Review Article: Profit Smoothing in Accounting

Masoume Biari¹, Mansur Garkaz²*

¹Department of Management, Aliabad Katoul Branch, Islamic Azad University, Aliabad katoul, Iran
²Department of Management, Gorgan Branch, Islamic Azad University, Gorgan, Iran

Corresponding Author Email: m_garkaz2011@yahoo.com

Received: 05 March 2015
Accepted: 10 June 2015
Published: 17 August 2015

Abstract: the phenomenon of profit smoothing can affect behavior of users of financial statements. Most investors prefer to invest in companies with a constant profit process because companies with high fluctuations in their profit have a higher risk than companies with smooth profit. The purpose of the study was to investigate results of the conducted researches on profit smoothing. According analyses, it can be said that various factors affect profit smoothing such as ownership, company growth, information asymmetry and risk.

Keywords: Accounting, Profit Smoothing, Risk, Information Asymmetry.

Introduction

The purpose of accounting and financial reporting is to satisfy information needs of users. The basic financial statements are main tool to transfer information to intra-organizational individuals and customers. The profit and loss statement is one of basic financial statements that are very important to evaluate management stewardship or their duty towards their considered resources. The profit and loss statement includes return of resources controlled by management of business unit and reflects performance of the unit during the considered period. Since management of business unit is responsible to prepare financial statements and according direct access of managers to information as well as voluntary choices in accounting methods, there is possible to smooth profit (Baharmoghaddam, 2006).

By increasing development of global financial markets on 20th century, issues such as management and profit smoothing in the world of accounting, management, economics and other sciences are studied with special sensitivity, and each of scholars and researchers have discussed and interpreted results of their findings from their special perspectives. Profit smoothing is one of important issues in profit management. Profit smoothing includes applying opinion of company's management in transposition to record accounting of income and expenses, account costs or transfer them for later years so that the company gains process of profit without major changes over several years.

Briefly, profit smoothing is a deliberate or unintentional action that is performed by management and using particular tools on accounting to reduce fluctuations in profit. One of main objectives in profit smoothing is to create a more stable flow to support paying more profit (Dacsher, H. & Melkon, 1995). Flow of more stable profit can be perceived as lower risk leading to higher stock price and less cost of borrowing. Profit smoothing is to coordinate profit consciously to achieve the considered process or level (Fakhari & Yousefnejad, 2006).

According opinion of researchers, the phenomenon of profit smoothing can potentially affect behavior of users of financial statements and market members will misguide due to steady flow of profits from the action because companies with high fluctuations in their profit have a higher risk than companies with smooth profit and most investors prefer to invest in companies with a constant profit process. Therefore, this study examined theoretical bases and analyzing the conducted results in profit smoothing.
Combining Results

Profit Smoothing: Goals and Incentives

Generally, profit smoothing includes applying opinion of company's management in transposition to record accounting of income and expenses, account costs or transfer them for later years so that the company gains process of profit without major changes over several years. Management objective is to show stable and dynamic company for investors and capital market. Profit smoothing is an informed action that managers consider it to reduce periodic profit fluctuations by considering common methods of accounting principles. Profit smoothing follows specific purpose: creating a stable stream of profit growth (Matsumoto, 2002).

Profit smoothing is the process of manipulating recognition time of income or the reported income; therefore, flow of the reported income will experience little change so that will not increase the reported income in long-term. The manipulation requires a company with high profit to provide necessary raw reserves when needed, in order to regulate flows (E’atemadi & Javadi, 2005). Profit smoothing means efforts of business unit management to reduce abnormal profit fluctuations, to the extent that is allowed in accounting principles and interests of management (Hijazi et al, 2011). Managers use various tools to smooth profit such as discretionary, dividend income, research and development expenses, extraordinary items, classifying accounting items, selling assets etc.

There are factors encouraging managers to deal with issues and smooth companies’ profit. They attempt to show growth of their companies smoothly through artificial profit smoothing, in order to show continuity of companies under their management. One of primary purposes of profit smoothing is to maintain company's reputation because reputation will represent an efficient and dynamic company. Obtaining a proper place among competitors and capital market lead to a favorable view of investors and creditors toward company, company does not require expensing more costs to compete with other similar companies and will get credit and loan by a lower cost.

The most important motivation for profit smoothing is the belief that companies with proper processes without major changes are more valuable than similar companies. Profit smoothing increases company’s stocks in exchange and attract potential investors. Results of the conducted study on 358 companies listed on the USA stock exchange showed that companies without many changes in their profits over previous years have higher stock value and less debt compared with similar companies.

Artificial Smoothing (Accounting Smoothing)

Management performs the smoothing and management controls and influence on some economic events such as early or delay sales in a business unit. In other words, artificial profit earnings will only lead to transfer costs and incomes in financial periods (Francis, 2004).

Real Smoothing (Transactional or Economic Smoothing)

This type of smoothing is not resulted by an economic event, but resulted by measures so-called accounting manipulations, which they have no effect on cash flows of business unit. Real smoothing refers real events that have conducted based on or without regard to the effect of smoothing. Artificial smoothing relates those accounting methods that are applied to transfer incomes or expenses from one period to another one (Francis, 2004).

Patterns of Profit Smoothing

a) **Immersion Pattern:** This pattern is generally used when so-called a case is past remedying. This means that a company incurs loss and its amount is not important. In such cases, managers consider suspicious and future losses in the considered loss. The model is primarily performed when changing management members and reform organizations.

b) **Pattern of Minimizing Profit:** The pattern is used when a company is pressured socially or politically, or when manager receives a certain amount as reward. Political and social costs play more influence role such as applying income tax for companies or public pressures to reduce price of goods when company obtain high profits.

c) **Pattern of Maximizing Profit:** In contracts that profit management has minimum and maximum payment, when profit is between two numbers, management will focus its efforts to maximize profit to payable amount.


d) **Pattern of Profit Smoothing**: Either politically or in viewpoint of stock market and shareholders, it is better that profit has little fluctuations. It is the most common pattern of profit management (Javadi, 2009).

**Information Asymmetry**

Information symmetry is formed when managers and market have the same information about company. Therefore, managers and market endure uncertainty on company similarly. In information asymmetry, managers have more and better on market due to private and confidential information about company. It means that they access company information before informing market. Company’s specific information will be released on market through events revealing information. Before disclosure, market has some uncertainty about company. Company information asymmetry is total uncertainty about that company because it is possible that managers and market have same information on the impact of market variables on company value (Badavmahanandi et al, 2012).

Market reaction to profit announcement can be the first measure of company's information asymmetry through information disclosure. It is believed that declaration and paying dividends to shareholders can reduce company's information asymmetry. Information asymmetry can be determined in terms of intelligence environment, intensity of public announcements and number of company’s transactions and it can be influenced by behavior of managers or market. For example, when there is announced about a company publicly, market may be better informed about real situation and reduce information asymmetry. According signaling theory, when companies face with information asymmetry, they will prefer to increase their paid interest as a sign of quality and profitability.

In one hand, increasing interest payments will increases efficiency rate of companies in future; but on the other hand, if the company is highly dependent on external financial resources, this payment will not benefit for it because cost of providing external financing sources is more expensive than the cost of local financing. Therefore, companies usually prefer to pay lower profits or no profits between shareholders instead providing external financing. No interest payments can be a negative indication of company in stock price and impact market value and company's returns negatively.

According agency theory, when companies face with information asymmetry, they will increase their payments to reduce agency conflict. In one hand, increasing the paid interest can increase company's efficiency in future, but on the other hand, reduces company's internal resources. Reducing funding will allow company's management to return capital market for providing the required resources of company. Returning capital market to provide financing recourse transfer a negative sign of company to market that it cannot influence value of company's stock price and future returns (Jelinek, 1986). According hierarchical theory, companies reduce payments to shareholders when facing with problem of information asymmetry. The approach reason is company’s avoidance from preparing the required financing in capital market due to decline confidence in the company and high cost of external financing.

Reducing the paid profits to shareholders can have a direct impact on future stock returns of the companies. Declining confidence in company can have a direct impact on future value and its shares on market and ultimately affect future returns. According to what was said, it can be predicted that companies usually reduce their paid interest by increasing level of information asymmetry in market because cost of providing external financing resources is much more expensive than internal resources. Reducing the paid interest cannot transfer good signs on company to market. As a result, public interest toward the company will be reduced that it has a negative impact on company's future returns. According life cycle theory, companies usually prefer to distribute lower profit between their shareholders in the early years of establishing because of profitable investment opportunities. However, they will increase the profit over time and raising financial resources. As public interest in shares of new companies is less than older companies, their stock market has lower boom than other companies. Thus, it is predicted that stock returns of companies will be increased by increasing their age.

**Information Asymmetry and Profit Smoothing**

Despite information asymmetry between managers and owners, profit smoothing is one of proper methods to disclosure latent information. In terms of tax savings, profit smoothing in the present value reduces tax liability of the expected future profits. Opportunistic using profit smoothing may have an adverse effect on transparency of the reported financial data. One of consequences of unclear economic information is that it may affect willingness of investors to buy shares. Thus, less transparency causes less liquidity that it increases capital cost of company due to increase liquidity risk. In addition, increasing transaction costs due to low liquidity may reduce possibility of stock price discovery and as a result, increases uncertainties associated with share price. On the other hand, according concept of information asymmetry, high variability of profits will lead to more information interest for aware investors compared with unaware investors. Increasing variability of the reported
profits show transactional loss of investors and force them to leave the market. The results are inconsistent with the obtained results by Gerani who believes that profit smoothing maintains unaware investors in market and increase transactions’ liquidity. Several analytical models indicate that opportunistic profit smoothing is increased by raising information asymmetry.

For example, Truman and Titman (1988) showed that information asymmetry between management and shareholders are a fundamental condition for earnings management. They assumed that there is an overlap between groups of shareholders. Vendor shareholders will allow management follow a clear policy of profit smoothing to instill a proper picture for group of buyers. In this model, manager has an information advantage over shareholders. As a result, in such a situation, information asymmetry is a necessary condition for earnings management. If profit smoothing decreases uncertainty on information of business unit and with regard to rational investors, the smoothing should affect stock value. If profit smoothing only decrease a specific or non-systematic risk in company, such a risk will be decreased and should not affect stock price; in market-based information, specific risk of business unit may be priced because investors cannot make it different completely. Some researchers suggested that the effect of quality of accounting information and financial disclosures are not diversified, as a result, characteristics of business unit can affect stock price.

**Risk and Profit Smoothing**

Investors believe that the fixed profit guarantees higher dividend compared with fluctuation profit. Profit fluctuations are considered as measures of company's overall risk and companies with a smoother profit have less risk. Therefore, companies with smooth profit are more interested by investors and they are more suitable place for investment. Profit manipulation is one of earnings goals, thus profit smoothing can be considered as a part of profit management (Mollanazari & Karimi Zand, 2007). Profit smoothing is an informed action that managers consider it to reduce periodic profit fluctuations by considering common methods of accounting principles.

**Company Growth and Profit Smoothing**

Company growth opportunity is one of factors affecting opportunistic behavior of managers. When a manager has a relatively high free cash flow and when there is various investment and growth opportunities for company, manager can use the funds in activities in line with growth of company. In such a situation, given that the investments are considered to grow company and continue its current trends, it will result to fewer risks and returns similar to the current return and therefore, profit will not experience many fluctuations. In contrast, when opportunities for growth and investment are limited, managers will invest with different risk and return higher than company's current operations. In such a situation, company's profits will fluctuate and manager will smooth profit to control the fluctuations, which they are arose by high risk investment (Jelinek, 1986). Usually, larger firms are more considered by analysts and investors; therefore, accounting information has more efficient process in large companies. Company growth can represent its overall risk. More funds can reduce company's overall risk because larger companies are more exposed to public safety and they are more known. Some accounting analysts have considered the partnership between profit smoothing and company's growth. The founder believes that due to ambiguities to predict profit, only managers with high quality in their profit can be successful. Larger have less incentive to smooth profit because they are more known to analysts. The larger size the company, the more will of managers to manage earnings because managers in large companies have more responsibility against stakeholders and profit smoothing relates with firm size, difference between real earnings with the expected earnings and reward plans. Firm size is expresses as sum of sales in a year that accounting changes are carried out. Larger companies are more exposed to more public safety and as they are interested by analysts, they will have less incentive for profit smoothing.

**Dispersed Ownership and Profit Smoothing**

Managers in companies with multiple owners that have no major shareholders have more incentive to manage their earnings because price of information processing is not economically justified for small shareholders. As a result, they are forced to rely profit and loss information reported by management. In companies that institutional investors are owner major part of the company, possibility of earnings management will be higher than other companies because they emphasize on profits close to the projected profits. Porter says that managers of the companies aware cost of failure to achieve the desired benefits of institutional investors; therefore, they attempt to achieve the desired conditions of investors with profit management (Porter, 1992). There is a relationship between ownership structures with profit management. Ownership structure also varies in different companies. In the USA, financial institutions and investment companies are owners of majority of shares. Investment companies and minor investors have a short-term investment horizon. However, holding
companies have a long-term investment horizon. They concluded if shareholders with short-term investment horizon are major shareholders of a company, possibility of earnings management in such a company is high. A group of activists in capital market rely on simple indicators of profit, particularly minor shareholders in companies without enough financial analysts.

**Conclusion**

The purpose of the study was to investigate results of the conducted researches on profit smoothing. For example, Tucker and Zarowin (2006) showed that profit smoothing can provide proper conditions for investors to exclude information from profit. Also, if managers manipulate profit numbers deliberately, profit smoothing may cause confusion in its information. Baltagi (2005) believes that profit management is a part of the designed accounting. In other words, it means creating pre-built object and image to transfer data using accounting information. Profit smoothing, profit management, false accounting and failures of accounting system are different aspects of the planned accounting.

Francis et al (2004) suggest that smoothing trends toward desirable profit because it may reduce uncertainty about future cash flows. However, they noted that among all profit trends based on accounting, the relationship between profit smoothing with risk information is weaker than the relationship between accruals quality and information risk. Kzlynk (1999) believes that companies that voluntarily report details on the predicted net profit, they will increase net profit by reducing discretionary accruals. Degeorge et al (1999) believe that corporate executives and investors consider profit reporting accurately. Management aware of profit importance for shareholders and consider natural consequence of accounting profit as its reward. Haley and Vahlm (1999) argue that profit management is done when managers use their judgment in financial reporting to mislead users of financial information. In this case, managers select procedures in accounting system and profit reporting that cannot reflect real economic situations. In a research, Nowravesh et al showed that large companies have profit in Iran that motivation of the management is increased by increasing debt. The research results showed that large companies have used accruals to low taxes and larger companies are more interested to profit management. In a research titled factors affecting profit smoothing and profitability of the listed companies on Tehran Stock Exchange, E’atemadi and Javadi Mazdeh (2009) showed a positive relationship between profitability rate with desire of companies to profit smoothing, but there is no significant relationship between liquidity ratio, dividend ratio and firm size (Badavarnahandi et al, 2012).

Pourheidari and Aflatooni (2006) showed that managers of Iranian companies smooth their profit using optional accruals and income tax and deviation in operational activities are main drivers to smooth profit using accrual items. In the study, firm size, ratio of liquidity to total assets and profit fluctuations are not as important as drivers of profit smoothing (Hijazi et al., 2011). In a research titled examining the relationship between profits smoothing with industry type of the listed companies on Tehran Stock Exchange, Mollanazari and Karimi Zand (2007) showed an adverse strong relationship between firm size and profit smoothing. There are also considerable differences between profit smoother companies in terms of industry types. There is also a significant relationship between artificial profit smoothing and firm size. Finally, there is no significant relationship between artificial profit smoothing and industry type.

According the conducted analyses, it can be said that many factors affect profit smoothing such as ownership, company growth, information asymmetry and risk. For example, in companies that institutional investors are owner major part of the company, possibility of earnings management will be higher than other companies because behavior of institutional investors is variable and temporary and their objective is to maintain stocks for a short term. Profit smoothing relates with firm size, difference between real profit with the expected profit and reward plans because larger companies are more exposed to public safety. Larger companies are more exposed to more public safety and as they are interested by analysts, they will have less incentive for profit smoothing.

**References**


