The relationship between accounting information quality with discretionary accruals and stability of earnings

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Abstract
In this study, the relationship between financial reporting quality and discretionary accruals and earnings stability is investigated. For this purpose the data of listed companies in Tehran Stock Exchange during the period 2007 to 2012 are used. To measure the quality of financial reporting, SEC classification in the related area is used. Results showed that companies that provided high quality information had lower discretionary accruals in comparison to low quality firms. But in analyzing the stability of earnings, no significant differences between high and low quality firms was found.
Key words: quality of financial reporting, stability of earnings, discretionary accruals.

1. Introduction

According to the conceptual framework and theories that were provided by Financial Accounting Standards Board in recent decades, the primary objective of financial accounting and reporting is to provide useful information for economic decisions made by users of financial (FASB, 1978).

Investors as the major suppliers of corporate resources are seeking complete and accurate information about financial status of companies. This kind of information is reflected in the financial statements of the companies and investors use this information consistently without adjusting them according to accounting methods that were used in the companies or without considering how this information is obtained (Hendriksen,1982).

One of the fundamental preconditions for ensuring investors and creditors for participating in economically productive activities is providing and presenting information that is useful for them in making economic and financial decisions. Providing different mechanisms to assure investors and other users of financial information about the quality of financial information is an essential rule which leads to efficiency of the capital markets and optimum allocation of capital.

Accounts who provide fair information, have a crucial role in increasing the quality of existing information (Saghafi and Ebrahimi, 2009).

The purpose of accounting and financial reporting is to supply demands and needs of intended users of the financial information. The main tool for conveying information to users and external entities is providing basic financial statements. Income statements are one of the basic financial statements that have crucial importance in the task of assessing the stewardship or accountability of management for the resources that they have at their disposal. Income statements contain the return resulted from resources controlled by the entity's management and reflects entity's performance during certain periods. Because entity's management is responsible for preparations of financial statements, the directors have direct access to information and the right to choose the optional methods of accounting, so the possibility to change the discretionary accruals and earnings management exists.

The low frequency and consistency of earning is an indicator of earning's quality. Thus, most investors invest in shares of companies which have stable earnings and assumed to have high quality of information.

2. Background research

Saghafi et al (2011) studied the interrelationship between the quality of Accounting Information, excessive investment and free cash flow in companies listed on the Stock Exchange of Tehran. The results indicated that higher quality of corporate accounting information resulted in less excessive investment and this occurs more in companies with high rate of free cash flow and the effect of high quality information on reduction of excessive investment is greater in these companies.

Saghafi and Arab Mazar Yazdi (2010) did an empirical test on the relationship between investment performance and the quality of financial reporting. Research results showed that in the Tehran Stock Exchange there is practically no significant correlation between the variables.

Arab Mazar and Talebiyan (2009) examined the impact of financial reporting quality (using accruals quality index) and risk information on the capital expenditures of listed companies in Tehran Stock Exchange during 2001 and 2005. Their findings indicate that the cost of capital (cost of dept and cost of equity) companies with lower accruals quality is more than the cost of capital companies with higher accruals quality. More than that, according to findings of this research the impact of discretionary accruals quality on cost of company's capital is more than the impact of Non-discretionary (essential) accruals quality on cost of company's capital. Gilaninia et al (2012) examined the relationship between financial reporting quality and investment efficiency in a sample of listed companies in Tehran Stock Exchange. The results showed that there is no relationship between financial reporting quality and excessive investment, and although there is a negative relationship between financial reporting quality and low investment but the coefficient of relationship is negligible.

Chen et al (2010) examined the relationship between the quality of accounting and capital adequacy. The results suggest the positive impact of accounting quality on the capital adequacy. Hijazi et al (2011) investigated the issue of whether the total accruals and discretionary accruals as the two earnings smoothing criteria, reduces uncertainty about information provided by entity. The results showed that there is a significant negative correlation between earning smoothing and uncertainty of entity's information, more than that discretionary accruals as a measure of earning smoothing are more capable of explaining the information asymmetry in comparison with total accruals. Mehran et al (2011) examined the relationship between conservatism and unexpected discretionary accruals, using the modified Jones model and modified Jones model with nonlinear cash flows for separation of accruals, in Stock Exchange of Tehran. The results indicated that unexpected discretionary accruals obtained from the modified Jones model have a significant positive relationship with conservatism but unexpected discretionary accruals obtained from the modified Jones model with nonlinear cash flows do not have a significant effect on conservatism.

Mahfozi and peikarnegar (2011) examined the relationship between accruals quality and price concurrency (scale to measure relative firm-specific information, which is reflected in the price) in the Tehran Stock Exchange listed companies. The results showed that discretionary accruals quality for listed companies in Tehran Stock Exchange has a direct relationship with the price of concurrency. Osta and Qytasy (2012) examined whether the life cycle of an entity has any effect on the usage rate of discretionary accruals. The results showed that the use of discretionary accruals is different at different stages of the life cycle. This means that the usage rate of these items in growth stage is more than their usage in maturation and fall-off stages but the usage rate in maturation stage is greater than fall-off stage. Mosley et al (2012) examined the association between discretionary accruals quality and the quality of disclosure and checked whether they are complementary in explaining the time series variation in portfolio returns, or not. Their results showed that there is a positive correlation between discretionary accruals quality and the quality of disclosure. companies with higher disclosure quality have less preference for earning management but they have higher quality discretionary accruals.

Meshki and Noordydeh (2012) investigated the effects of earning smoothing on the stability of company's earning. The results indicated that the stability of earnings in companies with earnings smoothing is more than the stability of earnings in companies with no earning smoothing. Also, companies that have attempted to smooth earnings, compared with other companies have showed more stability contribution in the future. khodadadi et al (2012) examined how the stability of company's cash earning with respect to discretionary accruals was created by components of cash dividends. The results showed that, high stability of company's cash earning with respect to discretionary accruals is the result of third component of cash dividends namely payment of the owners' rights. Also, Cash paid to creditors have the least stability compared to other components of cash.

Ahn and Kwon (2010) examined the stability of the earning and market reaction in the stock market of Korea over the period 2000 to 2008. Their results showed that high level of stability of earnings in the Korean stock market and this stability of earnings is greater for cash flow in comparison to stability of accruals. Also, the Korean stock market participants typically show more reaction to the stability of cash flows earnings than the stability of accruals earnings.

3. **Theoretical and research hypotheses**
3.1.   *Quality of Accounting Information*
The main objective of financial statements is to provide relevant information about the company's financial and operational condition to help investors and creditors in making important financial decisions. The financial statements that fulfill this objective have good quality (Aboody & Hughes, 2005).

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The quality of financial reporting refers to the extent to which, companiesfinancial reporting, economical condition and its performance over a certain period of time is measured and presented honestly (Khajavi et al, 2012). In other words, if managers comply neutrality and objectivity in presenting the items inserted in the financial statements, we can say that the financial reporting has high quality (Brandt et al, 2010).

3.2.   Discretionary accruals

Accepted accounting principles authorize the managers to change the amount of reported earnings and always report an equal amount of earning in company's financial statements. The most important factors are total accruals   and   discretionary   accruals   (Moghaddam   et   al,   2012). The analysis of earnings management shows that management focuses on the usage of discretionary accruals. Discretionary accruals   are   accruals that cannot be described by the normal operation (Defond and Subramanyam, 1998). These are the accruals that are subjected to the management distortions and are unusual in nature (Stolowy And Gaetan, 2000). Discretionary accruals show the authority of the management in determining the time of identification and limitation of credit sales (Ahmadinejad, 2011). This leads to financial statements that do not disclose the actual situation of the company therefore the investors and users are unable to properly use these financial statements to make the right decisions which results in low quality of financial reporting.

Depreciation expense, investment income, earning and loss from the sale of fixed assets and depreciation of premiums and deductions of securities are examples of discretionary accruals.

3.3.   Stability earning

Reported earnings are an important financial information that are considered by people in making financial decisions. Financial analysts generally consider reported earnings as a prominent factor in their evaluation and judgment. Also investors rely on financial information which are inserted in the financial statements of economic entities in making decisions for investment in companies, in particular, reported earnings. They believe that the fixed earnings compared to unfixed earnings guarantee higher dividend. Since the fluctuations of earning are considered as an important measure of the company's overall risk, therefore, firms with smooth earning   have   lower   risk   for   investment   (Venus   et   al,   2006). Stability means the reproducibility (continuous) of current earnings. High stability of earnings shows that the company has more power to maintain current earnings and the quality of earnings is considered higher (Khajavi and Nazemi, 2005). Stability is of the qualitative characteristics of earnings in accounting that is based on the accounting information. Stability earning is a measure that helps the investors in assessing the company's future earnings and cash flows. Investors rely more on stable earnings rather than unstable earnings in assessing future earnings and expected cash flows (Kurdistani, 1997).

According to what was presented the hypothesizes are as follows:

- ✓ **H$_1$:** Firms that provide high quality accounting disclosures are likely to exhibit lower discretionary accruals.
- ✓ **H$_2$:** stability of earnings in firms that provide high quality accounting disclosures has significant difference from stability of earnings in firms that have low quality accounting disclosures.

4.   Research methods, Community and sample:

In this study, in terms of solidarity and the methodology is a quasi-experimental research in the field of positive research PAT and that is done with the actual data. This research in terms of nature and purposes is an applied one. Also this study is based on real information of stock market, financial statements, notes along the financial statements and the reports of assemblies companies. In this study the necessary information for forming the test hypothesize, is collected from financial statements, the Tehran Stock Exchange databases site, Rahavard novin databases. After choosing a sample from the available companies, Excel spreadsheet software is used for calculation of the data. For analyzing the data, regression models and R software were used.

The population for this study is the listed companies in Tehran Stock Exchange Market between the years 2008 to 2012. Firms that do not have the following conditions due to the limitations of the study will be removed:

1-Firms   shouldn't   have   changed   the   financial   year   in   their   financial   statements;
2-Firms aren't shouldn't be members of holding industries, because their nature is different from other firms;
3-Their   financial   information   should   be   available;
4-Firms   should   be   listed   in   Tehran   Stock   Exchange   from   March   19,   2009.
5 - Information and data required for this research has been collected from various sources depending on the type of needed information. Information related to literature review and theoretical were collected from library sources and scientific databases and journals. The information required for this study is generally obtained from Rahavard novin software, Tehran Stock Exchange website, financial statements, reports that were published by the Tehran Stock Exchange.

5. Research methodology

To test the first hypothesis the panel regression is used to determine the association between discretionary accruals and cash flows as well as the relationship between profitability, debts and size of the company. Regression model is as follows:

First equation:

$$DAC_{i,t} = \alpha_0 + \alpha_1 AQ_{i,t} + \alpha_2 AQ_{i,t} \times OCF_{i,t} + \alpha_3 AQ_{i,t} \times LNA_{i,t} + \alpha_5 AQ_{i,t} \times ROA_{i,t} + \alpha_5 AQ_{i,t} \times TLSFU_{i,t} + e_{i,t}$$

Where:

$AQ_{i,t}$ is a dummy variable representing the quality of reported accounting information. $AQ_{i,t=1}$ for firms reporting high quality accounting information and $AQ_{i,t}=0$ otherwise,

$ROA_{i,t}$ is net income before extraordinary items scaled by total assets,

$TLSFU_{i,t}$ is total liabilities scaled by shareholders' funds,

$OCF_{i,t}$ is operating cash flows scaled by total assets,

$LNA_{i,t}$ is the log of total assets,

$DAC_{i,t}$ is the discretionary accruals that are estimated using the cross-sectional Jones model (Jones, 1991). The study uses the residuals of the following regression model as discretionary accruals (see also DeFond and Subramanyam, 1998; Bartov, Gul, & Tsui, 2001; Kothari, Leone, & Wasley, 2004; Garza-Gomez, Lee, & Du, 2006).

Second equation:

$$AC_{i,t} = \alpha_0(1/A_{i,t-1}) + \alpha_1 \Delta REV_{i,t} + \alpha_2 PPE_{i,t} + e_{i,t}$$

where:

$AC_{i,t}$ is accruals in year t scaled by lagged total assets, i.e. total assets in year$t-1$. Accruals equal the annual change in current assets (excluding cash) minus current liabilities (excluding short-term debt and income tax payable) minus depreciation,

$A_{i,t-1}$ is total assets in year $t-1$,

$\Delta REV_{i,t}$ is the annual change in revenues in year t scaled by lagged total assets,

$PPE_{i,t}$ is property, plant and equipment in year t scaled by lagged total assets,

$e_{i,t}$ is the error term.

Also speed of identifying the losses were analyzed because large losses are evidence for low earnings management (Lang, Radi and Wilson, 2005). The SP dummy variable as a measure of low earning (Lang, Linz and Miller, 2003; Barth, Lndsmam and Long, 2008) and dummy variable LL as a measure of timely loss recognition (Lang et al, 2003 and 2005) were used. The statistical model is as follows:

Third equation

$$AQ_{i,t} = \alpha_0 + \alpha_1 ROA_{i,t} + \alpha_2 MVBV_{i,t} + \alpha_3 TLSFU_{i,t} + \alpha_4 OCF_{i,t} + \alpha_5 LNA_{i,t} + \alpha_6 SP_{i,t} + \alpha_7 LL_{i,t} + e_{i,t}$$

where:

$SP_{i,t}$ is a dummy variable indicating a measure of small profits. $SP_{i,t}=1$ if net profit scaled by total assets is between 0 and 0.01 and $SP_{i,t}=0$ otherwise,

$LL_{i,t}$ is a dummy variable indicating a measure of timely loss recognition. $LL_{i,t}=1$ if net profit scaled by total assets is less than -0.20 and $LL_{i,t}=0$ otherwise. All other variables are defined as in Before the equivalences.

Negative coefficient $SP_{i,t}$ shows that the firms who provide high-quality accounting information tend to manage their earning figures, i.e. they report negative figures more than positive figures. Positive coefficient $LL_{i,t}$ shows that high-quality accounting firms are more willing to report large losses.

To test the second hypothesis, is used the following models:

To assess the stability of earnings the Autoregressive time series model was used in which the earnings of the current period are adherent of the earnings in previous period. In other words, in this model earnings persistence represents stability earning. This pattern was designed in 2002 by Dechow and Dichev.

Fourth equation

$$EARN_{i,t} = \alpha_0 + \alpha_1 EARN_{i,t-1} + e_{i,t}$$

where:

$EARN_{i,t}$: current period earnings before items unexpected;

$EARN_{i,t-1}$: earnings prior period before items unexpected;

$e_{i,t}$: residual regression model;

This test is performed using the colleted data from sample companies for the financial years mentioned before, $\alpha 1$ (the coefficient of the independent variable) is the rate of stability earning during the course of the investigation.

To test the second hypothesis, the model introduced by Paek et al (2007) was used. This model is tested by fitting the following regression model and analysis of the acquired statistics.

fifth equation:

$$E_{it+1} = \alpha_0 + \alpha_1 \times E_{it} + \alpha_2 \times AQ_{it} \times E_{it} + e_{i,t}$$

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E_{it}: earning Before Extraordinary Items;
$AQ_{i,t}$ is a dummy variable representing the quality of reported accounting information. $AQ_{i,t}=1$ for firms reporting high quality accounting information and $AQ_{i,t}=0$ otherwise,

α_1 Shows the stability of earning for firms with low accounting quality and $\alpha_1+\alpha_2$ Shows the stability of earning for firms with high accounting quality.

6. **Results**

Table 1 shows the descriptive statistics for companies with high-quality accounting disclosure and for the companies with low-quality accounting disclosure. To test the hypothesis of the research the cross-sectional data obtained during the period of 2007 to 2012 is analyzed. Although to test some hypotheses such as the calculation of discretionary accruals in the first hypotheses previous period financial information has also been used. So the some of the information is related to 2006. 1026 year-company were observed. Descriptive statistics show that companies that with low quality accounting disclosures show high growth (MVBV) and companies with low quality accounting disclosures (LNA), show a high level of debt (TLSFL) and large changes net earnings (ΔREV).

	Descriptive Statistics AQ=0 n=288				Descriptive Statistics AQ=1 n=737			
	Minimum	Maximum	Mean	Std. Deviation	Minimum	Maximum	Mean	Std. Deviation
OCF	-.3189	.9562	.096363	.1390454	-.4085	8.7171	.157655	.3449124
ROA	-.3127	.5113	.053458	.1184017	-.3274	25.4904	.174278	.9438325
TFLSU	.0066	536.0539	3.935454	33.8223198	.0007	924.2958	2.804958	35.0376176
A	22725	215517128	5435056.98	2.167E7	26018	369509395	4746969.59	2.437E7
A0	19552	192233879	4943202.40	1.938E7	22725	332209644	3897427.76	1.987E7
EARN	-7214156	7287292	208069.82	1095794.071	-564468	23504246	480745.93	1687107.688
PPE	.0010	1.3358	.252679	.2101007	.0001	21.7528	.317304	.8254224
ΔREV	-34.0690	2.8066	-.117438	2.2124568	-39.7015	5.1232	.023917	1.9277698
LNA	4.3565	8.3335	5.844434	.7382593	4.4153	8.5676	5.944291	.6432497
AC	-18.9777	.5662	-.076086	1.1314249	-1.3870	38.3639	.082093	1.4265996
MVBV	-33.1233	26.2493	1.305018	4.3190098	-4706.6667	35.1167	-4.527022	173.4993979

First hypothesis : Table 2 shows that the first hypothesis is confirmed, it means that companies that provide accounting disclosure with high quality have lower discretionary accruals. Table 2 shows that the coefficient AQ.TLSFU is not significant. AQ coefficient is negative for companies with high quality i.e. companies which provide high-quality accounting information have less accruals and therefore have less preference for earnings management. The positive coefficient for AQROA and AQLNA indicates that companies with high quality of financial disclosure and low return on assets (ROA) and size (LNA), have little discretionary accruals. The reverse is also true for company with low quality of financial disclosure. Also, companies with high quality of financial disclosure and more operating cash flows have less discretionary accruals, the same is also true for companies with low quality of financial disclosure. Also the total debt to shareholders' funds (TLSFU) variable has been removed from the model due to insignificance of the variable .

Table 4 test whether the companies manage their accounting figures to report low earnings than losses and whether identify the assets than large losses in the financial statements as a measure of earnings management? Results show that companies that provide high quality accounting disclosure, show larger (LNA). But speed of identifying the losses was not observed due to the insignificance of both SP and LL variables and their removal from the model.

Table 2: Results obtained from panel data model For equation 1

	Coefficients	Estimate Std. Error	t-value	Pr(>|t|)
AQit(0)	1202821	981212	1.2259	0.220536
AQit(1)	-2669713	741991	-3.5980	0.000336 ***
AQit(0):OCFit	-1922259	816004	-2.3557	0.018676 *
AQit(1):OCFit	-1439294	459307	-3.1336	0.001776 **
AQit0:LNAit	-209343	165886	-1.2620	0.207247
AQit(1):LNAit	496287	123539	4.0172	6.32e-05 ***
AQit(0):ROAit	1880163	971093	1.9361	0.053127
AQit(1):ROAit	353882	165624	2.1367	0.032863 *

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Table 3: Results obtained from panel data model For equation 2

	Coefficients	Estimate Std. Error	t-value	Pr(>|t|)
PPEit	1.676747	0.030474	55.023	< 2.2e-16 ***

Table 4: Results obtained from panel data model For equation 3

	Coefficients	Estimate Std. Error	t-value	Pr(>|t|)
LNA	0.0406302	0.0052469	7.7436	2.304e-14 ***

The second hypothesis: The results in Table 5 and 6 show that the second hypothesis is rejected. This means that stability of earnings in high and low quality financial disclosure companies have no significant differences. To investigate this hypothesis, the fitted model was first used for companies with high quality of financial disclosure (AQ = 1) and then it was used for companies with low quality of financial disclosure (AQ = 0). Tables indicate that the significance of independent variables in the two tables is less than 0.5, so the coefficient of the two variables is statistically significant. the α_1 is 1 in both Tables. Therefore, there is no evidence to accept the hypothesis and we can argue that the stability of earnings in companies with high and low quality of financial disclosure have no significant differences.

Table 5: Estimated coefficients Otto regression models for corporate with AQ = 1

	Coefficients	Estimate Std. Error	t value	Pr(>|t|)
EARNi(t-1)	1.000e+00	4.286e-18	2.333e+17	<2e-16 ***

Table 6: Estimated coefficients Otto regression models for corporate with AQ = 0

	Coefficients	Estimate Std. Error	t value	Pr(>|t|)
EARNi(t-1)	1.000e+00	4.669e-18	2.142e+17	< 2e-16 ***

7. Discussion and conclusions

This study investigated the aim of preparing high and low quality financial reports by firms listed in Tehran stock exchange. This study investigated whether there is a relationship between the discretionary accruals, the accruals that show the rate of earnings management, and the quality of accounting information. The study also investigated whether there is a significant difference between the stability of earnings in companies with high and low quality of financial disclosure or not.

companies that have high -quality financial disclosure, are bigger so they have the capacity of being known in markets. Also, they show high liquidity and profitability measures which implies that they have good financial status, this encourages the managers to provide high quality information in order to impress investors. companies with high information quality, have lower accruals therefore are less likely to manage earnings. Both high and low quality companies have high earnings, so stability of earnings do not differ between these two types of companies.

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