THE ROLE OF INCOME SMOOTHING ON FINANCIAL PERFORMANCE INDICATORS

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ABSTRACT

The primary objective of this study is to determine whether income smoothing procedures have an impact on the financial performance of return on assets (ROA) and return on equity (ROE). Data for this study came from a sample of banks that are listed on the Iraq Stock Exchange. The research sample consists of banks listed between 2015 and 2019 on the Iraq Stock Exchange. The model estimate is done using the panel data approach. Five banks match the required requirements, and the samples were chosen using a purposive sampling technique. This study employs Miller's model to distinguish between banks that used income smoothing and banks that did not, as well as certain statistical techniques to examine the data. Two indices of financial performance—return on assets (ROA) and return on equity (ROE). Were used to compare the performance of smooth and non-smooth income banks and the variations in the influencing variables that influence each. The findings of this study demonstrate that return on assets (ROA) and return on equity (ROE) have a considerable impact on income smoothing procedures, while variable volume has a significant positive impact as well. In this study, we observed statistically significant differences between banks with and without smooth income in terms of their returns on assets (ROA) and returns on equity (ROE). We found a statistically significant positive relationship between bank size, financial success, and income smoothing in our study.

KEYWORDS

Income smoothing, financial performance, Banking sector, Miller's model, and emerging economy.

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1. INTRODUCTION

Income smoothing is a type of earnings management that management use across several periods to display a constant level of profit flow. To attain the level of earnings anticipated by the market or analyst, management may often employ income smoothing to lessen earnings volatility over a given time [1] By setting aside a portion of income during prosperous times and increasing reported income during periods when it falls short of expectations, the volatility of income can be reduced. Several factors might affect a company's income-smoothing procedures. Profitability is one of the key elements that affect income smoothing. A company's profitability, which is a gauge of its level of managerial effectiveness, is its capacity to make profits over a period [2]

Income smoothing is frequently impacted by a number of factors, including financial performance. This practice is a typical method of managing profits. The managers implement the income smoothing approach, which involves boosting or reducing reported income to reduce its volatility. Creating reserves or earnings from the unreported amounts of earnings in good years to cover the low financial performance years is the procedure of income smoothing. The smooth revenue the company reports in its financial statements for each period is a sign of a strong corporation, and investors and management favor this characteristic since it demonstrates the firm's strong performance [3]. One of the elements that motivate behavior income smoothing is financial performance. This practice is a common technique for managing profits. The managers use an income smoothing approach that involves changing the reported income either increasing or recreating to reduce its volatility. The creation of reserves or profits from unreported earnings in strong years to offset the low financial performance years is the practice of income smoothing.

Smooth revenue in the financial statements for every period is a sign of a strong company, and investors and management favor this feature since it indicates strong company performance [3]. Management is responsible for creating the financial statements. As a result, agency theory claims that management knows more about the firm than the firm owner. So, managers have the freedom to take a variety of alternative measures to adjust different accounting procedures in a way that serves the interests of the business. This is what motivates managers to undertake income smoothing, whether they realize it or not [4]. To satisfy the interests of the firm owner or the manager of the firm itself, management activities to smooth out income are typically based on this. Managers use income smoothing to minimize the tax burden paid and/or raise stock prices or company value to satisfy the interests of business owners. while satisfying the requirements of management itself, meaning getting payment or keeping his job [5]. By examining income smoothing practices as one of the forms of management intervention in the accounting measurement and disclosure process and their impact on the financial performance indicators of banks, the findings of this study add to the body of knowledge about firms' income-smoothing behavior.

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As well as the significance of researching the techniques employed by management for income smoothing practices and their effect on enhancing the financial performance of banks, as well as the significance of employing the (Miller model) in identifying and diagnosing income smoothing practices.

The purpose of this study is to investigate the connection between financial success and income-smoothing strategies. This paper's main goal is to demonstrate how, in the context of earnings management, income smoothing procedures have an impact on the significance of earnings value and financial performance. On these topics, a prior study has been conducted. Yet, other studies have shown contradictory findings. The goal of this study is to increase the accuracy of achieving the best reflective outcome by evaluating a model for income smoothing screening techniques.

This paper is organized as follows: the next section is followed by a discussion of reviews of the literature to develop the research hypotheses. Next, the research method and data-collecting process are described, followed by a discussion of the empirical results. The paper ends with a conclusion.

2. LITERATURE REVIEW

2.1. INCOME SMOOTHING

According to agency theory, a firm is a legal agreement between the party in charge of managing a resource and the owner of the resource. When the principal assigns the agent to action and gives them the power to make decisions, an agency relationship may develop. [6]. in a relationship based on agency, the principal expects the agent to represent his interests. The main objective of the agent's activities, regulations, and tactical decisions is to maximize his welfare. Agents, on the other hand, might work against the interests of the principal since they have their interests. According to agency theory, management, and principals' competing interests have an impact on how earnings are managed. By relocating employees, managers may enhance their well-being. It's possible for managers to want to artificially boost company performance. The manager's position will rise through expanding the business, accelerating its growth, or improving performance. The objective is to strengthen employment security from the possibility of dismissal and secure jobs, bonuses, and pay increases [7].

The goals of management activities for income smoothing often revolve around advancing the interests of the business's manager or owner. Managers smooth out profits to lower tax liabilities and/or boost stock prices or company value to fulfill the objectives of business owners. However, to keep his job or fulfill the needs of management itself, such as receiving a salary [5]. By replacing the revenue from a poor year with that from a good year, income smoothing attempts to equalize the swings in income that are associated with particular years. Similarly to this, moving losses or spending from time to time can alter income volatility. For instance, a

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corporation may lower discretionary costs in a given year to boost current profitability but do so at the risk of raising discretionary costs in the next year [8]

The accounting and finance literature has been interested in the topic of income smoothing for many years. Most studies viewed income smoothing as "immoral" due to the "cheating" and "misleading" that went on because it was done by any firm's management. [9]. Proponents claim that one of the incentive accounting practices known as "income smoothing" is modifying and manipulating swings in a company's earnings at specific high points. There are two feelings that apply to the management of earnings. The first is more prevalent and rejects income management, but in the second case, stakeholders define such actions as management according to their preferences [10]. Actions to smooth out income are typically taken for a variety of reasons, such as lowering taxes or avoiding pressure from employees to raise salaries or pay. To draw in investors, creditors, and other outside parties, company management might also take steps to obtain the desired profit position in the income statement. This is due to the dysfunctional behavior of income smoothing, which seeks to increase investors' perceptions of the company's worth [11]

2.2. FINANCIAL PERFORMANCE

A financial ratio is a technique used to describe the connection between two types of financial data in mathematical terms. According to [12], the purpose of performance measurement is to compare business performance and management to the company's goal or target. It is also true that a company's financial standing may affect how well it operates. As a result, financial statements are crucial diagnostic tools for knowledge management. A company's financial position and operating results are stated in its financial statement at a specific period of time. According to research done by [13], firms with a habit of achieving past period earnings are more likely to engage in income-smoothing earning management methods, and as a result, earning management practices are highly correlated with company success. that there is a link directly connecting earnings management to business performance [14].

Also, it found that there is a substantial inverse association between the degree of earnings management and the performance indicators for firms [15]. As a result, the literature study offers enough proof that there is a considerable connection between effective earnings management techniques and company success. The financial performance focuses on factors directly related to financial reports and includes a variety of measures, but financial leverage and profitability ratios, such as return on assets (ROA) and return on equity, are beneficial for investors to invest in the capital market and minimize high tax payments (ROE), The two ratios that will be utilized in this study and connected to the examination of the financial statements of the performance of the firm are:

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Return on Asset (ROA)

The capacity of the firm to turn a profit from sales, total assets, and own capital is known as profitability. Users of financial statements should be highly familiar with profitability ratios since they provide information about a firm's potential to create profits. A higher profitability ratio indicates better management of the organization [16]. When the return on asset (ROA) is positive, it may be used to determine if the firm can make money from the total assets utilized in operations [17]. If the return on assets (ROA) is negative, it might indicate that the company's activities do not generate a profit (loss) [18].

Return on Equity (ROE)

According to [19] .ROE evaluates the company's shareholders' returns, including both preferred and common stockholders. ROE has evolved into one of the factors that investors use to assess a company's stock price since it directly affects a company's intrinsic worth [20]. If a corporation has no debt, both its ROA and ROE will be equal. There is a similarity between ROA and ROE. Yet, ROE will surpass ROA if the firm has financial leverage [21]. Debt will enhance the company's cash flow and its asset base [22].

3. HYPOTHESIS DEVELOPMENT

The research supports the presence of managers' incentives to smooth compensation based on agency theory. Even when it is not in the best interest of shareholders, the separation of ownership and control encourages managers to manage earnings to serve their interests [23], [24] and [25] for example, examined the impact of income smoothing and earnings quality on the financial performance of pharmaceutical companies quoted on the Nigerian Stock Exchange from 2006 to 2014. The current study focuses on the financial performance and income smoothing of banks listed on the Iraqi Stock Exchange. The profitability ratio return on assets (ROA) affects income smoothing. A high profitability ratio is one of the reasons to undertake income smoothing since it demonstrates the company's capacity to generate profits in the future, and management might manage the earnings using that knowledge [26] .This study's primary goal is to investigate how income smoothing affects the financial performance of banks that are listed on the Iraqi Stock Exchange with a focus on the relationship between profitability and financial performance. Out of the three variables studied, two hypotheses may be made based on the theory of variables and the findings of previous research, and all of the hypotheses are as follows:

H1: Income smoothing has a significant impact on the financial performance indicators, represented by the return on assets (ROA)

H2: Income smoothing has a significant impact on the financial performance indicators, represented by the return on equity (ROE)

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4. METHODOLOGY

This study is an example of explanatory research, which uses hypothesis testing to explain the causal link between variables. Identify cause-and-effect correlations between the variables by designing this research. Secondary data is what was used. The study's data are from the Bank of Iraq's 2015–2019 financial report statistics.

4.1. POPULATION AND SAMPLE

All commercial banks registered on the Iraqi Stock Exchange between 2015 and 2019 make up the study's population. Purposive sampling, which has regularly resulted in published audited financial accounts, is used to collect samples. Quantitative data and secondary data, specifically data in the form of figures obtained from observation data on financial ratios from financial statements collected from various points in time and data collected from those registered with the Iraq Stock Exchange in the years 2015 to 2020, are the types and data sources used in this research.

4.2. DEFINE OPERATIONAL VARIABLES

Income smoothing is the independent variable in this research. Several studies describe the models used to measure income smoothing practices, [27] and [28] but for this study, we picked the Miller model since it is the most recent model for doing so, is simple to use, and can easily be obtained the data needed to utilize it. to assess income-smoothing techniques. Miller (2007) introduced the ratio of the relationship between the change in working capital as an element subject to manipulation and the cash flow from operating activities as an element not subject to manipulation because current assets and liabilities are the constituent elements of working capital (current assets - current liabilities).

The dependent variable is a variable that will be tested for the effect on the independent variable. In this research, the dependent variables used are ROA (Y1) and ROE (Y2) Below are the measurements of the variables. Table 1 presents the measurement of the used variables .

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Table 1. Variable Measurement

Variables	Measurement
Income smoothing (X)	So-called the Miller Ratio, it can be used to detect manipulation of profits, as its value is zero in the absence of manipulation. If the Miller ratio differs from zero (negative or positive), this is an indication of the existence of manipulation in the profit number. Prepared according to the accrual basis. (ΔWC / CFO) t-o – (ΔWC / CFO) t-1 = 0 CA: denotes current assets, CL: denotes current liabilities WCΔ: denotes the change in net working capital, CFO: Refers to cash flow from operating activities.
ROA (Y1)	ROA is a tool for measuring a company's ability to earn profits through total asset management. The formula is net income divided by total assets [22]
ROE (Y2)	ROE is generally one of the most important variables in determining what level of capital is due. The formula is net income divided by equity.

5. DATA ANALYSIS AND DISCUSSION

This study examined the impact of income smoothing practices on bank financial performance (ROA) and (ROE) in the period 2015-2019.

Table 2. Apply Miller's model to the study sample banks

Banks	fiscal year	(ΔWC / CFO) t-o – (ΔWC / CFO) t-1 =0
Kurdistan	2015	0
	2016	20.782
	2017	-21.149
	2018	-21.149
	2019	-3
Cihan	2015	0
	2016	284
	2017	-2.743
	2018	2.825
	2019	-1.375
Erbil	2015	0
	2016	453
	2017	0.02
	2018	-363
	2019	-2.05
Mosul	2015	0
	2016	8
	2017	-3.151
	2018	4.494
	2019	3.762

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It appears in Table No. (2) that it has been confirmed that there are income smoothing practices in a sample of banks listed in the Iraq Stock Exchange through the use of the Miller model, where the decision was taken based on the consideration that if the result of the Miller ratio is not equal to zero, then the bank is considered a practitioner of smoothing Income If the result of the Miller ratio is zero, the bank is no longer a practitioner of income smoothing, and it is clear from the table that a total of the banks in the research sample practiced income smoothing during the years (2015 to 2019). Where it turned out that there is a practice of smoothing the income according to certain models, while the results differed when using other models. It is also noted in Table No. (3) The statistical analysis of the variables of the study, which include the return on assets (ROA) variable (Y1) and the return on equity (ROE) variable (Y2). According to the sample banks and during the period 2016-2017, as follows:

Table 3. Financial performance ratios of the study sample banks

Banks	fiscal year	ROA (Y1)	ROE (Y2)
Kurdistan	2016	8	13
	2017	38	68
	2018	5	11
	2019	1	0.0003
Cihan	2016	32	68
	2017	26	51
	2018	0.0006	14
	2019	0.0007	1
Erbil	2016	16	31
	2017	13	23
	2018	4	14
	2019	-7	-14
Mosul	2016	8	13
	2017	10	18
	2018	6	9
	2019	8	12

In terms of the dependent variables, it appears in Table No. (3), represented by the variable return on assets (ROA) of the Bank of Kurdistan, the highest return was achieved in 2017, and it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means that this rate varied for this The bank during the period and relatively high risk. And the average return on equity (ROE), the second variable of the Bank of Kurdistan, was the highest return achieved in 2016, and it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the high Relatively risky. Which reflects the variation in this rate during the study period.

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It reached (ROA) for Cihan Bank, it was the highest return achieved in 2016, and it was the lowest return in 2018, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the relatively high risk. And that (ROE) the second dependent variable of Cihan Bank reached and was the highest return achieved in 2016, as it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the relatively high risk. Which reflects the variation in this rate during the study period.

The (ROA) for Erbil Bank has the highest return achieved in 2016, as it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the relatively high risk, and the (ROE) was the second dependent variable for the bank in Erbil. It reached the highest return achieved in 2016, as it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the relatively high risk. Which reflects the variation in this rate during the study period.

The (ROA) for the Mosul Bank had the highest return achieved in 2018, as it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the relatively high risk. Also, (ROE), the second dependent variable of the Mosul Bank, has the highest return achieved in 2016, and it was the lowest return in 2019, and the amount of return ranged between these two years for the rest of the years, which means the variation of this rate for this bank during the period and the relatively high risk. Which reflects the variation in this rate during the study period.

5.1. DESCRIPTIVE STATISTICS

Table No. (4) shows the general average of the independent variable income smoothing (X), which amounted to (-1.2097) with a negative value, which means that the majority of banks have income reduction practices for tax evasion, and the highest value was (20.78) in the Bank of Kurdistan in 2016, as well The lowest value was (-21.15) in the Bank of Kurdistan in 2017, and the standard deviation was (9.5545) and the coefficient of variation was (91.289), and this indicates that the values of the variables in the study sample were clear.

Table 4. Analysis of variables for the study sample

	N	Minimum	Maximum	Mean	Std.	Variance
91.289	9.5545	-1.2097	20.78	-21.15	16	Income Smoothing
-.01	.04	.0106	.01210	.000	16	ROA Y1
-.01	.07	.0208	68	-14	16	ROE Y2

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The first dependent variable (Y1), which represents the rate of return on assets (ROA), was the general average at the level of the sample banks amounted to (0.0106), and the highest value was (0.01210) in Erbil Bank in 2016, which means that this indicator has recorded a decline during the study period. While it was the lowest value in the Bank of Erbil in 2019 and the standard deviation was (0.04) and the coefficient of variation was (-0.01), which increased the variance of this indicator and this confirms the high-income smoothing.

Also, the second dependent variable (Y2), which represents the rate of return on equity (ROE), was the general average at the level of the sample banks amounted to (0.0208), and the highest value was (0.068) in the Kurdistan Bank in 2017 and Cihan Bank in (2016). This means that this indicator has recorded a decline during the study period. While the lowest value was (-0.014) in the Bank of Erbil in 2019, the standard deviation was (0.07), and the coefficient of variation was (-0.01), which increased the variation in this indicator, and this confirms the high smoothing of income.

5.2. HYPOTHESES TESTING

Table No. (5) Shows the effect of the independent variable (income smoothing practices) on the dependent variables (financial performance indicators) through the following:

Table 5. Results of regression analysis

Variables	**Dependent Variable ROA (Y1)**					
	R	R^2	T test	B	A	SIG
Income smoothing (X)	2	14.7	704	2	3.83	0.50
	Dependent Variable ROE (Y2)					
Income smoothing (X)	1	18.24	741	1	4.27	0.55

The dependent variable ROA: The slope of the correlation coefficient (R) is (0.50) and the coefficient (R2) reached (3.83), which means that (4%) of the change in return on assets was caused by the variable income smoothing practices during the research period. The calculated (t test) value of (** 0.002) is supported, which means that the relationship is significant in the model at a confidence level of (0.002). The values of (B), which was (0.704), the value of the slope value in the model as in Table No. (5), and this project came in the first example, and this project was in the preliminary work. On this basis, the hypothesis was accepted, which states that there is a statistically significant effect of smoothing income on the return on assets in the study sample.

The dependent variable ROE: as the correlation coefficient (R) reached (0.55) and the coefficient of determination (R2) reached (4.27), which means that (4%) of the change in return on equity was caused by the independent variable income smoothing practices during the period The research supports the calculated (t test) value of

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(0.001), which means that the relationship is significant in the model at a confidence level of (0.001). As for the values of (B), which were (0.741), it may indicate that the change in the independent variable (income smoothing practices) by one unit is reflected by the amount of these values on the return on equity. This means the amount of slope in the model as in Table No. (5). The value of (A), which amounted to (18.24), refers to the value of the dependent variable when the value of the independent variable is equal to zero. This effect came in line with the propositions of applying income smoothing practices and their impact on the return on equity. On this basis, the first hypothesis was accepted, which states that “there is a statistically significant effect of smoothing the income on the return on equity in the study sample banks”.

6. CONCLUSION

This study aims to investigate how income smoothing methods affect financial performance measures and how income smoothing functions as a mediator between these indicators in Iraqi public banks. It has been demonstrated that income smoothing improves the quality of wages. The quality of financial reports and earnings reports can be raised by income smoothing. The report's quality increases with decreasing income volatility. The study's findings revealed that revenue smoothing procedures exist in the banks that made up the study sample, and their origin may be traced to the conflicting interests of the parties to the agency represented by management and shareholders.

The management and stockholders are the parties to the agency that are represented. From the values of the standard deviation, the coefficient of difference, the maximum value, and the lowest value, it became clear from the analysis that there is a disparity in the values of the independent and dependent variables. The study's findings demonstrate that the income smoothing practices variable has a significant and statistically significant impact on the dependent variables (indicators of financial ratios) which the (T-test) value has demonstrated.

Profitability is a crucial indicator of a bank's health and has the power to sway the choices of investors. As the informational value of returns on assets controlled by banks is crucial to luring investors to invest in banks, the test results reveal a substantial positive trend, indicating that management would struggle to manage profits amid the deteriorating profitability of banks. This will increase the motivation for banks with lower levels of profitability to level out their income, and consistent revenue values can also satisfy a bank's top management.

The study's limits on the availability of data between 2015 and 2019 have led to a decrease in the sample's number of banks. When doing comparable research on Iraqi commercial banks, more pertinent data can be found by expanding the sample size by including more banks. Although the Iraqi Stock Exchange produced a decent summary report, one of the drawbacks of this study is the lack and incompleteness of

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information connected to the financial reports of the various business units. This may limit subsequent investigation in greater depth on income smoothing for enterprises in other industries.

Factors analyzed and years will be enhanced to allow a realistic picture of income smoothing on the Private Commercial Banks. Other financial ratios may be employed in future publications to analyze the variables influencing income smoothing. Hence, the performance of each type of business can be analyzed in more depth. For instance, various financial ratios other than (ROA) and (ROE).

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