AN OVERVIEW INCOME MANAGEMENT AND INCOME SMOOTHING AND ITS IMPORTANCE IN ACCOUNTING

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Abstract

Accruals are categorized into two categories discretionary accruals and also non-discretionary accruals. Discretionary accruals are accruals that management can apply control over them and they are applicable terms my management and they are recorded based on the taste and choice of management. Relative ability to reduce or increase of reported earnings by managers are introduced as manipulation of accounts. Topics such as maximizing, minimizing, or smoothly refers to who implicitly take action to manipulated of accounts. Of course manipulation of accounts be encompasses considerably broader scope. Accruals are defined as distance between operating cash flows and accounting profit. Earnings management is intentional interference in external financial reporting process with intent to obtain a benefit. Income smoothing has two forms: 1-Reduction of Earnings; It is when the expected profit will be high temporarily, 2-Incremental Earnings; It is when profits will be lower than expected profit or profits of the previous year. Fraud is any action intentional or fraudulent one or several people of managers, employees or persons illegally. The purpose some of frauds may not be falsification of financial statements. Fraud that be done involving one or more persons of managers called as managers fraud and also fraud that be done by staff called employee fraud. In this article explains to importance of accruals, earnings management, earnings management utility, income smoothing and the role that play in the accounting.

Keywords: *Accruals, Income Management, Income Smoothing*

Introduction

Copeland (1968) is introduced relative ability to reduce or increase of reported earnings by managers as manipulation of accounts. Topics such as maximizing, minimizing, or smoothly refers to who implicitly take action to manipulated of accounts. Of course manipulation of accounts be encompasses considerably broader scope. Including how to classify items in profit and loss statement is raised in the accounting literature frequently, or relating to the balance sheet that is less mentioned (Graham Et al 2005). Incentives to manipulate accounts are among the items that should be more attention. Sometimes, managers used the accounts as tool to displaying unrealistic to achieve long-term goals of the company or artificially reduce the perceived risk. (Kothari Et al 2005)

Previous Research

Shariat Panahi and Samaei (2004) with reviews 44 companies during the years 1998-2001 showed that there is a significant correlation between income smoothing and adjusted returns based on risk. Companies do income smoothing have more abnormality return on average (Moghadam 2006). Ghaemi and Ghiasmand (2003) showed that effect of income smoothing is weak on the abnormal returns of companies. Khajavi and Nazemi (2005) also showed that average returns (normal and abnormal) of companies will not be affected the amount of accruals and related components. Alameh Haeri (1998) choice deviation of benefit actual changes from itself process as final measure of identification of income smoothing reached to following conclusions: 1) Income smoothing has positive correlation with increase of stock prices. 2) There isn't correlation between the size and type of industry with income smoothing. 3) Profitability has positively correlated with income smoothing. (Mashayekhi 2005)

Accruals

Zay (2001) is defined accruals as distance between operating cash flows and accounting profit. Accruals are categorized into two categories discretionary accruals and also non-discretionary accruals. Discretionary accruals are accruals that management can apply control over them and they are applicable terms my management and they are recorded based on the taste and choice of management. Non-discretionary accruals are limited due to organizations' regulatory and other external factors and they aren't applicable terms by management. (Herrmann Et al. 2003)

The Purpose of the Accrual Based on Accounting

The primary purpose accrual accounting is help to investors in assessing the economic performance of a company during a period through the application of accounting principles such profit compliance and identify. There is evidence that on those accordance as a result application of accrual, accounting profit is smoother than cash flows related to it (Accruals have negative relationship with related cash flows). (Daniel Et al 2010)

Earnings Management and Fraud

Healy and Wahlen (1999) say: Earnings management occurs when managers use personal judgments in financial reporting and can be manipulated structure of the equations order to change the financial reporting (Chen 2009). Fraud is any action intentional or fraudulent one or several people of managers, employees or persons illegally. The purpose some of frauds may not be falsification of financial statements. Fraud that be done involving one or more persons of managers called as managers fraud and also fraud that be done by staff called employee fraud. (Matsuura 2008)

Earnings Management in Financial Accounting Theory

Earnings management could be examined both the terms of the contract and financial reporting. Terms of the contract, earnings management acts as one way of low-cost for support the company against unforeseen circumstances in contracts. In terms of financial reporting, managers are able to influence on company's stock market value by earnings management (Burgstahler 1997). In the labor market this issue is a means to provide information within the organization to market. So from both perspectives, earnings management in some cases may lead interesting and desired results. But it is possible that some managers abuse from profit management. From contractual perspective may be managers are done opportunity profit management for personal benefit with the cost of other contract parties. From the perspective of financial reporting managers may be have trying to fool the market with the profit manipulation. In any case, this entry is indicates that managers do not accept the efficiency of the securities market completely and with profit management have corrupted the ability to rely on financial reporting. Profit management is indicated great interest of managers to reported profits. (Kim Et al. 2009)

The Importance of Profit Management

Accounting is followed to measurement of economic information report to decision makers. Depending on the users of accounting information, accounting is division into two branches management accounting and financial accounting. Management accounting is effort in order to provide the required information management for decision. Against, financial accounting is considered as a strong source of information in order to meet the needs of investors and credit providers (Such as suppliers, regulatory authorities, clients, suppliers and employees). The responsibility for the preparation and accounting reports for individuals outside the Organization is the management of the company. (Roychowdhury 2006)

Earnings Management Utility

A good profit management may be decision that in the period during which operational income is low, the number of assets be sell. If appropriate expression, creation process will not be misleading. Some people believe that such action is marred decision and reduces profits quality but the decision is based so that "is obtained results reliable?" And also" are interchanges expressed appropriately?" Hence, we can conclude that earnings management isn't bad for ever. In fact, it is the acceptance and required issue inside and outside the company by all owners of capital market interest. (Azad 2004)

Incentives of Earnings Management

The ability to change in accounting methods because lack of required uniform procedures, also managers' exclusive access to part of the financial information and features of accrual accounting and incentives such as job security, bonuses, illegality, avoid reporting losses and reduced earnings, debt contracts, rising wealth, achieve the expectations of shareholders and programs anticipated all these create incentive in the management that they do manipulation earnings apply in different ways in the their interest and in the direction of a conflict with the interests of other groups. (Ajinkya 1984)

Income Smoothing

Managers are done income smoothing so that increase profits when profit is down, and also reduce it when profit is up. More precisely Gordon provided theory of income smoothing with expressed the four assumptions as follow:

1. Benchmark for corporation's management in the choice between accounting methods is maximizing utility or management's welfare.
2. Management's utility increases with job security, growth rates of remuneration and rights, and also growth rate of company's size.
3. Acquisition is part of management objectives that was expressed in the assume 2 has depends to the satisfaction of shareholders relative to firm performance.
4. For managers is essential satisfaction of the shareholders relative to earnings growth (Or rate of return on equity) and also stability of earnings that they could follow their goals.

If the above four assume be accepted so managers within their power means accepted range of accounting rules should smooth the reported earnings and the earnings growth rate. (Zang 2006)

Types of Income Smoothing

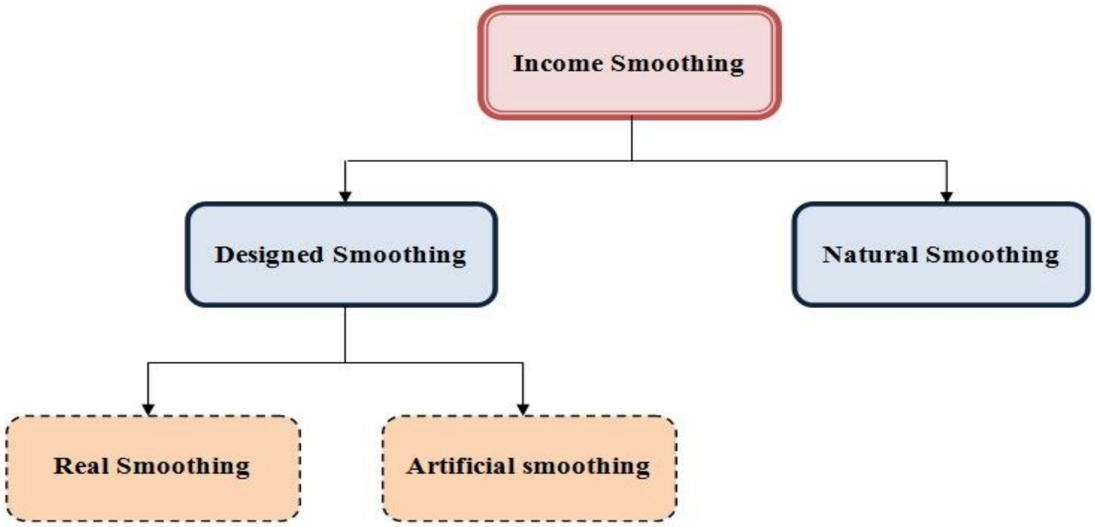

Figure 1: Types of Income Smoothing

The natural smoothing arise process of generating income that creates smooth flow. Namely, income generation process creates smoothly income inherently and this kind of smoothing isn't earnings management. Because does not exist any manipulation in profits. Conversely, income intentional smoothing be attributed management intentional action. It was mentioned divided to two types real and artificial. (Dechow Et al. 1995)

Income Smoothing Purposes

1. Increase in company shareholder value in Stock Exchange and typically increase in company's value..
2. Reduction of corporate risk and therefore payments lower interest in borrowing and reduce the company's cost of capital.
3. Raise funds because investors and creditors believe that investment risk is low and it is a good place for investment.
4. Data transfer to market and facilitate income predictive capability.
5. Improve relationships with employees, suppliers of raw materials and etc.
6. Tax incentives
7. Contractual incentives such as debt contract, management bonus contracts
8. Reduce the risk of deportation and dismissals
9. Special Features of company such firm size, firm profitability, ownership control or manager control, economic sector.

(Herrmann Et al. 2003)

Conclusions

Accruals has identified as the difference between profit and cash the results of operations. The primary purpose accrual accounting is help to investors in assessing the economic performance of a company during a period through the application of accounting principles such profit compliance and identify. Earnings management occurs when managers use personal judgments in financial reporting and can be manipulated structure of the equations order to change the financial reporting. Real earnings management methods included: Manipulation sales through accelerating the timing of sales or create overproduction with falling prices or create easier credit conditions, reduce discretionary spending, and also additional or excessive production in order to report lower the reality cost of goods sold.

There are two types of income smoothing. Natural smoothing, intentional smoothing or designed smoothing. Designed smoothing also named management smoothing and it is divided to two types: 1- Real smoothing that named the transactional or economic smoothing. 2- Artificial smoothing or accounting smoothing. Income smoothing purposes included increase in company shareholder value, reduction of corporate risk, raise funds, data transfer to market, improve relationships with employees, suppliers of raw mate, tax incentives, contractual incentives, reduce the risk of deportation and dismissals. The ability to change in accounting methods because lack of required uniform procedures, also managers' exclusive access to part of the financial information and features of accrual accounting and incentives such as job security, bonuses, illegality, avoid reporting losses and reduced earnings, debt contracts, rising wealth, achieve the expectations of shareholders and programs anticipated all these create incentive in the management that they do manipulation earnings apply in different ways in the their interest and in the direction of a conflict with the interests of other groups.

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