EXTRAORDINARY ITEMS, INCOME SMOOTHING AND MARKET VALUE OF EQUITY

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ABSTRACT

This research examines issues related to the reporting of extraordinary items. The first issue concerns the changes of accounting standards on extraordinary items, which has limited the scope of extraordinary item. It is found that there are significant changes on the incidence of reported extraordinary items during the period after the adoption of the new standard. The findings supported the arguments that the new standard on extraordinary items had consequently abolished the items from financial statements.

We also hypothesize that extraordinary items classification choice is a means used by companies to smooth income. Two types of statistical tests performed have confirmed the proposition that the disclosure of extraordinary items is subject to this type of manipulation during the period before the adoption of the new standard.

Although it is proved that the broad definition of extraordinary items allows companies to manipulate income, evidence gathered from univariate regressions demonstrate that extraordinary items are significant for investors in valuing a firm's equity. Thus, investors took into accounts the extraordinary items even though it is disclosed 'below the line'.

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INTRODUCTION

1.1 INTRODUCTION

Financial statements are prepared to communicate economic measurements and information about the resources and performance of a reporting entity. According to the approved Malaysian accounting standard, the MASB 1, the purposes of financial statements are to provide information about the financial position, performance and cash flow of an enterprise and to show the results of management's stewardship of the resources entrusted to it, for the use of a wide range of users in making economic decisions. Since the users of financial statements have no access to a company's accounting records, they depend greatly on the financial statements when making judgments and decisions.

However, the increasing trend of creative accounting has made the financial statements less reliable and less transparent. Accountants prepare the statements to "window-dress" their organizations by taking advantage of the loopholes in accounting standards. Although creative accounting is not against the law, in the hands of less scrupulous management, it can be a highly dangerous instrument of deception (Naser, 1993). The investing community at large can be misled into making decisions from information which is based on manipulated accounting figures. To a certain extent, the existence of creative accounting distorts the usefulness of financial statements and impedes them from meeting the prescribed objectives.

This research examines one component in financial statements that is very commonly subjected to creative accounting, that is the extraordinary items. The International Accounting Standard (IAS) 8 issued by the International Accounting Standard Committee (IASC) in 1978 has broadly defined extraordinary items as