

## The Compression of Earnings Quality Measures Impact and Smoothing Earnings on the Excess Return in the Companies Listed on the Tehran Stock Exchange

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**Abstract:** The present study aimed to identify measures of earnings quality and effective income smoothing, the stock pricing error, the comparison of metrics profit stability, predictability profit, profit ratio of standard deviation, the standard deviation of cash flows non-accrual normal accrual quality, earnings response coefficient correlation between accruals and cash flows and  $R^2$  on stock excess returns of companies listed on the Tehran Stock Exchange is paid. This study in terms of performance is descriptive. The population of 102 companies listed in Tehran Stock Exchange during the period 2007-2014.

**Key words:** Quality of earnings, income smoothing, absolute value added returns, profit ratio, cash flows

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### INTRODUCTION

In today's world investors move engines and progress and development are taken into account and therefore the information that they for their decisions is crucial. Investors using the company published information to make decisions. One of the goals of the investment is profit and investors tend to invest in companies that are less volatile earnings.

A beneficial effect on stock returns has caused a topic as earnings quality to be raised by financial analysts. Benefit in terms of reducing the risk of data quality reducing cost of equity and increasing the volume of related transactions is the cost of capital. If the general public, the financial reporting process or do not have confidence in published financial information investors are deterred and this in turn, the development of capital markets and prevent economic growth. So, the quality of earnings in investment for investment creates more enthusiasm (Beaver, 2002).

One of the indicators of quality of earnings, the earnings stability. So, profit as the end result of a long process accounting, so much attention and emphasizes the users of accounting information is influenced by accounting policies, the management gives opportunity to the recognition and measurement of costs and benefits decision measure. Management is motivated by the use of Non-conservative conservative accounting practices, the

company's profit growth to stabilize. One of the most important and most common of these actions is income smoothing. So business units that have benefited are smoother, more favored investors. This makes, some managers in different ways such as acceleration and delays in shipping and invoicing inventory increases and decreases in the end, change the method of calculating depreciation, etc. are performed income, smoothing (Cheni *et al.*, 2009).

**Literature review:** Francis *et al.* (2004) in his research to the study of the seven criteria earnings quality and their relation to the cost of equity and real returns paid. The results showed that based on the relationship between accounting standards and stronger cost of equity and efficiency is the relationship between accounting-based criteria (Francis *et al.*, 2004). In his study "estimate abnormal accruals and evidence of mispricing" the study studies the performance abnormal accruals models in the prediction of annual returns as a measure of pricing mistake began. The results of their study revealed that a modification of Jones, compared to other models accruals, the most powerful relationship with its yield.

In a study entitled "added measures of earnings quality and returns" to study this the quality criteria profits are commonly used, how key objective of financial reporting for investors do pay. They showed that all parameters except for smoothing by

adding returns are negatively correlated this result shows that generally smooth profit is a desirable feature.

Naser and Yaser (2009) this research entitled "Relationship Between Quality of Earnings and Return on Equity in the Companies Listed in Tehran Stock Exchange" to provide appropriate criteria to measure earnings quality and its relation to returns stock companies listed on the Tehran Stock Exchange. In conclusion investors are concerned about earnings quality and changes in stock prices and consequently the return on equity, earnings quality will be affected by the measure and the linear relation is verifiable.

Khoshtinat and Esmaili in his study titled "The Relationship Between Quality and Return on Equity" the relationship between earnings quality and stock returns of companies listed on the Tehran Stock Exchange, examine. The survey research hypotheses, using regression analysis for the period 2004-2000 shows that the weak relationship between earnings quality and stock returns there.

Khoddamipoor and Mahroomi in his research as "income smoothing, mispricing of stocks and investment companies" the study of literature related to income smoothing and its impact on the relationship between stock price and the amount of investment companies have paid.

**Profit quality evaluation criteria:** Quality of earnings, financial reporting is a key feature. Quality financial reports to decision-making and therefore improve the efficiency of capital markets. However, earnings quality, a far-fetched concept and people tend it, to understand different ways. There is a bit of a comprehensive agreement but research has created a variety of measures of earnings quality, earnings quality is considered a special feature that focuses. In this study, eight criteria Earnings Quality (EQ) is chosen that is usually used in the empirical literature. They include accounting and market-based values are: Criteria related to time-series properties of earnings. A stable or stable income to the extent that the profits on future. Earnings are mapped, stability or stability shed. In other words, sustainability or sustainable means of income stability repeatability and continuous profits in the coming years. Profit sustainability including measures based on accounting data is considered by many researchers on topics related measures with time-series properties of earnings is included.

**Predictability:** Predictable is one of the qualitative characteristics of accounting information, improve the relevance of the information. Reviewing the literature

suggest that predictability by many researchers as one of the relevant criteria the characteristics of time series are defined. Predictability can be measured in different ways, the criteria in the form of profit ability in anticipation of future profits and cash flows are measured.

Income smoothing approach to assess quality of earnings income smoothing that some researchers have interpreted it to variability. Smoothing, a measure of profitability is associated with the properties of time series (a class of measures of earnings quality which by Schipper and Vincent has been introduced.

Leoz using two criteria, they measure income smoothing. The first criterion operating profit ratio of standard deviation, the standard deviation of operating cash flow which are both based on total adjusted assets believe that the possibility of manipulation of the operating profit, compared to operating cash flow further. The lower the standard deviation lower operating profit is likely higher income smoothing and as a result, the benefits of high quality, special mention will not be smaller than indicated smoothing and thereby, lower quality earnings.

The second measure the use of correlation between changes in accruals and changes in the cash flows. The negative correlation indicates more smoothing and consequently, lower quality earnings. Criteria derived from the relationship between profit cash flow and accruals.

Measures introduced in this chapter, the relationship between the cash and accrual components have caused. This criteria is enormous diversity of topics. Dechow and Dichev (2002) suggest that the majority of the criteria used in the literature to measure earnings quality are in the headlines. All these criteria are based on the idea that some features in accrual earnings quality will be reduced while the cash component of profit increase quality leads to profit.

**Accruals quality:** Quality of accruals the rate at which (realization) accruals, refers to future cash flows (Francis *et al.*, 2004). This measure of earnings quality by many researchers in the headlines criteria derived from the relationship between profit, cash flow and accruals included. Francis *et al.*, (2004) argue that this measure including measures based on accounting data. Dechow and Dichev (2002), the criteria in the headlines of criteria, time-series properties of earnings instead of the data. Accruals quality closely with the income smoothing so that most of the models used to measure accruals quality is used to measure income smoothing.

The relationship between the value of profits the ability to profit in explaining the efficiency relevance

refers to the value of profits in other words each the size of the benefit of greater capacity, efficiency is important in explaining the relationship is worth it harder. Francis *et al.* (2004) the value relevance of earnings, market-related criteria to be classified in heading. For them, the value of profits related criteria include qualitative characteristics of relevance and reliability respectively. To measure earnings quality, from an efficiency-based approach is used. Dechow and Dichev (2002), another title as earnings response coefficient instead of linking the value of profits will be used. This is while Schipper and Vincent the value relevance of earnings as a measure of earnings quality will not be considered. In some studies, the information content of earnings as a measure of earnings quality is remembered but the operationalization of this criterion, the value relevance of earnings have been used. Its history value as a measure of earnings quality, goes back to 1968. Before Ball and Brown academic research, accounting, earnings quality through compliance with the theoretical framework or uniform measurement system were examined. Beaver (2002) the way they assess earnings quality in their studies, changed. They show that NEWS profits can be some capital market characteristics (such as return variability around the announcement of changes in profit and turnover) are correlated. Thus, according to the results of this research, it is not surprising that earnings response coefficient, a measure of profitability to be considered in the decision or earnings quality (Dechow and Dichev, 2009).

**Theories:** In this study, the following hypotheses will be tested:

- $H_1$ : Between measures of earnings quality and value added absolute returns there is a significant relationship
- $H_2$ : The criteria for income smoothing and the absolute value added returns there is a significant relationship
- $H_{31}$ : The relationship between measures of earnings quality and add absolute returns between companies with high earnings quality and low earnings quality, there is a significant difference
- $H_4$ : The relationship between measures of income smoothing, adding absolute returns between companies with high earnings quality, earnings quality down, there is a significant difference

## MATERIALS AND METHODS

The population in this study consists of all companies listed on the Tehran Stock Exchange during

the year 2014-2007. The surveyed companies in order to test hypotheses using systematic elimination have been selected, their number now is 102 (Perotti and Wagenhofer, 2014).

## RESULTS AND DISCUSSION

**The first hypothesis:** In the first hypothesis was that between measures of earnings quality and value added absolute returns, there is a significant relationship. Multiple regression results show that of the eight criteria for the quality of earnings is intended, 6 criteria earnings stability, predictability profit, profit ratio of standard deviation, the standard deviation of cash flows, abnormal accruals, AQ and earnings response coefficients, the absolute value added returns are impressive. It should be noted that the three criteria of predictability of earnings, accruals unusual and accrual quality positive effects and negative effects of other variables. The results of this hypothesis, the results obtained by Francis *et al.* (2004) is consistent.

**The second hypothesis:** The second hypothesis was that among the criteria for income smoothing and the absolute value added Returns, there is a significant relationship. In this study for smoothing earnings ratio of two standard deviations profit, cash flow, standard deviation and correlation between accruals and cash flows are used. Multiple regression results show that compared with profit standard deviation, standard deviation of cash flows, had a negative impact on the absolute value added returns and correlation between accruals and cash flows have no effect. The results of this hypothesis, the results obtained by Francis *et al.* (2004) is consistent.

**The third hypothesis:** In the third hypothesis was that in the relationship between measures of earnings quality and add absolute returns between companies with high earnings quality and earnings quality down there is a significant difference or not. To test this hypothesis, the companies were divided into two categories, companies with high earnings quality and companies with low earnings quality. The third hypothesis test results show that for firms with high earnings quality, earnings stability criteria, the predictability of profit, profit ratio of standard deviation, the standard deviation of cash flows, abnormal accruals, accruals quality and factor call profits, the absolute value added returns have an impact and benefit for low-quality earnings stability relative standard deviation profit, cash flow, standard deviation, correlation between accruals and cash flows, abnormal accruals, quality items commitment and response rate benefits, plus the absolute value of returns on impact. In companies

with high earnings quality, functionality profit forecast positive effects on the absolute value added efficiencies and increase the added value of absolute returns while companies with low earnings quality, no significant effect. Due to this, it can be concluded that the third hypothesis, with 95% accepted and the relationship between measures of earnings quality and add absolute returns between companies with high earnings quality and earnings quality, low, mean difference there is significant. The results of this hypothesis, the results obtained by matches.

**The fourth hypothesis:** The fourth hypothesis was that in the relationship between income smoothing measures, adding absolute returns between companies with high earnings quality and earnings quality down there is a significant difference or not. To test this hypothesis, the companies were divided into two categories, companies with high earnings quality and companies with low earnings quality. The fourth hypothesis test results show for companies with high earnings quality and low correlation between accruals and cash flows, the value added absolute returns have no effect. Benefit ratio of the standard deviation, the standard deviation of cash flows, negative impact on the value added absolute returns and despite the fact that for companies with low earnings quality, appropriateness criteria better model. Due to this, it can be concluded that the hypothesis is accepted fourth with 95% and the relationship between measures of income smoothing, adding absolute returns between companies with high earnings quality and low earnings quality, the difference there is significant.

## CONCLUSION

The results of the data analysis and test hypotheses suggest that between the above criteria and excess return, a significant relationship exists with the exception of the measure of correlation between accruals and cash flows and  $R^2$  that significant effects are not. As well as income smoothing measures, the profit standard deviation, standard deviation of cash flows, negative impact on the absolute value added efficiency and measure the correlation between accruals and cash flow is unaffected and in measures of earnings quality also for companies with high earnings quality, standard  $R^2$  and the correlation between accruals and cash flow was unaffected and in companies with low earnings quality, the criterion for predictability of earnings and  $R^2$  no significant effect.

## SUGGESTIONS

In the first hypothesis, the impact of the measures of earnings quality, value-added absolute returns was studied. The results of testing the first hypothesis suggests that six measures of earnings quality, significantly adding to the value of absolute returns influence. According to the results obtained from testing the first hypothesis, it is suggested managers, financial analysts and investors, the most attention, the company reported earnings allocated day. Managers keep growing profits benefit because they have their reward depends on the level of corporate profits. Financial analysts are involved in processing and interpretation of information and understanding of earnings quality, earnings quality essential part of process. Given the importance of the institutions, financial advisors, recommended that companies in terms of the quality of investigation and the accordingly, ranking the companies announced.

In the second hypothesis, the effect of smoothing the absolute value added returns is studied. Based on the results obtained from testing the second hypothesis is suggested to managers, the pricing of stocks, the benchmark interest income smoothing have special. Because of the high standards of accuracy income smoothing to reduce errors in pricing its stock.

In the third hypothesis, the impact of the measures of earnings quality, the absolute value added returns in companies with high profits and low quality is examined. There are companies that more power, higher earnings quality, to predict a profit and this leads to, pricing to make fewer mistakes. So to the Stock Exchange, it is suggested that based on this study, a method for evaluating and disclosing earnings quality design and to identify measures of earnings quality and in this regard, companies superior earnings quality, to introduce investors. Investors, financial analysts and other stakeholders is recommended, the quality of data reported, especially more attention to profits and its decision-making models themselves their terms. The fourth hypothesis, the effect of smoothing the absolute value added returns in companies with high profits and low quality is examined. It can be seen in the companies surveyed, negative relationship between income smoothing and there's excess return. So, the managers recommended that measures your income smoothing of the respondent.

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