UNIVERSITI PUTRA MALAYSIA

INCOME SMOOTHING PRACTICES AMONG LISTED FIRMS IN MALAYSIA

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INCOME SMOOTHING PRACTICES AMONG LISTED FIRMS IN MALAYSIA

By

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Thesis Submitted to the Graduate School, Universiti Putra Malaysia, in Fulfilment of the Requirements for the Degree of Master of Science

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DEDICATION

To both of my parents; Ummi and Walid, my husband; Roslan,

my kids; Ikmal Hanafi and Esdma Rauhah,

and all my brothers and sisters.
The income-smoothing phenomenon is well documented in accounting and finance literature. Although the existence of income smoothing practices have been detected in varying degrees across different samples, many issues relating to the practices of creative earnings management remain unresolved to date. However, the real danger is not that immoral management is busily engaged in these manipulative practices but the eroded confidence in the usefulness of financial accounting statements. The common issue of interest in previous income smoothing studies was the methodology or model selection used to identify the income smoothing sample firms. Recent studies such as Albrect and Richardson (1990), Ashari et al. (1994), Michelson et al. (1995), and Carlson and Bathala (1997) adopted the income smoothing (IS) index model developed by Eckel (1981). This model is 'preferable' than the classical expectancy model because it mitigates the use of predicted earnings and the need to observe income smoothing behaviour over a long-term period. However, this model is unable to directly estimate the extent or amount of
smoothers and the direct instruments for income smoothing in firms. In addition, it heavily relies on several reasonable and general assumptions. Therefore, the main objective of this study is to verify the direct instruments used for income smoothing. The discretionary accounting changes and start-up costs (pre-operating and preliminary expenses) were observed and tested using the expectancy model to ascertain the extent of smoothing behaviour. A start-up sample of 231 firms from the main and second board of the KLSE was analysed for presence of smoothing behaviour using an IS index model and expectancy model over a nine-year period (1990-1998). The analysis was divided into three different periods, from 1990 to 1996, from 1997 to 1998 and from 1990 to 1998 to isolate managerial behaviour on smoothing during the pre-economic crisis and crisis period. The results from both models show higher percentage of smoothers during the crisis period. This is consistent with the expectation that managers have strong motivation to smooth income during the economic crisis period to counter the fluctuation in reported income. The finding also shows that the expectancy model is more appropriate to identify income smoothing firms during the economic crisis period. The non-parametric test was performed to determine the final sample of smoothing firms. These sampled firms were further analysed to determine the factors influencing income smoothing practices. Nine explanatory variables were tested and only three variables were found significant, namely, the profitability, debt financing and management ownership factor. The profitability and debt-financing factor have a negative relationship with income smoothing practices while the management ownership has a positive relationship. This implies that the firm with higher profit and greater level of debt has fewer tendencies to practice income smoothing. On the other hand, the manager-controlled firms are more likely to smooth income in a
favourable way. These results suggest that principal-agent relationship and the profitability of a firm have strong impact on income smoothing behaviour.
Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Master Sains

AMALAN PELICINAN PENDAPATAN DI KALANGAN FIRMA-FIRMA YANG DISENARAIKAN DI MALAYSIA

Oleh

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I certify that an Examination Committee met on 12th December, 2001 to conduct the final examination of Nor Raihan Binti Mohamad on her Master of Science thesis entitled "Income Smoothing Practices Among Listed Firms in Malaysia" in accordance with Universiti Pertanian Malaysia (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulation 1981. The Committee recommends that the candidate be awarded the relevant degree. Members of the Examination Committee are as follows:

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DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.

NOR RATHAN BINTI MOHAMAD

Date: 20/2/2002
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CHAPTER 1

BACKGROUND OF INCOME SMOOTHING

1.1 Introduction

The income smoothing phenomenon is well documented in accounting and finance literature. It is generally regarded as a signalling aspect of managerial behaviour directed at the production and communication of financial information to the public. In other words, it is an intentional action by the management to reduce fluctuations in reported earnings. The existence of income smoothing practices have been detected in varying degrees across different samples but many issues relating to the practices of creative earnings management remain unresolved to date.

1.2 Definition of Income Smoothing

Income smoothing can be defined as an effort to reduce fluctuations in reported earnings. Hepworth (1953) was one of the earliest few to research into income smoothing, though he did not define income smoothing precisely, but suggested that managers could deliver a stable earnings stream by juggling with accounting choice.
Beidleman (1973) defined income smoothing as an intentional dampening of fluctuations about some level of earnings that is currently considered to be normal for the firm. In this sense, income smoothing represents an attempt on the part of the firm's management to reduce abnormal variations in earnings to the extent allowed under sound accounting and management principles. Koch (1981) specifically noted that the management practices income smoothing using either the artificial instruments or the accounting variables, or real instruments or the transactional variables.

Income smoothing can be viewed from the perspective that there must be a smoother, a purpose, an object and the instruments used to carry out smoothing. Usually, the smoother is the management and the purpose of income smoothing is to reduce earnings fluctuation, while the object of income smoothing is the variable of which the management wishes to smooth, that is the reported income numbers and the instruments are the accounting and transactional variables.

Smooth income streams can occur naturally or it can be a result of manipulation of reported income numbers. The latter is referred to in the literature as discretionary smoothing, as contrasted with non-discretionary (non-manipulative) smoothing of earnings. Ronen and Sadan (1981) suggested that discretionary smoothing could be accomplished along three dimensions; a) smoothing through events occurrence or recognition, b) smoothing through allocation over time and c) smoothing through classification (classificatory smoothing).
Smoothing through events occurrence or recognition or real smoothing can be accomplished by altering the timing of the occurrence of real transactions to achieve the smoothing objective. These transactions include capital asset acquisitions; discretionary spending on advertising, research, and maintenance; or the recognition of sales transactions. Timing the recognition of real transactions might be considered a special case of real income smoothing. For example, companies may delay (after shipment) or accelerate (before shipment) the recognition of sales transactions at year-end depending upon the dictate of the smoothing objective. This particular means of smoothing clearly violates accepted ethical and accounting standards.

Smoothing through allocation over time or artificial smoothing may be achieved by shifting of costs or revenues from one accounting period to another. Many specific actions can facilitate artificial smoothing, but generally, it is either accounting procedures or accounting estimates deviate from what one would regard as those producing the "proper" matching of income and expense items.

Classificatory smoothing involves classification of borderline expense items between the ordinary and extraordinary categories to affect the reported amounts of ordinary income. A broad perspective of income smoothing is diagrammatically presented in Figure 1.1 (see Appendix A1).
1.3 Issues on the Income Concept

Belkoui (1993) noted that income is a basic and important item of financial statements that has various contexts. Income is generally perceived as a basis for taxation, a determinant of dividend-payment policies, an investment decision-making guide and an element of prediction.

The reported profit or income is used for computing the earnings per share, a ratio which is widely used as a basis for evaluating performance and valuing shares in business combination. The accounting income is also considered useful for control purposes such as the stewardship role of management.

The concept of income from the accountants’ perspective is different from that of the economist. Accounting income is based on the transaction approach, which places great emphasis on the operations or activities transacted in order to arrive at profit, but the economists insist on the capital maintenance approach, which takes into account any increment in values of assets, irrespective of whether they have been realised. The rationale of why this transaction approach is considered superior to economists’ approach is because of its reliability, in terms of measuring the elements of revenues and expenses.

However, the relevance of accounting income under the transaction approach has become controversial primarily because it cannot portray economic wealth or value. Recent development on this issue was the introduction of the “fair value” accounting
method by the European Commission (EC). Fair value is normally defined as the current market value of a financial instrument rather than its historic cost, i.e. the original purchase price. This method aims to take account of developments in markets (such as widespread use of so called derivatives).

Standard setting bodies around the world such as the International Accounting Standards have been working to ensure the impact of these instruments are properly reflected in company financial statements. As for now, there is no international consensus that fair value accounting is appropriate in all cases. Fair value accounting would therefore not be permitted for balance sheet items such as fixed assets and certain financial instruments, such as long-term debt.

1.4 Financial Reporting Practices In Malaysia

Financial reporting in Malaysia is governed by public sector legislation and private sector regulatory bodies. The statutes that have significant impact on financial reporting in Malaysia are:

a) the Companies Act, 1965
b) the Income Tax Act, 1967
c) the Securities Commission Act, 1993 and
d) the Financial Reporting Act, 1997

Public sector legislation principally consists of statutes promulgated by the Parliament. Compliance with the provisions of these statutes is legally enforceable. Private sector bodies such as the Malaysian Institute of Accountants (MIA) do not
have legal power to enforce compliance. However, there are often strong deterrents against deviation from accepted practices. Deterrents come in the form of the Kuala Lumpur Stock Exchange (KLSE) Listing Requirements and the accounting pronouncements issued by the MIA and the Malaysian Accounting Standards Board (MASB).

The Companies Ordinances (and amendments) of 1940, 1946 and 1956 are the first documented financial reporting regulations before the independence of Malaysia. Then, in 1965 the Malaysian Companies Act was passed to govern limited companies in the country. The Malaysian Companies Act 1965 is very similar to the 1948 Companies Act of the United Kingdom.

The legislation is mostly embodied in sections 167 to 171 in the Companies Act 1965 and is elaborated in its Ninth Schedule. This Act together with the schedule specifies the reporting requirements, rules and regulations and the disclosure requirements in the financial statements of Malaysian companies. Under the Act, company directors are solely responsible for the preparation of the statutory accounts and must present them (having been audited by certified auditors) to the shareholders at the annual general meeting.

The Financial Reporting Act, 1997, established the Financial Reporting Foundation (FRF) and the MASB. The MASB is an independent statutory body and its aim is to continually improve the quality of external financial reporting in Malaysia and to contribute directly to the international development of financial reporting. The
primary responsibility of the MASB\(^1\) is to issue new accounting standards, revise or adopt existing accounting standards, issue statements of principles, develop a conceptual framework and undertake public consultation in the determination of the contents of its pronouncements.

Section 558 of the Financial Reporting Act 1997 states that Accounting Pronouncements issued by the MASB and the Approved Accounting Standards are to be regarded as opinions on best practice in financial reporting in Malaysia. As such, with the legislation of the Financial Reporting Act, 1997, accounting standard setting in Malaysia is now the responsibility of the MASB. Refer Table 1.1 (see Appendix A2) for the status of IAS, MAS and MASB.

Tan and Chew (1996) reported that the extent of voluntary disclosure practices among Malaysian companies is very low. However, it is expected that the trend toward full disclosure-based reporting will grow with the enforcement by the regulatory authorities. The Central Bank of Malaysia, for example, issued BNM/GP8, which requires full disclosure practices among banks and financial institutions.

\(^1\) The functions of the Board are set out in Section 7(1) of the Financial Reporting Act 1997