

**A STUDY ON THE RELATIONSHIP OF EARNINGS
AND CASH FLOW WITH CORPORATE LIQUIDITY
IN THE TRADING/SERVICE SECTOR IN MALAYSIA**

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ABSTRACT

The relative usefulness of earnings versus cash flow in providing information to decision makers has been examined in many contexts. However, research is lacking which empirically tests the relative information provided by these two measures in the context of explaining corporate liquidity. Realizing this fact, a number of previous studies have been conducted to test the relationship between measures of earnings, cash flow and liquidity.

The purpose of this study is to extend the analysis further to analyse the relationship of earnings and cash flow with corporate liquidity by considering the industry effects which focuses on the quoted companies in the trading/service sector. The sample of this study are taken from 40 public companies, listed on the trading/service on the Kuala Lumpur Stock Exchange (KLSE) Main Board. The Correlation and Regression analysis are used to analyse the accounting data obtained from annual reports of the respective firms between 1992-1996. The results of this study indicates that there is no significant relationship exists between earnings and cash flow with corporate liquidity.

The overall implication of the result is that both earnings and cash flow cannot be used to provide information in the trading/service sector in Malaysia. The relationship of the earnings and cash flow may be vary if the other sectors are selected as the sample. The significance of the relationship may be period specific and may vary for the static and dynamic measures of liquidity (cash conversion cycle). This is due to the fact that this study done on a sample in the only consisted of top big companies in the trading/service sector listed on the Kuala Lumpur Stock Exchange (KLSE) Main Board. Thus, it is not possible to generalise the findings beyond these areas. However, the findings in this study can be used as a general guide to determine the relationship of earnings and cash flow with corporate liquidity.

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CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

Accounting research is often concerned with the relationship between accounting information and user decisions. In Statement of Financial Accounting Concepts No. 5, paragraph 52, the Financial Accounting Standards Board (FASB) states that an important use of information about a company's cash flow includes helping to assess factors such as the entity's liquidity financial flexibility, profitability and risk.

The FASB's contention regarding liquidity, however has not much been empirically validated i.e the information that cash flow actually provides about a company's liquidity has not much been empirically measured. A related question involves the use of accrual earnings to provide information about liquidity. This study addresses these issues by examining the relationship between earnings and cash flow and corporate liquidity in the service sector in Malaysia.

Profitable companies do not necessarily be equated with good performance. This is because nowadays there are many profitable companies that had to be closed down due to financial distress. Since then, analysts have developed many performance measurements that have reflected the actual situations. Therefore, the rise in corporate bankruptcy has led to an increased interest in the examination of corporate liquidity.