

Disclosure of Extraordinary Items and Income Smoothing Behaviour in Malaysia

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ABSTRAK

Kertas ini mengkaji amalan pendedahan item luar biasa oleh syarikat yang tersenarai di Bursa Saham Kuala Lumpur (BSKL) di mana ketika itu piawaian asal berkaitan item luar biasa iaitu SI 8 – Unusual and Prior Period Items and Changes in Accounting Policies masih digunakan. Definisi yang diberi oleh SI 8 bagi item luar biasa adalah longgar dan terdedah kepada penyalahgunaan sehinggalah SI 8 yang disemak semula digunapakai dalam tahun 1997 dan diikuti oleh piawaian MASB 3. Artikel ini melaporkan sama ada pendedahan item luar biasa ini mempunyai hubungan dengan gelagat pelicinan pendapatan. Ia juga melaporkan sejauh mana pendedahan item luar biasa ini mempunyai hubungan dengan kos politik, penggearan dan pemegangan saham pengurusan syarikat. Kajian dilakukan ke atas 244 syarikat yang tersenarai di BSKL yang melibatkan syarikat yang telah membuat pendedahan item luar biasa sekurang-kurangnya sekali di antara tahun 1991 hingga 1995. Kajian mendapati amalan pendedahan item luar biasa adalah tinggi. Walau bagaimanapun hasil kajian menunjukkan tiada bukti bahawa pengurusan syarikat menggunakan item luar biasa untuk melicinkan pendapatan. Pendedahan item luar biasa ini juga tidak dijelaskan oleh kos politik, penggearan dan pemegangan saham pengurusan syarikat. Oleh itu tanggapan bahawa piawaian yang diterima pakai sebagai alat untuk menghalang amalan pelicinan pendapatan adalah tidak relevan kerana di Malaysia tiada bukti bahawa item luar biasa digunakan untuk melicinkan pendapatan. Justeru itu, piawaian baru dijangka hanya boleh digunapakai untuk meningkatkan paras kebolehbandingan dan keseragaman pelaporan di kalangan syarikat di Malaysia.

ABSTRACT

This paper investigates disclosure practice of extraordinary items (EI) by listed companies in Malaysia during which the original standard on EI, SI 8 – Unusual and Prior Period Items and Changes in Accounting Policies was still in place. Until the adoption of the revised standard in 1997 (revised

SI 8 and subsequently replaced by the MASB 3), the definition of EI given in the original SI 8 was very loose and it was opened to abuse. This paper also reports on whether EI disclosures were associated with income smoothing behaviour and the extent to which disclosure of EI was related to political costs, gearing and management interest. A total of 244 Kuala Lumpur Stock Exchange (KLSE) listed companies that disclosed EI at least once from 1991 to 1995 were included in this study. The study found that the incidence of EI was very high. However, the results showed no evidence of management using EI as a tool to smoothe income. Further, EI disclosures were not explained by political costs, gearing and management interest. As there was no evidence of the use of EI to smoothe income in Malaysia, the belief that the new standard (that restricts the definition of EI) would curb the practice of income smoothing is not relevant. The adoption of the new standard could only be expected to enhance the level of reporting comparability and consistency among Malaysian companies.

INTRODUCTION

The use of extraordinary items (EI) by management has been the subject of extensive investigation (see Jordan, Henderson and Gordan 1990, Lynn and McGuinness 1995 and Choo and Lee 1998). Accounting standard setting bodies elsewhere such as the Financial Accounting Standards Board, the Accounting Standard Board and the Australian Standard Review Board have made significant changes to their earlier standard dealing with extraordinary items in an attempt to curb the potential abuses largely arising from the very loose definition of items considered as EI.

In Malaysia, EI was originally contained in *SI 8 – Unusual and Prior Period Items and Changes in Accounting Policies*, following an adoption of *IAS 8* issued by the International Accounting Standards Committee (IASC). The Standard was made effective by the Malaysian Institute of Accountants (MIA) in January 1987. Upon revision of the Standard by the AISC, the MIA adopted the new revised standard and issued it as *SI 8 (Revised) – Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, in January 1997. Following establishment of the Malaysian Accounting Standards Board (MASB) in 1997, the revised standard was approved and reissued as *MASB 3 - Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* in July 1999. For the purpose of this paper, the revised Standard will be referred to as *MASB 3* and the original Standard as *SI 8*.

Where EI is concerned, *SI 8* dealt with the definition of EI and its disclosure guidelines. The adoption of this standard by MIA was seen as an attempt to improve the accounting standards in Malaysia in line with the standards in developed countries such as Australia, the United Kingdom and

the United States of America. The accounting standards that deal with EI in these countries restrict the interpretation of items that fall within the definition of EI. Thus, the adoption of the revised standard is seen as a step to harmonise the accounting standards and to facilitate comparability of financial information among Malaysian companies. More importantly, the issuance of the revised standard was seen as an attempt to curb an alleged abuse, namely that management used EI as a loophole to smooth or even to manipulate earnings since the definition of the items in SI 8 was left to the discretion of the management.

In SI 8, extraordinary items were defined as "... gains and losses that derive from events or transactions that are distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly" (para 3). In this broad definition, what constitutes ordinary activities is left to the management to define. Thus, the very "open" nature of the definition has given rise to inconsistency in reporting financial performance among companies over time. Thus, the issue of potential abuse by management to use EI to inflate or deflate the reported earnings is of a major concern.

However, in MASB 3 (previously revised SI 8), the reporting of extraordinary items is more restrictive in which a clear definition of EI was provided. In MASB 3, EI have been defined as "... income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly." (para 6 of MASB 3). The word "clearly" was added to the definition before the phrase "ordinary activities" to make it more specific. To ensure that the use of EI is not being abused, the standard states that "Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise" and that "... only on rare occasions does an event or transaction give rise to an extraordinary item"(para 12 of MASB 3). Consequently, the Standard provides only two examples of events or transactions that generally fall into extraordinary items, namely assets' expropriations, and earthquake or natural disasters (para 14 of MASB 3). Nevertheless, paragraph 18 states that "When items of income and expense within profit or loss from ordinary activities are of such size, nature and incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". The standard, in paragraph 20, further provides circumstances that warrant separate disclosure in accordance with paragraph 18.¹

STUDY OBJECTIVES

This paper attempts to investigate the disclosure practice of EI and to determine whether EI is used as a tool to smooth earnings in Malaysia. To date, no such study has been conducted in Malaysia. Much of the evidence on EI is from developed economies. For instance, Lynn and McGuinness (1995) showed that, over a period of five years, 61.2 percent of the companies in Hong Kong had at least reported EI once, and the yearly incidence rate for EI ranged from 25 to 36 percent. An even higher incidence rate was recently observed. For instance, Choo and Lee (1998) reported that 85.9 percent of the Singaporean companies reported EIs from 1992 to 1994. These findings suggest a high degree of EI disclosure by companies.

In particular, this paper attempts to investigate the following issues:

- The incidence of EI among Malaysian companies.
- The nature of EI among Malaysian companies.
- The relationship between EI and income smoothing.
- The relative size and incidence of EI against size, gearing and management ownership.

The findings of the paper provides evidence as to the nature, extent and explanations of reporting of EI among the Malaysian companies during period prior to adoption of the revised standard (which was subsequently adopted as MASB 3). The findings are useful to predict the characteristics of companies that are likely to get around MASB 3 in order to enable them to report EI. In fact, it has been noted that, during the exposure draft (ED) stage, the "... proposed change of the ED has caused much criticism." (Ng 1996: 11). The author (Ng 1996: 11) argued that "... many reporting entities in Hong Kong have refused to comply with the restriction despite the consequence of qualified audit reports." For instance, the Institute of Certified Public Accountants of Singapore (ICPAS) experienced strong objections from the business community when the Provisional Statement of Accounting Standard (PAS) 19 dealing with EI was issued in 1994 to replace the Statement of Accounting Standard 8 (SAS 8) (Choo & Lee 1998). The PAS 19 was subsequently withdrawn on 29 December 1995. Though this study investigated during the period prior to the adoption of "more restrictive" definition of EI, there are still many countries which have not adopted the revised standard of EI issued by IASC. Thus, the findings of this study will be useful to these other countries in understanding the reporting of EI and its link with income smoothing.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

MASB 3 is regarded as consistent with the *all-inclusive* concept of income. Under the concept, all transactions that result in a net increase or decrease in the shareholders' interest during the period, other than dividends or capital transactions, are to be included in determining the net income for the period. However, to facilitate earnings predictability and thus, to minimise earnings variability, transactions are further categorised into ordinary and non-ordinary. Thus, non-ordinary and infrequent transactions (commonly known as EI) are presented below the line (i.e. after taxes). Moreover, due to their infrequency and non-ordinary in nature, it is expected that analysts do not place a heavy weightage on EI in determining a firm's earnings permanence. Rather, items that are trading in nature and are expected to consistently contribute to the firm's current and future earnings are to be given higher weightage (Shamsul Nahar 1999).

Nonetheless, the issue on the presentation of EI remains controversial. One argument is that market is perceived to be functionally-fixated, where all the numbers presented in the financial statements are taken as they are without making any necessary adjustments. According to Belkoui (1992: 150):

The functional fixation and naïve investor hypotheses assume that a sufficient number of investors are unable to perceive the cosmetic nature of certain accounting changes or are "fixated" on the bottom figure of net income.

Existing evidence, to some extent, supports the contention (e.g. Healy and Palepu 1993, 1994). In fact, the concept of impression management, as argued by Ayres (1994) also seems to lend support to the contention.

However, in the literature, the market is said to be informed and is not easily fooled by the cosmetic accounting differences or accounting changes (Belkoui 1985: 128). Kaplan and Roll (1972), for instance, showed that the market reacted indifferently to the inventory valuation procedures that inflate earnings without tax consequences. Perhaps, due to the sophisticated nature of users, a low incidence rate in EI (13.5 percent) was observed in the United States (Jordan et al. 1988). Given that the Malaysian environment more resembles that of the Singapore and Hong Kong environments, which reported a high EI incidence rate, we would expect that the incidence rate of EI will be high as well, relative to that in the US.

As for management's tendency to use EI as the vehicles to manipulate earnings, we could offer several reasons. First, the present definition of EI is very broad and it is open to abuse. The use of EI offers not only the amount but also the timing of the recognition. Thus, given the amount of net income that is achievable for the period and the amount of targeted net

income preset early in the period, the management may use EI to achieve the target. Second, EI are used in anticipation of future earnings. If the management foresees that future years are bleak, it may be better to transfer future earnings in the forms of EI to the current years. In fact, Lynn and McGuinness (1995) argued that the high incidence rate of EI among the Hong Kong companies was due to the uncertainty after 1997. Third, management uses EI as an effective tool to “smooth” earnings, and thus, earnings are spread evenly over periods. Greater fluctuations in earnings over the periods will make it difficult for the market to predict the earnings with accuracy. Earnings variability was, in fact, shown to positively and significantly influence the incidence of income smoothing (Beattie, Brown, Ewers, John, Manson, Thomas & Turner 1994). In fact, it has been argued that the use of EI was motivated by the fact that it would either enhance the reliability of the trend data of ordinary income in predicting the firm’s cash flow or eliminate the noise from the ordinary income (Barnea, Ronen & Sadan 1975). Nonetheless, based on the evidence found in their study, Demsey, Hunt and Schroeder (1993) concluded that there was a greater tendency for firms to report losses as EI and gains as ordinary income. This approach would effectively inflate the income from operations. Thus, the evidence may suggest that management attempts to disguise the “true” ordinary income for the period.

Based on the foregoing discussion, the following hypothesis is to be tested in this study:

H1: The incidence of EI is positively associated with income smoothing.

Previous studies have also shown that large percentages of increase in earnings, particularly in large firms, can attract unwelcome interference by the Government through, for instance, the withdrawal of subsidies or taxes (Craig & Walsh 1989) or even the firm’s monopoly power (Watts and Zimmerman 1986). Watts and Zimmerman (1986) earlier argued that political visibility could lead to an unfavourable response from the Government. Thus, large reported earnings by large firms could lead to the Government’s withdrawal of certain concessions given to the firms. Given the expected unfavourable interventions from the Government or even the labour unions, the firm’s size, as proxy for political costs, was found to be positively and significantly associated with the incidence of income smoothing. However, Beattie et al. (1994) did not find evidence supporting their contention of a positive and significant influence of political visibility on income smoothing. Perhaps, the use of sales as a measure of political costs had driven the insignificant findings. In another related study, Craig and Walsh (1989), who used market capitalisation as an indicator of the tendency of income smoothing, provided evidence consistent with the contention of positive

association between firm size and the incidence of income smoothing. This leads to the following hypotheses:

H2a: The relative size of EI is greater for larger firms than for smaller firms.

H2b: The incidence of EI is greater for larger firms than for smaller firms.

Likewise, the presence of a high degree of debts in the firm is also predicted to be positively associated with the incidence of income smoothing. Evidence has shown that financial statements were used to fulfill the purpose of monitoring the debt contracts (see Smith & Warner 1979; Leftwich 1980), which serve as the device to restrict the behaviour of the management. Thus, the level of leverage signifies the closeness to breaching the debt covenants. Moreover, high probability of breaching the covenants could lead to greater likelihood of expected costs of default and or renegotiation (Beattie et al. 1994). Their evidence showed that the influence of level of gearing on income smoothing was positive and significant, which was consistent with their proposition.

Based on the above arguments, the following hypotheses warrant testing in this study:

H3a: The relative size of EI is greater for larger gearing firms than for smaller gearing firms.

H3b: The incidence of EI is greater for larger gearing firms than for smaller gearing firms.

In the agency theory framework, separation between owner-manager has been argued to result in divergent interests (Jensen & Meckling 1976). To align the divergent interests, contracts are often written so that the agency costs are minimised. Two agency costs are often referred to, namely agency costs of equity and agency costs of debts. Thus, it is predicted that the higher the degree of management ownership, the lower the degree of the divergence of interests and so are the agency costs, and vice-versa. Therefore, lower management ownership level leads to the creation of contracts that are intended to restrict the opportunistic behaviour of the management. High management ownership leads to an alignment of management incentives with those of outside shareholders (Niehaus 1989). The evidence, for instance, by Warfield, Wild and Wild (1995), supports the contention. Nonetheless, greater management ownership could also lead to managerial labour market and market for corporate control mechanisms becoming less effective (Beattie et al. 1994). This contention has earlier been empirically shown by Morck, Shleifer and Vishny (1988). Thus, the direction of the relationship between management ownership and income smoothing is not determinate.

Thus, the foregoing discussions lead to the following hypotheses:

H4a: The relative size of EI is greater for firms with smaller management ownership than for firms with greater management ownership.

H4b: The incidence of EI is greater for firms with smaller management ownership than for firms with greater management ownership.

DATA AND METHODOLOGY

Data were collected from publicly available sources. To identify companies that disclosed EI in their annual reports, the Kuala Lumpur Stock Exchange (KLSE) Companies Annual Handbook comprising financial statements for the period from 1991 to 1995 inclusive, were investigated. Companies listed on the Main Board of the KLSE with complete financial statements from year 1991 to 1995 were considered in the study. Consequently, companies that disclosed EI at least once within the time frame were included in the sample.

Subsequently, annual reports over the financial years 1991 to 1995 of the sample companies were examined to determine the amount and nature of the extraordinary items. As EI could either be gains (positive) or losses (negative), the proportion test was carried out to determine the dominant sign of the EI. The test would enable the researchers to determine whether there was a clear direction of EI or it just happened at random. Moreover, the test would enable the researchers to determine whether gains or losses were systematically reported, as concluded by Dempsey et al. (1993).

The identification of the nature of EI reported by each company is a difficult exercise due to the fact that most companies reported more than one nature of EI in a particular year. After going through the annual reports, the nature of the EI was subsequently classified into nine major categories, as shown in Table 1. The nature of EI being identified for a particular company in a particular year is one whose absolute amount is at least fifty percent of the greater of the sum of all positive EI or the sum of all negative EI in absolute amounts. A company would be considered to have other uses (category 9) if the EI neither falls into the major categories identified, nor none of the items satisfy the fifty percent criterion.

Subsequently, data from a sample of firms that disclosed EI in the annual reports over the five year-period were gathered with respect to profits before extraordinary items (PBE) and profits after extraordinary items (PBE+EI). The presence of income smoothing would be evident if the coefficient of variation of profits before extraordinary items (CVPBE) was significantly different from the coefficient of variation of profits after extraordinary items (CVPAEI). This was accomplished by comparing their means using a t-test.

TABLE 1. Nature of extraordinary items

Code	Item
1	Sales/disposal of long term investments
2	Sales/disposal of property, plant and equipment
3	Goodwill written off
4	Compulsory acquisition of property by government
5	Write-down of assets to recoverable amount
6	Discontinues operation
7	EI in associated companies
8	Expenses related to listing and issue of securities
9	Others

Political costs, gearing and management ownership were measured by the firm's market capitalisation, debt to equity ratio and management shareholding respectively. Data on the market capitalisation, debt and equity were obtained from the KLSE Companies Annual Handbook. Management shareholding was measured by aggregating the percentage of equity interest owned by the firm's executive directors. To test *H2a*, *H2b*, *H3a*, *H3b*, *H4a*, and *H4b* a median score of each of the variables would be used as a cut-off point to segregate sample firms into two categories: high and low with respect to political cost, gearing and management interest. Median was used as it would split the observations into two about equal number of cases. Subsequently, t-tests on the difference in the mean values of EI of each group would be conducted to determine if the relative size of EI (i.e. $REX=EI/PBEI$) was related to political costs, gearing and management ownership of a company.

To determine if the incidence of EI would have any link with political costs, gearing and management ownership of the firms, the incidence of EI (termed as COUNT) reported during the five-year period for each firm was initially counted. The value of COUNT would range from 1 to 5. The mean values of market capitalization, debt to equity ratio and management shareholding of each firm throughout the five-year period were used to measure political cost, gearing, and management ownership respectively. A median score of each of the variables was used as a cut-off point to segregate sample firms into high and low categories with respect to political cost, gearing and management interest. Subsequently, a t-test on the difference between the mean of COUNT in each of the high and low groups of the variables was performed.

RESULTS

As of 31 December 1995, a total of 369 companies were listed on the KLSE Main Board. A total of 284 companies had their financial results published in the KLSE Companies Annual Handbook for the years 1991 to 1995, and out of this, 244 companies (85.9 percent) disclosed extraordinary items at least once in their income statements. This figure closely resembled that found in Singapore (Choo and Lee 1998). A breakdown of the percentages for the respective years is depicted in Table 2. Only the 244 companies that reported extraordinary items at least once in their 1991 to 1995 income statements are considered for further analysis. The occurrence rates were high, ranging from 54.8 percent (in 1992) to 60.6 percent (in 1994).

TABLE 2. Incidence rate of EI in the income statement of companies listed on the KLSE

No. of companies listed on the KLSE Main Board as of 31 December 1995:					369
No. of companies with complete financial reports (1991 – 1995):					284
No. of companies with complete financial reports (1991 – 1995), reporting EI at least once:					244
Incidence rate of EI					85.9
	1991	1992	1993	1994	1995
No. of companies reporting EI (row 1)	170	171	193	211	215
No. of available companies with financial statements (row 2)	284	312	324	348	362
Percent of companies reporting EI (row 1/ row 2)	59.9	54.8	59.6	60.6	59.4

Table 3 presents the descriptive statistics, results on the direction of EI and the proportion test conducted for each of the five years. The results suggest that companies showed greater tendency to report positive EI rather than negative figures. This dominance of EI with positive signs was supported by the significance found in the proportion test for all the years. This finding is therefore consistent with those found in Hong Kong and Singapore by Lynn and McGuinness (1995) and Choo and Lee (1998), respectively. Hence, companies in Malaysia are more likely to report positive EIs as opposed to those in the US (Jordan et al. 1988).

Table 4 shows the results of the nature, occurrence rates of EI reported by the companies (in Panel A) and test on the presence of income smoothing (in Panel B). Results in Panel A of Table 4 show that the disposals of investments and fixed assets account for more than fifty percent of the occurrences of EI. One explanation for this phenomenon is that disposal of

TABLE 3. Descriptive statistics

	1991	1992	1993	1994	1995
Mean EI	9,892	6,465	17,953	15,974	18,096
Standard Deviation EI (in RM '000)	52,291	37,412	54,019	45,123	49,679
Positive Sign	99	98	116	117	111
Negative Sign	62	56	54	59	56
Zero	83	90	74	68	77
% Positive Sign	61.5	63.6	68.2	66.5	66.5
% Negative Sign	38.5	36.4	31.8	33.5	33.5
Proportion Test	0.228*	0.282*	0.382*	0.33*	0.33*

Note: *p<.05 (2-tailed)

TABLE 4. Nature, occurrence rate of EI and use of EI to smoothe income Panel A: Nature of EI

Code*	1991	1992	1993	1994	1995
1	34.8%	39.0%	42.2%	48.0%	48.2%
2	14.3%	19.2%	13.7%	14.5%	13.7%
3	4.3%	6.8%	7.5%	4.0%	5.4%
4	5.0%	2.7%	5.6%	4.6%	6.5%
5	13.7%	8.2%	3.7%	3.5%	6.0%
6	1.2%	2.7%	4.3%	4.0%	2.4%
7	3.7%	4.1%	3.7%	6.4%	4.8%
8	6.2%	1.4%	1.2%	4.0%	3.0%
9	16.8%	15.9%	18.1%	11.0%	10.0%
Total	100%	100%	100%	100%	100%

Note: * Refer to Figure 1 for label

Panel B: Use of EI to smoothe income

Coefficient of Variation	Cases	Mean	Std. Dev.	T-value	Sig.
Before EI	244	0.3621	4.2973	0.378	0.706
After EI	240	0.4809	2.3145		

fixed assets is clearly outside of a firm's ordinary activities. Thus, it was conveniently classified as EI. This finding is consistent with those of Lynn and McGuinness (1995) and Choo and Lee (1998) who found that asset sale/discontinuance was the prominent nature of EI by companies in Hong Kong and Singapore respectively. Thus, the argument proposed by Lynn and McGuinness (1995) that the disposal of fixed assets contributes to the dominance of the positive EI is applicable in Malaysia.

The t-test comparing the mean scores of the CoV for profits before EI (CVPBE) and the CoV for profits after EI (CVPAEI) for each of the periods showed that the mean difference between the two scores was not statistically significant, as shown in Panel B of Table 4. Therefore, H1 was rejected. The finding, thus, did not support the contention that EI was used as a tool to smooth income which is consistent with the findings in the studies by Lynn and McGuinness (1995) and Choo and Lee (1998) for Hong Kong and Singapore companies respectively.

TABLE 5. Comparison of relative size of EI (REX) by firm size, gearing, management interest

Panel A: H2a: Firm's size

	1991	1992	1993	1994	1995
Mean (low)	-1.7760 (n=79)	0.2507 (n=75)	-6.9336 (n=84)	0.4.2580 (n=87)	0.0974 (n=83)
Mean (high)	8124 (n=82)	0.7741 (n=76)	1.6702 (n=85)	0.6894 (n=89)	0.8240 (n=84)
T-value	1.106	0.698	0.772	-1.177	1.884
P-value	0.27	0.486	0.441	0.241	0.061*

Note: * $p < 0.10$ (2-tailed)

Panel B: H3a: Firm's gearing

	1991	1992	1993	1994	1995
Mean (low)	0.1827 (n=80)	-0.0253 (n=76)	-6.0650 (n=85)	1.8077 (n=88)	0.7685 (n=84)
Mean (high)	-1.0902 (n=81)	1.0499 (n=78)	0.8944 (n=84)	3.0992 (n=88)	0.1536 (n=83)
T-value	-0.542	1.442	0.624	0.424	-1.590
P-value	0.588	0.151	0.534	0.672	0.114

Panel C: H4a: Management interest

	1991	1992	1993	1994	1995
Mean (low)	-1.4014 (n=79)	-0.0752 (n=76)	4.2075 (n=84)	4.2410 (n=87)	0.4796 (n=83)
Mean (high)	0.4515 (n=82)	1.0985 (n=78)	-9.3438 (n=85)	0.7060 (n=89)	0.4464 (n=84)
T-value	0.790	1.576	-1.218	-1.165	-0.085
P-value	0.430	0.117	0.225	0.245	0.932

The remaining hypotheses, H2a, H2b, H3a, H3b, H4a and H4b were also tested using t-tests. The median scores of firm's size, gearing and management interest were used as the cut-off point to segregate companies into high/low in size, gearing and management interest. Consequently, the mean score of EI for each category was compared to determine if (high/low) size, (high/low) gearing and (low/high) management interest link with (high/low) relative value of EI. Table 5 presents results of the t-tests.

TABLE 6. Comparison of relative size of EI (REX) by firm size, gearing and management interest (between the 1st and the 3rd sub-groups with 2nd sub-group being deleted)

Panel A: H2a: Firm's size

	1991	1992	1993	1994	1995
Mean (low)	-3.2885 (n=53)	-0.1268 (n=50)	-10.5847 (n=56)	5.2745 (n=58)	0.0282 (n=55)
Mean (high)	1.0995 (n=53)	0.2712 (n=53)	2.3007 (n=57)	0.5470 (n=59)	0.3317 (n=56)
T-value	-1.115	-0.845	-0.771	1.053	-1.782
P-value	0.267	0.400	0.442	0.295	0.078*

Note: * $p < 0.10$ (2-tailed)

Panel B: H3a: Firm's gearing

	1991	1992	1993	1994	1995
Mean (low)	0.3501 (n=53)	0.1318 (n=50)	-6.9986 (n=56)	2.0043 (n=59)	0.5909 (n=56)
Mean (high)	1.4550 (n=53)	1.5225 (n=54)	0.7088 (n=57)	5.0367 (n=57)	0.2062 (n=55)
T-value	1.425	-1.284	-0.465	-0.672	0.741
P-value	0.156	0.202	0.643	0.503	0.298

Panel C: H4a: Management interest

	1991	1992	1993	1994	1995
Mean (low)	0.5877 (n=59)	-0.2997 (n=52)	5.0046 (n=56)	5.7357 (n=59)	0.3395 (n=56)
Mean (high)	0.4617 (n=55)	0.7261 (n=51)	-14.5852 (n=57)	0.5006 (n=58)	0.4741 (n=55)
T-value	0.248	-1.084	1.181	1.153	-0.260
P-value	0.805	0.281	0.240	0.251	0.796

Results in Table 5 (Panel A) reveal that size, with the exception of 1995, does not have any significant bearing on the relative size of EI. Consequently, H2a is not supported. This evidence is consistent with that of Lynn and McGuinness (1995) in Hong Kong. Thus, a firm's size does not have any significant role on EI in Malaysian companies. Similarly, both gearing and management interest were also found to be unrelated to EI as shown in Panel B and C. Therefore, H3a and H4a are not supported either.

Further analysis was carried out by splitting the observations into three equal number of cases and subsequently comparing only between the first (i.e. low) and third (high) sub-groups. This exercise would minimize the potential for confounding effects from the middle "grey" sub-group. Results of the analysis are presented in Table 6.

Results in all panels (A, B and C) are generally identical to those found in Table 5. Thus, all the variables (i.e. political costs, gearing and management interest) do not have significant bearing on the disclosure of EI. Thus, H2a, H3a and H4a are not supported.

TABLE 7. Frequency of incidence (COUNT)

COUNT*	Frequency	Percent (%)
1	46	18.9
2	32	13.1
3	38	15.6
4	39	16.0
5	89	36.5
Total	244	100.0

Note: * mean COUNT = 3.38

TABLE 8. Comparison of incidence rate of EI by firm size, gearing, management interest

	Firm Size	Gearing	Management Interest
Mean (low)	3.2951 (n=122)	3.2295 (n=122)	3.2049 (n=122)
Mean (high)	3.4672 (n=122)	3.5328 (n=122)	3.5702 (n=121)
T-value	0.873	1.543	1.859
P-value	0.383	0.124	0.064*

Note: *p<0.10 (2-tailed)

Finally, Table 7 presents the distribution of COUNT across the firms over the five-year period. The incidence rate is considered high where over fifty percent of the companies disclosed EI at least four times during the five-year period. Results on the association between the incidence of EI (COUNT) and the three variables are presented in Table 8. The results suggest that (low/high) management interest is the only variable that is associated with the (low/high) incidence of EI. Thus, H4b is supported. The other two hypotheses (i.e. H2b and H3b) relating size and gearing to the incidence of EI are not supported. The result on size is therefore consistent with that found by Lynn and McGuinness (1995) in Hong Kong.

DISCUSSION AND CONCLUSION

This paper investigated the incidence and nature of EI among Malaysian listed companies as well as the use of EI as a tool to smooth income. Results showed that 85.9 percent of the companies with complete financial statements from 1991 to 1995 disclosed EI in their annual reports. This shows that the incidence rate of EI in Malaysia was as high as in Singapore (i.e. 85.9 percent) as reported by Choo and Lee (1998), and higher than that observed in Hong Kong (i.e. 61.2 percent) by Lynn and McGuinness (1995). The very loose definition of EI outlined in the original SI 8 might have contributed to this widespread use of EI in these countries. This is evident by the variety in nature of EI found during the period of our study.

Nonetheless, gains (losses) arising from disposal of assets accounted for more than fifty percent of the overall nature of EI. Gains from disposal of assets might have contributed to the dominance of positive EI, which might have explained the dominance of positive EI. The dominance of positive EI contradicts the conclusion made by Dempsey et al. (1993), who claimed that firms showed greater tendency to report losses as EI and gains as part of the firm's ordinary income. The evidence, nonetheless, was consistent with the findings by Lynn and McGuinness (1995) and Choo and Lee (1998). Thus, this finding refutes the contention that management manipulates EI to inflate ordinary earnings. Perhaps, as the findings showed, the dominant nature of EI which arose principally from disposal of assets had caused the Asian companies to not report losses as much as their US counterparts would normally do.

The very restrictive definition of EI contained in the Revised SI 8 (which was subsequently adopted by MASB and known as MASB 3 in 1999) did not seem to support the contention that its adoption was intended primarily to curb management manipulative behaviour. This is because our evidence suggests that management did not use EI as a tool to inflate ordinary income. In fact, the predominance of the positive EI suggests that

management does not inflate ordinary income via EI. Had the management intended to inflate ordinary earnings, we would have found that the predominant directions of EI would have been negative. Our evidence also suggests that EI was not used as a tool to smoothe income. Thus, the prevailing belief that management uses EI to smoothe earnings is unfounded. Hence, the question that comes naturally is: Where EI is concerned, is there a need for the original SI 8 to be superceded by the revised SI 8? The fact that PAS 16 was short-lived in Singapore may help answer this question. Moreover, the study by Lynn and McGuinness (1995) suggested that "... their inclusion as a part of operating income in the future should not necessarily make forecasting more difficult." (72). Therefore, it does not seem to matter whether EI is reported above the line or below the line as they have no significant informational content. Nevertheless, the adoption of MASB 3 will make financial reporting among companies more comparable though at the expense of a more erratic reported income. Further, as argued by Dechow and Skinner (2000), earnings management will not be viewed as problematic if capital market participants could observe (and are able to make the necessary adjustments) at low cost. They further argued that if a particular accounting policy is sufficiently disclosed in the footnotes, sophisticated investors are expected to be able to understand the consequences of such policies on the stock prices (Dechow and Skinner 2000).

The findings also showed that (high/low) size, (high/low) gearing and (low/high) management interest did not link to (high/low) EI. However, the study showed that (low/high) management interest was related to (low/high) incidence of EI. The direction of this finding is not the direction that we had predicted. This evidence contradicts the agency theory, which argues that high management interest leads to lower tendency to manipulate earnings and therefore a lower incidence of EI was predicted. Hence, a high incidence rate of EI for high management interest is perplexing. This unexpected finding may be reconciled by the earlier findings by Morck et al. (1988) who found that there was a curvilinear association between management interest and the value of the firm. Their evidence showed that when management interest was within the range of five to twenty-five percent, there was a negative association between management interest and the value of the firm. This finding may suggest that when the management owns an interest between 5-25 percent, the management would tend to report higher earnings via EI (for instance, through disposals of assets). Data in this study showed that over the five year period, the annual average of management interest ranged between 13.65 percent (1991) to 14.59 percent (1995) and therefore, falls within the specified range (i.e., 5-25 percent) as suggested by Morck et al. (1988).

The findings also showed that the reporting of EI in a firm's annual report is not associated with income smoothing as evidenced by the

insignificant difference between earnings without EI and earnings with EI. The findings were generally in congruence with those found in Hong Kong (Lynn & McGuinness 1995), and in Singapore (Choo & Lee 1998). This implied that companies were very unlikely to use EI to manipulate income.

Finally, this study offered evidence with regard to EI disclosures prior to the adoption of the Revised SI 8. Further study may be carried out to determine the extent of compliance by Malaysian companies following the adoption of the Revised SI 8 (i.e. now MASB 3, post-1999 periods) and perhaps to investigate avenues that a firm would use to get around the more restricted definition of EI. It is expected that one possible avenue for continued reporting of EI is by changing the name of extraordinary items to exceptional items (or abnormal items) which is not defined in any standard. Finding from such a study would further reveal the reporting practice among Malaysian companies which could be useful to the standard-setters.

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NOTE

1. Circumstances that warrant separate disclosures in accordance with paragraph 18, MASB 3 include: (a) the write-down of inventories to net realisable value or property, plant and equipment to recoverable amount, as well as the reversal of such write-downs; (b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring; (c) disposals of items of property, plant and equipment; (d) disposals of long-term investments; (e) discontinued operations; (f) litigation settlements; and (g) other reversals of provision.

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