European Online Journal of Natural and Social Sciences 2013;
vol.2, No.3 (s), pp. 1553-1558 ISSN 1805-3602 www.european-science.com

The earnings management and its impact on investment decision making in capital assets

Zohre Moradi, Farzaneh Nassir Zadeh

Department of Accounting, Faculty of Economics and Business Administration, Ferdowsi University, Mashhad. Iran

Abstract

Given that the conducted studies about earnings management have dealt with the effect of earnings management on investment decisions made by enterprises so the current article is mainly intended to review of the studies regarding earnings management as well as quality of the impact by earnings management on corporative decision making for investment. In this essay, investment decision making means those decisions, which are related to investment in corporative capital assets. The results of the conducted studies indicate that earnings management may affect on efficiency of investment in capital assets and this leads to making inefficient and inappropriate decisions.

Keywords: Over-Investment, Capital Assets, Investment Efficiency, Earnings Management

Introduction

According to users' view of financial statements, particularly investors, determining net profit is one of the paramount aspects of financial reporting in joint stock companies for which from attitude of board of directors and shareholders, net profit is a criterion for evaluation of management's efficiency in any institution. Alternately, market value per share and profit of any stock depend on rate of net profit and profitability trend in joint stock companies for long years. The annual increase in profit for joint stock companies make shareholders sure and attract the new investors to purchase corporative stocks and it will encourage banks and other credit foundations to give loans further (Ravanshad and Talebnia, 2010).

Through presentation of income statement, the commercial units purpose the important information about the financial performance of the commercial unit. The net profit and loss is the important figure that users of financial statements employ in making financial decisions. Usually, investors play special attention to figure of the reported profit (as one of the important factors in decision making). As a result, directors may manage it to increase value of their shares. Thus, due to the importance of the reported profit, earnings management has been the subject for many studies during several decades.

On the other hand, presentation of unreal information may adversely affect on decisions made by users of the financial statements and lead them to make inappropriate decisions.

Theoretical framework and review of literature

The increasing spread of economic activities and their ever- growing complexity on the one hand and necessity of paying attention to accounting accurate information and financial reporting on the other hand has lead to creating important institutional changes in accounting thoughts and theories as well as modern analytical and managerial methods in accounting. Further focus and paying attention to income statement is one of the foremost changes of this kind (Mollanazari and Karimizand, 2007).

One of the paramount evaluation criteria for performance and determining the value of economic enterprise is the reported profit in financial statements that have been always adapted by users like shareholders and investors etc. since several ap-

Corresponding author: Zohre Moradi, Department of Accounting, Faculty of Economics and Business Administration, Ferdowsi University, Mashhad, Iran

proximation techniques may be employed to calculate profit (earnings) in accounting so computation of an economic enterprise is influenced by approximation methods in accounting. Management of an enterprise is responsible for preparation of financial statements (Hemati and Poorheidari, 2004). When enterprises are under the pressure of adverse economic conditions, their managers ask for accounting division to improve the last row of financial statements namely profit and thereby change their information content. Despite of all its flexibility, it does not seem that accounting can provide the useful data for management under such circumstances. Earnings management is one of the techniques, which are used sometimes for arrangement of presentation of information regarding corporative favorable status. Earning management denotes general intervention by management in process of determining profit, which is often in line with the managerial arbitrary goals(Taghavi et al, 2010).

As usual, investors pay special attention to figure of the reported profit (as one of the important factors in decisions making). As a result, directors may tend to manage earnings to increase value of their own stocks. For this reason, due to importance of the reported profit, earnings management is the subject for many researches during the recent decades.

Studies have shown low fluctuation and stability of profit signify their quality so that investors may tend to invest in stocks for the enterprises with more confidence since they have profit trend with more stability. Thus in this course, earnings management may be considered as a method to arrange for communication and favorable financial status of enterprises that done by management intervention in process of determining profit(Noravesh and Hosseini, 2009).

As a process for taking deliberative steps within the limits of accounting agreed principles, earnings management has been defined to approach the reported profit to the given level so this measure is done in order to approach the reported profit to the level of target earnings through manipulation in accounting (Mollanazari and Karimizand, 2007).

Earning management is done when managers change in financial reporting by means of judgment in financial reporting and structures of transactions for the sake of interests of beneficiaries (including shareholders, creditors, personnel, government, and investors etc) regarding corporative economic performance or under the influence of implementation of arbitrary results, which depend on the reported accounting records(Hemati and Poorheidari, 2004).

Schipper K. (1989) expresses earnings management as purposeful intervention in process of external financial reporting in order to acquire personal benefit. He immediately adds that the more comprehensive definition of earnings management covers the real earnings management which has been created by decision about investment schedule or decisions about financial provision to change the reported profit or also some of its elements.

De George F. et al (1999) define earnings management a type of artificial manipulation on the expected level of profit for some certain decisions (including predication of analysts and or approximation of previous profits trend for prediction of future earnings). According to their view, the main motive for earnings management is in fact to manage investors' image of the given commercial unit(Bazzazzadeh and Dehghan, 2011). According to Paul M. Healy and J.M Wahlen (1999), earnings management occurs when managers employ their personal judgments in financial reporting and manipulate structure of transaction toward changing of financial reporting. This action is done either in order to mislead some shareholders and investors regarding corporative economic performance or by aiming at affecting on results of the contracts which their conclusion is subjected acquisition of certain profit. But Scott (1997) refers to earnings management as power of an enterprise in taking accounting policies to achieve some of manager's certain objectives(Namazi et al, 2011).

From Whild et al (2001) view, earnings management denotes the management's general intervention in process of determining profit that is often in parallel with managerial arbitrary goals (Khajavi et al, 2011).

With respect to the conducted studies in the field of accounting literature, Stolowy and Berton (2004) divided it into three classes of earnings management, profit smoothing, and reporting from accumulation of negative items by their classification that respectively overlap the goals of affecting on profit level per share, reducing profit dispersion per share, and reduced profit per current share in order to increase profit for the future share at the lower level to each other(Modares et al 2009).

The circle of earnings management is beyond manipulation of reporting techniques and it also covers even manipulation of real activities (e.g. increase production level and inventories for reduction of the final cost of the sold goods)(Nikoomaram et al ,2009).

Earnings management purposes and motives

There are many possible reasons for earnings management. With respect to the importance of profit and its high information content, the managers always try to follow up it in line with certain goals and manipulate the amount of reported profit while the presence of earnings management has drawn highly attention in many researches and recognition of certain motives in earnings management seems essential to discover and prevent from such behaviors.

Fields et al (2001) explain how several motives usually predict identical behaviors from earnings management since disclosure of the related interventions of certain motives encounter with problem in many behavioral studies. In addition to the existing constraints, the other problem is to distinguish behaviors of earnings management from other effects of financial reporting.

Kellog and Kellog (1991) define two motives for earnings management: encouraging investors to purchase corporative stocks and increasing market value for the given enterprise. Dye (1991) states that earnings management usually is derived from benefitting of managers from advantages of information dissymmetry and has purposed two important points. First, profit is manipulated to increase bonus for managers; and at the second, the practical investors like that the market to adapt better corporative value(Khajavi et al, 2011).

The existing behaviors of managers for earnings management for its positive impacts on corporative share price indicates that strong motives for rising stocks price or attract of more investors logically increase earnings management.

Managers have some motives concerning to earnings management that they can be implied as follows:

1. Receiving managerial bonuses

It seems that if management's bonus is paid based on one of the performance criteria (such as accounting profit) the manager will try to adapt accounting techniques to increase profit and thus his/her bonus.

2. Reducing political cost

Since size and magnitude of an enterprise serves as parameter for its political repute and honor so it is predicted that compared to small businesses, the large enterprises more likely adapt those accounting techniques, which reflect lower profit. Accordingly, it is assumed that if the account party for contract with the enterprise knows that accounting profit (earnings) shows exclusive proprietorship of owner for the profit thus such awareness may create heavy burden for the given enterprise. Therefore, if managers of enterprises feel that they are center of notice in this trend, they have such a motive to adapt accounting techniques that show the profit with lower value. With such a behavior, they try to reduce the possibility of political measures against the enterprise and thus to lower the expected political costs.

Attraction of capital

The more stable profit an enterprise has, the more demands exist for corporative bonds and securities and as a result value of corporative stocks increases and risk for investment in the enterprise will reduce.

Earnings management researches approaches

Mac Nichols (2004) refers to three approaches for earnings management researches in accounting literature. First, in those studies which are based on a group of accrual items where they have often used John's model. Secondly, the researches based on certain accrual items that examine one or more accrued items, and the third one that is research approach based on distribution of profits (equities) after their management in which earnings are evaluated at three thresholds of zero level, equity of previous year, and expectations of analysts from the profit in current year as any evidences for earnings management.

The review of this literature based on earnings management denotes the presence of different approaches toward measurement of earnings management. One of these foremost approaches based on discretionary accruals is a parameter for determination and revealing earnings management in commercial units. As rate of discretionary accruals increases, the possibility for arbitrary (opportunistic) behaviors by management increases and it is a sign of low reliability on profit(Modares et al, 2009).

Accounting profit may be divided into two elements i.e. cash and accruals. The accrual items are a general terms including both accrual and deferral accounting items. In some research texts, the accrual items have been classified into types: discretionary accruals (or abnormal) and non- discretionary accruals (normal). In any case, discretionary accruals serve as appropriate tools for earnings management. In research literature, earnings management is accruals from earnings spread (net profit) and resultant cash flows from operation. The expectable (normal) levels of accruals, which are approximated based on investors' available information under normal conditions, called discretionary accrued items. Discretionary accruals are the product of subtracting the approximated non- discretionary accruals from total discretionary accrued item.

Investment efficiency

Investment efficiency conceptually means acceptance of projects with positive current net value and investment inefficiency denotes passing through these investment opportunities (under- investment) and or selection of projects with negative current net value (over- investment)(Saghafi, and Arab Mazar Yazdi, 2010).

As usual, an investment efficient policy is defined as all investment projects with recoverable positive net value that will result in entering future cash fund into a commercial unit and therefore these projects should be accepted. All projects with negative recoverable net value will cause future cash flow to exist so these projects should be rejected(Lara et al, 2009).

One commercial unit is defined as efficient in investment when it selects all projects with positive current net value. Thus, under some circumstance when there is no friction like incompatible selection or agency costs; inefficient investment is to dispense with investment opportunities with positive current net value (under- investment). Furthermore, inefficient investment comprises of projects with negative current net value (over- investment) as well(Modares and Hesarzadeh, 2008).

Several persons usually involve in decisions on investment like corporative financial managers and capital providers etc; if financial results are not sincerely and properly reported and the enterprise implements earnings management, in order to achieve market expectations, both investment parties execute over- investment. As a result, manipulation of profit by enterprise may affect corporative interior decision making and lead to inappropriate and inefficient decisions for investment(Mac Nichols and Stubben, 2008).

Earnings management may affect on investment efficiency in several ways including as follows:

1) Investment decisions depend on expectation from investment benefits and this in turn affects on growth and demands for corporative products. Also expectations from corporative growth are based on some information like income and profit. Improper presentation of financial performance may disrupt trend of revenues and profits. Therefore, earnings management may lead to distortion of expectations from corporative growth. Pursuant to this trend, decision makers of the enterprise in the field of investment may tend to over- investment because of lack of knowledge about the corporative growth real trend and its real profit(Lenard and Yu, 2012).

Thus, if the financial results are not sincerely reported and the enterprise tends to earnings management then in order to achieve capital market expectation, investor parties may implement over- investment. As a result, manipulation of corporative profit may affect on corporative interior decisions and this leads to make adverse and inefficient investment decisions(Nichols and Stubben, 2008) .

2) According to theoretical bases of agency theory, managers always tend to maximize their own interests and this causes that these interests are sometime in conflict with the interests of beneficiaries outside the enterprises like shareholders and loaners. The existing potential conflict among management, ownership, and loaners may affect on investment structure, corporative governance, and investment policies of the enterprise and it leads to increasing in making inefficient decisions by management instead of selection of projects with positive current net value, management chooses some projects that reduce corporative value (project with negative current net value) and exposes the enterprises with challenge of improper selection of projects(Saghafi and Arab Mazar Yazdi, 2010).

3) On the other hand, those enterprises which execute earnings management may provide financially at lower rate and this also in turn affects on decisions for investment by enterprises.

So far few researches have been carried out regarding the impact of earnings management investment decisions so in this section we refer to some of them:

Linck et al (2013) conducted a study under title of "whether manager use discretionary accruals when they are exposed to financial restrictions". Hypotheses of that study included this point that those companies which are exposed to financial constraint may adapt discretionary accruals as a tool to show future positive outlook that enables them to increase capital and to invest again from the acquired capital. They found that the enterprises, which are exposed to financial limitation and at the same time they posses good opportunities for investment, have discretionary accruals at higher level than other corporations. As a result, they can attract more capital and take measure for investment. If an enterprise invests appropriately then corporative performance will improve otherwise the given enterprise will not have efficient investments(Linck and Tao, 2010).

In an investigation, Lenard and Yu (2012) explored the impact of earnings and quality management in accounting over- investment. They employed discretionary accruals as a parameter for earnings management. Their results indicated that earnings management affects on investment and discretionary accruals are an important parameter for over- investment(Lenard and Yu , 2012).

Cohn and Zarowin (2009), in a survey, reviewed the relationship among earnings management (real earnings management and discretionary accruals earnings management) and over- investment. They found that over- investment exists both in those enterprises which are involved in real earnings management and those ones that tend to earnings management of discretionary accruals; but the results showed that real earnings management affects more adversely on corporative investments(Cohen and Zarowin, 2009) .

In another study, Mac Nichols and Stubben (2008) examined the effect of earnings management on corporative investment decisions. They adapted investing in fixed assets as a parameter for investment. Their results showed that the enterprises, which implement earnings management in comparison with other firms and during several periods, may execute over- investment. Similarly, results of their research indicated that presentation of proper information might lead to making efficient decisions in the enterprise.

Wang (2006) also found that those enterprises, which implement earnings management, might execute over- investment in Research and Development (R&D) activities, merging, and acquisition of over- investment(Lenard and Yu, 2012) .

In another survey under title of economy of fraudulent accounting, Kedia and Philippon (2006) purposed that earnings management fraudulent accounting might be followed by important economic consequences. They concluded that the enterprises with lower productivity (efficiency) might tend to over- investment in order the present a better image of their financial and economic status. This measure may distort the allocation of economic sources in economy. Likewise, they found that enterprises might execute over- investment during the periods when they tended to earnings management and when fraudulent financial reporting is disclosed they withdraw extra capital from the enterprise so their efficiency is improved(Kedia and Philippon, 2006).

In their research, Maureen et al (2005) examined this question that does earnings management affect on corporative investment decisions? Their findings showed that over- investment was appropriate during the period when improper reports have been presented but over- investment has been reduced at next periods(Linck et al, 2010).

In Iran, in a survey conducted by Modares and Mohammadi (2009), they investigated into the impact of earnings management on investment decisions made by the admitted enterprises in Tehran Security and Exchange Organization (TSEO) during 2001-5. By means of Eckel's index in enterprises, they divided them into two groups of profit manipulating and non- manipulating of profit. Results of this survey showed that profit manipulating enterprises had not the expectable higher investment level than investment opportunity during period of profit manipulation. Similarly, at the next financial period, these enterprises have not also expected the lower investment level than the investment opportunities(Modares and Mohammadi, 2009).

Conclusions

The conducted researches in the field of earnings management indicate that few studies have been carried out concerning to the impact of earnings management on investment efficiency. Results of these studies show that earnings management affects on investment decisions made by enterprises and leads to making inefficient and inappropriate decisions.

References

Bazzazzadeh, H and M. Dehghan (2011). Cash fund resulting from earnings management and operation: K-S model test. Journal of accounting management, 4 (9), 23-39.

Cohen, D. and P. Zarowin (2009). Earnings management and Excess Investment: Accrual-Based Versus Real Activities. New York University. 1-43.

Hemati, D and O. Poorheidari (2004). The review on the impact of liability contracts, political cost, bonus plans, and ownership on earnings management in admitted enterprises by Tehran Security & Exchange Organization (TSEO). Journal of accounting and auditing studies,11(36), 47-65.

Kedia, S and T. Philippon (2006). The Economics of Fraudulent Accounting, Review of Financial Studies, 22(6), 2169-2199.

Khajavi, S., A. Bayazidi and S. Jabarzadeh Kangarlooee (2011). The study on the relationship among earnings management and social responsibility of the admitted enterprises by Tehran Security & Exchange Organization (TSEO). Journal of accounting advancement, Journal of Accounting Advances, 3(1), 29-54.

Lara,G., G.Osma and F. Penalva (2009). Accounting conservatism and corporate governance. Review of Accounting Studies, 14(3), 161-201.

Lenard. MJ and Yu. Bing (2012). Do Earnings Management and Audit Quality Influence Over-Investment by Chinese Companies? International Journal of Economics and Finance,4(2), 21-30.

Linck, J. Netter, J and S.Tao (2010). Can Earnings Management Ease Financial Constraint? Evidence from Earnings Management Prior to Investment. Available:http://dx.doi.org/10.2139/ssrn.1573147.

Mac Nichols,F and R.Stubben (2008). Does earnings management affect firms investment decisions? The Accounting Review. 83(6), 1571-1603.

Modares, A and J.Mohammadi (2009).The review on effect of earnings management on investment decisions in the admitted enterprises by Tehran Security & Exchange Organization (TSEO).Journal of economy, 87, 34-43.

Modares, A and R.Hesarzadeh Reza (2008). Quality of financial reporting and investment efficiency. Quarterly of Security & Exchange Organization, 1(2), 85-116.

Modares, A., Z. Ghafghazi and A. Sahakeri (2009). An investigation into motives of earnings management in admitted enterprises by Tehran Security & Exchange Organization (TSEO) (case study: oil, chemical, and metallic industries). Scientific- research quarterly of Financial accounting, 1(3), 59-78.

Mollanazari, M and S. Karimizand (2007). The study on relationship among profit smoothing and type of industries in admitted enterprises by Tehran Security & Exchange Organization (TSEO). Journal of accounting and auditing studies, 14(47), 83-100.

Namazi, M., A. Bayazidi and S. Jabarzadeh Kangarlooee (2011). The review on the relationship among quality of accounting and earnings management in admitted enterprises by Tehran Security & Exchange Organization (TSEO). Journal of accounting and auditing studies, 3(9), 4-22.

Nikoomaram, H., I.Noravesh and A.Mehrazin, (2009). Evaluation of discretionary accruals- based model for exploration of earnings management. Journal of management studies. 20(88), 1-20.

Noravesh, I and A. Hosseini (2009). The review on the relationship among quality of disclosure (reliability and punctuality) and earnings management. Journal of accounting and auditing studies, 14(55), 117-134.

Ravanshad, M and GH. Talebnia (2010). The review on relationship among earnings management and capital structure in admitted enterprises by Tehran Security & Exchange Organization (TSEO). Journal of financial studies, 3(8), 103-118.

Saghafi, A and M. Arab Mazar Yazdi (2010). Quality of financial reporting and investment inefficiency. Journal of financial accounting researches, 2(4), 1-20.

Taghavi, M., S. Jabarzadeh Kangarlooee and S. Khodayar Yeganeh (2010), Interpretation of the relationship among agency costs and corporative value with earnings management in admitted enterprises by Tehran Security & Exchange Organization (TSEO). Journal of financial engineering and portfolio management,1(3), 109-133.