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Investigating the Delay in Terminating Non-Profitable Operations Reduces the Cost of Capital in Corporations of Accepted in Tehran Stock Exchange

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Abstract

The main objective of this research is to investigating the delay in terminating non-profitable operations reduces the cost of capital in Companies Accepted in Tehran Stock Exchange. In this research statistical samples include 160 companies accepted in Tehran stock market whose data has been statistically analyzed during a period of 10 years (from 2005 until 20144). Research hypothesis has been through multiple regression and logistic models; according to the findings, increasing the timely realization of unachieved losses raises the possibility of stopping non-profitability. Also, the results showed that in consistent with the findings; the delay in stopping non-profitable operations has had no effect on the cost of the capital of statistical sample of companies during the course of the study.

Keywords: Timely Identification of Unachieved Losses, Termination of Non-profitable Operation, Cost of Capital, Corporations of Accepted, Tehran Stock Exchange

Introduction

Optimal and effective allocation of capital requires that the financial resources are invested in present positive net value projects and projects with negative net worth are quickly identified and set aside. Economic and financial theories play an important role for the financial reporting section in the optimal allocation of capital by reducing information asymmetry between the managers and the suppliers of capital of the company (Bushman et al., 2013).

Asymmetry of information between managers and investors cause problem of allocating capital classification. When the managers misuse the confidential information; investors refuse to invest. There are also the problems of representation and interest of managers which cause the sensitivity

of investors and create problem for financial current projects with positive value (Verdi, 2006).

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Problem Statement

Accounting information can help the efficacy (efficiency of investment) in two ways; 1) lowering the risk and asymmetry of information through providing fast, reliable, and valid information 2) helping company control mechanisms to stand against profitable motivation of managers and saving the interests of shareholders and creditors (Srivastava et al., 2015).

The managers of economic units are willing to release good news about the company as well as hiding bad news. These various factors of motivation in releasing come from different roots, like the payment of remuneration and occupational concerns (Ball et al., 2009).

The principles and procedures of accounting in order to maintain the interests of capital market and controlling the interests of managers propose the limiting principal of conservatism. Demand for conservative reporting shows that conservatism is beneficial for suppliers of financial reports of company. Optimistic looks of managers and private owners towards the company will most likely reflect in financial statements. As a result, pessimism in accounting is an essential factor to neutralize optimism (Kothari et al., 2009).

Basu (1997) proposes identifying the bad news faster in comparison with the good news in the report as a conditional conservatism and confirm that lower realization of potential profits against the realization of losses is caused by the use of conservative policy in financial accounting that stand against the interest of the administrators. Bushman et al. (2011) suggest that asymmetric understanding in accounting increases management incentives to avoid investing in projects with negative net present value and putting aside loss projects. They found that timely identification of the losses helps the manager in the detection and the rapid leave of loss projects. So it appears that the rapid identification of losses is potentially effective on the behavior of investment of managers of non-profit units since this process in the financial reporting procedures provides quick and reliable evidence for the shareholders and creditors regarding the negative performance of the company and enables these groups to immediately react to such negative results. As a result, if the managers forecast that the adverse effects of their decisions in the field of investment will quickly happen through decreasing the company's market value and increasing the cost of financing, they will less likely invest in the negative net present value and will more likely put aside such investments quickly. With regard to the above topics, the main question raised in the present research is as followings:

What is the relationship between timely identification of unachieved losses and the termination of non-profitable operations?

Literature Review

Hovakimian (2009) evaluated investment policies of companies in conditions of increasing and decreasing of cash flows. They realized that there is positive relationship between investment and cash flow. Also, considering an optimum model of investment, they resulted that managers invest less in cash deficiency conditions compared to the actual need of the investment.

In a research entitled "The role of conservatism in accounting in financial decisions of companies," Lee (2010) explores the impact of conservative policy in financial reporting on the financial flexibility of companies. The results of the investigation showed that the higher the degree of conservatism, the lower the flexibility of companies will be in the management of the company's liquidity, financing decisions, the sensitivity of investment in the financial restrictions and payment policies to shareholders.

Beatty et al. (2013) studied the conservative conditions included in debt contracts; they express when the costs of representation debt are higher, these contract conditions are used more. However, the evidence showed that contract conditions do not satisfy creditors' demand; therefore, to reduce the costs of representation debt, using conservative accounting is needed.

Bushman et al. (2003) studied the relationship between the corporate investment behavior with the potential timely recognition of losses. The results showed that the reduction of investment opportunities will potentially strengthen timely recognition of possible losses while there is not convincing evidence regarding the impact of timely recognition of possible losses on the sensitivity of investment to investment opportunities.

Pourzamani and Mansouri (2015) studied the effect of the quality of disclosure, this conservatism and mutual relations on the cost of equity capital. The results of testing hypotheses using the panel method shows that the quality of disclosure and conservatism have adverse effect on the cost of equity capital so that by increasing the amount of the quality of disclosure and the conservatism, the cost of equity capital of companies will be reduced.

Research hypothesis:

The delay in terminating non-profitable operations reduces the cost of capital

The test model of hypotheses and how to calculate variables

In order to test the hypotheses of the research, the regression model of Srivastava et al. (2015) are used as follows.

The Research Hypothesis Test Model

$$COC_{i,t}=\beta_0+\beta_1 DummyDiscontinuation_{i,t}+\beta_2 DummyLateDiscontinuation_{i,t}+\beta_3 MarketToBook_{i,t}+\beta_4 LogSize_{i,t}+\beta_5 CashDeficiencyQuartileRank_{i,t}+€_{i,t}$$

COC: cost of capital. In this research, in order to calculate the cost of capital, the model of Ohlson and Nahuot (2005) has been used.

Statistical sample of case study

In the present study, to test the hypotheses of the research, classified and calculated financial data of companies accepted at Tehran stock exchange have been used. In table 1, selection and extraction of appropriate statistical sampling show the sampling procedures with regard to research, the considerations and conditions and the data and information available in Exchange.

Table 1: Selecting and Extracting Sample

The number of companies that had a presence in the Stock at the end of the year 2014.		686 companies
Can be deducted: The number of companies that entered or got out of the stock during the years 2004 to 2014.	155 companies	
The number of companies that lefted of the stock during the years 2004 to 2014.	104 companies	
The number companies which were among the investment and financial intermediaries companies.	127 companies	
The number of companies whose financial year do not end in March.	65 companies	
The number of companies which changed their financial year in the course of the study.	21 companies	
The number of companies whose trading symbol has not stopped more than 4 months in a year.	33 companies	
The number of companies that has negative equity.	21 companies	
Sum of deductions		526
The number of companies whose data has been collected (final sample)		160 companies

Research Period

The scope of the research includes a 10-year time sequence from 2005 to 2014 in which evaluation of hypotheses is done using real data of these years. Since to calculate some of the variables of the study, the data of t period is needed, the data of 2004 was gathered and used in computing.

The results of the research hypothesis testing

Table 2: Chow test results for the research hypothesis testing of regression model

Chow F Statistics	Significance level	Result
9.381	0.000	Model is panel.

Housman test results for the research hypothesis testing of regression model are presented in the table 3.

Table 3: Housman test results for the research hypothesis testing of regression model

Statistics Chi-Sq	Significance level	Result
19.108	0.001	Regression is based on fixed effects.

The findings indicate that the significant level of Housman test is less than 0.05, rejecting the H0 hypothesis. Accordingly, the use of fixed effects method for fitted model of the research hypothesis testing of regression model is recommended. The results of the fitted model are presented in table 4.

Table 4: The results of the statistical analysis of the research hypothesis testing of the regression model

Variable	β Coefficient	Statistics t	Significance level
Fixed Coefficient	-0.846376	-0.905432	0.3654
LDIS	0.175768	0.573319	0.5665
DLD	0.041737	2.159819	0.0230
MB	0.046049	2.834758	0.0167
SIZE	-0.244826	-3.523254	0.0004
CASH	-6.547963	-2.458530	0.0141
Adjusted determination of Coefficient: 0.331 Durbin-Watson Statistics: 1.844 Statistics F: 4.682 Significance level of F Statistics 0.000			

The estimated coefficient for the variable DLD which reflects the effect of delay in stopping non-profitable operations on improving timely identification of unachieved losses, equal to 0.041 with a significant level of 0.023, which is less than 0.05 (error level of the test). This finding suggests that there is a direct and meaningful relationship among the aforementioned variables over the course of the investigation. In other words, by increasing delays in stopping non-profitable operations, the timely identification of non-profitable losses has gone up. This finding is compatible with the research hypothesis, which is accepted at the 95 per cent confidence level.

Summary and the Interpretation of Results from Hypotheses Testing

The findings of the research hypothesis test showed that a delay in stopping non-profitable operations does not reduce the cost of capital. Probably, in the Iranian capital and money markets, suppliers of capital do not pay attention to financial reporting procedures of profit-making units and only emphasize on functional figures of these reports. On the other hand, it is possible that managers not only apply their cautious attitudes in financial reporting, but also interfere in managing and applying the resources of companies.

Practical Recommendations

1) Based on the findings of the first hypothesis that timely identification of unachieved losses increases the possibility of stopping non-profitable operation, the managers of the stock companies managers are recommended that, in applying the procedures of financial reporting, act in a way to prevent potential and un-achieved losses.

2) On the basis of the findings of the second hypothesis that delay in stopping non-profitable operations improves timely identification of unachieved losses, the managers of profit-making units are recommended that, if they have invested in projects whose future revenues are ambiguous, try to stop them to prevent more losses.

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