out more activities including conducting investors' roadshows.

- Subsequently, over a period of time, the PLC's share price performed well and in the following year's AGM, the same shareholder commended the Group's efforts.

Related Party Transactions

This is one area that can potentially be subjected to abuses and malpractices by related parties such as major or controlling shareholders, which can be detrimental to minority shareholders' interests. Abuses in related party transactions, not at arm's length, can be carried out in many forms such as:

01 injection/sale of assets (can be properties) or business to the company by a related party at a consideration way above market value;

02 sale of company's assets to a related party for amounts significantly below market value;

03 provision of services or sale of products by a related party to the company at above market price;

04 provision of services or sale of products to a related party by the company at below market price.

Therefore, it is very important for investors to scrutinise all such deals and study in detail any advice and recommendation given by an independent adviser to see that it has been done with the proper processes in place.

Bonus Shares Issues, Rights Issues and Private Placements

One may deem bonus shares issues as no value accretion as he or she can draw an analogy to a cake cut into a few pieces and in the final analysis, you still receive the same amount of the cake.

Shareholders prefer having bonus issues as the share price is cheaper and more retail investors can buy them. The share price can be discovered when there are more players in the market. Over time, the price of the share may rise and can even exceed the pre-bonus price.

As bonus share issue may attract certain investors, one can assess whether a company is able or likely to declare bonus share issue by looking at the amount of reserve stated in its balance sheet. If the reserve is significantly higher than the company's issued and fully paid up capital, it would be able to declare bonus share issue of at least the ratio of 1:1 (i.e. one bonus share for every share held).

On the other hand, if a company has too many rights issues and private placements, particularly where there has not been any good utilisation of the funds raised, retail shareholders may not be too pleased. In addition, the private placements will cause dilution to the other existing shareholders. The situation may be mitigated if the placees of private placements are strategic investors who can bring value to the company.

Share Buy-backs

Share buy-backs carried out by a PLC may signal to investors that the company's share could be undervalued. This will also enhance the PLC's EPS if the company were to subsequently cancel the shares bought back (treasury shares) even if there is no change in the financial performance compared to the previous year.

However, if the company opts to sell back the shares at a higher price to realise some gains or to redistribute the shares to shareholders as *dividend in specie*, the EPS will revert to the same price as prior to the share buy-back.

The board's strategy for share buy-back is to deliver value for shareholders and to build on this strategy with the aim of enhancing shareholder value. Share buy-backs make sense only when a well-run, profitable company has excess cash and its share price is depressed.

Share buy-backs are now becoming increasingly popular after the current global financial crisis. Given the surplus cash, instead of distributing as dividends, share buy-back may appear to be more appealing if it actually manages to increase the share price, hence the shareholders can gain in terms of capital appreciation.

Many shareholders are, however, beginning to ask the company to give back these cash surpluses to them in terms of dividends instead of utilizing the cash for share buy-backs as they do not see value being created by the share buy-backs.

Stakeholders' Engagement/Management Policy

It is good practice for a company to have a proper stakeholders' engagement/management policy. There has been an increase in the number of stakeholders and also with pressing demands. This has been exacerbated with the growing importance of sustainability issues and companies have to manage their perceptions and demands well. Setting up a stakeholders' engagement/management policy and meeting up with stakeholders would help to address any issues raised by stakeholders and mitigate any problems. Investors would view positively such actions by the company.

Top 30 Largest Shareholders

The list of 30 largest shareholders is also of interest and use to investors. If the list includes strong institutional shareholders following, particularly, if there are astute investors, it may lend credence to the fact that it may be a good investment. Investors may tend to draw comfort from these shareholders' investments and ride along.

Shares Liquidity and Public Shareholding Spread

Shares with sufficient liquidity or higher float may tend to be relatively more attractive to investors as they can more easily buy and sell the shares in the open market. Those which are tightly held or controlled and have low liquidity may be manipulated and the share price may not reflect its true value. These shares also tend to have very wide spreads between the bid and offer prices.

Chapter 7

Key Focus Areas - A Summary

This chapter summarises some key areas where shareholders need to scrutinize and if necessary ask further questions and do more research regarding their company.

A External Auditor's Report

1. Independent auditors' report would be the first area that shareholders need to pay attention to.
2. The opinion of the Auditor on whether the accounts prepared reflects the true and fair view.
3. The shareholders need to read the opinion provided by the auditors and whether a disclaimer, qualified or adverse opinion including an emphasis of matter had been given, which raises a red flag
4. Frequent changes in independent auditors –also raises a red flag.

B Audited Financial Statements

Revenue/Profit

1. Percentage increase in receivables substantially higher than percentage increase in sales - May indicate slowness in collection of debts and potentially resulting in impairment or non-collectibility of receivables.
2. Any one-off items?
3. Is the increase sustainable?
4. If continuous losses - why ? and when can a turn-around be expected?
5. Assess the risk management. Is there a concentration of risks in say, the revenue and receivables in a few customers.

Cash and Gearing

1. Is the cash balance or free cash flow healthy?
2. Borrowings, Gearing
   - The gearing level and comparing against the industry level.
   - The level of borrowings in foreign currencies and the risks of exposure to interest rate risk and foreign currency risk.

C Financial Highlights, KPIs, Key Ratios

1. 5-Year Financial Highlights and Financial Indicators e.g. Return on equity (ROE), Earnings per share (EPS), Price earnings ratio (PER), Price Earnings to Growth Ratio (PEG), Price to Book Value (PBV), Dividend yield , profit margins
2. KPIs – achievements (current, Y-O-Y, trend), benchmarked against industry, domestic and regional peers.
3. Consistent inability to achieve KPI targets – unfavourable.

D Board and Corporate Governance Matters

1. Quality of Board and senior management staff
2. Reprimands by regulators
3. Investigations by auditors/regulators
4. Very high directors' remuneration when company is not performing well

E Environment, Social and Governance (ESG)

1. Not caring about sustainability practices
2. Issues regarding corporate responsibility:
    - impact of business on the environment
    - social concerns such as level of inclusion in a company's recruitment policies
    - human rights and consumer protection
    - employee welfare

F Industry Outlook, Prospects, Competition, Market Share, Expansion and M&As

1. Industry outlook, prospects, market share (consistently declining)
2. Competitive advantages/edge
3. M &As/diversification/new ventures, expansion (overseas, regional)
4. Acute competition, potential new competitors, threats, challenges and high risks

G Capacity and Utilisation, Capital Expenditure, Growth

1. Capex to expand capacity, overcapacity, utilisation %
2. Any concern on overcapacity which may dampen prices?
3. Consistently low utilisation rates of production

H Orderbooks and Contracts

1. Construction orderbooks, success rate of biddings
2. Reducing orderbooks not replenished adequately
3. If company has long term contracts or concessions, determine the number of years of contracts and concessions and other terms e.g. renewals, etc.

I Dividends

1. Dividend Policy, Dividend Payout Ratio, Dividends Declared, Dividend Yield, Dividend Reinvestment Plan

J Shareholdings, Share Liquidity, Share Buy-back, Valuation, Share Price and Total Shareholder Return

1. Top 30 largest shareholders
2. Level of institutional shareholdings and/or foreign shareholdings
3. Low share liquidity – more difficult to buy or sell especially in higher volumes.
4. Frequent share buy-backs

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List of Acronyms

AC	Audit Committee
ACCA	Association of Chartered Certified Accountants
AGM	Annual General Meeting
AR	Annual report
CG	Corporate governance
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation
EGM	Extraordinary General Meeting
ESG	Environment, social and governance
FYE	Financial year ended/ending
ICSA	Institute of Chartered Secretaries and Administrators
IIRC	International Integrated Reporting Council
IR	Integrated reporting
LR	Bursa Malaysia Listing Requirements
MD&A	Management Discussion & Analysis
KPIs	Key performance indicators
PLC	Public listed company

Appendix 1

Key Requirements and Good Practices/Recommendations on Disclosures in Annual Reports

1. Companies Act 1965
   http://www.ssm.com.my/acts/fscommand/CompaniesAct.htm
   Section 169. Profit and loss account, balance sheet and directors' report
   Section 174. Powers and duties of auditors as to reports on accounts

2. Bursa Malaysia Listing Requirements
   http://www.bursamalaysia.com/misc/system/assets/5949/MAIN_Chap9_AR4mths.pdf)

3. Malaysian Code on Corporate Governance 2012
   http://www.sc.com.my/wp-content/uploads/eng/html/cg/cg2012.pdf)

4. Bursa Malaysia CG Guide
   http://www.bursamalaysia.com/misc/system/assets/7257/CG_Guide2.pdf)

5. Bursa Malaysia Corporate Disclosure Guide
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Appendix 2

Malaysia-ASEAN Corporate Governance Report 2015 (some observations)

		2015	2014	2013
	No. of cos. assessed	870	873	862
		(%)	(%)	(%)
1	Disclosed policies that stipulate the existence and scope of the companies' efforts in addressing customers' welfare	20	11	12
2	Disclosed a policy on supplier/contractor selection practices which takes into consideration economic and non-economic factors such as environment, social or human rights	8	7	6
3	Described policies which ensured that their value chain was environmentally friendly or consistent with promoting sustainable development.	56	39	39
4	Elaborated on policies of the company's efforts to interact with the communities in which they operated	56	41	43
5	Put into place a policy on anti-corruption with detailed programmes and procedures to mitigate corrupt practices	14	11	11
6	Had policies in place describing how creditors' rights would be safeguarded	89	79	73
7	Disclosed activities on customer health and safety	17	10	11
8	Published the practices on supplier/contractor selection and criteria	7	5	5
9	Disclosed activities on implementing an environmentally friendly value chain	55	41	39
10	Disclosed activities to interact with communities	68	49	50
11	Disclosed anti-corruption programmes and procedures	11	9	10
12	Disclosed details of remuneration of each member of the board of directors, including the CEO	9	8	9
13	Companies with a Separate Corporate Responsibility or Sustainability Report/Section	73	67	64
14	Profiles of directors seeking election/re-election in their AGM notice clearly separating the directorships in listed and non-listed cos.	50	61	56
15	Provided explanation of their dividend policy	4	3	3
16	Disclosed activities on creditors' rights	71	69	60
17	Disclosed the health, safety and welfare of its employees	46	27	32
18	Disclosed employee training and development programmes	55	48	51
19	Procedures for complaints by employees concerning illegal (including corruption) and unethical behaviour	34	26	24
20	Policy or procedures to protect an employee/person who reveals illegal/unethical behaviour from retaliation	27	19	20
21	Policy covering the review and approval of material/significant RPTs	90	72	64
22	Disclosed trading in the company's shares by insiders for their directors and senior management	21	15	28

Appendix 3

Types of Auditors' Modified Opinions on Audited Financial Statements

Types of Modified Opinions	Description	Basis
Adverse opinion	(a) The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; OR (b) The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.	Having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
Qualified or "except for" opinion	In the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph: (a) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or (b) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.	Having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; OR unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
Disclaimer of opinion	(a) Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly, (b) The auditor does not express an opinion on the financial statements.	Unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive; OR in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Notes

Take Care of Your Invesments!

Authors

RITA BENOY BUSHON was appointed as the Chief Executive Officer of Minority Shareholder Watchdog Group (MSWG) on 1 January 2009. She had served the Employees Provident Fund (EPF) for 23 years since 1984 up to her retirement in October 2007 and held various senior positions in the Investment Department.

She was a Director of KFC Holdings (Malaysia) Berhad and Land & General Berhad since 2003 to 2007.

She led the Shareholder Responsibilities Committee and Diversity Working Group in 2011 to 2013 of the International Corporate Governance Network (ICGN).

In 2014 she spearheaded the group with institutional investors for the formulation of the Malaysian Code for Institutional Investors which was officially launched in June 2014. She is the Head of Secretariat & Council Member, Institutional Investor Council (IIC).

She was awarded the Women of Excellence Awards for “Outstanding Achievement”, the “Top 10 of Malaysia Towering Personality Recognition” in 2014 and the Brand Laureate Brand ICON Leadership Award for Transformation Leadership in 2011.

She holds the Investment Advisory Representative Licence under the Capital Market & Services Act 2007. Rita holds an MBA from Henley Management College (1993), and has an Honours Degree in Economics (Statistics) from Universiti Kebangsaan Malaysia (1984).

CHONG CHEE FERN graduated with an Honours Degree in Economics (Accounting), followed by a Postgraduate Diploma in Accounting, both from University of Malaya.

As a Chartered Accountant registered with the Malaysian Institute of Accountants and a holder of the Certified Financial Planner (CFP) qualification, he has vast experience in finance, banking and the capital market. Currently, he provides speaking engagements and training for PLCs, directors and senior management personnel on areas relating to the capital market and corporate governance.

He was the former General Manager, Corporate Monitoring in Minority Shareholder Watchdog Group (MSWG) where his responsibilities included monitoring selected PLCs, complaints and MSWG’s newsletters and annual surveys for MSWG Malaysia-ASEAN Corporate Governance Index. He had participated in panel discussions and forums encompassing corporate governance and capital market issues. He had worked in Bank Negara Malaysia for many years, mainly involved in supervising financial institutions and preparation of the Bank’s annual report and budget. His attachment with an international shipping corporation had also enriched his experience in finance, corporate planning, investor relations and the Group’s business transformation programme. He also had vast experience in internal audit and risk management in an investment bank.

MINORITY SHAREHOLDER WATCHDOG GROUP

Shareholder Activism and Protection of Minority Interest

11th Floor Bangunan KWSP, No.3 Changkat Raja Chulan, Off Jalan Raja Chulan, 50200 Kuala Lumpur.

Tel: (603) 2070 9090 | **Fax:** (603) 2070 9107 | **Website:** www.mswg.org.my