

Financial Characteristics and Cancelling Treasury Shares Events

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Abstract

Background/Objectives: This study explores the incidence of cancelling treasury shares events in Malaysia and examines the financial characteristics of companies that are more likely to cancel their shares. **Methods/Statistical Analysis:** The study utilizes descriptive analysis to assess the incidence of cancelling treasury share events among non-financial and non-utility Malaysian companies. Tobit regression analysis is used to gauge the relationship between firm financial characteristics and the incidence of cancelling treasury share events. **Findings:** There were a total of 175 events of cancelling treasury shares occurred between the years 2001 and 2012. This study finds that profitability positively and significantly affects the decision to cancel treasury shares, while excess cash flows negatively influence a firm's decision to cancel treasury shares. Furthermore, smaller size companies are more likely to engage in cancelling their shares. **Application/Improvements:** The study finds that smaller firms are more likely to cancel their treasury shares as these companies may have severe information asymmetry problems.

Keywords: Event Study, Financial Characteristics, Firm Performance, Share Repurchases, Treasury Shares

1. Introduction

Share repurchase is a method of distributing or paying out cash to shareholders that is available worldwide. Share repurchases activities are on the rise both in developed markets and emerging markets^{1,2}. One reason for its popularity is that it could be used to signal undervaluation of a firm's stock. Repurchases are well received by investors and stock prices on the repurchasing firms increase during the announcement period³⁻⁶.

Share repurchases have become prevalent after the Asian financial crisis in 1997⁷. Malaysian firms are also actively participating in buyback activities. From the inception year in 1997 until December 2005, 305 firms or about 30 percent of all listed firms was involved in share repurchase activities. Yet, studies pertaining to buybacks in Malaysia are limited and have focused mainly on either the announcement effects of buybacks⁸⁻¹⁰, managerial motives for repurchases¹¹ or long-term performance¹².

There are also limited empirical evidences relating to what companies do with their repurchased shares, which are treated as treasury shares. This is because treasury shares are considered dead shares or idle shares and thus are not subject to dividend¹³. In Malaysia, the Revised Technical Release 1999 dictates that these treasury shares can remain in the companies' financial position as a deduction from outstanding shares. These treasury shares can later be resold to the public or be cancelled. From 2001 to 2012, the numbers of cancelled treasury shares are quite large; thus provided an interesting avenue for research.

2. Objectives of Study

Very limited evidence available on what companies do with their repurchased shares or treasury shares. In Malaysia, the revised Technical Release¹³ on share buybacks indicates that companies can treat repurchased

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shares using treasury shares method in case they need to resell these shares in the open market or reissue them for the purpose of share dividend. The second option is to use retirement method which cancels these repurchased shares.

The first objective of this study is to explore the incidence of cancelling treasury shares events in Malaysia. Secondly, this study examines the characteristics of companies that are more likely to cancel their shares.

3. Literature Review and Hypotheses Development

The first testable hypothesis relates to firm profitability. It is argued that firms strive to maintain or improve their performance based on market indicators. Some of the most popular performance indicators are Earning Per Share (EPS)^{14,15}, Return On Assets (ROA) and Return On Equity (ROE)¹⁴⁻¹⁶. It is argued that companies with higher profitability have lower need to resell treasury shares to raise funds as compared to companies with lower levels of profitability. On the other hand, since share repurchases could be used to signal undervaluation and Malaysian authorities put a restriction that treasury shares cannot be greater than 10 percent of shares outstanding, better-performing firms might be inclined to cancel their treasury shares to better reflect their performance. The following hypothesis would attest whether profitability leads to treasury share cancellations.

3.1 H₁: Return On Equity (ROE) affects the Decision to Cancel Treasury Shares

Previous evidence indicates that a company repurchases its own shares to improve the capital structure level as measured by debt ratio¹⁷. It is argued that capital structure changes will lead to changes in security prices¹⁸. He hypothesises that firms embark on tender offer share repurchases to increase its leverage ratios which will eventually increase the after-tax value of the firms and eventually increase their value. It is found that companies repurchasing their shares in self-tender offers alter their capital structure either for the defensive mechanism against takeover or to improve capital structure level¹⁸. Debt to equity and long term debt to equity are used to test the level of indebtedness.

Although previous studies find level of debt influence

share repurchase decision, the Malaysian corporate environment might be different. In the Malaysian context, companies must show that they are solvent and are able to proceed with repurchase activities without external funds¹⁹. Therefore, it is expected that companies' debt level is not affected. However, the denominator of debt ratio would be reduced equivalent to the amount of repurchased shares. Thus, the magnitude of this change would depend on the amount of shares bought. In short, it is hypothesized that cancelling shares activities would not have any effect on debt level. The next hypothesis is as follows:

3.2 H₂: Companies' Level of Indebtedness does not affect the Decision to Cancel Treasury Shares

Previous evidences indicate that companies repurchase own shares when they experience lower growth¹². Using the same argument, it is hypothesised that companies having less growth opportunities are the potential candidate to cancel their treasury shares. Given that these companies have no other opportunities to expand their business elsewhere, there are willing to cancel their shares to improve their financial position even by window dressing. The next hypothesis is as follows:

3.3 H₃: Companies' Level of Growth Opportunities affects the Decision to Cancel Treasury Shares

Cash flow is also an important criterion in making any financial plan. Reference²⁰ raises the issue that managers of excess cash firms are subjected to severe agency problems. Having more excess cash at their disposal, managers are likely to over-invest in negative Net Present Value (NPV) projects, consume more discretionary perquisites for private benefit or simply retain cash unnecessarily. When firms distribute cash dividends to shareholders, the firms are actually reducing their agency costs. Holding investment opportunities constant, free cash flow hypothesis posits that shareholders with considerable excess funds should benefit from share buybacks.

Several studies^{21,22} find evidence that substantial cash holdings by repurchasing firms represent excess income. Firms tend to experience substantial increases in cash holdings prior to share repurchases but significantly reduce cash expenditures due to lack of opportunities.

In the case of cancelling treasury shares, cash flows are unaffected. Therefore, it is argued that even in the case of limited funds, companies may be compelled to cancel shares if it can reflect better performance;

3.4 H₄: Companies' Excess Cash Level does not affect the Decision to Cancel Treasury Shares

This study uses size as a control variable. Size is often used as a measure of information asymmetry. Size of a company can be measured by total assets or market value^{23,24}. This study argues that smaller size companies which have higher information asymmetry problems are more likely to engage in cancelling shares events.

4. Data Collection and Methodology

All data are from secondary sources. Data regarding the actual announcements of cancelling treasury shares are collected from Bursa Malaysia website while all other financial data are retrieved from DataStream database. The study utilizes descriptive analysis and Tobit regression model to examine the following research hypotheses: 1) To describe firms' financial characteristics that cancel their treasury shares and 2) To assess the relationship between firms' financial characteristics and cancelling treasury shares events.

5. Findings and Analysis

The following sections discuss the findings of the study. First, Section 4.1 explains the distribution of cancelling treasury events from year 2001 to 2012. Then it describes the industry distributions as well as the frequency

statistics. Next Section 4.2 discusses the findings for Tobit regression analysis.

5.1 Descriptive Analysis

Table 1 and Figure 1 show the distribution of cancelling treasury events throughout 2001 to 2012. A total of 175 events of cancelling treasury shares occurred between 2001 and 2012. Many of the cancelling events are repetitive events undertaken by the same companies either in the same year or in different years. Column three (repeat events) presents the repeated cancellation events for each year from 2001 to 2012. As a total, 73% or 128 events are repetitive cancelling events by the same companies.

As shown in Table 1 and Figure 1, cancelling of treasury shares occurred more frequently in 2004 and 2007 with 35 and 37 cancellations of treasury shares respectively. The last column in Table 1 dictates the number of new companies. Given that repurchases share is an option, many companies may not have the policy to repurchase. For those that choose to repurchase shares, they may have the tendency to repeat them several times. Therefore, the last column of Table 1 is intended to track down how many companies have been actively cancelling their shares over the 12-year period.

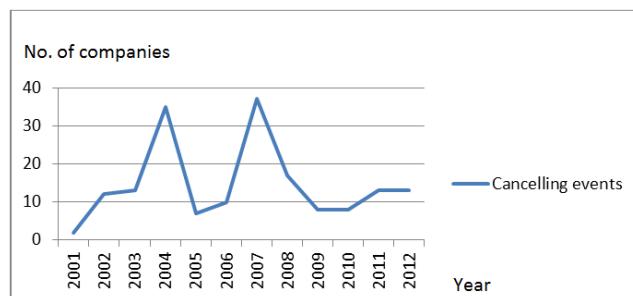


Figure 1. Cancelling TS events for the period between 2001 and 2012.

Table 1. Distribution of cancelling events from 2001 to 2012

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
1. Cancel Events	2	12	13	35	7	10	37	17	8	8	13	13	175
2. Repeat events	1	11	12	34	3	2	35	13	2	4	7	4	128
3. % Of repeat events	50	92	92	97	43	20	95	76	25	50	54	31	73
4. Company yearly	1	2	2	5	5	9	8	8	8	7	12	12	79
5. New companies	1	1	1	1	4	8	2	4	6	4	6	9	47

Table 2 presents the distribution of companies in accordance to Bursa Malaysia industrial classifications. Most of the companies that cancel their treasury shares are from consumer industry, which account for about 25 percent of the population, followed by industrial companies and trading and services companies. As presented in Table 2, more than half or 55 percent of companies that cancel their shares would eventually be delisted from Bursa Malaysia.

Table 2. Company industry distribution

No	Industry	Total	% of	Delisted	% of
		Company	population	company	delisted
1	Con- struction	3	6	1	33
2	Con- sumer	12	26	10	83
3	Finance	3	6	1	33
4	Indus- trial	11	23	4	36
5	Planta- tion	1	2	1	100
6	Property	4	9	4	100
7	Technol- ogy	4	9	3	75
8	Trading and Ser- vices	9	19	2	22
	Total	47	100	26	55

Table 3 lists down the frequency of cancelling events for each company for the period between 2001 and 2012. More than half or 57 percent of companies cancelled their treasury shares once during the 12-year period while 12 companies or 26 percent of the companies cancelled their treasury shares twice. Four and two companies cancelled their treasury shares three and four times respectively. Only 2 companies cancelled their treasury shares more than 10 times during this period while one company has 91 cancellations during the entire period.

Table 3. Frequency of cancelling events

Frequency	Companies	Total Events	% Of
Cancel Events			Population
1	27	27	57%
2	12	24	26%
3	4	12	9%
4	2	8	4%
13	1	13	2%
91	1	91	2%
Total	47	175	100%

Table 4. Yearly distribution of cancelling shares event

Year	Observations	Year	Observations
2000	1	2007	11
2001	2	2008	9
2002	2	2009	8
2003	5	2010	12
2004	5	2011	16
2005	13	2012	8
2006	13		
		Total	101 observations

The percentage of delisted companies in this sample is alarming and certainly poses intriguing questions. What are the characteristics of firms that cancel their treasury shares? Could cancelling treasury shares be an indication that the companies are having financial difficulties? Does the financial information produce in the annual reports convey quality and relevant information to the users? This study will focus on the first question.

Table 4 presents the yearly distribution of cancelling year events. A total of 101 yearly cancelling events is observed during 2001 to 2012. Table 5 presents descriptive analysis for cancelling treasury shares. The averages, median and maximum unit of treasury shares cancelled are 24.9 million units, 10.4 million units and 298 million units respectively. On average, companies cancelled 74.87 percent of previously held treasury shares on each cancelling events or transactions even though the median is 100%.

Table 5. Descriptive analysis

	MEAN	MED	MAX	MIN
ROE	4.89	8.09	30.79	-114.69
DEBT	30.98%	32.20%	78.85%	0.06%
GROWTH	1.17	0.87	4.78	0.11
EXCESS	0.08	0.09	0.28	-1.12
CASH				
SIZE (RM mil)	3,273	768	38,458	32
Unit Cancel (MIL)	24.90	10.40	298.40	6.20
% of Out- standing shares	3.80	2.29	10.00	0.00
% of Treasury shares	74.87	100.00	100.00	0.03

During 2001 to 2012, the average number of treasury shares cancelled is about 3.8% of companies' ordinary shares outstanding. Further investigation indicates that 43 events deal with cancelling of all (100%) previously held treasury shares.

All variables are then tested for correlation using non-parametric testing. None of the correlation is significantly high, suggesting that the model does not suffer from the severe multicollinearity problem. The study uses robust standard error to reduce problems of heteroscedasticity in the error term. To gauge the relationship between companies' financial characteristics and decision to cancel shares, we developed the following equation:

$$\text{CANCEL} = \alpha_1 \text{ROE}_{it} + \alpha_2 \text{DEBT}_{it} + \alpha_3 \text{GROWTH}_{it} + \alpha_4 \text{EXCESS CASH}_{it} + \alpha_5 \text{SIZE}_{it} + \varepsilon_{it} \quad (1)$$

Where,

CANCEL	Is the percentage of treasury shares cancelled for the year. It is calculated as the number of treasury share unit cancelled divided by ordinary shares outstanding;
ROE	Is the performance of firm measured by net income divided by total equity;
DEBT	Is the level of companies' indebtedness. It is calculated using the debt ratio, which is total liabilities divided by total assets;
GROWTH	Is the market to book value. It is calculated as the company's share price divided by book value;
EXCESS CASH	Is the earnings before tax, depreciation and amortisation scaled by total assets;
SIZE	Is the natural log of total assets.

5.2 Regression Analysis

Table 6 presents results of Tobit regression analysis with robust standard error. The first column of Table 6 lists down the expected sign of the relationship for each variable. The result in profitability as measured by Return On Equity (ROE) is significantly positive at 1 percent, thus supportive to the idea that profitability positively affects the decision to cancel shares. Companies with

higher profitability are concerned with their performance and would cancel their shares in an attempt to maintain or improve their performance.

The second hypothesis argues that companies' decisions to cancel shares are not influenced by the level of debt. The result is negative but insignificant. Even though the direction for growth opportunities is negative as predicted, but it is not significant therefore it does not provide strong support for the argument.

For excess cash hypothesis, the result is negative and significant at 5 percent. This means that the level of cash significantly influence company's decision to cancel shares. It points out that companies with lower excess cash are more likely to cancel their treasury shares.

Finally, the result for company's size is as expected. The study finds that smaller firms are more likely to cancel their treasury shares as these companies may have severe information asymmetry problems. Similarly, reference²⁵ finds that size of a firm affect firm's investment decisions.

Table 6. Tobit regression results

$$\text{CANCEL} = \alpha_1 \text{ROE}_{it} + \alpha_2 \text{DEBT}_{it} + \alpha_3 \text{GROWTH}_{it} + \alpha_4 \text{EXCESS CASH}_{it} + \alpha_5 \text{SIZE}_{it} + \varepsilon_{it}$$

CANCEL	Exp sign	Coef	Robust std Error	p-value
ROE	+ve	0.003	0.000	0.004***
DEBT	-ve	0.013	0.033	0.696
GROWTH	-ve	-0.006	0.006	0.290
EXCESS CASH	?	-0.260	0.109	0.019**
SIZE	-ve	-0.008	0.004	0.038**
Cons		0.174	0.076	0.024

*, **, *** denote significant at 10%, 5% and 1% level using two-tailed

6. Conclusion and Future Research

The objectives of this study are twofold. First is to explore the prevalence of cancelling treasury shares events in Malaysia. Secondly, it examines the financial characteristics of companies that most likely would cancel their own shares.

In summary, this study finds that profitability positively and significantly affects the decision to cancel treasury shares, while excess cash flows negatively influence a firm's decision to cancel treasury shares. Furthermore, smaller size companies are more likely to

engage in cancelling their shares. Although the direction of the result of growth hypothesis is as predicted, it is not statistically significant thus, provide no support for the argument. As for future research, study on detailed investigations into the effects of cancelling shares as well as study on different motivation for cancelling shares could shed lights on why high percentage of these type of companies choose to be delisted or going private.

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