FIRM SIZE AND SOLVENCY PERFORMANCE OF WOOD-BASED COMPANIES LISTED IN BURSA MALAYSIA

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FIRM SIZE AND SOLVENCY PERFORMANCE OF WOOD-BASED COMPANIES LISTED IN BURSA MALAYSIA

By

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DEDICATION

Dedicated to:

My beloved family

To all my batch mates

To all my course mates

As well as

To all my friends who give me full support

To complete my Final Year Project

ABSTRACT

Previous studies on the relationship between the firm size and solvency performance has been insufficient especially in wood-based industry. Thus, this study was conducted to determine the relationship of firm size and solvency performance as well as to investigate the impact of firm size's indicators toward the solvency performance of wood-based listed companies in Bursa Malaysia. The Pearson correlation results showed that both indicators of firm size, total assets and share capital, had a positive significant relationship with the indicators of solvency performance, which are debt-to-asset ratio and debt-to-equity ratio. The multiple linear regression results for the two models showed that only total assets caused an impact to the indicators of solvency performance. Results of this study are useful to several relevant parties such as managers, creditors and shareholders. Future study should investigate on other variables especially on the determinants of solvency performance.

ABSTRAK

Kajian mengenai hubungan antara saiz firma dan prestasi kesolvenan adalah tidak mencukupi terutamanya dalam industri berasaskan kayu. Oleh itu, kajian ini dijalankan untuk menentukan hubungan saiz firma dan prestasi kesolvenan syarikat-syarikat tersenarai berasaskan kayu di Bursa Malaysia dan untuk menyiasat kesan penunjuk saiz firm terhadap prestasi kesolvenan. Keputusan korelasi Pearson menunjukkan bahawa kedua-dua petunjuk saiz firma, iaitu jumlah aset dan modal saham, mempunyai hubungan positif yang signifikan dengan petunjuk prestasi kesolvenan, iaitu nisbah hutang kepada aset dan nisbah hutang kepada ekuiti. Hasil regresi linear berganda bagi kedua-dua model menunjukkan bahawa hanya jumlah aset yang menyumbangkan impak kepada penunjuk prestasi kesolvenan. Hasil kajian ini berguna kepada beberapa pihak yang berkaitan seperti pengurus, pemiutang dan pemegang saham. Kajian akan datang harus menyiasat tentang pembolehubah lain terutama tentang faktor penentu prestasi Kesolvenan.

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APPROVAL SHEET

I certify that this research project report entitled “Firm Size and Solvency Performance of Wood-Based Companies Listed in Bursa Malaysia” by Chang Wai Loong has been examined and approved as a partial fulfilment of the requirement for the degree of Bachelor of Wood Science and Technology in the Faculty of Forestry, Universiti Putra Malaysia.

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LIST OF ABBREVIATIONS

AAC	Annual Allowable Cutting
AANZFTA	ASEAN-Australia-New Zealand Free Trade Area
ACE	Access, Certainty, Efficiency
ACFTA	ASEAN-China Free Trade Area
ACT	Agency Cost Theory
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asia Nations
ATIGA	ASEAN Trade in Goods Agreement
	Automated Quotation
DAR	Debt-to-Asset Ratio
DER	Debt-to-Equity Ratio
DOSM	Department of Statistics Malaysia
FBM KLCI	FTSE Bursa Malaysia KLCI
FITEC	Furniture Industry Technology Centre
FTA	Free Trade Agreement
FTSE	Financial Times Stock Exchange
IMP	Industrial Master Plan
IPO	Initial Public Offering
KLCI	Kuala Lumpur Composite Index
KLSE	Kuala Lumpur Stock Exchange
KLSEB	Kuala Lumpur Stock Exchange Berhad
MDF	Medium Density Fiberboard
MES	Minimum Efficient Scale

MESDAQ	Malaysian Exchange of Securities Dealing and
MIDA	Malaysian Investment Development Authority
MITI	Ministry of International Trade and Industry
MJEPA	Malaysia-Japan Economic Partnership Agreement
MP	Malaysia Plan
NATIP	National Timber Industry Policy
PN 17	Practice Note 17
R&D	Research and Development
ROA	Return on Asset
ROE	Return on Equity
ROCE	Return on Capital Employed
SC	Share Capital
SES	Stock Exchange of Singapore
SFM	Sustainable Forest Management
SPSS	Statistical Package for Social Sciences
TA	Total Assets
VIF	Variance Inflation Factor
WISDEC	Wood Industry Skills Development Centre

CHAPTER 1

INTRODUCTION

1.1 General Background

In business world, a firm is an organization which sells goods or services to gain profits. There are mainly four types of firms which can be differed based on their ownership structures. Sole proprietorship, partnership, corporation and cooperative are the types of firm ownerships. Regardless of the structures, every firm shares the same purpose which is to maximize the wealth of the shareholders through boosting the firm's value or size (Brigham & Houston, 2013). Nowadays, the growing influences of multinational corporations in global economy have indicated the role that size is playing. Harvey and Graham (2002) showed that the role of firm size significantly affects the financial practices of a corporate firm. Large firms tend to outperform small firms with their influences in gaining variety of advantages.

Many investors believe that the larger the firm size, the easier a firm gets additional funding to positively affect a firm's value (Hidayah, 2014). Large firms are exploiting their size to gain access to the public debt markets in a lower cost to fulfil their financing needs. It is due to the fact that large firms are known to have a lower probability of bankruptcy, higher market power, and employ better technology which could contribute positively to firm profitability (Guney, Paudyal, & Antoniou, 2008) . Therefore, modern corporate firms tend to increase their size to get a competitive edge over their competitors by increasing their market share.

However, larger and more diversified firms could face scale inefficiencies issues and be less profitable because of bureaucratic processes, higher agency costs, and other costs associated with managing larger firms (Voulgaris & Lemonakis, 2014). Thus, to sustain a good financial performance, Muhammad Sori and Abd Jalil (2009) have provided insight that financial analysis and evaluation can be used as an early alerting method to detect any financial distress symptoms among the companies listed in the stock exchange.

Financial analysis is a process to analyze and evaluate the financial performance of a firm by using data from financial statement. The analysis of financial statements is based on the use of ratios. Ratios analysis involves calculation and interpretation of financial ratios to analyze and monitor firm's performance (Sokolov, 2008). With only ratios, they are not sufficient to understand past performance and predict future prospect. Thus, financial ratios need to be compared with some standards, such as industry trend or ratio trend, and it is how benchmarking is done. According to Vance (2003), benchmarking "involves analyzing the financial statements of the best companies in an industry and using their financial ratios as a basis for evaluation of a company's performance".

The financial analysis goes along with four directions which are liquidity, profitability, turnover and financial leverage (solvency). Liquidity is measured as the ability to fulfill its short-term obligations as they come due. It is as well stand for the ability to convert assets into cash quickly with lower costs. Liquid assets

are used to cover any financial emergency. Examples of liquidity measures are current ratio, quick ratio and operating cash flow ratio.

Profitability aids to indicate the ability of expenses management of a firm. It also helps to assess business' ability to generate earnings relative to its associated expenses. To achieve high profitability, ones have to utilize the resources available to generate profits. Return on asset (ROA), return on equity (ROE), return on capital employed (ROCE) and earnings per share are some of the examples to scale profitability.

Efficiency evaluation measures the rate of conversion for various accounts to turn into cash or sales. Some of the most important elements of working capital, which include accounts receivable, receive payable and inventory, need great attentions for high efficiency management. Indicators of efficiency evaluation include inventory turnover, average collection period, and accounts payable turnover.

Solvency is the ability of a firm to meet long-term obligations when they come due. In corporate capital structure, financial leverage allows a firm to have an asset base larger than its equity via debt financing. Financial leverage helps to increase the ROE of a firm as long as the cost of liabilities is less than return of funds investment. Contrary to equity, liabilities have predefined payment terms. A firm may have financial distress if it fails to meet the obligations. Debt ratio, debt-to-equity ratio and gearing ratio are some of the ratios which can help to evaluate the solvency level of a firm.

The analysis of financial performance can help various parties which include creditors and investors to obtain the financial information needed from the companies they are interested. Financial performance analysis serves the purpose of identifying financial performance of a company, reveal weaknesses, potential sources of problem occurrence in its plans and to find out strengths on which the firm can rely (Sokolov, 2008). According to the analysis results, necessary actions can be taken to resolve, improve or further strengthen the conditions of firm performance. Therefore, only with correct application of financial analysis, it will be capable of answering many questions concerning “financial health” of a business.

1.2 Problem Statement

There are various factors which can affect the solvency performance of a firm. The first factor is capital structure, which illustrate on how a firm finances its overall operations and growth by using different sources of funds including debts and equity. The debt level within the capital structure of a company play a huge role to affect the financial performance of a company. There are empirical results which showed that there is a strong negative correlation between debt level and economic performance which include solvency (Lambrecht, 2001). Thus, the choice between debt financing and equity financing is deeply affecting the ability of a company to meet its obligations in advanced.

Other than capital structure, size of a firm does as well matter. In previous studies, size of firm determines the solvency level a firm can achieve. Serrasqueiro and Nunes (2008) suggested that a larger firm size will hold onto much more resources and have an advantage to manage the cash flow and debt issuing in a more solvent way as compared to smaller firm size. In fact, the likelihood of a firm to face bankrupt or financial distress decreases with the increase of firm size (Bhattacharjee, Higson, Holly & Kattuman, 2009; Esteve-Pérez, Sanchis-Llopis & Sanchis-Llopis, 2010).

To measure firm size, there are few indicators available which have been used in previous studies. The first indicator is total assets, which is the combination of both current and fixed assets. It is widely used in different studies such as Khatab, Masood, Zaman, Saleem and Saeed (2011), Saliha and Abdessatar (2011), Banchuenvijit (2012), Doğan (2013) and Vithessonthi and Tongurai (2015). There are also previous researches which included total employees as one of the indicators such as Serrasqueiro and Nunes (2008), Pervan and Višić (2012) and Doğan (2013). However, it is not an ideal indicator as the labor intensity can vary among the industries. Some researchers suggested that paid up capital and total sales are more stable and relevant to measure firm performance (Ponnu & Okoth, 2009).

Thus far, there has been little study conducted regarding the relationship between firm size and solvency performance. A recent study conducted by Ramin, Lizam, Zabri and Ahmad (2017) has focused on the general listed companies in Malaysia. The findings showed that total asset as proxy of firm size has moderate influence

to both of the indicators of the solvency performance but when paid up capital was used as proxy, it has lesser influence on debt ratio and has no influence on current ratio. Nonetheless, there is still space to further explore on the relationship between firm size and solvency performance, especially within a sector, and in this regard, wood-based sector. According to the economic environment in Malaysia, wood-based sector is one of the major contributors to the national economy. In just 2016, the revenue collected was RM22.11 billion. At the same year, it contributed almost 2.8% of the total export of the country and created around 240,000 employment opportunities (MIDA, 2018). Given the contributions of wood-based sector towards the Malaysian economy, this study focused on wood-based companies listed in Bursa Malaysia.

1.3 Objectives

The objectives of this study are:

1. To determine the relationship between the firm size and solvency performance of wood-based companies listed in Bursa Malaysia.

2. To investigate the indicators of firm size which make an impact to the solvency performance of wood-based companies listed in Bursa Malaysia.

1.4 Justification

This study deserves the attention as it can help to understand the relationship between firm size and solvency performance. Generally, firms with larger size which are listed in Bursa Malaysia, are assumingly to have a better solvency performance without financial distress issues. However, the existence of Practice Note 17 Company list in Bursa Malaysia proves the fact that larger firm size is not absolutely indicating a better solvency performance. Practice Note 17 is a listed company in the Malaysian Stock Exchange that is financially distress or does not have a core business or has failed to meet minimum capita or equity which is less than 25% of the paid-up capital (Mohammed, 2012). The companies that entered PN 17 list are according to the existing standards. It is an early uncovering of weaknesses or risks which existed in the financial market for immediate intervention purpose. Therefore, Hasabullah and Zulkarnain (2009) stated that an early alerting signal can be detected by using financial data analysis, especially solvency performance to avoid financial crisis.

The result of this study is essential to a wide range of parties which includes managers, shareholders, creditors, auditors, suppliers, employees and other entities. It can be useful for the managers as it provides some understanding of business failures and bankruptcy, its causes and its possible remedies. Managers can improve their ability to leverage available resources of the firms to enhance the health of financial position and keep the firm solvent regularly. Shareholders would like to monitor the solvency performance of the companies to secure their investment from being abused by mismanagement. As for the creditors, suppliers

and employees, they have to acknowledge the ability of the companies to pay back obligations such as loans, account payable and accruals in advanced via observing the solvency performance to protect their own interests respectively. The investors are also concerned about solvency position of the company whether it is risky, in order to make the best investment decision. Therefore, solvency performance can provide insight of financial health which can be analysed in advance to project any early warning signal of financial distress and to avoid bankruptcy issues.

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