Comparative Investigation of Income Smoothing and Earning Quality on Firm Valuation of Listed Companies in Tehran Stock Exchange

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ABSTRACT

Investors need to have reliable information so that they can make appropriate decisions. On the most important types of information is earnings information with the two related concepts of smoothing and the quality of earnings. In order to show the performance of the company is enhanced, managers eliminate the periodic earnings volatility which is called smoothing. On the other hand, when cash from operational activities is higher than earnings accrual figures, earnings are considered as high quality. Accordingly, the present study attempts to examine the effects of income smoothing and earnings quality on the performance evaluation of the companies listed in the Tehran Stock Exchange. To do so, ten hypotheses were tested among the companies listed in the Tehran Stock Exchange over a time period from 2004 to 2009. The data analysis was performed using the student t-test and the mean comparison. Based on the results of the study, income smoothing and earning quality were found to be important factors affecting the performance of the companies listed in the Tehran Stock Exchange over the period under study.

INTRODUCTION

Given the developments that have happened in the world today, many countries, especially developing countries are looking for ways to make better use of their available facilities and resources. Accordingly, one of the important strategies to improve development is investment. Investors need to have reliable information so that they can take appropriate decisions. Such information includes earnings information which is determined through estimation and prediction. As managers have freedom in the way they estimate earning they may intentionally or unintentionally show that the business conditions are favorable. Therefore, the quality of corporate earnings may be affected by reporting principles and managers’ preferences. A method for assessing the quality of earnings is the assessment of earnings uniformity since uniformity or invariability indicates high quality earnings. The management can affect the earnings uniformity through items such as income smoothing. Therefore, income smoothing should also be taken into account so that the users could use confidently the reported earnings in their decisions.

The results of studies have shown that the low variability and high uniformity are indicative of the high quality of earnings. Consequently, investors become more confident to invest in shares of companies whose earnings are more stable. In addition, investors believe that companies that report more volatile earnings pose greater risks than the companies that report smoothed earnings. As a result, managers embark on the process of income smoothing in the flexible framework of generally accepted accounting principles in order to show a more stable image of the company’s profitability and that their company’s value is high.

Income smoothing is not a new concept. Gordon predicted that as long as managers started to use their discretion instead of accounting choices, they have smoothed income growth rate [6]. To choose among different methods, the management has a considerable power to take into account financial events based on generally accepted accounting principles. Besides, the management can schedule financial activities. Due to this flexibility, a manager may systematically affect the reported earnings from one year to another and smooth them. Therefore, earnings management may influence decisions made by investors and brings about consequences that are more significant especially for inefficient capital markets [7]. When the interpretation of a standard is highly flexible, the data presented in the financial statements are less integrated. In addition, conformity and conservation may result in mismanagement [9].
The present study aims to answer this question: Do income smoothing and high quality earnings affect the companies’ value? Besides, by presenting factors affecting the performance of companies the present study tries to take a significant step in helping investors and stockholders to make appropriate decisions.

Theoretical framework and research background:

Operational definitions of income smoothing and earnings quality:
Income smoothing has been defined as a conscious and deliberate action to reduce volatility of reported earnings during successive periods at a level of earnings which is considered the company’s normal level. Generally, income smoothing refers to the application of the management preferences to determine the priority of costs and earnings accounting records and taking into account expenditures or transferring them to next year’s so that the company has a stable income with no major changes during several successive years. A company is considered to be smoothing if the value of the ratio of earnings variability to sales variability is less than one. Every intentional income smoothing is dependent on the management intentions and objectives. The strong focus on managerial incentives will force managers to manipulate earnings. It seems that there are strong incentives exist to show earnings higher than what they actually are [5].

Numerous definitions have been provided for earnings quality. However, the present study focuses on the level of accrual figures. Earnings quality can be defined as the proximity degree of the company earnings to the cash flows generated. In other words, the lower accrual figures the higher the earnings quality.

Income smoothing tools:
According to Ashari et al., (1994), smoothing tools are as follows:
1) Earnings per share, 2) Changes in accounting policy, 3) Pension costs, 4) Extraordinary items, 5) Investors’ tax exemption, 6) Fixed and depreciation costs, 7) Accounting discretionary decisions between two or more generally accepted accounting methods, 8) Foreign currency exchange, 9) Different classifications in accounting, 10) Storage and reserves, 11) The company size, 12) Axial and lateral industrial sector, 13) Rewards, 14) Ownership [1].

Ways to identify smoothing behaviors:
Copland (1968) has suggested three possible ways to identify smoothing behaviors:
1. Direct investigation of managers through interviews, observation, and questionnaires
2. Direct investigation of independent professionals (e.g. AICPA members)
3. Posteriori information tests

To examine income smoothing, Ickle Model was used in this study as the disadvantages of traditional and Imhoff models have been overcome in this model. Based on Ickle Model, the smoothing institution is defined as an institution that employs a number of accounting variables so that the resultant outcome will minimize the earnings volatility. This model uses several variables and examines the smoothing during several periods.

The model has been designed based on four presumptions. Variables used in the model are income (I), sales (S), the percentage of variable costs to sales (VC %), fixed costs (FC), and the degree of general management manipulation in earnings (X). Accordingly, if the Ickle index is less than one \( \frac{CFM}{CFAS} < 1 \) the income smoothing has occurred.

Review of literature:
The relationship between income smoothing and the corporate performance was examined by Michelson et al (1999) in a study conducted in the U.S. economic environment. In this study, 358 companies were examined from 1980 to 1991 and the following results were observed:
1. Income smoothing was observed in the sample under study.
2. Smoother companies had a higher average return than non-smoother companies.
3. Market reaction towards small companies with income smoothing is greater than the market reaction towards larger companies.
4. There is a relationship between the industry type and smoothing.
5. Smoothing was done more frequently in larger companies than smaller companies [8].

The effects of smoothing and earnings quality on the corporate performance evaluation were explored in another study by Bao (2004). It was found that there is no significant difference between the prices of smoothing and non-smoothing stocks. In other words, there is no relationship between prices and earnings. It was also noted that there is also a significant difference between the P/E in smoothing companies and that of non-smoothing companies as the value of P/E in companies with higher earnings quality is greater than the value of P/E in companies with lower earnings quality [3].
Another study was conducted by Nourani (2002) on “Effects of income smoothing on the performance of companies listed in Tehran Stock Exchange”. In this study, 100 companies were included in the sample under study. The preliminary hypothesis was tested over the period from 1991 to 2000 and the main hypothesis was examined from 1996 to 2000. The results of the study suggested that the companies intend to perform income smoothing. However, the smoothing has no significant effect on the companies’ performance. Besides, it was noted that the industry type and the company size have no effect on the non-normal returns [10].

The most comprehensive study carried out in the context of income smoothing in Iran was conducted by Badri (2009) on “Factors affecting income smoothing”. The study was performed on 139 companies listed in Tehran Stock Exchange from 1990 to 1992. He observed that factors such as the company size, profitability, ownership type, and the pricing factor are not among factors affecting income smoothing. The results of Badri’s study are different from the studies done in other countries, especially the U.S. [2].

Research hypotheses:

The following hypotheses were tested in the present study:
1. There is a significant difference between the annual performances of smoothing and non-smoothing companies.
2. There is a significant difference between the six-year performances of smoothing and non-smoothing companies.
3. There is a significant difference between the annual performances of companies with higher earnings quality and companies with lower earnings quality.
4. There is a significant difference between the six-year performances of companies with higher earnings quality and companies with lower earnings quality.
5. There is a significant difference between the annual P/E ratios of smoothing and non-smoothing companies.
6. There is a significant difference between the six-year P/E ratios of smoothing and non-smoothing companies.
7. There is a significant difference between the annual P/E ratios of companies with higher earnings quality and companies with lower earnings quality.
8. There is a significant difference between the six-year P/E ratios of companies with higher earnings quality and companies with lower earnings quality.
9. There is a significant difference between the performances of companies in different industries.
10. There is a significant difference between the P/E ratios of companies in different industries.

MATERIALS AND METHODS

The present study is an applied research in terms of the objectives it follows and is a descriptive and inferential study based on the way the research hypotheses are tested. The hypotheses are tested using t-test and the mean comparison. It is noteworthy that the present study is going to find whether there are any significant differences between the variables under study or not.

To collect the data, library and field methods were used in the present study. The population under study included all listed companies in Tehran Stock Exchange of which 172 companies were selected as the research sample and they were examined from 2004 to 2009.

The main research variables and the way they are calculated:

The variables manipulated in the present study are income smoothing, earnings quality indicator, the company performance, and the P/E ratio. However, income smoothing involves variables such as earnings and sales and earnings quality is estimated through variables such as operating cash flow and operating profit. In addition, the company performance is dependent on the company’s assets and liabilities. These variables are briefly reviewed as follows:

Income smoothing:

Income smoothing is measured by Ickle index. Based on the Ickle index, smoothing companies are those in which the value of variability dispersion coefficient for a gross earning period, the operative profit, or net profit to the variability dispersion coefficient for a smaller sales period:

\[
\text{Ickle Index: } \frac{CV\Delta i}{CV\Delta S}
\]

Where, \( CV\Delta i \) is the profit variability coefficient and \( CV\Delta S \) is the sales variability coefficient. Consequently, if the value of \( \frac{CV\Delta i}{CV\Delta S} \) is less than one, the income smoothing has happened and the income has been smoothed.
Otherwise, if the value of $\frac{CV_{AL}}{CV_{AS}}$ is more than one, the income smoothing has not happened and the income has not been smoothed.

**Earnings quality:**
Earning quality is measured through Sloan Model. Based on this model, if the cash from operations is greater than the accrual income, the earnings quality is high. Otherwise the income quality is low. Accrual earnings are obtained by subtracting cash from operations from operative profit.

**The company performance:**
The company performance is measured by risk level. The risk itself is calculated as the ratio of the total liability to the total assets. A low earning variability and the low value of the ratio of the total liability to the total assets shows the low level risk. Accordingly, the lower risk the higher the company value and the better the company performance.

**P/E ratio:**
P/E ratio is calculated by dividing the market price of the shares to the earnings per share. The data related to the P/E ratio are calculated by TADBIR PARDAZ Software using the stocks data.

**Methods of data analysis:**
Indices of central tendency and dispersion are calculated before testing the research hypotheses in order to analyze the variables under study descriptively. Mean as the most important measure of central tendency and the standard deviation as the most important dispersion measure are determined in this study.

**Referential data analysis:**

**T-test:**
T-test is used to determine whether there is any difference between the means of two different samples or not. After the t value is calculated it is compared to the corresponding t value in the distribution t with the degree of freedom (N-2) and the significance level of α%. If the estimated t is greater than the t value in the table, the null hypothesis will be rejected. On the other hand, if the value of the estimated t is less than the t value in the table, the null hypothesis will be confirmed:

$H_0: \mu_1 = \mu_2$

$H_1: \mu_1 \neq \mu_2$

**One-factor (one-way) ANOVA:**
The null hypothesis and the alternative hypothesis are as follows:

$H_0$: The means of groups are the same.

$H_1$: At least one mean is different from the rest.

If the significance level is less than 0.05, the null hypothesis is rejected and the alternative hypothesis will be confirmed. As a result, at least one mean is different from the rest.

**Levin Test:**
Another test used in this study is Levine Test by which homogeneity (uniformity) of the group variances is tested. The hypotheses related to this test are expressed as follows:

$H_0$: Variances are uniform.

$H_1$: Variances are not uniform.

**Multiple Comparison Test:**
This test performed after ANOVA will determine whether the differences between group means are significant or not. The multiple comparison test was used in this study through a LSD method.

**Results:**
The experimental results of the study are presented through descriptive and inferential statistics. Descriptive statistics includes mean, standard deviation, the minimum and maximum value of performance, and P/E ratio for the industries under study.
As can be seen in Table 1, of the P/E mean values the mean value P / E Industry, food industry, except sugar and then tile, ceramic and cement industry; the food industry except for sugar industry has the highest mean and standard deviation. Tile and ceramic industry and cement industries occupied the other positions. Besides, electronic devices industry had the least mean and standard deviation. Therefore, it is expected that the significant differences between the mean values of the above industries and other industries in terms of smoothing and non-smoothing sectors with high and low earnings quality are confirmed.

As shown in Table 2, the food industry except for the sugar industry had the lowest average performance while the tile, ceramic, and cement industries had the highest average performance over a six year period.

Testing the research hypotheses:
H1: There is a significant difference between the annual performances of smoothing and non-smoothing companies.

Table 3 shows the mean, standard deviation and t values for smoothing and non-smoothing industries for each year separately.

As shown in Table 3, since the significance level for all the years is zero or less than 05/0; the means for the industries are not equal and thus there is a significant difference between the means of smoothing and non-smoothing companies for each year over the time period from 2004 to 2009. Besides, as the mean difference is positive; the average performance of smoothing companies is higher than that of non-smoothing companies.

H2: There is a significant difference between the six-year performances of smoothing and non-smoothing companies.

As shown in Table 4, since the significance level for all the years is zero or less than 05/0; the means for the six-year period are not equal and thus there is a significant difference between the means of smoothing and non-smoothing companies for each year over the time period from 2004 to 2009. Besides, as the mean difference is positive; the average performance of smoothing companies is higher than that of non-smoothing companies.
The second hypothesis tests the overall performances of smoothing and non-smoothing companies over a six year period. As shown in Table 4, the null hypothesis concerning the equality of performance means for a six year period from 2004 to 2009 is rejected at the confidence level of 95% and the t value of 12.59. As a result, there is a significant difference between the average performances of smoothing and non-smoothing companies industry, with the smoothing companies having a higher average performance than non-smoothing companies.

**H3:** There is a significant difference between the annual performances of companies with higher earnings quality and companies with lower earnings quality.

As shown in Table 5, except in 2008, the equality of the equality of performance means of companies is not confirmed. The average performances are equal for companies with high and low earnings quality.

**H4:** There is a significant difference between the six-year performances of companies with higher earnings quality and companies with lower earnings quality.

A comparison of the six-year performances of companies with higher earnings quality and companies with lower earnings quality (Table 6) shows that companies with low earnings quality have a higher average performance than companies with higher earnings quality over a six-year period. The results of t-test also suggested that there is a significant difference between the six-year performances of companies with higher earnings quality and companies with lower earnings quality at the confidence level of 0.01.

**H5:** There is a significant difference between the annual P/E ratios of smoothing and non-smoothing companies.

As shown in Table 7, the equality of the mean values for the P/E ratio between industries with high earnings quality and industries with low earnings quality has been rejected. Besides, the mean value of the P/E ratio in companies with high earnings quality is higher than that of companies with low earnings quality during the whole period under study except in 2009.

**H6:** There is a significant difference between the six-year P/E ratios of smoothing and non-smoothing companies.

<table>
<thead>
<tr>
<th>Table 5: Analysis of the third hypothesis (sig = 0, df = 170).</th>
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<tbody>
<tr>
<td>T value</td>
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<tr>
<td>---------</td>
</tr>
<tr>
<td>-5/22</td>
</tr>
<tr>
<td>-2/8</td>
</tr>
<tr>
<td>3/54</td>
</tr>
<tr>
<td>2/79</td>
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<tr>
<td>-1/11</td>
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<tr>
<td>-4/56</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 6: Analysis of the fourth hypothesis (sig = 0, df = 170).</th>
</tr>
</thead>
<tbody>
<tr>
<td>T value</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>-2/42</td>
</tr>
</tbody>
</table>

A comparison of the six-year performances of companies with higher earnings quality and companies with lower earnings quality (Table 6) shows that companies with low earnings quality have a higher average performance than companies with higher earnings quality over a six-year period. The results of t-test also suggested that there is a significant difference between the six-year performances of companies with higher earnings quality and companies with lower earnings quality at the confidence level of 0.01.

<table>
<thead>
<tr>
<th>Table 7: Analysis of the fifth hypothesis.</th>
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<tbody>
<tr>
<td>Significant Level</td>
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<td>-------------------</td>
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<tr>
<td>0/034</td>
</tr>
<tr>
<td>0.02</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>0/036</td>
</tr>
<tr>
<td>0</td>
</tr>
</tbody>
</table>

As shown in Table 7, the equality of the mean values for the P/E ratio between industries with high earnings quality and industries with low earnings quality has been rejected. Besides, the mean value of the P/E ratio in companies with high earnings quality is higher than that of companies with low earnings quality during the whole period under study except in 2009.

**H6:** There is a significant difference between the six-year P/E ratios of smoothing and non-smoothing companies.

<table>
<thead>
<tr>
<th>Table 8: Analysis of the sixth hypothesis.</th>
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</thead>
<tbody>
<tr>
<td>Significant Level</td>
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<tr>
<td>-------------------</td>
</tr>
<tr>
<td>0.003</td>
</tr>
</tbody>
</table>

The second hypothesis tests the overall performances of smoothing and non-smoothing companies over a six year period. As shown in Table 4, the null hypothesis concerning the equality of performance means for a six year period from 2004 to 2009 is rejected at the confidence level of 95% and the t value of 12.59. As a result, there is a significant difference between the average performances of smoothing and non-smoothing companies industry, with the smoothing companies having a higher average performance than non-smoothing companies.

**H3:** There is a significant difference between the annual performances of companies with higher earnings quality and companies with lower earnings quality.

As shown in Table 5, except in 2008, the equality of the equality of performance means of companies is not confirmed. The average performances are equal for companies with high and low earnings quality.

**H4:** There is a significant difference between the six-year performances of companies with higher earnings quality and companies with lower earnings quality.

A comparison of the six-year performances of companies with higher earnings quality and companies with lower earnings quality (Table 6) shows that companies with low earnings quality have a higher average performance than companies with higher earnings quality over a six-year period. The results of t-test also suggested that there is a significant difference between the six-year performances of companies with higher earnings quality and companies with lower earnings quality at the confidence level of 0.01.

**H5:** There is a significant difference between the annual P/E ratios of smoothing and non-smoothing companies.

As shown in Table 7, the equality of the mean values for the P/E ratio between industries with high earnings quality and industries with low earnings quality has been rejected. Besides, the mean value of the P/E ratio in companies with high earnings quality is higher than that of companies with low earnings quality during the whole period under study except in 2009.

**H6:** There is a significant difference between the six-year P/E ratios of smoothing and non-smoothing companies.
According to Table 8, the equality assumption of the mean values for the P/E ratio between industries with high earnings quality and industries with low earnings quality has been rejected and the mean value of the P/E ratio in companies with high earnings quality is higher than that of companies with low earnings quality during the period under study.

H7: There is a significant difference between the annual P/E ratios of companies with higher earnings quality and companies with lower earnings quality.

According to Table 9, the equality assumption of the mean values for the P/E ratio between industries under study for 2005, 2007, and 2009 has been rejected but it has been confirmed for 2004, 2006, and 2008. As a result, the mean values for the P/E ratio are not equal in smoothing and non-smoothing companies in 2005, 2007, and 2009 but they are equal in 2004, 2006, and 2008.

H8: There is a significant difference between the six-year P/E ratios of companies with higher earnings quality and companies with lower earnings quality.

According to Table 10, the equality assumption of the six-year mean values for the P/E ratio between smoothing and non-smoothing has been rejected and the mean value of the P/E ratio in smoothing companies is higher than that of non-smoothing companies during the period under study.

H9: There is a significant difference between the performances of companies in different industries.

This hypothesis examines the equality of the average performances of companies under study regardless of the classification of companies of in terms of year, whether they are smoothing and non-smoothing, or if they are of high or low earnings quality. To do so, variance homogeneity test was used to examine the performances of companies under study.

As shown in Table 11, since the significance level is 0.072 (P > 0.05); the null hypothesis is not rejected and the group variances are equal so ANOVA test can be run to examine the equality of the average performances between companies under study. As can be seen in the following table, since the significance level is 0.001 (P < 0.05); null hypothesis is rejected so at least one group is different from the other groups.

The equality of the average P/E ratios of companies under study is examined via the above hypothesis regardless of the classification of companies of in terms of year, whether they are smoothing and non-smoothing, or if they are of high or low earnings quality. To do so, P/E variance homogeneity test was used to examine the P/E ratio in companies under study.
As shown in Table 13, since the significance level is 0.09 (P > 0.05); the null hypothesis is not rejected and the group variances are equal so ANOVA test can be run. As can be seen in the following table, since the significance level is 0.001 (P < 0.05); null hypothesis is rejected so at least one group is different from the other groups.

<table>
<thead>
<tr>
<th>Variable</th>
<th>F Statistic</th>
<th>Degree Of Freedom</th>
<th>Significant Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance Of The Industries</td>
<td>2.86</td>
<td>1031</td>
<td>0.09</td>
</tr>
</tbody>
</table>

Inferential statistics were estimated in this study through t-test, (one-way) one-factorial ANOVA, Levin Test, and Multiple Comparison Test. The results of analysis of hypotheses are summarized in Table 15:

<table>
<thead>
<tr>
<th>hypotheses</th>
<th>hypotheses Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hypotheses is Confirmed</td>
<td>1</td>
</tr>
<tr>
<td>Hypotheses is Confirmed</td>
<td>2</td>
</tr>
<tr>
<td>Hypotheses Is Not Confirmed Only 2009</td>
<td>3</td>
</tr>
<tr>
<td>Hypotheses Will Be Confirmed</td>
<td>4</td>
</tr>
<tr>
<td>The hypotheses are confirmed in the years 2005, 2007 and 2009, but it is rejected in years 2004, 2006 and 2008.</td>
<td>5</td>
</tr>
<tr>
<td>Hypotheses is Confirmed</td>
<td>6</td>
</tr>
<tr>
<td>The hypotheses are confirmed in the years 2004, 2006 and 2008, but it is rejected in years 2005, 2007 and 2009.</td>
<td>7</td>
</tr>
<tr>
<td>Hypotheses is Confirmed</td>
<td>8</td>
</tr>
<tr>
<td>Hypotheses is Confirmed</td>
<td>9</td>
</tr>
<tr>
<td>Hypotheses is Confirmed</td>
<td>10</td>
</tr>
</tbody>
</table>

Discussion:
As the results of the study suggest, there is a significant difference between the average performances of smoothing and non-smoothing companies from 2004 to 2009. As this difference is positive, it can be said that the average performance of smoothing companies has been always higher than that of non-smoothing companies. The same was true for the performances of companies in question over the whole six-year period under study as there is a difference between the average performances of smoothing and non-smoothing companies. However, similar results were observed with little difference concerning the earnings quality. The average performance of companies with higher earnings quality was not equal to the average performance of companies with lower earnings quality from 2004 to 2009 except in 2008 in which the performances of both groups are equal. Therefore, the average performance of companies with lower earnings quality was greater than the average performance of companies with higher earnings quality.

The findings of the study also indicated that the annual mean of P/E ratio in companies with lower earnings quality was significantly different from that of companies with higher earnings quality the time period from 2004 to 2009. The annual mean of P/E ratio was always greater in companies with higher earnings quality during the whole period except in 2008. The same thing was observed for the six year period under study indicating that the mean of P/E ratio was greater in companies with higher earnings quality.

On the other hand, the annual mean of P/E ratio in smoothing and non-smoothing companies was totally different from the above scenario. In other words, the equality of the means of the P/E ratio in industries under study in 2005, 2007, and 2009 was rejected but it was confirmed for 2004, 2006, and 2008 so the annual means of the P/E ratio are not equal in smoothing and non-smoothing companies in 2005, 2007, and 2009 but they are equal in 2004, 2006, and 2008. However, the equality assumption of the six-year means of P/E ratio between smoothing and non-smoothing was rejected and the six-year mean of P/E ratio in smoothing companies is higher than that of non-smoothing companies during the period under study.

The performance and P/E ratio were examined without considering the earnings quality and the smoothing conditions to find out whether there is any significant difference between the companies in question or not. Accordingly, it was noted that the performance of the food industry (except for sugar industry) is significantly different from the performances of other industries as the performance of the food industry was lower than other industries. On the other hand, tile, ceramic, and cement industries had the highest performance among the industries studied. In addition, the transportation and tire industries with the smallest value of the P/E ratio were significantly different from other industries. But the food industry (except for sugar industry) has the greatest level of the P/E ratio than other industries.

Conclusions:
The findings of the study, in general, indicated that income smoothing companies had a better performance in both one year and six year periods than non-smoothing companies. Therefore, those companies that smooth their income have a better performance than the companies that do not so. Besides, it was noted that not only the
companies with higher earnings quality and the companies with lower earnings quality did not perform equally except in 2008 but also the companies with lower earnings had a better performance.

However, unlike performance; the P/E ratio had a different story. The annual means of P/E ratio were not equal among the companies with higher earnings quality and those with lower earnings quality (except in 2009) as the companies with higher earnings quality had a higher P/E ratio. On the other hand, the P/E ratio did not follow a regular pattern in smoothing and non-smoothing companies. For instance, the P/E ratio was not equal between the two groups of companies in some years but it was the same for the both groups in other years. Besides, it is not clear which group had a higher annual P/E ratio. On the other hand, the six year means of P/E ratio were not the same in smoothing and non-smoothing companies as the former had a higher P/E ratio during the period under study.

On the whole, it can be concluded that the average performance and the P/E ratio were significantly different between smoothing and non-smoothing companies and between companies with higher earnings quality and those with lower earnings quality; a finding that was observed in most years during the period under study.

Suggestions based on the results of the study:

Based on the results of the study it can be said smoothing is a significant factor that can affect decisions taken by managers, financial experts, and all users of information about the company’s performance.

1. Given that earnings and their measures are often used in reward plans and contracts related to liabilities, making decisions based on partial or low quality earnings causes unequal distribution of wealth. Accordingly, lenders are recommended to consider earnings quality more accurately. Besides, low quality earnings are unfavorable from an investment point of view as it causes incorrect allocation of resources and thus resulting in a decline in the economic growth. Low quality earnings do not have the needed efficiency and direct the resources from basic and important projects with real expected returns to useless projects with false returns. Therefore, investors are suggested to consider earnings quality more accurately.

2. The findings of the present study suggested that quality is a significant factor affecting the performance of the companies under study. Given the Financial Accounting Standards Board emphasis on the utility of decisions, it is believed that the earnings quality and financial reporting quality in general are taken into account by those people that use such reports for transaction purposes and making decisions about their investments.

3. Since investors are not generally skilled in the analysis of financial statements and financial analysts do so on their behalf, analysts who are actually the main users of the corporate information are recommended to raise investors awareness by studying, analyzing, and correcting financial statements and information. Besides, there analysts are required to make it clear whether smoothing in the company is the result of the managers’ manipulation or it has occurred naturally. In the case that earnings are presented artificially it should be determined whether they attract investors in the short term or whether they can be effective in long term or not.

4. It is recommended some conferences be hold to have different aspects of income smoothing explained and analyzed to enhance the financial statements users’ view and show them the truth about the decision to be made.

REFERENCES