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SURVEYING THE RELATIONSHIP BETWEEN ABNORMAL DISCRETIONARY EXPENSES AND THE COST OF EQUIT AMONG THE LISTED COMPANIES IN TEHRAN STOCK EXCHANGE

Elnaz Qodsi*[1], Asgar Pakmaram[2]

[1]Department of Accounting, Germi Branch, Islamic Azad University, Germi, Iran.

[2]Department of Accounting, Germi Branch, Islamic Azad University, Germi, Iran.

ABSTRACT

The main aims of this study surveying the relationship between abnormal discretionary expenses and the cost of equity. Quality of the information together with the ease of access to financial information and other information is the most important reason for choosing this target population. Due to the nature of research and also some inconsistencies among the listed companies in Tehran Stock Exchange was used the removal systematic sampling (purposive). 152 firms were selected as the sample. To analyze the data, the methods of descriptive statistics (mean, percentage and frequency) and inferential statistics such as: Kolmogorov-Smirnov test for normality of the data. Also, to analysis of hypotheses we used Regression. To analyze the data is used SPSS and E views software. Findings show that abnormal discretionary expenses has not significant relationship with cost of equity at company that listed in.

Keywords: Earnings management, abnormal discretionary expenses, Tehran Stock Exchange.

INTRODUCTION

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 (Lee, 2007).

There are various capital markets and managerial incentives for firms to beat earnings expectations. First, there is a market premium to beat earnings expectations (Bartov et. al., 2002). Second, managers would want to beat earnings expectations to maximize the present value of their compensation or stock options (Healy, 1985). Third, managers of firms prior to new equity issuance or selling stocks on their personal accounts (received from earlier stock-based compensation) have an incentive to guide analysts‘expectations downwards before earnings announcement, and later beat these “walked-down“ expectations at earnings announcement in order to obtain the highest possible share price during equity issuance or stock sale on their personal accounts (Richardson et. al., 2004). Lastly, firms may receive

additional market premium from having a track record of consistently beating earnings expectations (Kasznik and McNichols, 2001).

Earnings management can be defined as the selection of accounting policies to achieve a desired financial reporting result. Using accrual based earnings management techniques to meet analysts' forecasts in the United States has been well documented in the literature (Krull 2004). Accruals are the difference between net income and cash flows. For example, when companies sell items to others on credit during a growth period, the sale creates an accrual of revenue. When companies engage in earnings management, they can increase or decrease income by creating accruals; these are often referred to as non-discretionary accruals. However, it is the discretionary accruals, accruals created to manipulate changes in reported earnings that are of concern. These types of accruals include using increasing or decreasing estimates of bad debt reserves, warranty costs, and inventory write-downs. Prior to the passage of the Sarbanes Oxley Act, research found extensive evidence of accrual based earnings management. For example, Robb (1998) shows that bank managers make greater use of the loan loss provision to manipulate earnings upward when analysts have reached a consensus in their earnings predictions. Payne and Robb (2000) find that firms with pre-managed earnings below analysts' earnings expectations have greater positive abnormal, or discretionary accruals. Skinner and Sloan (2002) document an asymmetrically large negative price response to negative earnings surprise associated with growth stocks and they found evidence that this phenomenon is the result of expectation errors about future earnings performance. Kasznik and McNichols (2001) also find that firms that meet expectations in one or two years do not command a market premium over and above their market fundamentals; however, firms that consistently meet market expectations do receive a higher valuation. Moehrle (2002) reports that firms use restructuring accrual reversals to manage earnings to beat analysts' forecasts.

Richardson ET. al. (2004) document that managers of firms that are having new equity issuance or selling stocks from their personal accounts (through option exercises and stock sales) guide analysts' forecasts downwards prior to earnings announcement so that they can beat these forecasts at the announcement.

Koh et al. (2008) examine earnings management and the propensity of firms to meet or exceed analysts' expectations in the periods following the Sarbanes Oxley Act. The study finds that managers are less likely to employ accrual based earnings management techniques in the periods following the accounting frauds of the late 1990s and early 2000s. Furthermore, the findings indicate that meeting or exceeding the analyst forecast in the post-Sarbanes Oxley period is more positively associated with future cash flows. This suggests that the decrease in accrual based earnings management techniques has improved the quality of firms' earnings, as they are more reflective of future performance. Cohen et al. (2008) investigate the prevalence of earnings management before and after the Sarbanes Oxley Act. The results indicate that instances of earnings management were increasing in the pre-Sarbanes Oxley period, and decreasing in the periods following the Act, suggesting that the Act has effectively curbed accruals manipulation activities.

In public finance, discretionary spending is government spending implemented through an appropriations bill. This spending is an optional part of fiscal policy, in contrast to entitlement programs for which funding is mandatory (Mandal, 2007: p140). In the United States, discretionary spending refers to spending set on a yearly basis by decision of Congress. Such spending is usually authorized by Congress in another act. Provisions of an appropriations act that authorize spending are earmarks. When an authorization act also appropriates funds, it is called mandatory spending.

Firms obtain capital from two kinds of sources: lenders and equity investors. From the perspective of capital providers, lenders seek to be rewarded with interest and equity investors seek dividends and/or appreciation in the value of their investment (capital gain). From a firm's perspective, they must pay for the capital it obtains from others, which is called its cost of capital. Such costs are separated into a firm's cost of debt and cost of equity and attributed to these two kinds of capital sources (Fama and French, 1997).While a firm's present cost of debt is relatively easy to determine from observation of interest rates in the capital markets, its current cost of equity is unobservable and must be estimated. Finance theory and practice offers various models for estimating a particular firm's cost of equity such as the capital asset pricing model, or CAPM. Another method is derived from the Gordon Model, which is a discounted cash flow model based on dividend returns and eventual capital return from the sale of the investment. Another simple method is the Bond Yield plus Risk Premium (BYPRP), where a subjective risk premium is added to the firm's long-term debt interest rate. Moreover, a firm's overall cost of capital, which consists of the two types of capital costs, can be estimated using the weighted average cost of capital model (Francis, 2004).

Philosophers have been struggling for a long time to clarify what might be meant in social policy by the term ‘equity’. Summarizing that discussion, let alone seeking to add to it, is beyond the capacity of the author and, fortunately, beyond the scope of this paper. There is general agreement that the aim of public policy cannot and should not be equality in the sense that everyone is the same or achieves the same outcomes – a state that appears to be both impossible and undesirable. Rather, a commitment to equity suggests that differences in outcomes should not be attributable to differences in areas such as wealth, income, power or possessions (Zhi et al, 2012).

In financial theory, the return that stockholders require for a company. The traditional formula for cost of equity (COE) is the dividend capitalization model:

$$\text{Cost of Equity} = \frac{\text{Dividends per Share (for next year)}}{\text{Current Market Value of Stock}} + \text{Growth Rate of Dividends}$$

A firm's cost of equity represents the compensation that the market demands in exchange for owning the asset and bearing the risk of ownership. The cost of equity is the relationship between the amount of equity capital that can be raised and the rewards expected by shareholders in exchange for their capital (Zhi et al, 2012).

METHODOLOGY

Quality of the information together with the ease of access to financial information and other information is the most important reason for choosing this target population. Due to the nature of research and also some inconsistencies among the listed companies in Tehran Stock Exchange was used the removal systematic sampling (purposive). In order to determine the statistical community of this study the following conditions has been considered:

(1) Not to be member of banks, financial institutions, investment, holding and leasing company and not because of the nature of their specific activities, the examined factors relationship in this study varies for such institutions and cannot be generalized to other

(2) To observe the ensure comparability, the financial year of firm should be ending on March 29 of each year.

(3) The company does not have financial year during 2008 to 2013 and in mentioned financial years should not be unprofitable. Also the book value of shareholders should not be negative during the case study.

(4) The financial statements of these companies should be available.

By considering the above conditions, 152 firms were selected as the sample. In the present study, according to the type of data and methods of analysis, the combined data was used.

To analyze the data, the methods of descriptive statistics (mean, percentage and frequency) and inferential statistics such as: Kolmogorov-Smirnov test for normality of the data. Also, to analysis of hypotheses we used Regression. To analyze the data is used SPSS and Eviews software.

Table 1: K-S Test results

Variable	Z	P-Value
KS	1.112	0.189
ABEXP	7.159	.000
SIZE	1.358	0.104
LEV	1.97	0.002

The results of K-S Test shows that the test distribution for LEV, ABEXP are not normal. So re-running the test and the results in Table (2) is observed that a significant amount of initial data from which the natural logarithm (Ln (V)) has been more than 0.50, therefore, with a 95 percent Confidence level, data distributions are normal.

Table 2: re-running the test results

Variable	P-Value
ABEXP	0.134
LEV	0.125

So we can use Multi Regression, T test, F test and Durbin Watson to test the hypothesis of the research. In order to determine the relationship between the variables of the study, the SPSS tool has been used.

RESULTS AND CONCLUSION

Hypothesis: There is relationship between abnormal discretionary expenses and the cost of equity

The statistical way of analysis of hypothesis is two ways, H_1 is acceptance of hypothesis and H_0 is rejecting of hypothesis. In other words, it means that H_1 has positive meaning and H_0 has no meaning.

Table (3) regression analysis to predict cost of equity based on unusual production costs. The Regression model has being in the follow:

$$KS_{i,t} = C + \beta_1(ABEXP_{i,t}) + \beta_2(SIZE_{i,t}) + \beta_3(LEV_{i,t}) + \varepsilon_{i,t}$$

Table 3: Multiple Regression Model Test

Variables	Coefficient	T	Sig.
C	0.183	3.757	0.000
ABEXP	0.267	1.872	0.061
SIZE	0.003	0.771	0.440
LEV	0.013	2.826	0.005
F Prob.		3.936 0.008	
Durbin Watson		1.518	
H (Housman) Prob.		23.523 0.000	
Breusch-Godfrey Prob.		2.416 0.092	
ARCH Prob.		0.928 0.336	
R2 AdjR2		0.083 0.079	

In multivariable regression equation to determine the coefficient of determination (R^2) and the weight of each variable (Beta) a collection of independent variables enter in the equation. Moreover, in order to determine the contribution of each variable in the explanation of the dependent variable the multivariate regression model was used.

According to the above results, the statistical probability F (0.008) is rejected the null hypothesis and is suitable for panel data.

After the F test the null hypothesis is rejected, the question is which one of the ways the relationship can be in the form of fixed or random effects, can be examined. The Housman test determines. Its P-value is 0.000. It show that the random effects model is preferred over the fixed effects.

The above Table is stating that 8.3% of the variation is expected in the cost of equity.

There is relationship between abnormal discretionary expenses and the cost of equity. According to the table 6, the p-value (0.061) is bigger than 0.05. It means that abnormal

discretionary expenses has not significant relationship with cost of equity at company that listed in Tehran Stock Exchange.

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