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IPO PROFIT GUARANTEES AND INCOME SMOOTHING

A thesis submitted to the Graduate School in partial fulfillment of the requirements for the degree Master Science (International Accounting) Universiti Utara Malaysia

by
Noraizan Bt. Ripain

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Jaminan Keuntungan IPO dan Pelarasan Pendapatan

Abstrak
IPO Profit Guarantees and Income Smoothing

Abstract

The imposition of Initial Public Offering (IPO) profit guarantees is widespread among companies that seek listings on the Second Board of the Kuala Lumpur Stock Exchange (KLSE). It is a unique feature of the IPO market in Malaysia during 1996-1999. Extending prior research on income smoothing, this study investigates the income smoothing behavior on a sample of 92 IPO companies with profit guarantees of which 54 of them reported profit guarantee surpluses. For each of the companies, Eckel’s Income Smoothing Index (1981) is calculated based on two sub-periods: i.e. (1) ten-year period comprising five years before and five years after listing, and (2) five-year period comprising one year before and one year after the profit guarantee period. Chi-Square and Kruskal-Wallis tests are used to test the association between the incidence of income smoothing and whether a company reported a profit guarantee shortfall or surplus. The evidence accepts the null hypothesis that there is no significant difference in income smoothing between companies with IPO profit guarantee surplus and IPO profit guarantee shortfall for both sub-periods. In addition, the findings also indicate that income smoothing is not associated with factors such as company’s sectoral classification, type of auditor and year of listing.
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22 March 2003
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1.0 Introduction

Income smoothing is a specific example of earnings management (Beattie, Brown, Ewers, John, Manson, Thomas and Turner, 1994). It refers to the deliberate attempt by management to level the trend of earnings. Or as Worthy (1984) colorfully put it, executives engage in income smoothing “to purge the wiggles and spikes from the lines that chart their profits.” Moses (1987) defines the smoothing behavior as an effort to reduce fluctuations in reported earnings, rather than to maximize or minimize reported earnings.

Hepworth (1953) was the first to introduce the concept of income smoothing. He suggests that income smoothing creates stable earnings that give owners and creditors a more confident feeling towards management. To smooth income, a manager takes actions that increase reported income when income is low and takes actions that decrease reported income when income is relatively high (Stolowy and Breton, 2000) rather than tries to exaggerate earnings in all states (Fudenberg and Tirole, 1995).

The contents of the thesis is for internal user only
References


