

Understanding, Perceptions and Reliance of Financial Statements Among Malaysian Insurance Policy Holders

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ABSTRACT

Customers of today's world are exposed to a variety of products and investments. It is best that they are aware of the consequences on their return of investment. Thus, this study examined the level of understanding and reliance of insurance policy holders on financial statements. Evidence was provided on the denotative meaning accorded to financial terms found in corporate reports, using the instrument developed by Haried (1972, 1973) and further adapted by Chudry et. al. (2000). A survey was conducted on 312 insurance policy holders. The study also focused on the denotative meanings of semantic analysis. For the purpose of this analysis, six financial terms were chosen: turnover, profit from operations, loss from operations, accumulated depreciation, dividend per share and goodwill. From the denotative analysis, the respondents scored high level of understanding on terms such as turnover and dividend per share.

There was no relationship between the perceived understanding and the actual level of understanding on insurance policy holders. The regression analysis showed that the independent variables such as perception on relevancy and perceived understanding were significant variables to influence the level of reliance on financial statements.

Introduction

Financial information is formally communicated by companies to their users through the financial statements produces in annual reports and prospectuses or press releases. Hence, financial statements prepared should be useful and relevant to users (Olsson, 1981). These users, however, are not all academically trained to understand the financial statements. This might cause an expectation gap between the preparers and the users. Nevertheless, as today's investment becoming more diversified and complicated, financial statements still play an important role for all users. Without good understanding of financial statements, users will be at the disadvantage especially for those individual investors or customers.

In this competitive market, individual investors or customers need to realize that the consequences of committing themselves to investment products or unsuitable insurance are greater than that of buying a book or a shirt. Currently, there are various types of insurance available in the Malaysian market. To name a few, there are Life Assurance, Personal Accident Insurance, Endowment Assurance, Annuities, Mortgage Reducing Term, and the latest in the market is Investment-linked Life Insurance. Before deciding which insurance to invest, potential insurance buyers need to survey wisely. They need to find out whether the insurer is a reputable company with an unblemished track record in term of service, product quality and fund management and fund performance. They should aware of the fact that money is wasted when they cancel their insurance policies (Ng, Jenny, 2000).

Thus, the question raised is whether the insurance policy holders look for the financial information before deciding to purchase the insurance? To what extent they understand the financial information? Do insurance policy holders' understanding on the financial statement is the same as those preparers? The objective of this current research is to investigate on one category of users, namely the insurance policy holders regarding their understanding on the financial statements. Specifically, the objectives of this study are:

1. to identify the level of perceived understanding on financial statements.
2. to measure the level of understanding on denotative meaning of financial terms.
3. to investigate the relationship between the level of perceived understanding and the understanding on the denotative meaning of financial terms.
4. to explore the potential relationship between the reliance of the insurance policy holders' and perceptions toward financial statements when purchasing insurance.

Literature Review

Understanding Financial Statements

The issue of understanding the financial statements is a global issue. Several accounting terms are used interchangeably. According to Silhan (1978), some of financial terms are not clearly defined and thus, cause unnecessary differences in terminology. Even the name for annual report is interchanging with several other terms such as annual reporting, financial reporting or financial statement. In Malaysian scenario, for instance, some companies used debtors and creditors, whilst others used accounts receivable and accounts payable to describe the same terms. This situation may give confusion to some especially when the terms are translated into the Malay Language.

Few studies have been conducted in the areas of understanding on the denotative and connotative meanings of financial statements from various perspective. One of the most established study in analyzing the semantic dimensions of financial statement was done by Haried (1972, 1973). He studied not only the perceptions of users on the financial statements, but also on the evaluation of two techniques namely the semantic differential and the antecedent consequent methods. However, the attributes selected in his study were very lengthy which might affect the respondent's ability to digest the specific terms with each of the attributes. Haried's study was later adapted by Chudry et. al. (2000). They found that a majority of shareholders 'claim' to understand accounting information. However, the shareholders' perception on the level of understanding was much higher than their actual level of understanding. Chudry et. al. (2000) also found that revealed that private

shareholders possess a fairly sophisticated perception of the denotative meaning of key terms in the profit and loss account, which was similar to the earlier studies by Haried. Another study done by Bagronoff and Houghton (1994) has measured connotative meaning across different cultures of national boundaries. They found that there was a significant difference in classification decisions made by two groups from North American and Australian auditors.

Improving the Communication Process and the Expectation Gap

To have an effective communication process between the preparers and the users, the information in the financial statements must be understood by both parties (Higson, 1997). In the other word, both the preparers and the users should have the same understanding. Nevertheless, users might have perceived or interpreted the meanings of the financial statement differently from those of preparers. This is due to the high standards of terminology and concepts used in the financial statements. Schuetze (1991, 2001) commented that ordinary people, chief executive officers, line operating managers, members of board of directors, investors, creditors, regulators, who are not accountants, should be able to understand the financial statements. After the Enron case, Fuller (2002) stated that the financial statements should be more transparent to help the shareholders.

Many researches have discussed the effects of financial information on the users' judgment and decision making (e.g. Moser 1989, Joseph, et.al. 1996 and Hirst 1995). The investors need to understand the financial statement for different type of purposes. Until today, many parties continue to argue that current financial statements still have its own limitations. Newman and Sansing (1993) found that some public disclosures will be deliberately inexact. This can create major communication problems among users since disclosure policies are used by multiple users. In 1974, Oliver studied whether there existed a confounding lack of communication regarding sets of accounting concepts by using semantic differential technique. Oliver found that there was a nonconformance perceptions of the meaning of these concepts between the accounting educators and the other six professional groups. Oliver's research was different from those earlier studies done by Haried (1972 & 1973). Silhan (1978) analyzed the divergent terminology that caused communication difficulties encountered by readers. He proposed an approach to theory

presentation which minimizing the unnecessary differences in terminology. Silhan concluded that clearly defined terms are important for the communication and the understanding of financial information.

Research Methods

This study used a questionnaire survey method to collect relevant data. The selected terms and scales used in this survey was adopted from Harried (1972& 1973), and Chudry et.al. (2000). Comments and reviews gathered during the pilot study phase were collated and used to modify the questionnaire. About 50 final year students and lecturers from Faculty of Accountancy, UiTM have been selected in the pilot study. There were three main parts to the questionnaire. The first section comprised the descriptive demographic questions; the second section was the evaluation of the overall financial statements; the final section related to the denotative meaning of selected terms.

In general, the variables used in this study were measured using both nominal and ordinal scales. To evaluate the overall understanding of the financial terms, six variables were used namely “turnover”, “profit”, “loss”, “dividend”, “accumulated Depreciation” and “goodwill”. In testing the financial literacy level of the denotative meanings on selected financial terms, 10 (ten) simple choices of definition were given for each term as in Figure 1. Three best answers were included in each term, which based on the accounting standards and several discussions with accounting experts. Respondents were asked to select three choices of which they consider as the “best” denotative meaning of the financial terms. The answers from the respondents were carefully assessed so that the only “correct and direct” answers can be obtained. In doing this, the current study had accordingly simplified the earlier versions introduced by Harried (1972) and later adopted by Chudry et. al. (2000).

This research focused on the insurance policy holders as the direct users, rather than other type of users for a couple of reasons. The increasing awareness on the importance of securing insurance policies either for ‘life’, ‘belongings’, ‘medication/ hospitalization’, ‘education’ and other related reasons makes the insurance policy holders a strategic group for this study. Potentially, it is expected that a large adult proportion of the population in this country will become an insurance policy holders in one way or another. The larger sample was later randomly selected by way of a convenient sampling. A sample size of 312 representing

insurance policy holders were chosen within the Klang Valley area. The respondents were each given an explanatory letter, a reply- paid envelope, and a souvenir to encourage participation.

Table 1 exhibits the demographic characteristics of the respondents. More than 70% of the respondents were from the private sector. About 55% of the respondents were at the executive level while others were at the management and professional levels. In terms of educational background, most respondents were degree holders (49%) and A-Level certificate (37%). The respondents were mostly at the age of 20-29 (42%) and 30-39 (35%). They comprised more of males (12% extra) than females and the Malays were the majority. Most of the respondents acquired personal endowment (life insurance) as compared to education insurance.

Table 1: Profile of Respondents

Category	Frequency	%	Category	Frequency	%
1. Working sector			2. Age (years)		
a. Public	72	23	a. less than 20	1	1
b. Private	227	73	b. 20 – 29	132	42
c. Entrepreneur/ own business	11	4	c. 30 – 39	110	35
			d. 40 – 49	53	17
			e. 50 or more	15	5
3. Current position held	40	13	4. Race		
a. Management	38	12	a. Malay	208	67
b. Professional	165	55	b. Chinese	76	24
c. Executived	58	20	c. Indian	23	7
d. Others			d. Others	5	2
5. Educational Background			6. Gender		
a. Degree/ Master/ PhD	152	49	a. Male	174	56
b. A-level/ STPM/ Matrik/ Diploma	117	37	b. Female	138	44
c. SPM	38	12			
d. Others	5	2			
7. Type of insurance acquired (there are cases of respondents acquired both types)					
a. child education				86	27.6
b. personal endowment			241	77.2	
Total				312	100

Analysis of Data Findings

Objective 1: To identify the level of perceived understanding on financial statements.

The respondents were initially asked to ‘self rate’ their financial literacy level. Table 2 depicts this outcome. The average relative understanding of the respondents was 3.3226, with a standard deviation of 0.9062. The average respondents rated themselves as having a good understanding, though standard deviation was quite big. This result indicates that majority of the respondents regard themselves as having good understanding of financial statements when purchasing insurance. Only 14.5% (scale 1 & 2) admitted that their understanding were weak.

Table 2: The Perceived Level of Understanding on Financial Statements

Understanding the Financial Statements	Frequency	Percent (%)
5 – Very Good	32	10.3
4 – Good	89	28.7
3 – Average	144	46.5
2 – Poor	37	11.9
1 – Very Poor	8	2.6
Total	310	100
Mean	3.3226	
Std. Dev.	0.9062	

Objective 2: To measure the level of understanding on denotative meaning of financial terms

In Table 3, the actual level of understanding on financial statements were analyzed according to the education background of the respondents. The actual understanding was measured using the denotative semantic meaning. As mentioned in the methodology, the respondents’ correct answers were added and given scores (maximum 3) of the three answers. On average, the achieved scores (total column) of the respondents on each term were still low, which showed that the respondents did not actually understand the actual meaning of the term. Respondents chose to understand only terms that affected them personally such as “turnover” and “dividend per share”, which were rank first and second respectively.

Table 3: Mean Analysis on the Denotative Meaning According to the Education Variable [The range of the Denotative Scores were Minimum of 0 and Maximum of 3]

6 Selected Financial terms	Education Background			Total	Rank	Sig
	Degree	A-level	SPM			
1. Turnover	1.6184	1.4786	1.0789	1.4968	1	0.004*
2. Profit	0.8750	0.880.	0.6579	0.8526	6	0.268
3. Loss	1.2039	1.2308	07632	1.1635	4	0.006*
4. Dividend Per Share	1.4737	1.5431	1.2632	1.4759	2	0.285
5. Accumulated Depreciation	1.5329	1.4615	1.1579	1.4615	3	0.032
6. Goodwill	1.0395	0.8462	0.4474	0.8974	5	0.006*

Comparatively, a technical term and difficult, such as “accumulated depreciation”, received high points in term of their understanding. This could be due to their working experience and personal life in using the term. The respondents understanding on basic terms such as “profit from operation” and “loss from operation” were very low. This might be resulted from the confusion of accrual and cash basis concepts. As expected, understanding on the meaning of “goodwill” was very low. The definition of the goodwill term in accounting and business usage were quite different. The results were also reflected that the level of education has significance influence on the actual level of understanding on financial terms.

Objective 3: To Investigate the Relationship between the Perceived and the Actual level of Understanding on Financial Terms

Further analysis on the denotative meanings of financial terms was carried out. For the denotative understanding, a factor analysis was done to find out the best grouping for the six different financial terms. All the six terms can be group into one variable known as denotative meaning. As shown in Table 4, the average scores of the denotative meaning (refer to the denotative overall column) according to the perceived understanding are less than 1.5, which is relatively low. There is no relationship between the respondents’ perceived understanding (‘self rate’) and the denotative scores. Their understandings do not match with the actual level of understanding.

Table 4: *Perceived Understanding versus Overall Actual Understanding (Denotative Meaning): A Comparative Analysis*

PERCEIVED UNDERSTANDING	DENOTATIVE (OVER-ALL)
5 – Very Good	1.271
4 - Good	1.284
3 - Average	1.184
2 - Poor	1.269
1 – Very Poor	1.083

[The range of the denotative scores were minimum of 0 and maximum of 3]

Objective 4: To Explore the Potential Relationship between the Reliance of the Insurance Policy Holders’ and the Perceptions Toward Financial Statements when Purchasing Insurance

The following table 5 shows the correlation of each variable. Five variables were selected to find the bivariate analysis. The results stated that the perceived understanding was significantly correlated with the respondents’ perception on the financial statements attributes of simplicity and relevancy. This indicates that as the perceived understanding was higher, the respondents would regard the financial statements would be more simple and relevant to them. The other three variables were significantly correlated with the degree of the respondents refer to financial statements the 0.01 level at the predicted sign. This shows that as the level of perceived understanding getting higher, the respondents would be more often to refer to the financial statements when making decision. Likewise, as the financial statement was perceived simple and more relevant, the respondents would refer more often to financial statements. The study had checked on the effects of multicollinearity among the independent variables. They were not more than 0.70, which meant that the correlations were low and acceptable.

Further analysis on the variables selected was done using regression analysis:

$$y = -.538 + 0.623x_1 + 0.00858x_2 + 0.361x_3$$

where,

y1 = Reliance on financial statements

x1 = Perceived level of understanding

x2 = Perceptions on financial statement: simplicity x3 = Perceptions on financial statement: relevant

Table 5: Correlation Among Variables

	Financial Statement: Simplicity	Financial Statement: Relevancy	Financial Statement: Reliance	Actual Understanding (denotative)
Perceived Understanding	0.248**	0.120*	0.479**	0.068
Fin. Stmt.: Simplicity	1.000	0.074	0.168**	-0.016
Fin. Stmt. Relevant	—	1.000	0.232**	0.033
Fin. Stmt. Reliance	—	—	1.000	-0.023

(*) and (**) indicate significance at $p < 0.05$ (2-tailed), and $p < 0.01$ (tailed) respectively.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.512a	.262	.255	1.0790

a. Predictors: (Constant), FSRELEV, FSSIMPLE, UNSTD2

Coefficients a

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-.538	.413		-1.303	.194
	UNSTD2	.623	.071	.451	8.747	.000
	FSSIMPLE	8.580E-02	.107	.041	.801	.424
	FSRELEV	.361	.107	.169	3.382	.001

a. Dependent Variable: REFER2

The perceived level of understanding ($x1$) showed a significant variable in influencing the reliance on financial statements. Further, the ‘relevant’ variable ($x3$) showed a significant influence the reliance of financial statements. A different result was showed on simplicity. Thus, it can be assumed that the respondents who perceived that they

understand the financial statements (x_1) and considered that financial statements are relevant to them (x_3), then they will rely more on financial statements (y) for decision-making. From this model, it shows that the perceptions are highly correlated with the reliance on financial statements. Once the respondents consider that they understand financial statements, they would have better perceptions and would rely more on financial statements when making investment decision.

Conclusion and Future Research

The analysis revealed that the actual understandings on denotative meaning of the insurance policy holders are still low. Interestingly, it can be implied that the users did not use financial statements in making decision related to insurance policy. Even if they do so, their levels of understanding on important terms are still questionable. The worse scores were on the profit/ loss from operations and goodwill terms. The beliefs of the insurance policy holders tend to be towards money or cash basis, rather than accrual basis. In the regression analysis, the reliance on financial statements was very strongly related to two variables; the perceived level of understanding and the relevancy of financial statements. This also indicates that the insurance policy holders whom refer to financial statements were those who have higher actual understanding on the denotative meaning, and those who perceived financial statements to be relevant. There were users who did not used financial statements in making decision related to insurance policy. This is a major setback to them because they are making huge insurance investment for long run but ignorance on the financial feedback of insurance companies.

The results on the six key terms may not be absolute to portray the overall understanding of users on the denotative meanings of the financial statements. Future research on the other key terms from other statements such as the Cash flow is recommended. Further, it can also examine the level of understanding on the denotative meanings of financial terms amongst specific users such as bankers, financial analyst, employees and line managers. Comparative results between KLSE sectors would provide a useful insight on the level of understanding of financial terms amongst users. It is advocated in this research that if financial reports are to be relevant, their intended usage must be clearly understood by the users.

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Figure 1: *Denotative Meaning of Financial Terms*
 Note: *The respondents were asked to choose only 3 choices*

Question 1 No. If you have turnover , then you have _____.	Question 2 No. If you have profit from operation , then you have _____.	Question 3 No. If you have loss from operation , then you have _____.
i potential profits or losses	i A tax liability	i Less demand of sales
ii Liability	ii Revenue exceed costs*	ii An unprofitable business*
iii Money	iii A cash inflow	iii No retained profits
iv Contribution	iv Surplus funds	iv Slow business
v Revenue*	v Potential dividend distributed*	v Cash flow difficulties
vi Sales*	vi Revenue	vi To review the cost of inputs and price of outputs*
vii Customers	vii Happy shareholders	vii A cash outflow
viii Income*	viii Money to use	viii No dividend
ix Creditors	ix Created wealth*	ix Excess costs*
x demand/market	x A successful year	x A reason for shareholders to query the worth of their investments

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Question 4 No. If you have dividend per share, you have _____.	Question 5 No. If you have then accumulated depreciation, then you have _____.	Question 6 No. If you have goodwill, then you have _____.
i Happy shareholders	i Contra Assets*	i More customers
ii Distributed profits*	ii Equity	ii Intangible assets or reserve*
iii Less retained profits	iii A declining business	iii Cash Inflow
iv A profitable business	iv Lower book value of fixed assets*	iv A developing business
v A cash outflow	v Shorter life of fixed assets	v Purchased a before * business
vi A return to shareholders *	vi Allocated the wear and tear of fixed assets*	vi Business Connections
vii Reserves	vii More debts	vii Created wealth
viii An appropriation of profits*	viii Lower tax amount	viii Goodwill amortized*
ix A liability to shareholders	ix Depreciation expense	ix Management ability
x A good financial position	x Estimated value of fixed assets	x Good business reputation

• *the correct and direct answer for the term being asked*