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Investigating the Relationship between Financial Distress and Earnings Management in Corporations of Accepted in Tehran Stock Exchange

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Abstract

Earnings Management is one of the important aspects of financial reports quality and the main subject between all the stockholders or a company. Any interference that leads to devaluation of the reports can be effective in decision making methods of financial reports users. The purpose of this research is investigating the Relationship between financial Distress and Earnings Management in Corporations of Accepted in Tehran Stock Exchange in during time between years of 2008-2015. This study in terms of purpose is applied research and regarding the method of inference, this research is descriptive – correlational research. Research results show that which in research hypothesis with the increase of the free cash flow as a standard of financial Distress, Earnings management will be increased. According to the positive and significant relationship between financial distress and earnings management, it can be said that free cash flows of companies can consider as motive factor for earnings management. The obtained results with the control variables firm size and financial leverage the resulted outcomes still hold ground.

Keywords: Earnings Management, financial Distress, Operating free cash flow

Introduction:

As a result considering the importance of investigating the relationship between financial Distress and company`s earnings management, predicting Distress is one of the main subjects of companies categorization. Owners, managers, investors, commerce partners and governmental institutes are interested in evaluating company's financial situation, since in case of Distress a good deal of expenses will be imposed on them. Explaining the reason(s) of companies` financial problems is not a simple task in every case. Financial problems of most of the companies are due numerous reasons and in the end the lead to an occurrence (financial inability) that immediately brings about the causes of failure. Failure`s major and fundamental cause may not be identifiable from the available evidences. Some debate the reasons of failure and disappointment from creditor perspective, in a way that indebt owners would be interviewed regarding the causes of failure. Undoubtedly various answers would be given. Lack of capital probably had a high rate in debtors list of failure reasons and inability was rarely accepted (Nazaripour & Kanani, 2014). Managers have higher motivation to manage Earnings s in mid periods. Additionally, optional accruals are different in mid periods, as time management in mid periods has a more positive perspective and postpones the unpleasant new until the final period to manage Earnings (Gouni %& co, 2008). Furthermore, accounting standards require that some of the incomes and expenses (such as taxes on income) that have an annual nature primarily be accounted for the whole year so that we can efficiently identify the mid period` share. Therefore, management can use opportunistically use the estimates and reflect mid periods performance incorrectly using a tool called Earnings management (Des & Co 2009). Earnings management is one of the important aspects of financial report quality and the main subject among all the shareholders of the company. Since amount of Earnings is considered an important standard of performance evaluation, therefore, any interference that causes the devaluation of the reports can affect the decision making methods of financial reports users (Zengin & Uzkan, 2010). Hence, it can be said that shareholders pay significant attention to qualitative and quantitative aspects of Earnings. Quantitative aspects of Earnings can be amount of optional accruals. In a way that the higher the optional accruals are in Earnings, the higher manageability of Earnings becomes (Bolou & Talebi, 2010). However the important point is that the usage of annual optional accruals (an standard of Earnings management) to discover Earnings management leads to the none-discovery of Earnings management, as the effects of managing high and low Earnings s (to manage Earnings) in mid periods will be adjusted at the end of the year, which this leads to a reduction in the average of accruals at the end of the year (Zengin & Uzkan, 2010). Moreover, managers have higher motivation for Earnings management in mid periods. In addition, optional accruals are different in mid periods, since management in mid periods has a more positive perspective and postpones the unpleasant news till the final mid period so that he can manage Earnings (Gouni & Co, 2008 (In addition, accounting standards require that some incomes and expenses (such as tax on income) that have an annual nature primarily be estimated for the whole year so that we can efficiently identify mid period`s share according to it. Therefore, managers can use these estimates opportunistically and reflect mid periods performance incorrectly using a tool called Earnings management (Das & co, 2009). The Current research has done to investigate the relationship between financial Distress and Earnings Management in Corporations of Accepted in Tehran Stock Exchange. We try to answer that question that if there is a relationship between financial Distress and Earnings management. If it is positive, how is it?

Problem Statement

Recent Distress of the companies and accounting scandal (i.e Enron and Worlcom, etc) have brought about a strong motivation for legislators to reevaluate companies` board of directors. As a reaction to this concern US congress established a law to strengthen the independent committee of the companies. In this law a lot of importance has been given to the structure of auditing committee. In other words, recent Distress in national and international levels necessitate the existence of financial predicting of firms, one of simplest and most famous models of predicting I prediction of financial Distress and continuance of firm activities is Altman model. This model was designed in other economic model and its version in Iran is following with high rate of error. Earnings management is one of the important aspects of financial reports quality and the main subject between all the stockholders or a company since amount of Earnings is considered an important standard for performance evaluation. Therefore, any interference that leads to devaluation of the reports can affect decision making methods of financial reports users (Zengin & Uzkan , 2010). Thus it can be said that investors pay significant attention to qualitative and quantitative aspects of Earnings. Quantitative aspects of Earnings can be considered as the amount of optional accruals. In a way that the higher the optional accruals in Earnings it indicates higher manageability of Earnings (Bolo & Talebi, 2010). But the important point is that employing annual optional accruals (an standard of Earnings management) to discover Earnings management leads to the none-discovery of it, since the effects of managing high and low Earnings s (Earnings management direction) of mid periods are adjusted at the end of the year which leads a reduction in the average of accruals at the end of the year (Zengin & Uzkan, 2010). In addition, managers have higher motivation in mid periods for Earnings management. Additionally, optional accruals are different during mid-period, since management has a more positive perspective in mid periods and postpones unpleasant news till the final mid period so that he can manage Earnings (Gouni & Co 2008). In addition, accounting standards require that some incomes and expenses (such as tax on income) that have an annual nature primarily be estimated for the whole year so that we can efficiently identify mid period`s share according to it. Therefore, managers can use these estimates opportunistically and reflect mid periods performance incorrectly using a tool called Earnings management (Das & co, 2009). The Current research has done to investigate the relationship between financial Distress and Earnings Management in Corporations of Accepted in Tehran Stock Exchange. Managers can use their knowledge in commerce activities of the company to improve the efficiency of financial statements as a tool for transferring information to potential investors and creditors. Despite this, if managers have motivations in misleading financial statement users through applying their authority in accounting selections in financial reporting, it is possible that Earnings management occurs. Earnings management is an important aspect of financial report and the main subject of all the company`s shareholders. Therefore, any interference that leads to the devaluation of the reports, can affect the decision making methods of financial reports users (Uzkan 2010).

The aim of financial reporting is providing useful information for commerce decision makings. Earnings report is a standard for evaluation company`s performance and one purpose of financial reports. Due to the importance of Earnings for the consumers managers try to manipulate sum and the method of Earnings provision. Using accruals is one of the methods which managers use to manipulate Earnings the system of committed accounting. This behavioral phenomenon of managers is called Earnings management (Qorbani & GolMohammadi 2012). Furthermore, obtained results of this research can be

useful in investor's decision makings aligned with more attention to effective factors in Earnings management, and financial Distress of the companies.

Research Background

Saeedi and Aghaei, (2002) investigated predicting financial Distress of accepted firms in valuable paper market of Tehran. In the present research using one of the newest present methods about classifying (BIZ networks) to predict financial Distress in accepted firms in valuable papers market of Tehran was investigated.

Raei and Fallahpoor (2012) in a research investigated financial Distress of firms by using artificial nervous systems and compare the power of predicting of nervous systems in compare with multivariable separated method. They defined firms of case 141 of business law from date of their membership as Distress firms and predict these firms by using data of previous years. investigated variables in this study are including: current ratio, the ratio of profit before discount and tax to asset, the rights of stock owners to debts, returned capital to total asset and ratio of profit before discount and tax to sale. They selected 40 firms with financial Distress during 1993-2000 and also they selected 40 other firms randomly as health firms. The mean of prediction correctness of linear separated model is 93.4 percent and correctness of predicting artificial nervous networks is 95.3 percent. They assumed cutting point in separated linear model as 0.5 percent. and finally they concluded that ANN model of artificial nervous networks in predicting financial Distress has more accuracy of prediction in compare to multivariable model of MDA. Indeed regarding to 3o points, the obtained result is considerable. Their using from cutting point if 0.5 percent in multivariable separated model and low accuracy of model was investigated.

Hajiha and Ghaem maghami, (2012) , investigated the4 role of controlled accounting in decreasing Distress of firm. Their findings indicated that there is relationship between controlled accountings and Distress risk and firm ope4rations is including controlled accounting to decrease Distress. The findings of the present research are adoptable with universal studies and they can support all subordinate groups during decision making. Other researches in Iran, investigated the tests of Distress models such as Altman, Springit, Shirata, Zimeski models. Some of them are research of Sabzevari about tested of Altman model to determine firm Distress in stock market and also the study of Mehdi Goldow titled: comparative investigation of efficiency of Distress models of Altman, Springt, Zimesk and Shirata in Tehran Stock Exchange

Antonio Lopo Martinez (2010) in a research in Brazil investigates that whether the growth of corporative governance, auditing comments by the four major auditing companies have a relationship with a tendency to commitment in Earnings management through accounting selections or operational decisions. Evidences from one of the Brazilian companies indicate that a list of Nevo Mercado (new market) a part of Sao Paolo`s stock exchange needs to increase corporative governance performance. Among other requirements and auditing by one of the four major auditing companies, reduces Earnings management through audition selections and conditional comments of auditors is a scale of Earnings management. At any rate, except for special cases of the list of the second section of Nevo Mercado and auditing by the

four major auditing companies do not give reassurance regarding the reduction of Earnings management through operational decisions.

Syed Zulfiqar Ali Shah et al., (2010) conducted a research titled "corporative governance and Earnings management in Pakistani listed companies". Through using Jones`s adjusted model they calculated optional accruals and by testing the hypotheses through regression method concluded that the quality of corporative governance has a positive relationship with Earnings management .One of the reasons of this result the revelation of corporative governance methods that are presented by the companies.

Zengin & Uzkan (2012) They investigated the relationship between auditing quality and Earnings management in mid period financial statements using 2152 observations in during of three months of the companies from 2009 to 2012. They found out that 4 auditing giants, expertise in industry and tenure of auditing company (as auditing quality indexes) limit optional accruals (an index for Earnings management).

Wuchun Chi et al., (2013) investigated the relationship between advanced auditing and true Earnings management in 1800 companies from 2008 to 2013. In their research they first found out that expert auditors in industry and major auditors (Capital N) receive higher wages than other auditors. They also concluded that expert auditors in industry and true major auditors limit Earnings, however, auditors with high tenure have a positive relationship with true management of Earnings and change of auditor can lead to lower Earnings management.

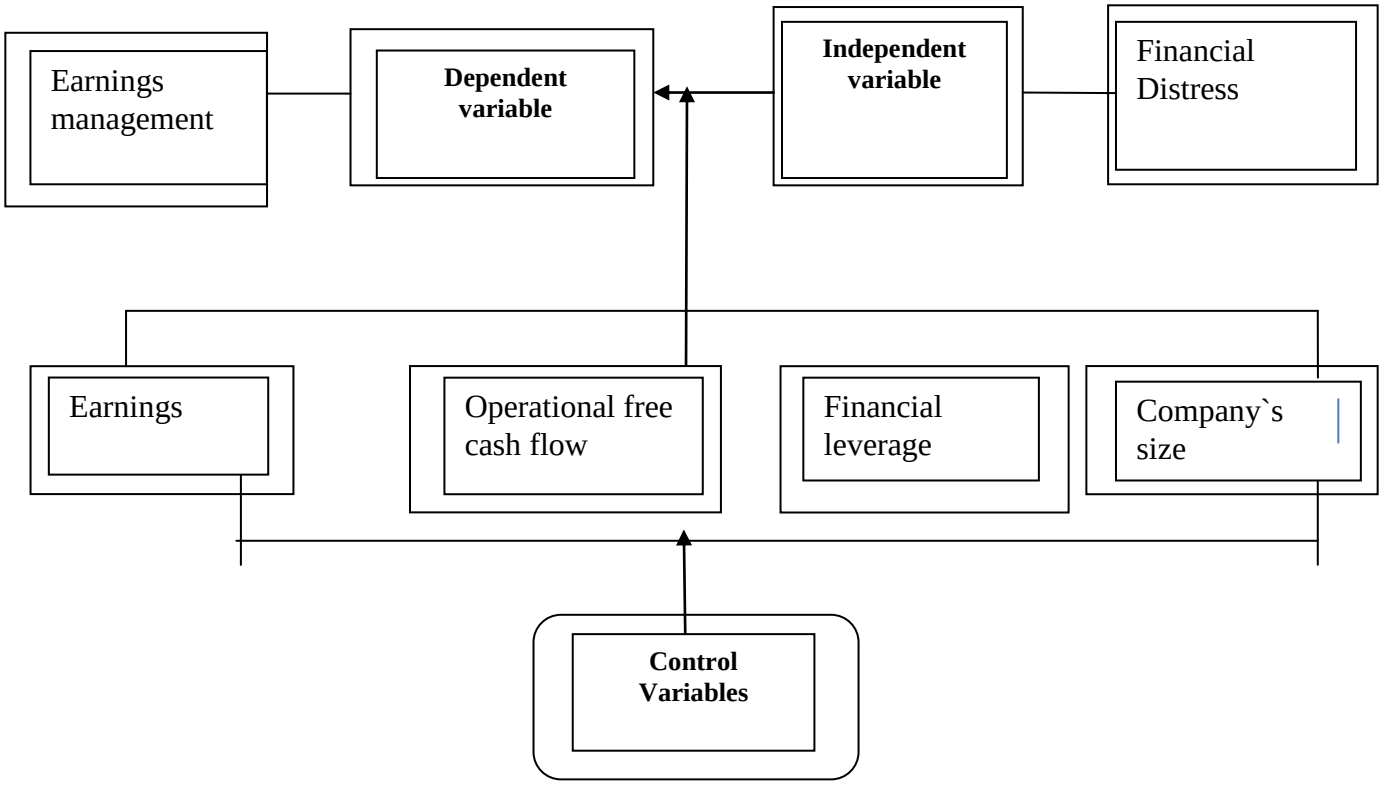
Nonahal et al., (2012) investigated the relationship between auditing quality and the reliability of accruals from 2008 to 2011. Research results show that audited companies by high quality auditors have a higher accruals stability coefficient in comparison to audited companies by the lower quality auditors and as a result have higher optional accruals reliability.

Hejazi & Mohammadi (2013) in a research attempted to predict Earnings management through nerve system and decision tree in Corporations of Accepted in Tehran Stock Exchange. Research results showed that the nerve system and decision tree method is more accurate in predicting Earnings management in comparison to linear methods and have lower error level. Furthermore, Earnings management have the most relations with optional and non-optional accrual variables of the previous period and company`s performance and the rate of Earnings consistency in both methods.

Research Question:
How much do the financial Distress and Earnings management have significant relationship in Corporations of Accepted in Tehran Stock Exchange?

Research Hypothesis:
There is significant relationship between financial Distress and Earnings management in Corporations of Accepted in Tehran Stock Exchange

Research Conceptual Model



Resource: Aziatul Waznah Ghazali ab, Nur Aima Shafieb, Zuraidah Mohd Sanusib (2015)

Test of statistical population and statistical sample

Test period of the research is a seven year spam based on the financial statements of 2008 to 2014 of the selected companies. Albeit, with considering the testing the research hypothesis we need to calculate changes of the year (t) in comparison to year (t-1), to compute some of the variables we need the information of the year 2008. Therefore, statistical population of this research is production companies of Accepted in Tehran Stock Exchange from 2008 to 2014 that have the following conditions:

1. Financial information of the company for the considered period is available.
2. The company have not receives losses during the period and end of the financial year ends with end of March, and do not change the financial year during the period under study.

3. It is not one of the financial banks or institutes (investing companies, financial intermediaries, Holding companies, leasing companies)
4. The companies are accepted in the exchange till the end of 2008 and do not exit the exchange from 2008 to 2014 from Corporations of Accepted in Tehran Stock Exchange.
5. During the research, does not remain inactive for more than four months, since calculating the variables under study related to the market regarding the mention companies and using them in the research can have unpleasant effect on research results.

Thus, number of the companies that had the above mentioned qualifications was 133.

Research findings

Research Hypothesis:

There is significant relationship between financial Distress and Earnings management in Corporations of Accepted in Tehran Stock Exchange.

To recognize the issue that the hypothesis model is model of combination data or a model with a fixed effect, or a model with a random effect, we investigate the Chow, Lagrange coefficient, and Hausman tests for the model. Table (1) presents Chow, Lagrange coefficient, and Hausman tests results. According to the mentioned tests, effects model is selected as fixed.

Table (1): results of testing the Chow, Lagrange coefficient and Hausman test

Model	Test Type	Test Statistic	Significant level	Test result
All the companies	Chow Test	1.62	0.000	Confirmation of fixed effect model against combination data model
	Lagrange Coefficient test	3.15	0.0075	Confirmation of random effect model against combination data model
	Hausman test	7.15	0.128	Confirmed of fixed effects against random effect

According to the results registered in table (1) research model for all the companies is estimated with fixed effects and estimate results are presented in table (2) to test the research hypothesis.

Table 2: Results of estimate model to test the research hypothesis

Dependent Variable DACC			
Explanatory variable	Test of Combinational data		
	Coefficient	T Statistic	P-Value
FCF	0.046	8.816	0.000
Earnings	0.010	0.219	0.825
Size	0.005	1.197	0.231
LEV	0.040	1.603	0.098
Liquit	6.55	0.144	0.0885
Intercept	-0.148	-2.543	0.011
F Statistic	29.05		
P-value	0.000		
R2	0.111		
Adjusted R2	0.107		
Durbin-Watson Statistics	1.866		

According to table (2) F test is known for showing the significant of the whole regression. Furthermore, in the selected model R 2 = 0.11 is obtained. Intended explanatory variables explain 40 percent of the changes of the dependent variable. Durbin - Watson statistic is between 1.5 until 2.5, which shows there is no self-correlation problem among perturbation sentences of estimated model. As the above table shows, financial Distress coefficient is positive and statistically is at the 5 percent error level of significant. It means that with increasing the financial Distress will be increased earnings management. Thus the research hypothesis will be confirmed. According to other results coefficient of profit variables, company`s size and financial leverage and liquidity have positive and significant relationship with Earnings management, and significant relationship was found between Earnings ability and liquidity with Earnings management.

Conclusion

According to the results of this research, in research hypothesis with considering the positive and significant relationship between Earnings management and as financial Distress in Corporations of Accepted in Tehran Stock Exchange, In others words, as with an increase in financial leverage managers motivation for management decreases, we recommend with an increase of financial leverage which as a consequence the pressures of debt contracts can lead to a decrease in in the financial Distress on the side of the managers, make them more cautious. Also it can be noted that free cash currents of the companies can be considered as drive for Earnings management. We recommend that other components regarding control and reduction of Earnings management be evaluated by considering managers awareness level of financial Distress of the companies in the hypothesis. Finally in this hypothesis regarding to positive and significant relationship between financial Distress and managing firm advantage of accepted firm in valuable papers of in Tehran Stock Exchange that managers of firms to show better of performance of their firms and maintain their value of stock and escape from loses that leads to equality of advantages

and profits of firms and finally they leads to financial Distress to this equality is considered in research hypothesis.

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