

## The Effect of earnings management with the Emphasis on the Role of Accruals on the Return of stock of the companies listed in Tehran stock exchange

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**Abstract:** The main objective of this study is to investigate the effect of earnings management with the emphasis on the role of accruals on the return of stock of the companies listed in Tehran stock exchange. The measuring of the earnings management in Return of stock is a very important to stockholders and investors. The evaluation of the efficacy of the investors of a company (performance of company and efficiency in the stock market) depends on choosing an appropriate measuring model for earnings management. Therefore this research with the purpose of presenting and comparing three models of measuring earnings management investigate the information content of stock market and the ability to predict the managers' behaviors. One of the main scales for the decision making in exchange is Return of stock which has information content alone. As regards the reaction of the capital market to the published information finally reflects in Return of stock so the efficacy of company earnings management on Return of stock for 116 samples from 2002 to 2012 was calculated through Panel data analysis method and other related data analysis tests. In this study the total accruals and discretionary and non-discretionary accruals components as independent variables and return of stock as dependent variables.

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**Key words:** earnings management, Return of stock, total accruals, discretionary and non-discretionary accruals

### Introduction

Part of the effective variables on Return of stock of companies is because of financial information which is compiled through accounting system. The most important proceedings in the area of investment are optimal allocation of resources. On the other hand, investors always follow earning utmost return with the use of financial resources which are provided. Since the prediction of Return of stock is one of the most important issues for investors in stock markets, Figures that can assist investors in this area are vital and can provide useful and related information for investors (Foroughi & Hamidian, 2010). Since the investors' attention towards earnings figures has been increased and high focus of users on profit, attention to the quality of it has been increased as well and accrual accounting is considered as an indicator of earnings quality when accounting earning becomes higher than the company's incoming cash flow, the existed extra has been accumulated through accruals. These stocks have less return because these extras have often been created by manager's naughtiness. Of course, this doesn't mean that accruals are invalid. Most of the times, these items are indicators of opportunity in future growths or good performance of company in past. Since these items are manipulated more than cash items by managers, it is expected that market gives less weight to them (Mehrani & Mosavi, 2010). Now a question asked on what effects the earnings management has on company's Return of

stock? One of the important issues in the investigation of effective factors on Return of stock. One of the studies on Return of stock is Sloan's research (1996). His results show that accruals has negative significant relation with Return of stock. In today's literature, this negative relation is called abnormal accruals (Foroughi & Hamidian, 2010). Therefore the purpose of this study is to specify the effect of earnings management with emphasis on the role of accruals on return of stock.

### Theoretical basics

Since the only and the most important information instrument of financial information users are financial Statements of each company so that they can make some decisions; if this information is not true, all people will incur losses. Because the information is not equally available to all users, between managers and investors, information asymmetry is created. Information asymmetry is a situation in which managers in comparison to investors have more unrevealed information about company's operations the various aspects in future. This results in that managers have motivation and opportunity for earnings management.

Managers manage accrual financial statements because accruals are more flexible. Estimates such as service life of fixed assets, ability of debt collection, discount rate of pension obligations and other end of the year accruals which adjust the reported profit are

traditional instruments which are used by managers during years and they are not directly observable (Moradi, et al, 2008). Under such circumstances, directors by use of accruals may overstate company's profit temporarily in this way they can trade the company's stock price over the real value. Finally this will cause increase in return of stock. Due to the fact that managers must return accruals in later periods, possibility of reduction with poor performance in later periods increases. Because for those companies with poor performance that implement earnings management, the cash flows may not be enough to hide the returned accruals (Ebrahimi Kordlor & Daryani, 2006).

Generally accruals are divided into two parts: Accruals due to the growth of companies' activities (non-discretionary accruals) Accruals due to efficacy of management of companies' operating assets (discretionary accruals)

Since in this study the effect of earnings management on return on Return of stock of companies Listed in Tehran Stock Exchange has been investigated, it has been tried to inform the companies' financial statements users that sometimes profit is managed and in this way the reported profit will be different from the true profit; this issue may cause increase in stocks price and return of stock consequently. In this condition, investors must make decisions more precisely and act more conservatively.

### Research history

Studies like Sloan (1996) show that there is a relation between accruals and return of stock and investors can use accruals information to get hand on extra returns. Therefore recognition of features of accruals as a part of accounting profit is necessary (Froghi & Hamidian, 2010). Richardson, et al (2001) while studying the relation between accruals and return of stock, observed the negative relation between rate of accruals and return of stock from 1997 to 1998. the result of their other research made clear that professional investors do not include low quality of profit in their process on making decisions. Chan, et al (2006) in their research investigated the relation of accruals and future return of stock and came to this result that companies with high accruals, in the later period of financial report, their return of stock decreases. Chan and Chan (2006) in another research study the relation between accruals and future return of stock with considering operating cash flows and found out that accruals after considering operating cash flows do not depend on return of stock and this finding shows that a part of accruals are related to cash flows which leads to anomalous accruals. David, et al (2009) investigated the relation between accruals, cash flow and return of stock. Accruals have strong

positive relation with return of stock and negative relation with cash flows prediction. In addition, creativity and innovation in accruals have negative relation with return of stock and innovation in cash flows with return of stock has positive relation. These findings show that innovation in accruals and cash flows include information about change in discount rate or earnings management in reaction to vast market of money value. Juris, et al (2011) did research on the relation between accruals and performance of return of stock after financing activity. This research investigated the relation between foreign financing anomalies with accruals anomalies and working capital accruals and long-term accruals separately. They understood that foreign financing and financing securities only have excellent return of stock. Portfolio analysis at the firm level regressions show that the external financing ability in predicting future return after controlling working capital accruals remains and it is ineffective. Thus this ability significantly decreases after controlling long-term accruals. Samaei (2003) studied the relation between smoothing profit and adjusting return of stock base on a risk. In his research, he declared that companies that have smoothed profit achieved more abnormal return than companies that did not smooth their profit. Ghaemi, et al (2003) examined the effect of smoothing profit on return of stock of those companies listed in Tehran Stock Exchange. Results show that there is no significant difference in abnormal return of stock between smoother companies and non-smoother ones. Khajoei and Nazemi (2005) studied the relation between quality of profit and return on Return of stock with emphasizing on accruals in Tehran Stock Exchange. 96 companies from 1998 to 2003 were studied. Findings clarify that companies' average return of stock are not under effect of amount of accruals and its components. In other words, it can be accepted that there is a significant difference between the companies' average return of stock that accruals report them the most and the least. Babajani and Yancheshmeh (2011) examined the effect of reliability of accruals on return of stock. Among the accepted companies in Tehran Stock Exchange from 2001 to 2008, 141 companies were selected. Results indicate that there is no strong negative relation between those current period profit accruals with low reliability and future return of stock. Dastgir and Rastegar (2011) investigated the relation between quality of profit (profit stability), accrual size and return of stock with quality of accruals. In this way 95 companies out of accepted companies in Tehran Stock Exchange were studied. Findings demonstrate that from 2000 to 2007 besides direct relation between quality of profit (Profit stability) and quality of accruals; with reduction of

quality of accruals and increase of accruals, Return of stock increases.

### Purpose of Study

The main objective of this study is what effects do earnings management with emphasis on the role accruals have on the companies' Return of stock in Tehran Stock Exchange?

### Hypotheses

In this study, Modified Jones model is used for measuring earnings management and this model needs division of accruals to discretionary and non-discretionary. Therefore, this study has three hypotheses:

Hypothesis 1: earnings management with emphasis on the role of total accruals has a significant effect on company Return of stock.

Hypothesis 2: earnings management with emphasis on the role of discretionary accruals has a significant effect on company Return of stock.

Hypothesis 3: earnings management with emphasis on the role of non-discretionary accruals has a significant effect on company Return of stock.

### Research Variables

Dependent variables:

Return of stock: the simple Return of stock is changes in price during a period divided by stock price at the beginning of that period. In other words, it is calculated via return of investing in normal stock, in a given period, with respect to price at the first and last of a period and benefits of ownership. The benefits of ownership in periods that company holds assembly are for the stockholders and in periods that assembly is not held is zero. And in this research company Return of stock is considered as dependent variable.

Independent Variables

earnings management: D, George (1999) defined earnings management as kind of artificial

manipulation of profit by manager to achieve expected the level of profit for some special decisions like Analysts' prediction or estimate of previous process of profits to predict future profits (Mashyekhi, et al, 2005). In this study company earnings management was calculated through Jones modified model (1995).

Discretionary accruals: those earnings and costs which are not required entering or withdrawing cash form the company and a profit-unit management can base on accounting tools according to accounting framework and standards increases or decreases them and in this regard show a profit-unit profit lower or higher than what it really is. Such as Depreciation, depreciable assets and doubtful debts expense. In this study discretionary accruals are considered as independent variables.

Non-discretionary accruals: those earnings and costs which are not required entering or withdrawing cash into or form the company but a profit-unit management cannot manipulate the profit and affect the profit of a profit-unit base on his own intentions. In this study non-discretionary accruals are considered as independent variables.

Company size: It equals the natural logarithm of total assets

Moses (1987) believes that the greater the size a company, the more motivated the company directors will be to manage profit. Due to enlargement of the companies, the responsibility of directors' accountability to stockholders will be expanded. Byte et al (2002) came to this conclusion that larger companies in comparison with smaller companies use earnings management more. Matsumoto (2002), Baritone and Simko (2002) and Frankel et al (2002) believe that the greater the size of a company, probability of accumulating predetermined artificial index increases.

### Measuring Models of this Research Variables

The following models were formulated of this research for testing of the hypotheses:

$$RET_t = \beta_0 + \beta_1 Size + \beta_2 BVMV_t + \beta_3 TAC_t + \varepsilon_t \quad (1)$$

$$RET_t = \beta_0 + \beta_1 Size + \beta_2 BVMV_t + \beta_3 DAC_t + \varepsilon_t \quad (2)$$

$$RET_t = \beta_0 + \beta_1 Size + \beta_2 BVMV_t + \beta_3 NDAC_t + \varepsilon_t \quad (3)$$

### Population and statistical sample

Sample size of this study is all the companies listed in Tehran Stock Exchange from the beginning of 2002 to 2011 and they were active. Due to largeness of population and some inconsistencies between population members, sampling was done

base on the following conditions and via systematic deletion method.

1. Companies are accepted before 2002 in Tehran Stock Exchange
2. The company is one of the financial intermediation companies.

3. End of financial year end is March.
4. Company has no changes in financial year during the study.
5. Company does not have suspension in trading more than six months during the study.
6. Needed information about these companies is accessible during research process.

Based on the mentioned conditions, 116 companies were selected.

#### Method of Data Collection

For collecting data about the independent variable from audited financial statements contained in the databases and internet website of the Tehran Stock Exchange as well as data related to dependent variable which have been extracted to NovinRahavard Software.

#### Method of Data Analysis

After collecting data which are needed for this study, selecting appropriate instruments for

calculating and analyzing related information to variables is of great importance. In this research, after collecting data from aforementioned sources, preparing variables via Excel software and doing needed calculation for achieving needed variables of this study, for calculating regression model through collected data and doing other analysis by using statistical method like mean, standard deviation, multivariate regression coefficient of determination  $R^2$  and F for investigating the significance of t statistical model in order to examine the significance of Coefficients, Eviews6 is used.

#### Testing Hypotheses and Research Findings

##### Descriptive data

In this study, first raw data was used to compute research variables and then research descriptive data including mean, median, maximum, minimum and standard deviation were computed and presented in the table 1.

Table 1. Research variables descriptive data

standard deviation	minimum	maximum	median	Mean	Abbreviation	Variables
0.29	79.52 -	734.14	12.32	33.18	RET	Return on equity
1.23	2.7	7.99	5.54	5.6	SIZE	SIZE
0.21	0.01	5.55	0.46	0.58	BVMV	Book value to market
0.64	1.86 -	23.62	0.19	0.43	TAC	Total accruals
0.33	0.465 -	5.905	0.0475	0.108175	DAC	Discretionary accruals
1.89	1.39 -	17.71	0.14	0.32	NDAC	Non-discretionary accruals

#### Dependent variables: RET

Table 1 shows that return on equity changes from -79.52 to 734.14, total accruals from -1.86 to 23.62, discretionary accruals -0.465 to 5.905 and non-discretionary accruals from -1.39 to 17.71. Standard deviation of non-discretionary accruals is more than standard deviation of total accruals and discretionary accruals. Therefore scattering of non-discretionary accruals shows more around mean.

##### Recognition test of appropriate panel data

In this study, number of observation for each stage is 116 observations and it includes a period of 10 years. In other words, on the one hand the relation of dependent and independent variables among 116 different companies and on the other hand, from 2002 to 2011 are tested. So for getting better results, the data panel method was used and for estimating the regression models, related data to 116 companies and period of 10 years were combined.

In using panel data, different models are used for testing hypotheses. These models are fixed effect model, random effect model and panel data model (pooled). Also different tests for determining appropriate models for data are existed like Chow t and Housman tests.

Models 1, 2 and three were used to test hypotheses 1, 2 and 3 respectably. In Chow test, if acquired data from the test are significant, Null hypothesis will be rejected and fixed effect model will be accepted. In the case that data is not significant, panel data model is used to test the hypothesis. In Housman test also, if acquired data from Housman testis significant, null hypothesis will be rejected and fixed effect model will be accepted. In the case that acquired data is insignificant, random effect model will be used to test the hypotheses. Results from Chow test are presented in table 2.

Table 2. Chow Test Results

Test Results	p-value	Chow Test Data	Test Model
Housman test <i>Panel data</i>	0	15.52	Model 1
Housman test <i>Panel data</i>	0	15.51	Model 2
Housman test <i>Panel data</i>	0	15.38	Model 3

Table 3. Housman Test Results

Test Results	p-value	Housman Test Data	Test Model
Random Effects Models	1	0	Model 1
Random Effects Models	1	0	Model 2
Random Effects Models	1	0	Model 3

For models 1, 2 and 3, the results of Chow test does not support the null hypothesis on the similarity of intercept in all the periods. Therefore the panel model (fixed or random effects) should be used to test the hypotheses. For selecting an appropriate model between fixed or random effects models, Housman test was used and the results are shown in table.3.

Results of Housman test for models 1, 2 and 3 show that this test hypothesis is supported. Therefore random effects method for estimating models is a more appropriate option. So for determining the type of the results of hypotheses testing are as follows.

#### Results of First Hypothesis Testing

The first hypothesis examines the effect of earnings management with emphasis on the role total accruals on Return of stock.

The assumptions of this hypothesis are as follows: H0: earnings management with emphasis on discretionary accruals does not have significant effect on Return of stock; H1: earnings management with emphasis on discretionary accruals has significant effect on Return of stock.

Table 4. First Hypothesis Model Testing Results

$$RET_i = \beta_0 + \beta_1 Size + \beta_2 BVMV_i + \beta_3 TAC_i + \varepsilon_i$$

sig.	t value	ratio	Factor
0.2293	1.202838	3.140116	Company size
0.000	5.395943 -	26.96848 -	Book value to market value
0.5247	0.636272 -	1.480532 -	total accruals
0.1492	1.443416	21.04077	fix
0.045294			coefficient of determination
0.042816			Adjusted coefficient of determination
18.28134			f value
0.0000			sig

Dependent-variables:-RET In this hypothesis dependent variable is Return of stock and independent variable is total accruals. As it is shown in the table.4, F value is % 99 significant. Since computed p- value was less than % 5. In this way research model was significant and independent variables in whole can explain dependent variable. Adjusted coefficient of determination (adjusted R2) computed through testing model was 0.042816. This figure shows that approximately 4 percent of changes in dependent variable; sample companies return on equity is explained by independent and control variables which are existed in the model. For examining its lack of correlation errors caused by model, Durbin-Watson test was used. 2 is appropriate for lack correlation. If it is 1.5 to 2.5, correlation will be rejected in model error figures. Since the value of Durbin-Watson which is computed through research model was 1.94, the existence of correlation in model error figures was rejected. After examining the significance of model, hypotheses analysis and significance of correlations will be investigated. Related values for determining the significance of correlation is static t value. In this

test, in addition to determining the significance of correlation, the effect direction of dependent variable is clarified. According to the presented results in table.4, t value is related to first hypothesis independent variable and significance level (p-value) is -0.636272 and 0.5247 accordingly. Due to the considered p-value for this research was 0.05, so the earnings management with emphasis on the role of total accruals has no effects on the company return in Return of stock. Therefore, the first hypothesis of the research is rejected.

#### Correlation Coefficients

Examining the correlation is statistical instrument that by which it is possible to measure the degree that one variable to another variable has linear relation. Correlation relation between this researches variables are shown in table.5. Correlation Coefficient between the independent variables of this research should not be high. Because the correlation between independent variables in one model flaws the regression results. If the intensity of correlation is above % 50, independent variables do not have correlation.

Table.5 Correlation Coefficients between Research Variables

	RET	SIZE	BVMV	TAC
RET	1			
SIZE	-0.000796	1		
BVMV	0.224946 -	0.098863	1	
TAC	-0.041837	0.094782	0.032735 -	1

It can be concluded that there is no correlation between independent variables.

Table 6. Second Hypothesis Model Testing Results

$$RET_t = \beta_0 + \beta_1 Size + \beta_2 BVMV_t + \beta_3 DAC_t + \varepsilon_t$$

sig.	t value	ratio	Factor
0.2293	1.202838	3.140116	Company size
0.0000	5.395943 -	26.96848 -	Book value to market value
0.5248	0.636272 -	5.922128 -	total accruals
0.1492	1.443416	21.04077	fix
0.045294			coefficient of determination
0.042816			Adjusted coefficient of determination
18.28134			f value
0			sig
1.945276			Durbin-Watson

Dependent-variables:-RET

In this hypothesis dependent variable is Return of stock and independent variable is total accruals. As it is shown in the table.6, F value is % 99 significant. Since computed p- value was less than % 5. In this way research model was significant and independent variables in whole can explain dependent variable. Adjusted coefficient of determination (adjusted R2) computed through testing model was 0.045294. This figure shows that approximately 4 percent of changes in dependent variable; sample companies return on equity is explained by independent and control variables which are existed in the model. For examining its lack of correlation errors caused by model, Durbin-Watson test was used. 2 is appropriate for lack correlation. If it is 1.5 to 2.5, correlation will be rejected in model error figures. Since the value of Durbin-Watson which is computed through research model was 1.94, the existence of correlation in model error figures was rejected. After examining the significance of model, hypotheses analysis and significance of correlations will be investigated. Related values for determining the significance of

### Second Hypothesis Testing Results

Second hypothesis of this study is examining the effect of the earnings management with emphasis on the role of discretionary accruals on Return of stock.

The assumptions of this hypothesis are as follows: H0: earnings management with emphasis on total accruals does not have significant effect on Return of stock.

H1: earnings management with emphasis on total accruals has significant effect on Return of stock.

correlation is static t value. In this test, in addition to determining the significance of correlation, the effect direction of dependent variable is clarified. According to the presented results in table.6, t value is related to first hypothesis independent variable and significance level (p-value) is -0.636272 and 0.5247 accordingly. Due to the considered p-value for this research was 0.05, so the earnings management with emphasis on the role of total accruals has no effects on the company Return of stock. Therefore, the second hypothesis of the research is rejected.

### Third Hypothesis Testing Results

Second hypothesis of this study is examining the effect of the earnings management with emphasis on the role of non-discretionary accruals on Return of stock.

The assumptions of this hypothesis are as follows: H0: earnings management with emphasis on non-discretionary accruals does not have significant effect on Return of stock.

H1: earnings management with emphasis on non-discretionary accruals has significant effect on Return of stock.

Table 7. Third Hypothesis Model Testing Results  
 $RET_i = \beta_0 + \beta_1 Size + \beta_2 BVMV_i + \beta_3 NDAC_i + \varepsilon_i$

sig.	t value	ratio	Factor
0.2293	1.202838	3.140116	Company size
0.0000	5.395943 -	26.96848 -	Book value to market value
0.5248	0.636272 -	5.922128 -	total accruals
0.1492	1.443416	21.04077	fix
0.045294			coefficient of determination
0.042816			Adjusted coefficient of determination
18.28134			f value
0.0000			sig
1.945276			Durbin-Watson

Dependent-variables:-RET In this hypothesis dependent variable is Return of stock and independent variable is total accruals. As it is shown in the table.7, F value is % 99 significant. Since computed p- value was less than % 5. In this way research model was significant and independent variables in whole can explain dependent variable. Adjusted coefficient of determination (adjusted R2) computed through testing model was 0.042816. This figure shows that approximately 4 percent of changes in dependent variable; sample companies return on equity is explained by independent and control variables which are existed in the model. For examining its lack of correlation errors caused by model, Durbin-Watson test was used. 2 is appropriate for lack correlation. If it is 1.5 to 2.5, correlation will be rejected in model error figures. Since the value of Durbin-Watson which is computed through research model was 1.94, the existence of correlation in model error figures was rejected. After examining the significance of model, hypotheses analysis and significance of correlations will be investigated. Related values for determining the significance of correlation is static t value. In this test, in addition to determining the significance of correlation, the effect direction of dependent variable is clarified. According to the presented results in table.6, t value is related to first hypothesis independent variable and significance level (p-value) is -0.636272 and 0.5247 accordingly. Due to the considered p-value for this research was 0.05, so the earnings management with emphasis on the role of total accruals has no effects on the company Return of stock. Therefore, the second hypothesis of the research is rejected.

### Conclusion

The main objective of accrual accounting is helping investors to evaluate the economic performance of a business unit in one period through using the accounting principles such as compliance and recognition of income. Accounting profit is

composed of accrual of cash and accrual components. Since accruals have timing and compliance in recognition of cash problems, they are more important in company performance evaluation to a large extent. In this study, based on the three main models and three hypotheses, the effect of earnings management with emphasis on the role of accruals on the return on equity was examined. For doing so, accruals through Jones adjusted model for research period was computed and it was considered as earnings management scale. Acquired results from data analysis showed that in the companies under study, accruals for achieving investors' needed return did not get to an outstanding success. One of the reasons for this, accruals are open to managers' manipulation and error of measurement and estimation, so they have low reliability.

### Practical Suggestions:

1. Since earnings management with emphasis on the role of accruals on Return of stock does not have significant effect, findings of this research suggest to the companies that they do not consider return on equity as a criterion for evaluating companies performance.

2. Since the sum of capital raise through share issue and debt is equal to total increase assets and increase in assets points to company size and studied companies could not acquire needed return for their investors; therefore findings of this research suggest to the companies that they use other methods to create necessary changes in size.

3. As the results of this research indicated in these industries earnings management with emphasis on the role of Return of stock does not have a significant effect and this means that the type of industry affects accruals, therefore findings of this research suggest to investors, analyzers, and other beneficiaries in their analysis consider the type of industry.

### Recommendation for Further Studies

1. In future studies other models except Jones adjusted model can be used to estimate Discretionary and non-discretionary accruals.
2. In future research, more control variables for enhancement of explanatory power of the dependent variable can be used.
3. It is recommended that testing hypotheses of this research is done for longer periods and also for different group industries in Tehran Stock Exchange separately.

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