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The Investigation of Effecting factors on Earnings Quality

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ABSTRACT

Main qualitative characteristics of Financial Statements are Understandability, Relevance, Reliability and Comparability. In this research we examine the effect of these factors on Earnings Quality in Accepted Companies of Tehran Stock Exchange (TSE) using Panel Data approach over time 2002-2010. In this regard these companies are divided in two groups (first with high earnings quality and second with low earnings quality). Results showed that Earnings Response coefficient (ERC) and explanatory power (R^2) in firms' portfolio with high relevance and reliability of earnings quality are higher than firms' portfolio with low Understandability, Relevance, Reliability and Comparability of earnings quality.
KEYWORDS: Understandability, Relevance, Reliability, Comparability, Earnings Quality.

1- INTRODUCTION

Accountants, make available to users financial information relating to the economic unit in the form of accounting reports using concepts, specific rules and procedures. Gains and losses reporting of a business unit is a variety of economic information that accountants can provide and users have special attention them. In the last row of gains and losses reporting, the amount of net earnings of economic unit is provided (Byard et al., 2006). Users can figure based on reported earnings, prospects of economic performance and its future prospects. Also one of the important features of accounting reports is its comparability with previous units' reports and reports of similar economic units. The question is: do all the functional features of economic units can be reflected in the amount of accounting earnings or not? Or is case such as the business risk reflected in net earnings? And is disable the net profit amount alone in expressing some important functional characteristics, particularly non-quantitative features? Suitable ground for the manipulation of earnings, inherent limitations of accounting and Possibility of using multiple methods of accounting has caused that the real profit of a firm is differ from reported earnings in financial statements. Because of earnings importance as one of the most important performance criteria and the value of economic businesses determinant, Professional accounting researchers and practitioners have to assess reported earnings by businesses (Chan et al., 2006). To evaluate these earnings, the concept of earnings quality is used. In various articles on the concept of earnings quality, there are two features to determine of earnings quality. One is benefit of the decision that has been provided by the Financial Accounting Standards Board and another is a connection between this concept and economic earnings (Byard et al., 2006). High quality shows that the usefulness of the earnings information for decisions of users and it's more consistent with the economic earnings. Some financial analysts are considered earnings quality as a continuous and ordinary benefit, Repeatable and creating cash flow from operations. Financial experts have been unable so far to achieve an independent measure of earnings that from their perspective have suitable quality (Jenkins et al., 2006). So, the concept of earnings quality is not a defined and proved thing that it can be achieved easily but it is a relative concept that depends on its relationship with perceptions and attitudes (Harris, 2000).

In finance and accounting texts, some of the properties of businesses have been identified that their existence leads to an increase in earnings quality. If a company has the following characteristics, then its quality will be higher:

- Stable and conservative accounting methods
- Income before taxes from operating and repeatable activities
- Achieving a level of profit and growth rates, independent of tax considerations (for example: reducing tax rates will lead to tax exemption).
- Having an appropriate level of debt

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- having an appropriate capital structure
- Corporate profits are not related to inflation

As mentioned, there are not the same definitions for the term earnings quality. Many studies in developed countries have confirmed that net earnings reported by enterprises have content information; but about the "uniform definition of the earnings" little study has been done. So the basic question is how to overcome the faults of earnings and such earnings that the so-called earnings quality has an important role in economic decisions and its use is very important in the Iran current economy. Other ways accounting choices can lower a firm's earnings quality include

- Recording revenue too soon or of questionable quality,
- Recording fictitious revenue,
- Boosting income with one-time gains,
- Shifting current expense to a different period,
- Failing to record or improperly reducing liabilities,
- Shifting current revenue to a later period, and
- Shifting future expenses to the current period as a special charge

In this regard, the main research questions are as follows:

- Is the quality of earnings can be useful to decision-makings of investors?
- Do the relevant and reliable information of financial statements increase the earnings quality?

According to existing theory and research background, questions have been developed as follows:

- Is Earnings Response coefficient (ERC) in firms' portfolio with high Understandability, Relevance, Reliability and Comparability of earnings quality higher than firms' portfolio with low Understandability, Relevance, Reliability and Comparability of earnings quality?
- Is explanatory power (R^2) for evaluate of market price in firms' portfolio with high Understandability, Relevance, Reliability and Comparability of earnings quality higher than firms' portfolio with low Understandability, Relevance, Reliability and Comparability of earnings quality?

After this section, in section 2, literature review is presented. Methodology and data are delivered in section3. Results will be analyzed in section 4 and finally Conclusion is presented in section 5.

2. LITERATURE REVIEW

Dechow (1994) in a study concluded that accruals will reflect short-term performance of company better than cash flows. By analyzing in a short period, he showed that accruals can be reflected in the stock returns rather than the cash. Sloan (1996) in his study states that companies with high accruals, reducing operating profit will face in coming years. So the size of accruals is a suitable criterion for evaluating earnings quality. Barth et al., (2001) determined coefficients estimated of the regression of price - return for determining the relevancy and reliability of information and showed that the accounting information are reflected in prices when these information are for investors relevant and reliable. Konan (2001) in an article entitled "Quality of earnings and stock returns," states that the accruals with high earnings quality have low stock returns; so their stock return will be weak. The weakness of relationship between earnings and returns are associated with low earning quality. If the earnings are closer to cash flow, its accruals will be lower and quality will be higher. Dechow and Divhev (2002) in a study entitled "The quality of accruals and earnings: The accrual estimation error", offer a new criterion for evaluating the earnings quality. They show that visible characteristics of companies can be as a tool to assess the quality of accruals. Francis et al., (2002) in their study investigated relationship between earnings quality and cost of debt and equity, and showed that companies with lower earnings quality have lower debt rates and higher interest rate of costs than firms with high earnings quality. Schipper and Vincent (2003) investigated the relationship between criteria of evaluating of earning quality and usefulness in decision making and economic earnings definition. They showed that the earnings quality depends on contracts based on accounting information. Scholer (2004) relates the earnings quality with accruals and to assess earnings quality uses accruals. He also states that the capital market reflects information about earnings quality in prices. Francis et al (2004) in their study assessed the relationship between capital cost and seven properties of earnings quality. These criteria include Accruals quality, stability, predictability, smoothness, relevancy, timeliness and conservatism. The results show that with low earnings quality, capital costs would be higher. Aboody et al., (2005) in a research titled "Earning quality, insider trading and cost of capital" investigated the relationship between the cost of capital and information asymmetry. The main findings of this study include "Information asymmetry is priced by the market", "there is a negative link between earnings quality and cost of capital" and "Aware people use confidential information efficiently". Barua (2006) considered two criteria for measuring the earnings quality. These two criteria are relevance and reliability. Results of this study are that high quality lead to Investors can better able to make their investment decisions. Also higher earnings quality makes useful the accounting information for decision makers.

3. METHODOLOGY AND DATA

The research model is as follows:

$$\Pr ice_{it} = \beta_0 + \beta_1 BVE_{it} + \beta_2 EPS_{it} + \beta_3 EPS.DE_{it} + \beta_4 EPS.EVAR_{it} + \beta_5 EVA_{it} + \beta_6 REVA_{it} \varepsilon_t$$

$\Pr ice_{it}$: Price of each Share

BVE_{it} : Book value of equity divided by the number of shares released

EPS_{it} : Earnings per share before unexpected items and discontinued operations

DE_{it} : Debt to capital ratio

$EVAR_{it}$: standard deviation of EPS

EVA_{it} : Economic Value Added

$REVA_{it}$: Refined Economic Value Added

ε : Model's Residuals

To do this work, companies listed on the stock exchange have been considered as the statistical community and Sample was extracted from these companies. Sample includes companies that have the following conditions:

- Companies are accepted before 2000 in Tehran Stock Exchange.
- The companies that end their fiscal year in Persian date Esfand 29 per year.
- These companies in the course may not stop or change the fiscal period.
- These companies are not included in investment firms.

4. RESULTS

Tables 1 and 2 represent the estimations of variables effect on stock price in tow group.

Table1: estimation result for companies with high earning quality

Significance	t	Standard error	coefficient	Variable Name
Significant	12.279	10.18	125	BVE
Significant	3.754	0.171	0.642	EPS
Significant	-2.963	0.027	-0.080	EPS.DE
Significant	3.158	0.0019	0.006	EPS.EVAR
Significant	2.684	0.019	0.051	EVA
Significant	2.622	0.037	0.097	REVA
			0.89	$\overline{R}^2$
			1.97	$D.W$

Table2: estimation result for companies with low earning quality

Significance	t	Standard error	coefficient	Variable Name
Significant	4.590	31.37	144	BVE
Significant	3.160	0.187	0.591	EPS
Significant	-3.286	0.021	-0.069	EPS.DE
Significant	2.727	0.0011	0.003	EPS.EVAR
Significant	4.273	0.011	0.047	EVA
Significant	3.458	0.024	0.083	REVA
			0.81	$\overline{R}^2$
			2.17	$D.W$

Results show that for companies with high and low earnings quality, variable of Book value of equity divided by the number of shares released and Earnings per share have positive effect on stock price. Also Debt to capital ratio has significant negative effect on dependent variables. Standard deviation of EPS has positive significant effect on stock price. In other hand, Economic value added and refined value added have positive effects on dependent variables, so first hypothesis is accepted. Also Earnings Response coefficient (ERC) in firms' portfolio with high relevance, reliability, comparability and understandability is greater than firms' portfolio with high relevance, reliability, comparability and understandability and second hypothesis is not rejected too.

5. Conclusion

Earnings quality, in accounting, refers to the overall reasonableness of reported earnings. It is an assessment criterion for how "relevance, reliability, comparability and understandability" a firm's earnings are, amongst other factors. It recognizes the fact that the economic impact of a given transaction will vary across firms as a function of their fundamental business characteristics, and has variously been defined as the degree to which earnings reflect underlying economic effects, are better estimates of cash flows, are conservative, or are predictable. In this research we find that companies with high earnings quality have better result than companies with low earnings quality, so in these companies, correlation coefficient and Earnings Response coefficient (ERC) are more than others.

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