

Disclosures of Materiality: The Practice of Malaysian Companies

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ABSTRACT

The reporting of information in the financial statements is pervasively based on the materiality concept. For the purpose of disclosing financial information, auditors use their professional judgments in deciding the appropriate materiality thresholds. There is evidence of a lack of consensus in disclosure thresholds that researchers and practitioners believe to have arisen from the absence of a clear guideline on materiality. This study uses an archival approach to provide empirical evidence of materiality thresholds for the disclosure of financial information among companies in the retail and finance industries in Malaysia. Results show that the threshold of a majority of the disclosed items being examined is very low (i.e., below 5% of net profit for the current year). The study found a significant difference in disclosure threshold between industries. The study suggests that specific guidelines on materiality threshold for different industries should be established for the disclosure of financial items.

ABSTRAK

Pelaporan maklumat dalam penyata kewangan adalah secara keseluruhannya berasaskan pada konsep kematerialan. Untuk tujuan pelaporan maklumat kewangan, juruaudit menggunakan pertimbangan profesional dalam menentukan tahap kematerialan yang sesuai. Bukti menunjukkan bahawa terdapat ketidakselarasan tentang tahap pendedahan yang para penyelidik dan pengamal mempercayai, disebabkan oleh ketiadaan garis panduan yang jelas tentang kematerialan. Kajian ini menggunakan pendekatan arkeb untuk memberi bukti tentang tahap kematerialan bagi pendedahan maklumat kewangan syarikat-syarikat dalam industri peruncitan dan kewangan di Malaysia. Hasil kajian menunjukkan bahawa berasaskan pada item yang diperiksa kebanyakan item tersebut adalah sangat kecil (iaitu, di bawah 5% daripada untung bersih tahun semasa). Kajian mendapati terdapat perbezaan yang signifikan pada tahap pendedahan di antara kedua-dua industri tersebut. Kajian ini mencadangkan supaya suatu garis panduan yang khusus disediakan

untuk memperbaiki ketiadaan konsistensi tahap kematerialan pendedahan item kewangan.

INTRODUCTION

This study used an archival approach to examine the application of materiality concept within the context of reporting of financial information. Results of past studies indicate that materiality thresholds for the disclosure of financial information are not consistent. A materiality threshold is commonly stated as the percentage of net profit below which an item is not material, hence is not disclosed separately in the financial statements, and above this percentage it is material, hence is disclosed separately in the financial statements (Iskandar 1996). Inconsistencies in materiality thresholds could be the result of industry factor (Iskandar & Iselin 1997). Earlier researchers on materiality (e.g., Dyer 1975; Firth 1979; Neumann 1968; Pattillo 1976; Woolsey 1954a, 1954b, 1973) believe that this inconsistency occurs as a result of the absence of a clear guideline for materiality. Since the concept of materiality forms the basis for reporting of financial information within the financial statements, further investigation into this inconsistency needs to be made. Past studies used an experimental design to examine the effect of industry (Iskandar 1996; Krogstad et al. 1984). The examination of archival data will provide further evidence for the application of the materiality concept for financial information reporting in practice.

The purpose of this study is, therefore, to obtain information about the existence of materiality thresholds concerning the disclosure of financial information in the financial statements of different industries. The following are the specific objectives of this study:

1. To obtain evidence on materiality thresholds of financial items separately disclosed in the financial statements.
2. To examine differences in disclosure thresholds across industries.
3. To determine the premise of establishing materiality guidelines.

THE CONCEPT OF MATERIALITY

The concept of materiality requires all 'material' financial information to be communicated in accounting reports and allows 'immaterial' information to be omitted. Materiality refers to the magnitude or nature of a misstatement (including an omission) of financial information either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been influenced or his decision affected, as a result of the misstatement (IAG 25). Accounting researchers and professionals have recognized the

importance of the materiality concept for many years as it ingrains deeply in financial reporting (Hofstedt & Hughes 1977).

The concept of materiality impacts differently on different interest groups who are primarily preparers, auditors, and users of financial statements. Auditors and preparers are expected to differ in their views concerning the purpose of financial reporting, the responsibilities associated with published financial statements, and the role of judgment in the accounting and reporting process (FASB 1975). Users are expected to benefit from the outcome of the accounting and reporting process undertaken by auditors and preparers. The preparers' basic concern is financial accounting and reporting while auditors have an attestation function to perform. The users' main expectation of financial information is that it is useful for decision-making purposes (e.g. investing and lending decisions). Since the information contained in financial statements is dependent upon both preparers' and auditors' materiality judgments, these judgments can affect users' decision making, both directly and indirectly. In fact, preparers' and auditors' materiality judgments are made with full consideration being given to the resulting impact on users. Regarding auditors, Carpenter and Dirsmith (1992) remark that auditors' judgments of materiality become a key issue through their ability to influence external decision-makers.

DISCLOSURE OF MATERIAL INFORMATION: THE RESPONSIBILITY OF AUDITORS

The disclosure of financial information in the financial statements reflects auditors' decisions on the appropriate materiality level. It is the primary responsibility of the auditors to ensure that financial statements provide information and disclosures according to established criteria. Auditors are responsible for their decisions to users of financial statements and audit reports (Stringer 1982). In fulfilling this responsibility auditors are involved in a considerable amount of decision making which requires consideration of materiality, particularly in planning the nature, timing and extent of audit procedures, performing the audit work, evaluating the effect of misstatement on the measurement and classification of accounts, determining the appropriateness of the presentation and relevant disclosure of the financial information, and in reporting the opinion on the audit of financial statements (IAG 25: para. 8).

STATEMENTS OF PROBLEMS

Problems of materiality arise as a result of the absence of criteria to guide its application in auditors' judgments. A comprehensive discussion

memorandum entitled “Criteria for Determining Materiality” was first issued in 1975 by the Financial Accounting Standard Board (FASB) in the United States. The objective was to obtain responses from various parties representing preparers, auditors, and users of financial statements towards the issuance of materiality guidelines. However, the memorandum was withdrawn in 1980. The Board decided that general standards of materiality could not be formulated to take into account all considerations entering into an experienced human judgment (FASB 1980: para. 131).

Despite the need for guidelines on materiality as indicated in some studies, for instance Mayper (1982), Morris et al. (1984), and Jennings, Kneer, and Reckers (1987), none has been developed in the United States or United Kingdom. In Malaysia, no separate accounting standard is devoted specifically to deal with the concept of materiality. Compared to other countries, auditors in Australia appear to be better guided in their materiality judgments. The accounting standards in Australia (AAS 5 “Materiality” and AASB 1031 “Materiality”) recommend that the materiality threshold should be somewhere within the range of 5% to 10% of the appropriate base. Auditors’ individual professional judgments are required only within the 5% to 10% range.

Whether specific guidelines are provided or not in these countries, the concept of materiality remains the basis for selection and application of accounting policies, as well as the disclosure of a change in accounting policies (IAS 1) in these countries. When there are no authoritative materiality guidelines, accountants often use their own rules of thumb (Jordan, Henderson & Gordon 1991). The need for materiality guidelines which may be greater in the government than in a corporate context, further supports the view for the establishment of specific materiality guidelines (Raman & Van Daniker 1994).

The above discussion indicates that there are no clear guidelines for the application of the concept of materiality. Auditors need to use their judgments in dealing with materiality. Except for Australia, the situation appears to be common in some countries including United States, United Kingdom and Malaysia. This situation ultimately results in different materiality thresholds being applied for the purpose of disclosure of financial information in the financial statements.

DIFFERENCES IN MATERIALITY THRESHOLDS

Results of past studies indicate a lack of consensus about materiality thresholds within the judgments group. A number of studies have found some differences in materiality thresholds. Table 1 contains past research findings that highlight these differences in terms of the range of materiality thresholds employed in making materiality judgments.

TABLE 1. Range of materiality thresholds

Study	Method	Findings
Neumann (1968)	Archival	Qualified opinion: 5%-10%
Boatsman & Robertson (1974)	Experiment	Disclosure of items: > 4%
Moriarity & Barron (1976)	Experiment	Income effect is a most important cue at: 5%, 10% & 20%
Woolsey (1973)	Survey	Material (immaterial) error: 5.8% (4%)
Messier (1983)	Experiment	Write down: 3% - 5%
Frishkoff (1970)	Archival	Dividing line of unqualified & qualified report: 25%
Krogstad et al. (1984)	Experiment	Income effect is a most important cue at: 2.7% & 7.3%
Morris et al. (1984)	Archival	Considerable of overlaps of materiality thresholds
Morris & Nichols (1985)	Archival	Material (immaterial): 17% (5%)
Iskandar & Iselin (1997)	Experiment	Disclosure of items: > 8.7%

As shown in Table 1 materiality thresholds are of different types, that is, audit opinion thresholds (Frishkoff 1970; Neumann 1968), disclosure thresholds (Boatsman & Robertson 1974; Messier 1983) and material/immaterial thresholds (Woolsey 1973). The finding of a wide range of materiality thresholds clearly shows a lack of consensus. The variation could be due to differences in the type of the judgment item rather than differences in threshold perceptions within the same type of judgment item. In this study, the effect of item type is controlled by examining only one disclosure item. (Refer to the section on the analysis of frequency of item disclosure in the financial statement below).

The lack of consensus in materiality thresholds may have occurred as a result of industry differences. A number of previous studies suggest that significant differences exist across industries in a number of accounting-related aspects including inherent risk (Dipietro et al. 1994), production of audit reports (Stein 1994), financial accounting errors (Ham et al. 1985; Hylas & Ashton 1982; Wright & Ashton 1989), and the relationship between employees' compensation and firm performance (Ely 1991). These factors suggest that different industries may require different materiality judgments and hence result in different materiality thresholds.

The Iskandar and Iselin (1997) study shows that the disclosure threshold in a particular industry, as applied by audit specialists in that industry, differs from those of another industry as applied by other industry specialists. Specifically, the study examines the disclosure thresholds in the retail and finance industries, and finds that the disclosure threshold used by finance industry specialists is lower compared to the disclosure threshold used by retail industry specialists. The study suggests differences in disclosure thresholds exist between industries. The authors explain that the difference is due to different levels of risk involved within each industry as perceived by auditors specializing in that industry.

It is argued, therefore, that besides the absence of materiality guideline the application of materiality concept for the purpose of financial information disclosure is influenced by the industry factor. This is believed to explain the inconsistencies of materiality judgments among auditors. On the basis of the above discussion the following propositions are suggested:

- P1: Disclosure of financial information in the financial statements of any industry is inconsistent.
- P2: The disclosure threshold in the finance industry is lower than the disclosure threshold in the retail industry.

METHODOLOGY

DATA

This study uses 'gain or loss from sale of fixed assets' to examine the application of materiality thresholds in the disclosure of the item. The item is selected because gain or loss arising from sale of fixed assets represents part of the ordinary activities of a company in any industry. Hence, gain or loss from sale of fixed assets is not being disclosed as an extraordinary item¹. The item is either included as an ordinary profit and loss or is separately disclosed in the financial statements if the amount is material. Thus, it provides a measure of materiality threshold which may be defined as the "materiality level" below which an item is immaterial and above which it is material. The threshold reflects the maximum amount by which to judge whether the financial information could be misstated and still not affect users' decisions.

COLLECTION OF DATA

The data was collected from the 1992 to 1996 published financial statements of companies in retail and finance industries listed on the Kuala Lumpur Stock Exchange (KLSE). Ringgit values for any disclosed gain or loss from sale of fixed assets as ordinary profit and loss items are recorded. The

percentage of the amount on net profit (after tax but before extraordinary items) of the company was calculated. The absolute and percentage data provide bases for the analysis.

ANALYSIS OF DATA

FREQUENCY OF ITEM DISCLOSURE IN THE FINANCIAL STATEMENTS

The archival data provides information about the frequency that the item is disclosed in the financial statements of listed companies in the retail and finance industries. For the purpose of this study, frequency is expressed in terms of the number of disclosure incidences as a percentage of the total number of companies in the industry. A high percentage indicates high incidence of the item being disclosed in the financial statements for the industry. A high frequency of disclosure also suggests that the transaction relating to the item occurs frequently in the industry.

Table 2 summarizes the frequency of disclosure of the gain or loss arising from sale of fixed assets for the retail and finance industries for the period 1992 to 1996. The table shows that frequency of the item disclosed in the financial statements is about the same in the finance industry as that in the retail industry. Tests of significant differences show that the number of observations for either the gain or loss item is not statistically different between the two industries at $p < .05$. This indicates that the frequency of disclosure items is common in both industries. The common characteristic of the item is important in order to avoid the effect of the nature of items on the results (e.g., Bernstein 1967; Carpenter & Dirsmith 1994; Frishkoff 1970; Woolsey 1954a, 1954b). Differences in the type of item under study may cause differences in materiality thresholds. (Please refer the discussion for Table 1). In order to avoid any confounding effect of item type on the result, this study examines only one type of item, that is, gain or loss on sale of fixed assets for both industries.

MAGNITUDE OF DISCLOSURE ITEM

The magnitude of the disclosed items is analyzed further by classifying the data into 13 groups of percentage of the item on net profit which are 1%, 3%, 5%, 7%, 8%, 10%, 12%, 15%, 20%, 25%, 30%, 40% and >40%. These percentages of the item on net profit are chosen because findings of past research show that materiality thresholds used for materiality judgments range from 3% (Krogstad et al. 1984; Messier 1983) to 25% (Frishkoff 1970). Table 3 displays the distribution of the disclosed item for the years 1992 to 1996, classified according to the level of the percentage effect of the item on net profit. The objective of this analysis is to determine the magnitude of the item actually disclosed in the financial statements.

TABLE 2. Frequency of disclosure items

Year		1996		1995		1994		1993		1992	
Items Disclosed Loss on sale of fixed assets	Ind.	Retail	Finance	Retail	Finance	Retail	Finance	Retail	Finance	Retail	Finance
	Freq. (%)	17 33.3%	16 29.6%	12 23.5%	13 24.1%	16 31.4%	14 25.93%	13 25.5%	16 29.6%	14 27.5%	13 24.1%
Gain on sale of fixed assets	Freq. (%)	33 64.7%	37 68.5%	39 76.4%	41 75.9%	33 64.7%	32 59.26%	37 72.6%	33 72.6%	29 56.9%	33 61.1%

TABLE 3. Size of disclosed items as percentage of net profit for 1992 - 1996

Item Disclosed	Industry		1 %	3 %	5 %	7 %	8 %	10 %	12 %	15 %	20 %	25 %	30 %	40 %	>40 %	Total
Loss on sale of fixed assets	Retail	Freq.	43	16	6	0	1	1	2	0	1	0	0	0	2	72
		(%)	59.7	22.2	8.3	0.0	1.4	1.4	2.8	0.0	1.4	0.0	0.0	0.0	2.8	
	Finance	Freq.	66	4	1	1	0	0	0	0	0	0	0	0	0	72
		(%)	91.7	5.6	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Gain on sale of fixed assets	Retail	Freq.	80	37	20	8	5	2	4	2	2	2	1	3	5	171
		(%)	46.8	21.6	11.7	4.7	2.9	1.2	2.3	1.2	1.2	1.2	0.6	1.7	2.9	
	Finance	Freq.	146	12	8	0	0	1	0	0	1	3	0	2	3	176
		(%)	83.0	6.8	4.5	0.0	0.0	0.6	0.0	0.0	0.6	1.7	0.0	1.1	1.7	

The table shows that the size of item separately disclosed in the finance industry generally ranges from 1% to 12% and in the retail industry from 1% to 40% of net profit for the year. This indicates that there exists inconsistency in the disclosure threshold within both industries; thus, it provides supports for Proposition 1. The result also indicates that many of the items disclosed separately in the financial statements are within 1% of the net profit for the year or below. For instance, in the finance industry, about 90% of the loss from sale of fixed assets and 83% of the gain from sale of fixed assets separately disclosed in the financial statements are below 1% of net profit for the year. In the retail industry, on the other hand, about 59% of the loss from sale of fixed assets and 47% of the gain from sale of fixed assets reported in the financial statements are 1% or below. In total almost 99% of the loss from sale of fixed assets and 94% of the gain from the same item that is disclosed separately in the finance industry are below 5% of net profit.

Results of the analysis indicate the following:

1. The size of item examined is relatively very small. Most items separately disclosed in the financial statements are less than 5% of net profit. This is particularly true for the finance industry. In the retail industry the size of item is relatively larger.
2. The disclosure threshold in the finance industry is lower than in the retail industry. Overall the disclosure threshold in the finance industry is 1% of net profit or below while the threshold in the retail industry is 5% or below. This finding is consistent with the earlier study on the influence of industry on materiality judgments (Iskandar & Iselin, 1997). Iskandar and Iselin (1997) suggest that different disclosure thresholds are used by different industries as a result of risk factor involved within an industry.

These findings also suggest that, in practice, auditors do not have specific guidelines on how materiality is to be judged. Their judgments as to what is the appropriate disclosure threshold appear to vary depending upon the type of industry under consideration and the auditors' industry specialization (Iskandar & Iselin 1997).

DIFFERENCE IN DISCLOSURE BETWEEN INDUSTRIES

A comparison of the magnitude of disclosed items is made between the retail and finance industries. Table 4 provides the mean value of disclosed gain or loss from sale of fixed assets, which is the average amount of the disclosed gain or loss by all companies disclosing the item in that industry.

Overall Table 4 shows that the mean values of both gain or loss on sale of fixed assets are larger for the retail industry than for the finance industry. These results show that the disclosure thresholds for both items are lower in

TABLE 4. Mean values for disclosed items for retail and finance industries

Items Disclosed	Retail		Finance	
	RM	%	RM	%
Loss on sale of fixed assets	343,528	3.05	113,781	0.58
Gain on sale of fixed assets	1,429,773	11.27	284,095	3.98

the finance industry than in the retail industry. A statistical test (t-test of significant difference) is performed to determine whether there would be any significant difference between the size of items disclosed within the retail industry and that within the finance industry. The results show that the differences are statistically significant for both items, that is, at $p = .001$ for loss from sale of fixed assets and $p = .011$ for gain from sale of fixed assets. The results are consistent with earlier findings suggesting that the disclosure threshold of the finance industry is lower as a result of the higher risk inherent in this industry compared to the retail industry (Iskandar & Iselin 1997). The results support Proposition 2.

Results from this archival study provide evidence, that in practice, accountants seem to disclose items of gain or loss from sale of fixed assets at an amount less than 1% of net profit for the year. Also, disclosures of items in the financial statements do not indicate any specific pattern between industries.

CONCLUSION

The results of this archival study indicate the following:

1. Gain or loss from sale of fixed assets is not uncommon for both the retail and finance industries.
2. In practice, in some cases, the standard of materiality is not being applied to disclose such items.
3. Disclosure thresholds for the finance industry are lower than for the retail industry.

Many items below the 5% threshold are disclosed separately in the financial statements. An earlier study indicates that practicing auditors agree that the industry of a client is a relevant factor in the judgments of materiality and abnormal items (Iskandar 1996). Differences in materiality thresholds are expected to occur between industries. An inter-industry difference in the size of the disclosed item is noted from the results of this archival study, although at this stage the conclusion is still preliminary.

Establishing a clear guideline on materiality may be required to guide the exercise of judgments by auditors. This suggestion has been supported

by some earlier researchers on materiality (Dyer 1975; Firth 1979; Neumann 1968; Pattillo 1976; Woolsey 1954a, 1954b, 1973) concerning the establishment of materiality guidelines, which can be used by independent auditors. Although in 1980 the FASB stated that general standards of materiality are not feasible, more recent researchers on materiality (e.g., Jennings et al. 1987; Morris et al. 1984) believe that auditors' judgments of materiality need to be guided in order to improve consistency and accuracy.

Accounting professionals share the same view. Jordan et al. (1991) conclude that some materiality guidelines need to be formulated. They believe that for such an important area as disclosure of the effect of changes in accounting principles in accordance with APB Opinion No. 20, it is necessary to improve the consistency of financial reporting in order to provide accountants with more confidence in a particular decision. According to these authors, accountants currently often use their own rule-of-thumb materiality guidelines for making materiality decisions. This practice shows that accountants require some criteria for guidance, even though "the decision concerning materiality is situation specific and depends on many factors" (Jordan et al. 1991: 18).

The above statements express the concerns of accounting researchers and professionals for the need to improve the quality of audit judgments. The diversity in the bases used for estimating materiality may lead to unjustifiably wide variation in the audit testing performed in similar audit situations (Raman & Van Daniker 1994). This discussion indicates the need for guidelines for the auditing profession in Malaysia, even though such guidelines may not be a substitute for the auditors' expertise of professional judgment. Hence, further research is necessary to help establish materiality guidelines of different industries.

ACKNOWLEDGEMENT

The authors would like to acknowledge the financial support provided by the Faculty of Business Management, Universiti Kebangsaan Malaysia. We are grateful for comments received from the seminar participants at Universitas Bengkulu.

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