

# **Impact of Overhead Costs Apportionment on Selling Price Determination in Malaysian Automobile Manufacturing Industry**

**Prof. Dr. Kabiru Isa Dandago**

*Universiti Utara, Malaysia*

**Zulaikha Rabitah Zaidi**

*Universiti Utara, Malaysia*

**Aliana Shazma Amir Binti Amir**

*Universiti Utara, Malaysia*

## **Abstract**

This study aims to examine the impact of overhead cost apportionment on selling price determination in the Malaysian automobile manufacturing industry. Specifically, the study looks at the treatment of overhead costs apportionment from the perspective of the profit making effort of automobile manufacturing firms. The methodology used is interview with staff of one automobile manufacturing company in Malaysia taken as a case study: that is Naza Automotive Manufacturing Sdn. Bhd. The findings of this study show that overhead costs apportionment has significant impact on the determination of “true and fair” selling price of an automobile manufacturing firm, especially as service centres are considered in primary apportionment before their shares are re-apportioned to production centres, using an appropriate method. This study, therefore, recommends that automobile manufacturing firms in Malaysia should adopt the activity based costing method of overhead costs apportionment as it considers service centres of the company together with production centres in fair apportionment of overhead costs, taking into account the percentage of services enjoyed by the production centres from the service centres. This would allow room for fairly accurate determination of total cost per unit of their products, which would ultimately lead to effective pricing decision.

**Key words:** Overhead Costs, Cost Apportionment, Activity Based Costing, Selling Price, Automotive Manufacturing Industry.

**Jel Classification:** M11, M20, M41

## **1. Introduction**

Many empirical studies such as Maines et al (2003), Alexander (2006) and Saxton (2012), have been carried out on accounting information, users of accounting information and auditors that examine the accounts without much attention given to the preparers of the financial reports. The preparers of the financial statement by this paper are the accountants of the reporting entity (representing management) and accounting firm (serving as auditors). The role of accountant in producing accounting information is vital and significant. Accounting information is usually prepared through the medium of financial statements, by the accountant of the reporting entity and audited by accounting firms before the information is released to various stakeholders. There are various factors that motivate firms to prepare financial statements. Among the incentives behind preparation of financial statements by firms are to get the support and appreciation of tax authorities, domestic investors, international investors, banks/lenders and regulatory agencies.

Banks, creditors and potential lenders require company's financial reports for them to assess the viability and liquidity position of the business before they can decide whether to grant credit or not. Investors, both international and domestic need financial statements for investment decision.

On the other hand, regulatory body like Bursa Malaysia requires listed companies to disclose or announce the following information: quarterly report to be released within two months from the end of each financial quarter; audited accounts to be released within four months from the financial year end; and annual reports containing audited accounts. Each company has to continuously disclose information on certain transactions by directors and related parties

According to Choi and Gray (2011 p.120), managers have incentives, like lower transaction costs in the trading of the firm's securities, greater interest

in the company by financial analysts and investors, increase share liquidity and lower cost of capital, to disclose accounting information voluntarily. Accounting information is usually prepared according to the Generally Accepted Accounting Principles (GAAP) and Malaysian Accounting Standard Board (MASB) guide lines. MASB is responsible for developing and issuing financial reporting standards relevant to various sectors of the Malaysian economy.

Accounting information that is useful must possess the primary qualities (relevance and reliability), secondary qualities (comparability and neutrality), and other qualities (materiality, understandability and timeliness). This information is to be produced by accountants and certified by auditors before it is made available to users.

The aim of this study is to create better understanding to the accounting information usefulness by inquiring into preparers` main motives for preparing the information in accordance with statutory requirements. The paper contributes to scanty literature on the impact of preparers of accounting information on the quality of financial reporting in Malaysia. The remainder of this paper is structured as follows: section 2 is about literature review, section 3 states methodology of the study, section 4 discusses the results obtained; and 5 concludes the paper.

## **2. Literature Review**

### **2.1 The Concept of Accounting Information**

The role of accountant in producing accounting information is to observe, screen and recognize events and transactions, to process them and compile corporate reports with accounting information that are communicated to users. The primary objective of accounting is to provide information that is useful for decision making purposes. Accounting information is usually produced, through financial statements, by the accountants of the reporting entity. These statements are prepared according to Generally Accepted Accounting Principles (GAAP). These principles provide the general framework for determining what information is to be prepared and

presented (Gary, 1994). GAAP includes broad principles of measurement and presentation as well as detailed rules that are used by professional accountants in preparing accounting information. The application of these rules, standards, guidelines, etc is to be tested for certification of the prepared accounting information by an external auditor whose report becomes part of the published financial statements of the reporting entity.

## **2.2 Qualitative Characteristics of Accounting Information**

Accounting information that make information provided useful to users in making economic decisions must possess the following qualities: relevance, reliability, comparability, understandability, timeliness and neutrality (FASB' 1980; IASB, 1989). Relevance and reliability are the primary qualities of good accounting information. Information has the quality of relevance when it is capable of making a difference in the economic decisions of users by helping them evaluate past and present events or confirming or correcting, their past evaluations (Beest and Braam, 2006). Accounting information has the quality of reliability when it is free from material error and bias (FASB, 1980) and can be depended upon by the users.

The secondary qualities are comparability and neutrality. Comparability enables users to identify and explain similarities in and differences between economic phenomena (FASB, 2005). This quality requires that transactions and event be measured and reported in a consistent manner to enable users to compare the results of a company from year to year or compare with the results of different companies. Neutrality implies that the preparer of information is not biased and that the information reported is not in favour of a particular user.

Other qualities of accounting information include: materiality, understandability and timeliness. Information cannot be useful to a person who cannot understand it (FASB, 1980). Information cannot be helpful to a person who cannot understand the information and, therefore, the objective of financial reporting cannot be fulfilled without the notion of understandability (Beest and Braam, 2006). Only material information is included in the financial statement. Information is material if its omission will affect or influence the

economic decision of the users. Information must be available when users need it. Although timeliness alone cannot make information relevant to users, a lack of it may cause a loss of relevance of information reported or even make it irrelevant (Bees tans Braam, 2006).

### **2.3 Preparers` Motives and the Decision Usefulness of Accounting Information**

The reasons or incentives behind preparation of accounting information by firms may be viewed in different ways. It may be seen as making information available for management decision making for the use of international investors, and domestic investors, and for tax authorities for banks/lenders and for regulatory agencies (Alexandra, 2006).

The provision of information that is useful to the decision making process is usually recognized as the main purpose of accounting information. International reports, such as Trueblood Report (1971) are focused on the need of external users and they identified decision usefulness as the main aim of accounting information. However, the decision usefulness as the main objective of accounting information has been criticized by William (1987) and Pallot (1991) as soft and limb. The fact that accounting information is used does not necessarily mean or imply that it is decision useful. Companies may prepare accounting information mainly for a particular user such as tax authorities and banks. The question then is: what is the quality of such accounting statement? Can it be useful to other users?

Previous studies in Russia have shown that financial reporting decision is largely driven by tax considerations (Goncharov and Zimmerman 2002). The main user of accounting information in Russia is tax inspectorate (Krylova 2003). Nobes and Alexander (2004) state that accounting data which are useful for tax purposes in not always relevant for other users. The tax returns normally require some adjustments to be made to the profit from the income statement before arriving at the taxable income.

According to Ilse and Klann (2010) accounting disclosure consists of demonstrating the process of recognition and measurement realized to outside users. There have been various studies and discussions about what should be

disclosed by organizations. Radebaugh and Gray (1997) state that disclosure does not need to be legal or enforced; it can be voluntary or informal. Choi and Gray (2010) point out that accounting disclosure is influenced by four main factors; environment, market for capital non-financial influences like unions and corporate demand for greater transparency. Managers have incentives to disclose information voluntarily; such as lower transaction costs in the trading of the firm's securities, greater interest in the company by financial analysts and investors, increase share liquidity and lower cost of capital (Choi and Gray 2010).

However, managers' disclosure choices reflect the combined effects of disclosure requirements and their incentives to disclose information voluntarily. Where the disclosure rules are not enforced, managers only comply if the cost of non-compliance is higher than the cost of compliance. According to Hise and Klann (2010), voluntary disclosure on the part of companies is the strengthening of their image in the stock exchange markets. On the other hand, there are companies that resist accounting disclosure unless there is pressure from the accounting community or from the public agencies. Hendriksen and Van (1992) expressed the fears that greater disclosure will help competitors to the detriment of shareholders and will give unions an advantage in negotiating wages, and investors do not understand accounting policies and procedures they would become confused. They also alleged that there exist other sources available for information at a much lower cost and, finally, that the needs of investors are not fully known.

Compulsory disclosure is one of the requirements of the stock exchange to enhance the total functioning of the market. According to Carvalho et al (2004), the relationship between investors and companies has become less solid and has resulted in mistrust due to the recent global financial scandals involving large companies. This led to increased demand for more relevant information disclosure that will increase transparency in financial reporting. Stock exchange and government regulators generally require listed companies to furnish both financial and non-financial information. Social responsibility reporting is also required, which refers to the measurement and communication of information about a company's effects on employee

welfare, the local community and the environment. This reflects a belief that companies owe stakeholders an annual accounting of their social and environmental performance just like the financial information they provide to shareholders.

Accounting information disclosed by firms that target international investors are of high quality. Securities and Exchange Commission and financial services agencies in Japan impose reporting and disclosure requirements on domestic and foreign firms that seek access to their market. They would want to make sure that investors have enough information to allow them to evaluate company's performance and prospects (Choi and Gray 2011). Malaysia Stock Exchange also imposes similar disclosure requirements. For instance, Bursa Malaysia requires listed companies to disclose quarterly report, audited accounts and annual reports containing audited accounts. Each company has to continuously disclose information on certain transactions by directors and related parties.

#### **2.4 Accounting Practices in Malaysia and MASB Standards**

Accounting practices in Malaysia is regulated by the Malaysia Accounting Standards Board (MASB). The MASB is established under the Financial Reporting Act 1997 as an independent authority to develop and issue financial reporting standards in Malaysia. The latest issued by MASB is the new accounting framework, the Malaysian Financial Reporting Standards framework (MFRS Framework). The framework comprises new and revised standards as issued by the International Accounting Standard Board (IASB). This framework is applied by all public entities but will be mandatory for all entities by year 2013.

MASB and the Financial Reporting Foundation (FRF) make up a new framework for financial reporting in Malaysia. This new framework comprises an independent standard-setting structure with representation from all relevant parties in the standard-setting process, including preparers, users, regulators and the accounting profession. MASB's mission is to develop and promote high quality accounting and reporting standards that are consistent

with international best practices for the benefit of users, preparers, auditors and the public in Malaysia. In a wider context, the MASB seeks to contribute directly to the international development of financial reporting for the benefit of users, preparers and auditors of financial reports.

In the pursuit of its mission, the MASB is guided by a clear set of policy objectives: to develop high quality, clear and enforceable national accounting standards for financial reporting that benefit users; to bring about harmonization of national accounting standards with international accounting standards; to promote the use and application of those standards by way of communication with and education of users, preparers, auditors and the public; to actively contribute to the development of accounting standards internationally, including, Islamic-based accounting standards, and to promote and support research in the area of financial reporting, in particular, for emerging markets and Islamic markets(MASB).

### **2.5 Regulatory Responsibility of Malaysian Institute of Accountants (MIA)**

MIA is a statutory Accounting body established by the Accountants Act 1967 to regulate and develop the accountancy profession in Malaysia. MIA is dedicated to raising the bar of accounting quality by developing and sustaining professional quality and expertise that can meet the most demanding global standards.

The word “accountant” is protected under the provision of the Act, which states that no one can hold himself or herself out to practice as an accountant unless he or she is registered as a member of MIA. To become a chartered Accountant in Malaysia, one must possess a recognized university accounting degree and must pass the qualifying examinations of recognized accountancy body. After becoming a full member of the recognized professional body and obtaining three years practical accounting experience, then one can be admitted as a chartered accountant. All persons practicing as accountants or auditors in Malaysia must be registered with the Institute (MIA) under the following categories of membership: Chartered Accountants,



Licensed Accountants and Associate Members. This shows that MIA certifies individuals as qualified accountants, issues licenses for practicing accountants and ensures ethical practices of accountants in Malaysia.

### **3. Methodology**

The research problem was investigated through questionnaire and interview aimed at accountants and auditors of the reporting entities. The choice of accountants and auditors is justifiable because the accountants of the reporting entities are involved in the preparation of the financial reports, while the auditors are appointed to examine and certify those reports as “true and fair” representation of financial position of the reporting entities or not. Auditors’ reports form part of the published financial statements of reporting entities. Copies of the questionnaires were administered to ten companies selected at random. Out of these target respondents, only one returned the questionnaire fully completed, which represents just 10% response rate. This poor response rate was due to the short notice (one week) given by the researchers and the busy nature of the respondents’ schedules. Follow up interviews were also conducted on the accountant and external auditor of the reporting entity to supplement the responses to the questionnaire items. Another purpose of the interview was to explore the respondents’ understanding of the listing requirements and the financial reporting practices in Malaysia. Analysis is based on the responses received from the single responding company, its chief accountant and external auditor.

### **4. Results And Discussion**

The External Auditor of the responding company and the chief accountant were interviewed at different times, to supplement or clarify the responses reflected to the questionnaire items. Four specific questions were asked that are related to the preparation of financial reports and certification of the reports. Below are discussions on the results/information obtained from the questionnaire and the two respondents:

#### **4.1 Preparation of Financial Statements: Accountant's Responses**

##### **A question was asked about the motives behind the preparation of financial statements by companies in Malaysia**

The response of the chief accountant to this question was that management prepares financial statements for several reasons, the most important of which is to ascertain the financial position of the business. Secondly, financial statements are prepared to give account of stewardship to the shareholders and other stakeholders, as per the requirements of the law and accounting standards. In addition, the method of preparation and contents of the statements have been standardized by the accounting standard setting bodies at the local and international levels and these standards have been made requirements that must be complied with by every registered company as a reporting entity. Beside this, high quality financial reports, carrying true and fair information, attract high net worth investors. It, therefore, means that complying with the law and accounting standards in preparation of financial statements would have high impact on the quality of the report.

##### **On whether or not the company complies with the provisions of the International Financial Reporting Standards (IFRS) while preparing its financial statements**

The accountant responded in affirmative; saying that the standards are being complied with as much as possible in the preparation of the financial statements even though the standards are newly adopted. As the accountant ensures compliance with the standards in preparing the financial reports of the company, it means that the standards are instrumental to the quality being assured on the financial report.

##### **The chief accountant was also asked about meeting all disclosure requirements in the financial reports**

In responding to this question, the respondent said it is a must because failure to disclose all necessary information in the financial statements attracts sanctions and no company wants to be sanctioned. He added that financial

statements are prepared to meet the listing requirements of Bursa Malaysia or to remain listed in the stock market. One of the listing requirements is full disclosure of information in financial statements. This implies that Bursa Malaysia listing requirements are contributing factors to the quality of financial reporting among listed companies and companies applying for listing.

**There was a question on credibility and confidence building role of the financial statements prepared by the company**

The accountant responded by saying that as professional members of MIA in preparing the company's financial reports they have to perform their responsibilities with the highest sense of integrity. Therefore, the output is expected to be of high quality. Beside, the attestation by the external auditors or the assurance given adds credibility to the financial statements. This shows that reporting entity's auditor contributes to the high quality of financial reports.

**4.2 Certification of Financial Reports: External Auditor's Responses**

**To be an external auditor in Malaysia, membership of MIA is required. A question was asked to find out if this auditor is a member.**

The answer was yes. He went further to say that no individual can practice accountancy, generally, and auditing, specifically, without being certified by the Malaysian Institute of Accountants (MIA), which is the only body to certify those practicing as accountants or auditors. This implies that the preparers and the auditors of our reporting entity are professionals, certified and licensed by MIA to prepare and audit financial statements. Therefore, MIA contributes to the quality of financial reports in Malaysia, taking this reporting entity as a case study.

**A question was posed to find out if practicing members of MIA observe technical and ethical standards in the discharge of their duties**

According to the auditor, members of the accountancy profession must strictly observe ethical standards; where anyone is found wanting, such a member must face disciplinary actions. This means that the preparer will not engage in unethical practices, such as misstatement and financial statements manipulation, so that the financial statements could show the true and fair view of the financial position of the entity. The auditor, however, has to certify the financial statements as such, following all established guidelines, rules and standards.

**The issue of compliance with IFRS by reporting entities in Malaysia was raised for the External Auditors response**

According the respondent, most companies comply except the small and medium-sized enterprises. MASB allows agriculture, real estate and small business to defer the adoption of IFRS to January 2014. During the preparation of the financial statements, accountants are expected to follow the IFRS checklist to identify the disclosures required and comply fully, and the auditors are to crosscheck to certify compliance. This shows that as financial statements are audited by an audit firm and unqualified report is issued, it means that high quality has been assured in the preparation of the financial statements and that compliance with IFRS for both disclosure requirements and presentation requirements have been ascertained.

**The auditor was asked to give his own assessment of the client company's compliance with regulatory framework in Malaysia**

According to the respondent, not only his client, all companies in Malaysia have tried as much as possible to comply with the requirements of MASB and BURSA in the preparation of their annual financial reports. By following the accounting standards, accounts prepared present true and fair views of results of operation and financial position of the reporting entities. This is impacting positively on the quality of financial report because of the distinctive provisions made by MASB to enhance usefulness of presentation and disclosure of financial statements and accounting related information.

## **5. Conclusions And Recommendations**

### **5.1 Conclusions**

The main purpose of accounting information is to provide information that is useful for decision making. In deciding what constitutes decision useful information, the qualities inherent to decision useful information were identified. The paper reviews the impact of preparers of accounting information on the quality of financial statements produced by companies in Malaysia.

One of the significant findings was that experience, passion for accounting profession and continuous training of preparers of accounting information impact positively on the quality of financial reports of companies in Malaysia. Secondly, compliance of preparers with the requirements of MASB, BURSA Malaysia and other regulatory bodies improves the quality of financial reports in the country. Thirdly, fear of disciplinary action by MIA against misconduct by members deterred them from engaging in unethical practices. MIA and regulatory bodies such as MASB and BURSA have contributed to the improvement in the quality of financial reports of listed companies. MIA certifies the accountants that are supposed to be employed as preparers of financial statements by reporting entities and public auditors that serve as auditors of listed companies in the country, while MASB and BURSA Malaysia provide guidelines for reporting entities to follow in preparing their financial reports. This adds a lot of credibility to the financial statements of the reporting entities in the country.

### **5.2 Recommendations**

Based on the improvement in the quality of financial statements of reporting entities, it is recommended that regulatory bodies should motivate preparers of financial statements by giving them public recognition award such as best reporting entity of the year award.

Accountants and auditors should always strive to live up to challenges of the codes of professional conduct and standard of performance expected of them, even in the midst of temptation to behave unethically in observance of their professional obligations to those they are providing services.

Acquiring knowledge and skills needed to become a chartered accountant is not enough nor the end of learning. After becoming professional members, accountants and auditors should involve themselves in self development by writing articles and presenting papers at conferences, seminars and workshops.

Finally, MIA should organize workshop/seminar/conferences on a quarterly basis to keep members abreast with current accounting issues, and make attendance mandatory to all members.

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