The Effect of the Management of the Pure Profit and Commitment Items Profit on Investment Choices

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Abstract

The purpose of the present research is to explore the effect of management of the pure profit and the commitment items profit on investment choices in Tehran stock broking. A model based on optional commitment items of Jones is used in the measurement of profit managing. The revenue of assets is also applied as an index of firm operation. Moreover, the effect of some variables of firms such as measure of accountant, independency of board of directors, institutional ownership and measure of firm on the relationship between profit managing and revenue of assets is evaluated. The function of analysis of mixed data by using a pattern including 100 firms in Tehran stockbroking from 2009 to 2012 was used. The research results showed that there is a meaningful negative relationship between optional commitment items and revenues of assets. Concerning several other tested variables, dependency of board of directors and the institutional ownership have a meaningful positive effect on relationship between profit management and revenue of assets, and measure of firm has a meaningful negative effect on the relationship.

Keywords: profit management, revenue of assets, optional commitment items, accountant measure, dependency of board of directors, institutional ownership

Introduction

The role of the information about economic choices is so vital, and investors are not able to recognize the opportunities and dangers of an investment without enough information. In order to information to be efficient on account users' choices, they have to be available in proper time. Since the financial information is too susceptible to pass of time, maybe it would lose its value and efficiency in decision making by elapse of time (Mahdavi & Jamalian Pour, 2011).

The profit reported by firms is considered as one of the important criterion in selection, function evaluation and economic agency evaluation that is usually used by many different users like stock shareholders, investors, stock agents. Since calculation of economic agent profit is affected by methods of accounting estimation, and providing of inventory is the duty of trading unit management. According to different reasons, the management may take the measure of profit managing.

The investors basically invest their cash funds in common stocks of profit-producing in order to gain more profit and more cashes. According to agency theory, two groups of owners and managers are corresponding to each other. Managers apply their options in selection of accounting methodology (Dechow & Ge, 2006).

Accounting standards let lots of trades to be registered with one or many different ways. For example, among several method of account fund evaluation, the method of calculation of depreciation of fixed assets, or the profit recognition methods for long term contracts can be used, and then can be changed. Activities like scheduling records of sale, value reduction of account
stocks and facilities, preparing and accomplishment of facilities and many more are all done by management (Habib, 2004).

**Statement of the problem**

Concerning the dissimilarity of the existing information between directors of a firm or beneficiary parties in activities of firm, the investment process is based on trust and reliance. In this study, the problem has been taken into consideration by setting a research about the role of trust in exposing the corresponding effect of the used method for profit management and also the effect of motivations of the directors for profit management on evaluation of investors in regard to the future operation of firm and the risk and tendency to investment in firm.

According to the predictions based on the trust in preset study, when managers use the methods of profit management based on commitment items vs. methods based on pure profit for the sake of investors' interest, the investors' view to the setting of firm would become more negative. In addition to these analyses, there are some evidences in this study that support the given explanation about investors' trust, and distinguish findings gained from this research and former studies about evaluation of investors related to the followed cash flows. Entirely, this study shows how to use accounting choices related to common cash flows by managers (like considering the research and development as stock vs. considering these costs as current costs) for finding a profit index or criterion that can effect on investors' tendency toward investment in firm. Therefore, regarding the given discussions, the main research question would be as following:

Whether the existing profit management based on commitment items vs. pure profit management can effect on investors' choices?

**Background of study**

Karami et al. (2012) investigated the existence of relationship between pure profit management and account profit management. The findings showed that when managers found out that the reported profit is smaller than the anticipated profit level, they determined optimization levels for both methods of pure profit management and account profit management and made the decision about manipulating the real activities and commitment items simultaneously. They used these two methods as supplementary to each other, and they considered perceptions and results from others in decisions related to every methods.

Mojtahed zade and Sad abadi (2013) studied the relationship of profit management and investment opportunities in their research by emphasizing on the ownership focus. Profit managing is measured by using the unmixed criterion of uncommon commitment items from Ball and Shivakumar's model (2006-2008); investment opportunities are determined as entity variable by the aim of geometric development of business wealth value, ratio of business wealth value to its official value and agency analysis. The right of cash flow and the right of control are considered as a criterion for ownership focus. The results from the research showed that there is not a meaningful relationship between geometric development of wealth and profit management. However, there is a meaningful relationship between the high ratio of business wealth value to its official value and agency analysis of both development index and profit management. Moreover, the ownership focus has not any effective role on the relationship of profit management and investment opportunities.

Dastgir and Qani zade (2014) studied the effect of the quality of commitment items on the rates of long-term investments in accepted firms in Tehran stock broking in 123 firms. The research results indicated a meaningful and positive relationship between the commitment items and long-term investments; but non-meaningful and negative relationship between profit quality and long-term investments; and by increasing the commitment items (reduction of profit quality), the long-term investments of the mentioned firms is enhanced.

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Pourheidari et al. (2014) studied the effect of profit management on investment manners of firms. In order to evaluate the real management of profit, three variables of uncommon cash flows caused by operational activities, optional uncommon costs and product uncommon costs were used. The result showed a meaningful relationship between uncommon cash flow caused by operational activities and optional uncommon costs with unprofitable investments. It means that the more exertion in the ground of the real management of profit, the more unprofitable investment of firms.

Subramanian (1996) found out that the optional commitment items have a powerful positive relationship with high future profit. According to Subramanian's view this relationship indicates the ability of optional commitment items in transferring information to public, in relation to the power of future profit for firm.

Burgstahler and Dichev (1997) found that the managers of firms use the profit management to avoid reporting the loss or reduction of incomes.

Balsam et al. (2002) discovered that market show quicker reaction to the manners of professional and skillful investors (institutional investors) than unskillful investors. They inducted that skillful investors have access to the other information sources and also meantime information, and therefore are very capable in dissection of the profit to optional and non-optional parts.

Cornett et al. (2008) investigated this subject that when evaluated operation is regulated in order to eliminate the effect of profit management, do the firm authority and reward plans again effect on function? Their findings showed that when optional commitment items are eliminated from the measured profit, the positive effect of variables of firm authority on function of firm is doubled.

**Research Hypotheses**

H1: There is a meaningful relationship between optional commitment items and future profit-taking.

H2: The effect of optional commitment items on future profit-taking in firms that are under audit of big institute is greater.

H3: The high ratio of uncharged members of board of directors increases the effect of optional commitment items on future profit-taking.

H4: The high ratio of institutional ownership increases the effect of optional commitment items on future profit-taking.

H5: The effect of optional commitment items on future profit-taking is much more in big firms than small ones.

**Statistical Population of the Research**

The statistical population of the present research includes accepted firms in Tehran Stock Broking from the beginning of 2009 to the end of 2013.

All the accepted active firms in Tehran stock broking at the end of 2013 were about 478 firms that were considered as the statistical population of the present research. However, because of the lack of data about all mentioned firms and possibility of selection of statistical entity, the number of mentioned firms is regulated by exertion of some limitations and conditions.

a. For comparability of data and variables, the firms that their financial year ending were not on final days of month were eliminated.

b. Banks and financial institutes and financial investment firms were eliminated because of the different quality of their activities from other trading units.

c. The firms that did not have all the necessary data for calculation of variables during the period object to study were eliminated.

d. The firms should have been accepted in Tehran stock broking before 2009, and they should not have any change in the financial year during the process of research.
By investigating the accepted firms in Tehran stock broking, and exertion of the following limitations and conditions, 100 firms (about 600 years-firm) were chosen for estimating models and testing research hypotheses. Figure (1) shows the way of selection of 100 firms, which are standard members. The mentioned crafts and the number of accepted standard firms selected in every crafts are exposed in figure (2).

Table 1. Firm selection data

<table>
<thead>
<tr>
<th>Explanation</th>
<th>Firm number</th>
</tr>
</thead>
<tbody>
<tr>
<td>The number of all the firms joint in Tehran stock broking</td>
<td>478</td>
</tr>
<tr>
<td>Those which did not keep their membership in stock broking during ten years period</td>
<td>92</td>
</tr>
<tr>
<td>Those firms that provide financial, investment and insurance aids</td>
<td>116</td>
</tr>
<tr>
<td>Firms that have not financial year ending in final day of month</td>
<td>86</td>
</tr>
<tr>
<td>When data of the research variables for considered firms are not available</td>
<td>84</td>
</tr>
<tr>
<td>Number of all the eliminated firms</td>
<td>378</td>
</tr>
<tr>
<td>the number of all the standard members (firms)</td>
<td>100</td>
</tr>
</tbody>
</table>

Table 2. Number of standard firms in every craft

<table>
<thead>
<tr>
<th>Firm number</th>
<th>Crafts</th>
<th>rows</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>automobile and manufacturing parts</td>
<td>1</td>
</tr>
<tr>
<td>9</td>
<td>constitutional metals</td>
<td>2</td>
</tr>
<tr>
<td>19</td>
<td>Cement &amp; chalk &amp; lime</td>
<td>3</td>
</tr>
<tr>
<td>9</td>
<td>Food products</td>
<td>4</td>
</tr>
<tr>
<td>15</td>
<td>Plants &amp; equipment</td>
<td>5</td>
</tr>
<tr>
<td>21</td>
<td>Chemical and medical products</td>
<td>6</td>
</tr>
<tr>
<td>8</td>
<td>Medical products</td>
<td>7</td>
</tr>
<tr>
<td>7</td>
<td>Mineral &amp; non-metallic products</td>
<td>8</td>
</tr>
<tr>
<td>100</td>
<td>Total amount</td>
<td></td>
</tr>
</tbody>
</table>

Variables and models of the study

The first step in research hypotheses testing is to make a precise and suitable definition for variables that make possible the measurement of features of research. Based on their roles in the research, variables are divided into two groups of dependent and independent. Independent or explanatory variables are such variables that can show the effect of economic decisions in behavioral researches. An independent variable which is called sometimes as introvert or motive variable is the theoretical or experimental reason of alternation in the target (Azar & Momeni, 2009). The way of measurement of each research variable and the hypotheses testing model is as follow:

a. Profit management – optional commitment items

The profit management that is used as a research entity variable will be measured by the regulated model of Jones (1995). Hanven et al. (2010) also used this criterion for measuring the profit management. This model indicates the optional commitment items. Accounting profit includes two parts of cash items and commitment items and the commitment items also are divided into the optional commitment items and non-optional commitment items. The management uses the profit commitment items for manipulating the profit, because these items in contrary to cash items are under the impression of accounting methods and trade timing. The profit optional commitment items are more inclined to be manipulated by management. The final measure for the profit management will be results of estimating the model.

In which:

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DiscAcc\textsubscript{i,t} ; the optional commitment items in year t for the firm i
TA\textsubscript{i,t} ; the total commitment numbers in year t for firm i
Receivables\textsubscript{i,t} ; the received accounts in year t for firm i
PPE\textsubscript{i,t} ; the total fixed assets (property, plants, equipment) in year t for firm i
Assets\textsubscript{i, t-1} ; the total assets in year t-1 for firm i

\textbf{b. Profit-taking index – revenue of assets}

In this research, the revenue of assets is used as profit-taking index. This index is calculated by the ratio of pure profit to the total amount of assets.

\textbf{The model of hypothesis testing}

The designed model for hypothesis testing in research is as below:

Two variables are used in this model. The used variables in this model are explained below:

ROA: (dependent variable) is profit-taking index that is measured by revenue of assets.

DACC: (independent variable) indicates the profit management which is measured by the optional commitment items in Jones' model.

AUDIT: (regulatory variable) indicates the measure of the audit. It is a bilateral variable, and if it belongs to the auditory organization firm, it would be number one, otherwise it is considered number zero.

OUT: (regulatory variable) indicates independency or entity of members of the board of directors which is calculated by the ratio of uncharged members to members of the board of directors.

INS: (regulatory variable) indicates the percent of institutional shareholders that is calculated by the ratio of shares that belong to institutes, banks, and organizations to shares of firms.

SIZE: (regulatory variable) is the measure of firm. (It is reached by logarithm of the total amount of assets of the firm);

LEV: (control variable) indicates the ratio of the financial leverage which is calculated by the ratio of the total amount of debits to the total amount of assets.

LOSS: (control variable) indicates the loss. It is a bilateral variable, and if the firm sustains a loss in current year, it would be number one, otherwise it is considered zero.

\textbf{Data Analysis}

The result of the meaningful testing of research model from 2009 to 2013 is presented in Table (3). According to the table, the statistic F is meaningful with reliability level of %99. So, the research model is totally meaningful and the independent and control variables in the model have ability of illuminating dependent variable. Regulated that the coefficient of determination resulted from model testing has been 0.5734.

This number shows 57% of changes of the dependent s. This means that the revenue of assets is attributed to existing control and independent s in the model and 43% of its changes are attributed to other factors. Durbin- Watson testing is used for studying of the auto-correlation of results of the Regression model. The results of this testing concordant with estimating the regression model are attained in E-views software setting. Its proper measure for the lack of auto-correlation is 2. The auto-correlation will be rejected in error rate of the model if the amount of this statistic to be between 1.5 and 2.5. Concerning the resulted measure of Durbin- Watson statistic, the auto-correlation presence is rejected in error rate of the model.

Concerning the results of research model testing, research model coefficient is as below:
Table 3. A summary of the research hypotheses testing results

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Kind of relation</th>
<th>Test result</th>
<th>Observation number</th>
<th>Regulatory Dependent</th>
<th>Dependent</th>
<th>Independent</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is a meaningful relation between optional commitment items and future profit-taking.</td>
<td>inverse</td>
<td>confirmation of hypothesis</td>
<td>500</td>
<td>Revenue of assets</td>
<td>Optional Commitment items</td>
<td></td>
</tr>
<tr>
<td>The effect of optional commitment items on future profit-taking is more in firms under audit of great organizations</td>
<td>–</td>
<td>Rejection of hypothesis</td>
<td>500</td>
<td>Audit measure</td>
<td>Revenue of assets</td>
<td>Optional commitment items</td>
</tr>
<tr>
<td>High ratio of uncharged members of the board of directors increases the effect of optional commitment items on future profit-taking</td>
<td>direct</td>
<td>Verification of hypothesis</td>
<td>500</td>
<td>Dependency of the board of directors</td>
<td>Revenue of assets</td>
<td>The optional commitment items</td>
</tr>
<tr>
<td>High ratio of institutional ownership increases the effect of optional commitment items on future profit-taking</td>
<td>direct</td>
<td>Verification of hypothesis</td>
<td>500</td>
<td>Institutional ownership</td>
<td>Revenue of assets</td>
<td>Optional commitment items</td>
</tr>
<tr>
<td>The effect of optional commitment items on future profit-taking is greater in big firms than small ones</td>
<td>inverse</td>
<td>Verification of hypothesis</td>
<td>500</td>
<td>Measure of the firm</td>
<td>Revenue of assets</td>
<td>Optional commitment items</td>
</tr>
</tbody>
</table>

Among s of the model, the three s of audit measure (Audit* DACC), ratio of financial leverage (LEV) and loss (LOSS) do not have meaningful coefficient (because their meaning level is lower than 0.05). Therefore, they are eliminated from final model. According to the following relationship if index of the optional commitment items of a firm (DACC) increases for one unit, on the average, ROA which means that ratio of revenue of assets decreases to 0.38, and vice versa. Moreover, if independent variable of members in board of directors (OUT*DACC) increase to one unit, on the average, ROA which means the ratio of revenue of assets increases to 0.069, and vice versa. Other coefficients also are interpreted in this way.

**Conclusion**

The message recognition of real management is significant for not only beneficiaries but also legislators of accounting principles. This group has to establish some regulations and standards for much control of firms' management practice in several different accounting methods selection in order to limit manager's freedom of action in many methods selection, but it is noticeable that profit managing is one of potential results of legislation of accounting principles because entity of definite standards leads to the limitation of management of commitment items, and also managers' tendency to use profit management increases. The first hypothesis investigated the relationship between profit management and future profit-taking. The testing results indicate that increasing the measure of the
profit management practice in sample firms would reduce the revenue of assets and the future profit-taking. The result of second hypothesis which studied the effect of the amount of audit on the relationship between optional commitment items and the future profit-taking indicated an important matter that the extent of audit in firms subject to study has not any meaningful compact on the relationship between optional commitment items and revenue of assets. The third hypothesis examined the effect of dependency of the board of directors (the ratio of uncharged members of the board of directors) on the relationship between optional commitment items and future profit-taking. Dependency of the board of directors in firms subject to study had a meaningful effect on the relationship between optional commitment items and revenue of assets. In another word, by increasing the number of uncharged members in the board of directors, the measure of optional commitment items in sample firms would also increase. The fourth hypothesis studied the impact of institutional shareholder on the relationship between optional commitment items and future profit-taking, and by increasing the percent of institutional shareholder in firm, the optional commitment items in sample firms would increase. The fifth hypothesis evaluated the effect of measure of firm on the relationship between optional commitment items and future profit-taking and by increasing the amount of firm assets, the optional commitment items would decrease in sample firms.

References