



Investigation of Political Costs' Effects on Earning Management in Accepted Firms in Tehran's Stock Exchange

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Abstract

In the present paper, effects of political costs on earning management have been studied in accepted firms in Tehran's stock exchange. Here, earning management is consciousness measures taken by managers to showing earning normal. 54 firms are under investigation during 2003-2010. Regression analysis method has been applied to examine assumptions. Obtained results show that there is a meaningful relationship between firm size and rates of government debts (G-debts), which is measurement index of political costs, with earning management. This paper is a practical research, which' results would investigate effects of political costs on earning management.

Keywords: Political costs, earning management, firm size, performance.

Introduction

Earning management could be a result of natural or intentional smoothing. Natural smoothing shows that earning process should be creator of smoothed process of earning and it would not be as a result of management's measures and decisions. Intentional smoothing would be related to management's measures and decisions. On the other hand, intentional smoothing would be as a result of management's measures¹.

Political cost is one of the factors, which causes earning management, because one of the main evidences of transferring assets from firm is political cost. Because of existing costs of data, transactions and decision making, firms would be managed by government².

Some of the firms, with certain economic features, would be mostly under hard and complex regulations, which government or other regulatory groups have approved. Therefore, they would try more to avoid transferring assets from the company³. Thus, political process cause that some firms, with political sensitivity, choose some strategies to postpone earning, because using earning by policy makers and legislators would present this assumption that firms' managers tend to use some accounting methods such as accelerated depreciation, which would decrease reported earnings⁴. So in this paper, due to significance of earning management in firms, relationship between political costs and earning management of accepted firms in Tehran's stock exchange would be practically investigated.

Main body: Earning smoothing, which is known as earning management in Iran, is one of the methods, which would be

applied to form information of desirable situation of firms (Wiled and partners, 2001). Financial reports are considered as the main information resources for economic decision making, which would be applied by managers, investors, creditors and others, to meet their information requirements. Since the data would not be available for all appliers as same, there would be imbalance between managers and investors' information. The imbalance between data is a situation, in which managers comparing to investors have more secret data about future performances and decisions of firm, this would cause that managers have motivation and opportunity to manage earning⁵. There are several definitions of earning management, which all would describe same concept. For example, in the opinion of Gardon and his partners, if managers choose a certain method of accounting and as a result reported earnings decrease, so the result would be smoothing or earning management.

Hilly and Valen believe that earning management would be created, when manager uses personal idea for financial report, and that this would be aimed in confuse some shareholders about real economic performance or influence in results of contracts, which depend on reported financial statistics.

Scott describes earning management as the authority of firm to choose accounting policies to achieve some certain goals of manager. About political costs one can say that political process would cause that some sensitive firms choose some methods, which would postpone the earning, because using earning by policy makers and legislators would present this assumption that firms' managers tend to use some accounting methods such as accelerated depreciation, which would decrease reported earnings. Lower reported earnings would decrease disagreements of government. Hence it could be mentioned that,

since investors have a special look on decision making as the main factors for decision making, researches in this field have a special significance⁶.

Managers are always searching for data, by which they can make good decisions and consequently increase their firm's proficiency⁷. Thus, they may find motivation for earning management, so identification of earning management motivations by firms can provide situation for well designed decision making of various groups. Investors have also a special look on rate of earning as one of the main decision making factors⁸.

One of the primary goals of earning management would be preservation of firm's credit, because this credit causes its efficiency and would also provide a good position for the firm among its competitors and capital market. Through this, investors can have a better judgment about the firm⁹. Therefore, managers may report a earning contrary to public advantages, to achieve some certain goals. Due to effectiveness of earning management on decision making of financial statement users, this research could be significant.

Research literature: Darrough and others have investigated earning management in Japanese firms during 1991-1996 and their obtained results showed that there is a meaningful relationship between political costs and earning manipulations. In this research, sales total variable has been applied as political cost's representative.

Gunny, have investigated results of real earning management using four instruments including decrease in costs of development, decrease in office, public and sales costs, increase in non-operating earning gained from selling non-current assets and overproduction. He believed that real earning management would lead to low earning report and operating cash flow. In addition, if a firm uses real earning management in the current year, would have lower income at the next year. Gunny has investigated active firms in New York stock exchange during 1998-2000.

Tehrani and others, studying relationship between political costs and firm size in Iran, found that there is a meaningful relationship between them and that political costs would be supported by law in the firms. This research has investigated all firms of Tehran's stock exchange during 2005-2007¹⁰.

Mohammad, studying the relation between political costs and earning smoothing in Iran, found that there is a meaningful relationship between them and that Arabic firms, with more staffs, face more pressure. This research has investigated 46 firms of Saudi stock exchange during 2005-2007.

Yan Zeng and Vinten, studying relationship between earning management and income in 52 Chinese firms during 2004-2008, found that there is no meaningful relationship between them.

Wen-lee, have studied earning smoothing in 83 Japanese firms during 2003-2008. Obtained results showed that larger firms would smooth earning more than small ones and their motivation would be increased along with increase in their debts. The results showed also that this smoothing would be provided by managers¹¹.

Pour Heydari and Hemmati, have investigated effects of debt's contracts, political costs, awards and ownership on earning management of accepted firms in Tehran's stock exchange and considered number of staffs as a variable to measure effects of political costs on earning management. Results showed that, firms, with a large number of staffs, would bear more political stress; thus, management of these units would decrease their earning to decrease in this stress. This paper, has investigated 62 firms in Tehran's stock exchange during 1997-2001.

Ibrahimi, Kordlor and Shahriari, studying relationship between political costs and conservation in Tehran's stock exchange, found that there is a negative relationship between investment size and conservation¹²; also there is a positive relationship between competition degree in industry and government's ownership with conservation. Results have also shown that there is no meaningful relationship between rate of tax and risk with conservation. In this paper, 71 firms were under investigation during 2002-2006.

Nourvash and Sepasi, have investigated the relationship between cultural values and earning smoothing of 64 accepted firms in Tehran's stock exchange during 1993-2004. Obtained results showed that there is a meaningful relationship between cultural values and earning smoothing; this showed that cultural factors have a crucial role in earning smoothing in Iran's stock exchange¹³.

Earning management: Scott describes earning management as some consciousness measures by manager about earning report to achieve some certain goals adjusted to accounting principles.

Degeorge and partners define earning management as a synthetic manipulation by manager to achieve desirable levels to make some certain decisions. In their opinion, in fact main motivation of earning management is investors' imagination about commercial unit¹⁴.

Generally, earning management would be considered as consciousness measures by manager to achieve certain goals in the framework of accounting managers have some information, which are unavailable for other members. If managers have intention to transfer some information, using earning management, which are not shower of real value of commercial unit, there would be no problem. On the contrary, some problems would be created when managers aim in confusing other users of earnings information¹⁵.

Earning management and political costs: Firms, as economic units, are always going to achieve more and more income. For various reasons including separation of ownership and management, firms are responsible for answering to outside individuals' questions in addition to their economic tasks. The most efficient form of answering, according to practical evidences, would be financial statement. Therefore, it seems that firms are responsible not only for economic tasks, but also they are responsible for representing statement about their activities. On the other hand, as they are trying to decrease in costs, they should conduct their financial statement in a way that users don't transfer assets to outside, using the statements. In other words, firms should consider economic effects of financial statement in addition to presenting their financial statements honestly according to accounting standards. Considering economic effects cause that financial statements not to be presented honestly as it was before. Failure to provide honest statement would be shown generally in the form of low income or high income¹⁶. Inefficient form of using financial statement, to avoid undesirable economic results, would be failure to observe accounting standards, which would be less observable due to financial statements' auditing and users' response to financial statements. Other form would be also using standards, which considers management judgment element in statement's decision making. Current focus of the research would be on those kinds of management judgments and their reasons, which would be created to obtain less earning. Since all methods using to gain less income, adjusted to accounting standards, cause imbalance in identification of advantages and hedges, this paper would assume "conservation" as an equivalent for presenting less earning¹⁷.

Firm size and earning management: Jonson and Mac ling have claimed that firms would be under the political attacks, and that people's attorneys tend to defend transferring assets from firms for themselves. These issues would be about social responsibility of most firms and necessity of some of them to pay costs for social problems such as earthquake, flood, etc, tolerating tax rates or some sanctions such as avoiding them from using some rights and advantages. Imposed costs on firms are adjusted to their size, because small firms are less observable and are less under political distributions of earnings¹⁸.

Firms have some tactics, by which they can decrease these costs. These firms' managers may avoid to state pure income to prevent from attracting media's attention. This tactic's logic is clear, because media are interested in publishing news about large companies including their polluting products, unusual increase in their income, staffs and managers' salary and so on¹⁹.

Assumptions: There are three assumptions in this paper to achieve its main purpose as follows; Firms, in which G-debts are more than total debts, managers are more interested in earning management; In large firms, managers are more

interested in earning management.

Statistic community: In the present study, samples have been selected from all firms of Tehran's stock exchange having some characteristics as follows; Considered firm should be accepted before 2000; End of their financial year should be 19th Mar; Data about considered firm should be available; To make statistic data homogeneous, financial institutions and banks should be eliminated.

Methodology

Since this research is going to investigate effects of political costs on earning management, kind of the analysis is correlation. To examine relationship between these variables, regression has been applied²⁰.

Research's variables and their measurement: Independent variable: In this paper, political costs have been considered as independent variables and effective factors on the earning management in firms. These political costs have been investigated using three indices including G-debt to total debt ratio, number of staffs (employee) and firm size²¹.

Political costs: Mozz believes that, the larger the firm size is, the stronger the motivation of managers would be in earning manipulation. In his opinion, larger firms are more responsible for answering public's questions and managers should answer more questions comparing to small firms²².

Some scientists are believe also that the more the size of firm is, the more its responsibility would be, so larger firms have less intention to manipulate earning comparing to small ones.

Firm size would not be considered just as political sensitivity. Number of staffs is another index for political sensitivity, because staffs are other political groups of firms. The more the number of staffs is, the more the pressure on the firm would be to achieve group's purposes. Therefore, manager may make some decisions to decrease imposed pressure. Another sensitivity index in this paper is G-debt to total debt ratio, which would be considered as an effective factor on the earning management. Each mentioned variables would be measured as follows²³.

SIZE= total assets, G-dept= G-debt to total debt ratio, Employee= number of staffs.

Dependent variable: In this paper, earning management is dependent variable and it would be also one of the main indices to determine rate of accruals manipulation. In the present research, accruals have been measured using Als-haly model. Accruals would be calculated as follows²⁴;

$$NADit = \alpha_1 (1/Ait-1) + \alpha_2 [(\Delta rev - \Delta rec) / Ait - 1] + \alpha_3 (PPEit / Ait - 1)$$

DAit= TAit/Ait-1_NDAit

Research model: Applied model to examine assumptions are as follows; $Em_i = \alpha + \beta^1 GDEBT_i + \beta^2 SIZE_i$.

Results and Discussion

Data collection; time and place status: Required data have been provided through observation and investigation of some evidences including financial statement data related to firm's shares in stock exchange. In this research, to provide literature of research, library method has been applied; processing Novin Rahavard software has been also applied to examine research's assumptions obtained from data of financial statement of firms. This paper has investigated some accepted firms in Tehran stock exchange during 2009-2010.

Data analysis: In this study, correlation of Pearson and multi-variable regression, have been applied for data analysis. Primary data have been provided and completed in the form of some files in the Microsoft Excel; then, SOSS was applied for statistic analysis of obtained results.

Colmogrov-Smirnov Test (data's normality test): H_0 : data are normal; H_1 : data are unnormal.

Table-1
Data Normality Test

Observation number	Meaningfulness level	H_0
540	0.087	Confirmed

Reference: researcher calculations: As it is obvious in table 1, since meaningfulness level is equal to 0.087 and more than 0.05, so H_0 (hypothesis) would be accurate to 95 percent. It means that data are normal. Obtained results from examining H_1 ; H_0 - there is no meaningful relationship between G-debt to total debt ratio and earning management; H_1 - there is a meaningful relationship between G-debt to total debt ratio and earning management.

To examine this assumption, following regression model would

be applied;

$$EM = \beta_0 + \beta_1 G-DEBT,$$

Where: EM= earning management; G-DEBT= G-debt to total debt ratio.

Reference: researcher calculations: According to table-2, since meaningfulness level is less than 0.05, so H_0 would be rejected, although, H_1 would be confirmed. Due to correlation coefficient equal to 0.413, there is a meaningful relationship between debt ratio and earning management in accepted firms of Tehran's stock exchange. R^2 is equal to 0.171; it means that debt ratio variable could represent 0.171 percent of changes of dependant variables (earning management).

Obtained results from examining H_2 : H_0 : there is no meaningful relationship between employee and earning management; H_1 : there is a meaningful relationship between employee and earning management. $EM = \beta_0 + \beta_1 Size$.

Reference: researcher's calculations: According to table-3, since meaningfulness level is less than 0.05, so H_0 would be rejected and H_1 would be confirmed. According to correlation coefficient equal to 0.376, there is a meaningful relationship between debt ratio and earning management of firms in Tehran's stock exchange. R^2 is equal to 0.141; it means that employee variable can present 0.141 percent of changes in dependant variable.

Determining accuracy of regression models and investigation of effects of presented model: With determining ratios of Durbin-Watson for each regression equation, one can find that there would be $1.5 < \text{Durbin-Watson} < 2.5$ for all variables and errors are independent.

Meaningfulness test of two-variable regression equations: In this section, meaningfulness of regression equations would be measured by variance analysis as follows in table-4.

Table-2
Correlation between G-debt to total debt ratio and earning management

Regression equation	Independent variable	Dependent variable	Correlation coefficient	R-Square (R^2)	Meaningfulness level	Durbin-Watson	H_0
1	Debt ratio	Earning management	0.413	0.171	0.00	2.055	rejected

Table-3
Correlation between employee and earning management

Regression equation	Independent variable	Dependent variable	Correlation coefficient	R Square (R^2)	Meaningfulness coefficient	Durbin-Watson	H_0
2	Debt ratio	Earning management	0.376	0.141	0.00	2.082	rejected

Reference: Researcher’s calculations: predictors: (independent variable), G-debt to total debt ratio; predictors: (independent variable), firm size; dependant variable, earning management.

As you observed in table4, meaningfulness level of all equations is less than 0.05, thus all regression equations are meaningful.

Presenting earning management forecast by each variable (T test): After F test and finding meaningfulness of regression equations, now this paper would investigate that which variable has a coefficient equal to 0, and that what is their value. To do this test, coefficients table has been applied and finally, due to values of variables, a two-variable model has been applied for earning management as follows;

Reference: researcher’s calculations: predictors: (independent variable), G-debt to total debt ratio; predictors: (independent variable), firm size; dependant variable: earning management.

As it is obvious in table5, all variables’ coefficients are opposite to 0. Due to values of α and β , and due to values of each variable, one can present a two-variable model as follows; EM= -56999.066+76806.865 G-DEBT, EM= -580275.9+45542.879 SIZE.

Research’s limitations: Every study, due to its nature, would

be face some limitations, which would slow down the process of the study or cause unclearness in it and consequently, obtained results would not be accurate and reliable. There are some limitations in this study as follows; Reservation of values and ratios of political costs by some firms because of issue’s sensitivity; Problems related to financial data accessing, especially political costs data.

Conclusion

In this research, two assumptions were presented. In the first assumption, it was mentioned that firms, having more G-debt than total debts, are more interested in earning management. In the second assumption it was mentioned that, in large firms, managers are more interested in earning management. And finally, the paper was investigated relationship between variables, using statistics analysis. Therefore, this paper found that the more the total assets are, the more the probability of earning management would be²⁵.

Suggestions: With respect to obtained results from the first assumption, one can suggest that, firms, in which G-debts are more than total debts, more supervisory should be taken by related institutions, so that the probability of earning management would be decreased. Due to second assumption also one can suggest that there should be sufficient supervisory on firm’s assets.

Table-4
ANOVA table

Regression equation		Total square	DOF	Mean square	F statistic	Meaningfulness level
1	Regression	1.83E+12	1	1.829E+12	110.591	(a) 0.000
	Residuals	8.90E+12	538	1.654E+10		
	Total	1.07E+13	539			
2	Regression	1.52E+12	1	1.571E+12	88.598	(b) 0.000
	Residuals	9.21E+12	538	1.712E+10		
	Total	1.07E+12	539			

Table-5
T^e test

Regression equation		Non-standard coefficients		Standard coefficient	T statistics	Meaningfulness level
		Variables’ coefficient	Standard deviation	β		
1	Independent variable ^a	56999.066	6458.810		-8.825	0.000
	Debt ratio ^b	76806.865	7303.666	0.413	10.516	0.000
2	Independent variable	-580257.9	59577.604		-9.740	0.000
	Debt ratio ^c	45542.879	4838.489	0.376	9.413	0.000

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