ACCOUNTING CONSERVATISM IMPACT ON REAL EARNINGS MANAGEMENT

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Abstract

Scope of this study, is evaluating the effect of accounting conservatism on earnings management at accepted companies in Tehran Stock Exchange. And also, Time scope of the study is period from early of2006untiltheendof 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 real earnings management and statistically is non-significant and unconditional accounting conservatism have positive impact on real earnings management and statistically is significant. Also, Company size, Book-to Market Value have positive impact on real earnings management and Rate of return on assets have negative impact on real earnings management at accepted companies in Tehran Stock Exchange.

Keywords*: unconditional accounting conservatism, conditional accounting conservatism, real earnings management*

INTRODUCTION

Earnings management can be classified into three categories: fraudulent accounting, accruals management and real earnings management. Fraudulent accounting involves accounting choices that violate GAAP. Accruals management involves within-GAAP choices that try to "obscure" or "mask" true economic performance (Dechow and Skinner, 2000). Real earnings management (RM) occurs when managers undertake actions that deviate from the first best practice to increase reported earnings.

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Schipper (1989) was one of the first to include RM in the definition of earnings management. She describes earnings management as "*a purposeful intervention in the external financial reporting process, with the intention of obtaining some private gain...[a] minor extension of this definition would encompass "real" earnings management, accomplished by timing investment or financing decision to alter reported earnings or some subset of it.*"

Fraudulent accounting and accruals management are not accomplished by changing the underlying economic activities of the firm but through the choice of accounting methods used to represent those underlying activities. In contrast, RM is accomplished by changing the firm's underlying operations. Examples of RM include cutting prices towards the end of the year in an effort to accelerate sales from the next fiscal year into the current year, delaying desirable investment, and selling fixed assets to affect gains and losses, all in an effort to boost current period earnings.

Even though accruals management may be less costly, with respect to future firm value, there are several reasons managers may still engage in RM. First, aggressive accounting choices with respect to accruals are at higher risk for SEC scrutiny and class action litigation, ex post. Second, the firm may have limited accounting flexibility (i.e. limited ability to report discretionary accruals). For example, accruals management is limited by the business operations and by accrual manipulation in prior years (Barton and Simko, 2002). In addition, accruals management must take place at the end of the year and managers face uncertainty as to which accounting treatments the auditor will allow at that time. Operating decisions are controlled by the manager, whereas accounting treatments must meet the requirements of auditors.

Prior studies provide strong evidence on the existence of RM. The use of RM by managers is supported by Graham et al. (2004) who survey 401 financial executives about key factors that drive decisions about reported earnings and voluntary disclosure. They report that 78% of the executives interviewed indicated a willingness to sacrifice economic value to manage financial reporting perceptions.

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 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 themost 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).

The main purpose of this study is:

- Determine the effect of conditional accounting conservatism on real earnings management
- Determine the effect of Unconditional accounting conservatism on real earnings management

METHOD

Scope of this study, is evaluating the effect of accounting conservatism on earnings management at accepted companies in Tehran Stock Exchange. And also, Times cope of the study is period from early of2006untiltheendof 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 99membersof 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).

Table1: descriptive analysis of variables

Variables	n	Mean	SD	Jarque-Bera	
				Statistic	Prob.
Real earnings management	594	-.003	.118	9.107	.110
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 real earnings management is -.003. 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:
H_0: Data distribution is normal
H_1: 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
Real earnings management	1.149	.143
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 real earnings management". And also we have two sub hypotheses:
1) Conditional accounting conservatism has impact on real earnings management.
2) Unconditional accounting conservatism has impact on realearnings management.
To test the hypothesis, we have used Multi Regression test according to this model:

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

Table 3: Hypothesis Test Results

Variable	Unconditional Accounting Conservatism			Conditional Accounting Conservatism		
	Coefficient	t	Prob.	Coefficient	t	Prob.
C	0.111	**-2.577**	0.012	-0.109	**-2.520**	.012
Accounting Conservatism	0.063	**2.810**	0.005	-0.003	**-1.155**	.248
)Sizeβ_2(	0.009	**2.794**	0.005	0.009	**2.868**	.004
)BMβ_3(	0.013	**2.157**	.031	0.012	**2.074**	.038
)ROAβ_4(	-0.229	**-6.395**	.000	-0.234	**-6.527**	.000
F	9.187			8.214		
Prob.	.000			.000		
Durbin Watson	1.636			1.676		
F test(Chow) Sig	3.260 .006			3.210 .007		
Husman	10.886 .028			10.835 .028		
Breusch-Godfrey	.566 .568			.313 .731		
White H	5.052 .000			2.943 .000		
R^2 AdjR^2	.124 .110			.112 .098		

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. Also, to asses show well the regression estimates (estimated with fixed or random effects) Hausman test has used. The results of the Hausman test shows the significance level for both models using fixed effects rather than random effects method is preferred. 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 auto correlation in the regression model. The Durbin Watson statistic are located in both casesbetween1.5and2.5,which indicates that there is no correlation between the components of the model error. Significant level of Statistic (0.000)in both cases lower than acceptable error(5%) and general regression models meaningful.

The R^2 and adjusted R^2 show that the independent and control variables explain changes of 11.2 percent in first case and 12.4 percent second case in dependent variables.

Due to the high level of probability(Prob.)of thet-statistic for the coefficient of error of acceptable B^1 in the first case, the test results show that conditional accounting conservatism have negative

impact on real earnings management and statistically is non-significant. Therefore, we can not 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^1 in the second case, the test results show that unconditional accounting conservatism have positive impact on real 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 impact on real earnings management and Rate of return on assets have negative impact on real earnings management at accepted companies in Tehran Stock Exchange

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