A Quasi–Empirical Investigation of the Relationship between Real Financial Events and Profit Management in Companies Accepted by New York Stock Exchange

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Abstract—Many current researches in the field of profit management are focused on discovering unusual accruals. Profit management may be performed by accruals, real financial events or both of them. Till now, little works have been performed to identify whether unusual accruals are due to manipulation of accruals without the effect of cash flows or due to manipulation of real events which are effective on both cash flows and arrears. The current study aims to evaluate manipulation of real financial events through focus on variables such as cash flows induced by operation, optional costs, variation in inventory and production costs. Accruals are selected as an appropriate alternative for measuring the profit management. The results show that there is a meaningful relationship between operation cash and variation in inventory and profit management in companies accepted by New York Stock Exchange.

Index Terms—Financial Management, Profit Management, Optional Costs, Real Financial Events, Operational Cash, Production Costs, Investment, New York Stock Exchange, Cash Flows

1 INTRODUCTION

By growing business and commerce affairs in today world and specialization of company managing, management and ownership becomes separated and managing of companies, internally and internationally, are performed by professional managers who are inform about complicated economical and financial problems. Owners offered their wealth to managers and want to inform about duties and performances of managers in order to make decision about cases such as maintaining or selling investments and evaluating performance of managers to re-recruiting or replacing them. In this way, accounting information provides a huge part of required information by decision makers. In fact, accounting is the information system of business units which provides and presents financial information. Most accounting information are reflected in basic financial statements and approximately all information required for decision makers including capital owners, potential investors, accreditors, financial analyzers and other users is provided by financial statements. One of the most used financial statements is profit and loss statement. This report reflects the performance of business unit during a financial period [1–11]. Managers of business units are eager, for many reasons, to vary their profit of financial period through applying various accounting methods [12–22]. In fact, accounting is “attributing numbers and digits to things or events based on regular and reasonable rules” [23–26]. The goal of accounting and financial reporting is providing information needs and requirements of users. The main tool for information transferring to persons and users who are out of organization is basic financial statements. One of the basic financial statements is profit and loss statement which is of great importance in evaluating consultancy of management or reckoning of management about their resources. Profit and loss statement involves efficiency induced by resources controlled by management of business unit and reflects the performance of business unit during the considered period. Since manager of business unit is responsible for providing financial statements and considering the fact that managers are of full access to information and have rights to select any accounting method, profit management is possible.

Managers can manipulate the profit through various methods. Some utilized tools in profit management have not directly affect cash flows which involve manipulation of optional accruals. In addition, managers manipulate real financial events to obtain considered favorite profit margin or to maintain conditions of last year. This is led to change in cash flows and even in some cases causes to variation in accruals such as reducing advertising costs in order to increasing the profit [27, 31, 33, 37]. Based on the performed studies [27–37], tools and methods for manipulating real financial events are selling with higher speed and acceleration, changing good transferring programs, Research and Development (R&D) costs, delay in identifying maintenance cost, cash discounts of sell and reducing advertising costs, general, office and sell costs, re-educating cost and transportation costs [38, 39]. These changes in financial reporting lead to misunderstanding of users from...
financial information related to infrastructure of economic performance and normal profitability approach as well as the results of contracts reported according to accounting reports [40].

Considering economic, social, political and cultural differences of the United States and western countries, identifying the utilized tools for profit and loss management and the amount of utilizing these tools by managers of various industries can be helpful for making appropriate economic decisions. Based on preliminary evaluations and studies of researcher, some tools utilized for profit management in companies suspected to profit manipulation is as following:

(1) If profit manipulation is possible by considering manipulation of real financial events through increasing cash discounts and or lengthening period of accreditation which finally leads to temporary increase in sell?

(2) If profit manipulation is possible by considering manipulation of real financial events through decreasing optional costs?

(3) If profit manipulation is possible by considering manipulation of real financial events using decreasing cost of sold product through increasing production?

In spite of accepted accounting standards, there is still no consensus about profit reporting among theorists and professionals due to lack of a comprehensive profit theory. In practice, profit reporting is encountering with various challenges. In addition, considering separation of ownership and management, the possibility of profit manipulation and misleading people in their decision makings should be considered due to conflict of interests and exclusive availability of some financial information for managers as well as the characteristic of accrual accounting in right of managers for selecting their favorite accounting method. At the other hand, considering recently distribution of justice stock of accepted companies in stock exchange market among all people in the United States, and considering the understanding and familiarity of various social groups with financial issues, it is necessary to present accurate and transparent information to society in order to make easy the issue of decision makings that leads to huge economic results. However, reported profits are always considered as one of the criteria for financial decision making and profit is generally considered by financial analyzers as a major factor in their assessments and judgments. Therefore, accepting economic consequences of profit reporting is inevitable. Theoretically, profit management is not only presented in non-efficient capital markets but also is presented in efficient capital markets. The general goal of the current study is helping for identification of financial events through increasing cash discounts or decrease in optional costs may be accompanied by increase in associated selling level and vice versa. In this manner, cash discounts and beyond demand production cause to higher production costs in relation to associated selling level while reduction in optional costs leads to lower optional costs in relation to associated selling level and vice versa. In this manner, cash discounts and beyond demand production reduce CFO while decrease in optional costs may be accompanied by increase in CFO [97, 98].

Researchers were studied profit management through manipulating real financial events (e.g., operational events) which affect cash flows in the United States. Although many American companies identified extraordinary items which led to decrease in profit, only a few companies reported annual loss. To investigate this issue, researchers were evaluated financial information of American companies. They were obtained financial information and data related to stock prices from online basic information service of financial search system of Nikki economic information electronic databank (NEEDS–FQ). Their selected population includes 1860 company–year and the rest of company–year are 12360.

Their basic assumptions are:

(1) About optional costs, considered companies are of low operation cash flow or low optional costs or both.

(2) About beyond demand production, considered companies are of high production costs.

The estimated regressions for company–years were similar to researchers’ regressions. This study has been successfully obtained some facts to show that American companies perform profit management for financial activities related to operation income level [99–101].


2 RESULTS AND DISCUSSION

Ability for changing in accounting methods, due to lack of commitment in uniform methods, as well as exclusive access of managers to some financial information and characteristic of accrual accounting and motivations such as occupational safety, reward, illegality, avoiding loss and profit decrease reporting, debt contracts, wealth increasing, achieving to expectations of stakeholders and predicted programs motivate managers to manipulate profit through various methods toward their benefits and against benefits of other groups.

Managers can manipulate profit through various methods. The utilized tools for profit management are including: (a) Manipulating optional accruals which have not directly affect cash flows. For example, inability to achieve borrowing conditions and change in costs of doubtful debts as well as delay in removing constant properties which their lifetime is over can be noted in this group. (b) Manipulating real financial events which lead to change in cash flows and even in some cases, lead to change in accruals such as reducing advertising costs in order to increase the profit. In the current research, manipulation of real financial events is considered.

According to preliminary evaluations, four following theories are considered in the current study:

(1) There is a meaningful relationship between unusual operation cash and profit management.
(2) There is a meaningful relationship between unusual optional costs and profit management.
(3) There is a meaningful relationship between unusual changes in inventory and profit management.
(4) There is a meaningful relationship between deviation in cost of production and profit management.

The current research is a quasi-empirical and after event research in the field of positive accounting researches and is based on historical data. In this method, researcher aims to discover and evaluate relationships between special factors and conditions or behavior which has been previously happened through studying results obtained from those. Regression method and OLS technique at 97% reliability level was used for testing assumptions of research.

3 CONCLUSION

The current study was evaluated the relationship between real financial events and profit management in accepted companies by New York Exchange Stock during a fifteen year period. In this regard, relationship between four factors including unusual optional costs, unusual operation cash, unusual production costs and unusual change in inventory and profit management were investigated.

The results obtained from research assumption tests were shown that the considered companies in the current research manipulate their profits. In fact, managers consider producing beyond demand or buying more than demand of inventory to reduce cost of sold products so that operation cash flows become lower than usual level and hence, profit increases. The type of obtained relationships in the current research is in accordance with the results reported by scientists and researchers. However, only two factors including unusual operation cash flows and unusual change in inventory were confirmed while at other countries, all four factors have been confirmed. Nevertheless, type of obtained relationships in the current research is in accordance with previous researches.

4 FUTURE STUDIES

Considering the fact that there have not been numerous researches in the field of profit management and its related issues in the United States, following issues may be useful for researchers who are willing to research in this field:

(1) In the current study, four effective tools of real financial events on profit management were tested. Considering economic, social and cultural environment of the United States, there are possibly other factors which should be identified and tested through researches and studies. It can be very helpful for developing literature of profit management in the United States.
(2) Factors such as value of capital market to its office value, size of company and accrual items should be considered in the future studies.
(3) It may be useful to choose another dependent variable of profit management such as programming the selling of constant properties, selling investments, increasing or decreasing research and development costs, and change in accounting methods and estimates as an alternative for optional accruals.

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