

EVALUATING THE IMPACT OF ACCOUNTING CONSERVATISM ON ACCRUAL-BASED EARNINGS MANAGEMENT IN TEHRAN STOCK EXCHANGE

Masoumeh Najadmohammadi Alarloog¹

Department of accounting, Science and Research Branch, Islamic Azad University, Ardabil, Iran.

Dr. Azim Aslani

Department of accounting, Astara Branch, Islamic Azad University, Astara, Iran.

Dr. Behnam Azadi

Department of accounting, Ardabil Branch, Islamic Azad University, Ardabil, Iran.

Abstract

Scope of this study, is evaluating the effect of accounting conservatism on accrual-based earnings management at accepted companies. And also, Time scope of the study is period from early of 2006 until the end of 2011. The sampling methods is used purposive sampling (systematic elimination method). To gathering data, we use Library method and Method of mining documents. And In order to analyze the data resulted from collected questionnaires deductive and descriptive statistical methods are used. So we can use Multi Regression test the hypothesis of the research. Findings show that conditional accounting conservatism have negative impact on accrual-based earnings management and statistically is non-significant and unconditional accounting conservatism have positive impact on accrual-based earnings management and statistically is significant. Also, Company size, Book-to Market Value and Rate of return on assets have positive impact on accrual-based earnings management at accepted companies in Tehran Stock Exchange

Keywords: unconditional accounting conservatism, conditional accounting conservatism, accrual-based earnings management

INTRODUCTION

Accounting conservatism is traditionally defined by the adage “anticipate no profit, but anticipate all losses” (e.g., Bliss, 1924). Anticipating profits means recognizing profits before there is a verifiable legal claim to the revenues generating those profits. Conservatism does not imply that all revenue cash flows should be received before profits are recognized. Thus the issue is one of verifiability. In the empirical literature the adage is interpreted as representing “the accountant’s tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as

¹ Correspondence author

losses” (Basu, 1997, p. 7). Conservatism is the asymmetry in the verification requirements for gains and losses. This interpretation allows for degrees of conservatism: the greater the difference in degree of verification required for gains versus losses, the greater the conservatism.

An important consequence of conservatism’s asymmetric treatment of gains and losses is the persistent understatement of net asset values. Capital market regulators, standard-setters and academics criticize conservatism because this understatement in the current period can lead to overstatement of earnings in future periods by causing an understatement of future expenses. For example, Accounting Research Bulletin 2 (AICPA, 1939) states: “*conservatism in the balance sheet is of dubious value if attained at the expense of conservatism in the income statement, which is far more significant.*”

Using “conservatism” to describe conservatism’s income statement effect for a particular period was popularized by conservatism’s critics. That usage does not fit with conservatism itself. Conservatism reserves the use of the term for the balance sheet and for income or earnings cumulated since the firm began operation.

Conservatism’s influence on accounting practice has been both long and significant. Basu (1997, p. 8) argues that conservatism has influenced accounting practice for at least five hundred years. Sterling (1970, p. 256) rates conservatism as the most influential principle of valuation in accounting.

There are many definitions of accounting conservatism. Kohler’s dictionary defines conservatism as “a guideline which chooses between acceptable accounting alternatives ... so that the least favorable immediate effect on assets, income, and owner’s equity is reported.” Bliss (1924) defines conservatism as: “anticipate no profit, but anticipate all losses.” According to Watts (2003) and Basu (1997), conservatism requires a “higher degree of verification to recognize good news as gains than to recognize bad news as losses.” As Sunder (1997) notes, “[t]he presence of uncertainty and the downward bias of measured current-period income, assets, and owner’s equity in the presence of uncertainty seems to be the essential aspects of conservatism” (Glover and Lin, 2013).

We measure conditional conservatism using (i) Basu (1997) asymmetric timeliness measure, and (ii) firm-specific C-Scores following Khan and Watts (2009). We measure unconditional conservatism using an accrual based measure (Ahmed et al. 2002).

It is well known that managers use accrual based earnings management techniques to provide flexibility within the accounting rules to report an earnings number that meets or beats the consensus analyst forecast. The market rewards firms that meet or exceed earnings expectations, and penalizes firms whose earnings fall short. In the years following the passage of the Sarbanes-Oxley Act of 2002, research shows that accrual based earnings management appears to be decreasing. Managers presumably perceive the risks and costs of detection to be higher than the benefits of managing earnings in a heightened regulatory environment (Amat, Gowthorpe, Perramon. 2005).

However, accrual based earnings management techniques are not the only tools available to managers to help them meet analysts’ forecasts. If a firm’s results of operations will not be sufficient to meet the analyst forecast for a given period, managers may also 1) structure actual transactions to achieve the desired accounting result, a phenomenon often referred to as “real transactions manipulation” or “real transactions based earnings management”, or 2) attempt to guide the analyst forecast down to a beatable level, a phenomenon referred to as “expectations management.” (Zang, 2008).

To capture accrual-based earnings management we use the modified cross-sectional Jones model (Jones, 1991) as described in Dechow et al. (1995). To capture real earnings management, we follow Roychowdhury (2006) and estimate abnormal levels of cash flows from operations, discretionary

expenses (advertising, R&D, and SG&A), and production costs. In addition, we combine these three measures into a comprehensive aggregate measure of real earnings management. So, the main purpose of this study is:

- Determine the effect of conditional accounting conservatism on accrual-based earnings management.
- Determine the effect of Unconditional accounting conservatism on accrual-based earnings management.

METHOD

Scope of this study, is evaluating the effect of accounting conservatism on accrual-based earnings management at accepted companies in Tehran Stock Exchange. And also, Time scope of the study is period from early of 2006 until the end of 2011. We selected population for the following reasons:

- The companies that are active in different industries and are members Tehran Stock Exchange
- The companies reported better of its governance and financial activity.
- Enabling better access to the company's audited financial information for analysis and hypothesis testing.
- The companies are not investment firms and financial intermediation.

In this study, sampling methods is used purposive sampling (systematic elimination method).

- We select firms that their financial year is March 19.
- The firms has not stopped their stock trading during the period of three months in Tehran Stock Exchange
- The firms that their information are available for selected variables in this study.

With the conditions imposed in this study consisted of 99 members of the company.

To gathering data, we use Library method and Method of mining documents. And In order to analyze the data resulted from collected questionnaires deductive and descriptive statistical methods are used. So we can use Multi Regression test the hypothesis of the research. The SPSS tool has been used.

ANALYSIS AND RESULTS

A) Descriptive Analysis

In the descriptive analysis, the researcher used descriptive statistics such as tables and indexes to describe the central tendency and Measures of Variation of data collected research. This transparency helps to explain the research. The results of the descriptive analysis of the data are presented in Table (1).

Table 1: descriptive analysis of variables

Variables	n	Mean	SD	Jarque-Bera	
				Statistic	Prob.
accrual-based earnings management	594	-.001	.124	9.166	.102
Accounting conditional Conservatism	594	.106	1.632	55.169	.000
Accounting unconditional Conservatism	594	.069	.200	65.114	.000
Company size	594	13.279	1.414	13.001	.098

Book-to Market Value	594	.693	.782	143.115	.000
Rate of return on assets	594	.111	.130	24.101	.009

According to table 1 results, the mean of accrual-based earnings management is -.001. Also, the mean of accounting conditional conservatism and accounting unconditional conservatism respectively is 0.106 and 0.069.

B) K-S test results

To check data normality hypothesis is formulated as follows:

H₀: Data distribution is normal

H₁: Data distribution is not normal

To test the above hypothesis is used Kolmogorov – Smirnov test. The results are presented in Table 2.

Table 2: Kolmogorov – Smirnov Test Results

Description	Z	P-Value
accrual-based earnings management	1.494	.083
Accounting conditional Conservatism	3.173	.000
Accounting unconditional Conservatism	1.192	.120
Company size	1.226	.131
Book-to Market Value	4.046	.000
Rate of return on assets	1.522	.061

The results Kolmogorov-Smirnov Test shows the test distribution is Normal.

C) Hypotheses Results

The main hypothesis of this study is “accounting conservatism has impact on accrual-based earnings management”. And also we have two sub hypotheses:

- 1) Conditional accounting conservatism has impact on accrual-based earnings management
- 2) Unconditional accounting conservatism has impact on accrual-based earnings management

To test the hypothesis, we have used Multi Regression test according to this model:

$$AM_{i,t} = C + \beta_1(Conser_{i,t}) + \beta_2(Size_{i,t}) + \beta_3(BM_{i,t}) + \beta_4(ROA_{i,t}) + \varepsilon_{i,t}$$

Table 3: Hypothesis Test Results

Variable	Unconditional Accounting Conservatism			Conditional Accounting Conservatism		
	Coefficient	t	Prob.	Coefficient	t	Prob.
C	-0.090	-2.237	0.025	-0.100	-2.423	.015
Accounting Conservatism	-0.202	-3.770	0.000	-0.001	-0.650	.515
Size β_2	0.004	1.341	.180	.003	1.083	.279
BM β	0.025	4.251	0.000	0.0025	4.901	.000
ROA β_4	0.283	6.336	0.000	.303	6.127	0.000
F	44.458			21.301		
Prob.	.000			.000		
Durbin Watson	1.873			1.874		
F test (Chow)	1.136			1.225		

Prob.	.339	.295
Breusch-Godfrey Prob.	1.074 .342	.975 .377
White H	12.679 .000	5.774 .000
R ² AdjR ²	.231 .226	.126 .120

CONCLUSION

According to research results, the significant level of F test (Chow) in both cases less than the acceptable error level panel data have selected for regression model. The results of anisotropy variance test (White test) shows that the difference of variance exists, in this case to resolve the dissonance of the variance of the estimation model is used to resolve the dissonance.

Also the Lagrange multiplier test (Godfrey brush test) indicates that there is no serial autocorrelation in the regression model. The Durbin Watson statistic are located in both cases between 1.5 and 2.5, which indicates that there is no correlation between the components of the model error. Significant level of F statistic (0.000) in both cases lower than acceptable error (5%) and general regression models meaningful.

The R² and adjusted R² show that the independent and control variables explain changes of 12.6 percent in first case and 23.1 percent second case in dependent variables.

Due to the high level of probability (Prob.) of the t-statistic for the coefficient of error of acceptable B^I in the first case, the test results show that conditional accounting conservatism have negative impact on accrual-based earnings management and statistically is non-significant. Therefore, we cannot accept the first research hypothesis in the first case with 95% confidence level.

Also, due to the low level of probability (Prob.) of the t-statistic for the coefficient of error of acceptable B^I in the second case, the test results show that unconditional accounting conservatism have positive impact on accrual-based earnings management and statistically is significant. Therefore, we can accept the first research hypothesis in the first case with 95% confidence level.

Finally, results show that Company size, Book-to Market Value have positive and Rate of return on assets impact on accrual-based earnings management at accepted companies in Tehran Stock Exchange

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