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Earnings Manipulation through Reduction in Discretionary Expenses and Future Financial Performance: Evidence from Pakistan

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ABSTRACT

The study finds the relationship between abnormal lower discretionary expenses and future financial performance. Four measures of financial performance measures; Return on Asset (ROA), Return on Equity (ROE) and Earning per Share (EPS) and Price to Earnings ratio (PE) are taken. Manufacturing firms listed on Karachi Stock Exchange (KSE) are selected for analysis and data is collected from year 2004 to 2011. Financial data is collected from the annual reports of the firms and data of market value is collected from business recorder site. Panel data analysis technique, Generalised least square methods is used for analysis. It has been revealed that there is negative impact on firm's subsequent performance which reduced discretionary expenses to report higher earnings but this impact is not significant.

Introduction

Mangers manipulate earnings to show good picture of the firm. This is done in two ways; by utilizing GAAP principles which is called accrual earnings management and by changing some business which is known as real earnings management (Schipper,1989; Healy and Wahlen, 1999). Accrual earnings management is done when books are maintained to report general public whereas real earnings management is applied in different operations during the whole period. Extensive work is done on accruals but researchers have given less attention to earnings manipulation through real earnings management.

Companies use different direct or indirect technique of accounting to either show higher earnings or to fulfil investor's expectations. Earnings Management is considered to mislead the general public; thus a fraudulent activity. Even if companies follow the GAAP principles, it may go against the laws and policies. For example, if a company follows the LIFO basis instead of FIFO basis to value inventory, it may give way to positive financial ratios, but it may not show the intrinsic value of the company.

There are different motives behind engaging in earnings management. Earlier studies proved that managers engage in earnings management to meet earnings thresholds and benchmarks (Guidry et al.; 1999, Kasznik ;1999, Defond and Jiambalvo; 1994). Motives behind meeting earnings targets include incentives for executives in the form of bonus and promotion and position of the firm in market. Ali and Zhang (2012) provided evidence that CEO manipulate earnings in the early period of their tenure in order to capture market and build their repute. Capital markets rate that firm higher which attain its forecasted target as compared to the firms which failed to meet analyst's forecasts (Myers et al., 2006). Employees and managers are interested in higher earnings as there extrinsic and intrinsic rewards are dependent upon reported earnings (Degeorge et al., 1999). Since capital market fluctuations are also due to change in firm's net income. Thus compensation of CEO is conditional on the value of stocks (Bergstresser and Philippon, 2006).

Since earnings management is to increase earnings in current period. This study aims to find out whether there is any impact of earnings management on future performance of the firm in Pakistan. Anjum et al.(2012) provided evidence that there is negative relationship between earnings management and profitability in the case of Pakistan. Proxy for earnings management was taken as John's model in their study. In this study other type of earnings management i.e real earnings management is considered. Return on Assets (ROA) was only taken as proxy of performance in order to measure real earnings management's impact on future performance (Gunny, 2010; Taylor and Xu, 2010; Leggett et al., 2010) in earlier studies. This study takes into account Return on Equity (ROE), Earnings per Share (EPS) and Price Earnings Ratio (PE) in addition to ROA as measures of performance.

Remaining part of this study is presented in 4 sections. Second section discussed previous studies done to investigate the said relationship and hypotheses development. Third section explains sample selection, methodology to conduct this study and description of variables used in this study. Fourth part discusses different results obtained after statistical analysis. Last section of this paper concludes the whole study.

Literature

Different studies present that manager engage in both type of earnings management; but these are not functional at a time. There exists a trade-off between these two types of earnings management techniques (Zang, 2012; Hashemi and Rabiee, 2011; Cohen and Zarowin, 2010). Managers engage in accruals earnings management before moving to real activities manipulation (Badertscher, 2011). Graham et al.(2005) conducted survey and in depth interviews of financial executives and shows that most of the managers choose real earnings management instead of accrual. Ewert and Wagenhofer (2005) document that in presence of stiff and firm accountings

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policies; managers manipulate earnings by real activity manipulation instead of accruals earnings management. Wang and Souza (2006) studied the use of reducing R&D expense in presence of lower accounting flexibility Findings show that when there is lower accounting flexibility; managers prefer to cut R&D expense. In other terms accrual earning management and real earning management are substitutes.

Roychowdhury (2006) examined that managers manipulate earnings to avoid losses by three types of real activities; to offer price discounts to accelerate sales temporarily, overproduction to record less cost of goods sold as a result of less per unit fixed cost, and cutting of discretionary expenses to improve reported margins. Ghaemi et al.(2012) investigated firms listed in Tehran Stock Exchange and revealed that managers manipulate earnings through manipulation of discretionary expenses, overproduction to lower cost of Goods sold and sales manipulation. Enomoto et al. (2012) documented three types of REM activities; manipulation of discretionary expense, sales manipulation and overproduction. Fazeli and Rasouli(2011) observed that the firms accelerate sales through offering price reduction and by overproducing inventory to avoid reporting zero earnings.

A long line of literature documents that mangers manipulate discretionary expense to report higher earnings. Cheng (2004) examined the relationship between R& D expenses, CEO compensation and firm's earnings. After analysis the results shows that alteration in R&D spending and alteration in CEO compensation are more strongly positively associated when the CEO is about to retire. It was also revealed that modifications in R&D expenditures and alteration in CEO compensation are highly significantly influence when the firm bear less earnings decline or not very higher loss. Dechow and Sloan (1991) investigated the whether CEO in their last years of service reduce discretionary expenses to report improved earnings.

Cohen et al. (2010) examined that managers make amendments in advertising expenses to avoid reporting losses, to avoid decreased earnings and to meet analyst forecasts. Osma and Young (2009) investigated that firms reduce R&D expenses in order to increase short term earnings. Bushee (1998) examined the relationship between R&D expense and meeting earning targets in presence of institutional investors. Analysis shows that firms try to achieve previous year earnings per share and to do this; managers reduce R&D expense if there less institutional ownership. Bange and Bondt (1998) investigated that adjustments are made in R&D expenses to manage earnings. It was also observed that if major shares are owned by institutional investors and CEO, then there would be less manipulation of earnings.

Xu and Su(2010) provided the evidence about earning manipulation through changing in R&D spending in high-tech industries. So companies are engaged n real earning activities through utilization of R&D expenses. Mande et al. (2000) provided evidence that Japanese managers adjust R&D expenses in order to report smooth earnings. Eldenburg et al. (2011) demonstrate that non profit organizations like hospitals engaged in real earning management activities like reduction in expenses for smooth earnings.

Mostly earnings manipulation activities are implemented to increase current income. But the potential costs of these activities appear in future earnings in form of poor income or loss.

Zhang(2008) studied the consequences of real earning management and reported that firms which are engaged in real activities manipulation bear lower income on the subsequent period. Taylor and Xu (2010) took three measures of real earnings management; overproduction, reduction in R&D and reduction in discretionary expenses and examined that impact of real earning management on subsequent operating performance is negative but this is not significant. By taking four measures of real earnings management: sales manipulation, overproduction, reduction in discretionary expenses and timings the sale of fixed assets; Gunny(2010) found a positive association in the future earnings and real earnings management. Leggett et al.(2010) revealed that manipulation through discretionary expenses caused lower operating performance in future. Bhojraj et al.(2009) also found negative impact future performance of firms which engaged in accruals earnings management and reduction in discretionary expenses. Gunny(2005) found negative impact on future ROA of real earnings management. Francis et al. (2011) and Li (2010) found negative impact on stock return as consequences of real earnings management. Mizik and Jacobson(2007) investigated managing of marketing expenses to deal with earnings and its impact on long term performance of the firm. Chen et al.(2010) examined that impact of accrual earnings management is negative whereas impact of real earnings management is positive on operating performance. Anjum et al.(2012) studied Pakistani firms and examined negative relationship between earning management through accruals and firm's future profitability.

Earliers studies show that firms engaged in earnings manipulation by reducing different expenses. Since, data of R&D expenses is not available; so, proxy in this study is taken as discretionary expenses; which are the summation of R&D, Advertising, Sales, General and Administartive expenses. Measures of financial performance are taken as return on assets (ROA), return on equity (ROE), earnings per share (EPS) and price earnings ratio (PE). In this study, following hypotheses are to be tested.

H1: There will be negative impact on ROA of the firms which manipulate earnings through reducing discretionary expenses.

H2: There will be negative impact on ROE of the firms which manipulate earnings through reducing discretionary expenses.

H3: There will be negative impact on EPS of the firms which manipulate earnings through reducing discretionary expenses.

H4: There will be negative impact on PE ratio of the firms which manipulate earnings through reducing discretionary expenses.

Methodology

Sample selection and data:

Firms of manufacturing sector listed in Karachi Stock Exchange(KSE) are selected as sample for this study. KSE contains total 17 manufacturing sectors. 119 firms are selected for the year 2004 to 2011. These firms are selected which on the basis of highest market capitalization. Selected firms represent more than 85% of the total market capitalization of KSE. Financial data is collected from annual reports of the selected firms; Whereas, market value of each firm is taken from the business recorder website that contains market value of all listed firms of KSE.

Measurement of REM

In order to increase current year's earnings managers cut discretionary expenses like Sales General and Administrative expenses, R&D investments and advertising expenses. To measure normal level of discretionary expenses with relative to sales of the year, model (A) was proposed by Dechow et al.(1998). This model was also used by Gunny (2010), Taylor and Xu (2010), Kim et al. (2010), Leggett et al. (2010) and Roychowdhury (2006).

$$\frac{\mathbf{DISEXP_t}}{\mathbf{A_{t-1}}} = \propto_0 + \propto_1 \frac{\mathbf{S_t}}{\mathbf{A_{t-1}}} + \boldsymbol{\varepsilon} \qquad (\mathbf{A})$$

Where

$\mathbf{S_t}$ = **Sales during time t**

$\mathbf{A_t}$ = **Total assests at time t**

DISEXP = **summation of R&D, advertising, sales, general and administrative expenses**

By applying this model to the data of selected companies, residuals are taken as level of abnormal discretionary expenses. Lower the value of the residual higher is the value of abnormal lower discretionary expenses. So for the sake of convenience and uniformity, residuals are multiplied by -1 and named that variable REM. In this study REM is the proxy of real earnings management.

Impact of REM on Financial Performance

After identification of real earnings management, now the impact of REM on financial performance is to be measured. Following models are formed on the basis of developed hypotheses.

$$\mathbf{ROA_{t+i}} = \boldsymbol{\alpha_0} + \boldsymbol{\alpha_1}\mathbf{REM_t} + \boldsymbol{\alpha_2}\mathbf{SIZE_{t+i}} + \boldsymbol{\alpha_3}\mathbf{ZSCORE_{t+i}} + \boldsymbol{\alpha_4}\mathbf{ID} + \boldsymbol{\alpha_5}\mathbf{GROWTH_{t+i}} + \boldsymbol{\alpha_6}\mathbf{ROA_t} + \boldsymbol{\varepsilon_{it}} \qquad 1$$

$$\mathbf{ROE_{t+i}} = \boldsymbol{\alpha_0} + \boldsymbol{\alpha_1}\mathbf{REM_t} + \boldsymbol{\alpha_2}\mathbf{SIZE_{t+i}} + \boldsymbol{\alpha_3}\mathbf{ZSCORE_{t+i}} + \boldsymbol{\alpha_4}\mathbf{ID} + \boldsymbol{\alpha_5}\mathbf{GROWTH_{t+i}} + \boldsymbol{\alpha_6}\mathbf{ROE_t} + \boldsymbol{\varepsilon_{it}} \qquad 2$$

$$\mathbf{EPS_{t+i}} = \boldsymbol{\alpha_0} + \boldsymbol{\alpha_1}\mathbf{REM_t} + \boldsymbol{\alpha_2}\mathbf{SIZE_{t+i}} + \boldsymbol{\alpha_3}\mathbf{ZSCORE_{t+i}} + \boldsymbol{\alpha_4}\mathbf{ID} + \boldsymbol{\alpha_5}\mathbf{GROWTH_{t+i}} + \boldsymbol{\alpha_6}\mathbf{EPS_t} + \boldsymbol{\varepsilon_{it}} \qquad 3$$

$$\mathbf{PE_{t+i}} = \boldsymbol{\alpha_0} + \boldsymbol{\alpha_1}\mathbf{REM_t} + \boldsymbol{\alpha_2}\mathbf{SIZE_{t+i}} + \boldsymbol{\alpha_3}\mathbf{ZSCORE_{t+i}} + \boldsymbol{\alpha_4}\mathbf{ID} + \boldsymbol{\alpha_5}\mathbf{GROWTH_{t+i}} + \boldsymbol{\alpha_6}\mathbf{PE_t} + \boldsymbol{\varepsilon_{it}} \qquad 4$$

Description of Variables:

This section gives details about the variables used in this study. Since the study is aimed to find the impact of real earning management on the performance of the firm. So REM indicator is our independent variable, dependent variable is financial performance. some control variables are which are to be considered because they can intervene the said relationship.

Independent variable:

Real earnings management is independent variable which is measures by abnormal level of discretionary expenses. This variable is calculated by taking product of residuals of model (A) and -1 and denoted by REM.

Control variables:

Some extraneous variables intervene to the relationship between real earnings management and financial performance. Thus these variables are required to be controlled. Difference control variables are taken in various studies to eradicate their influences on performance. The core element that is considered mainly affect the performance is size of the firm. Different measures are taken to control size. To control impact of size in measuring the association between real earnings management and performance, Chen et al.(2013) used natural logarithm of total assets as proxy of size. Leggett et al.(2010) defined size by taking logarithm of market value of equity. Gunny (2005) take natural logarithm of assets to control firm size. Chen et al.(2010) used natural logarithm of market equity to control firm size in order to check the impact of real earnings management on performance of the firm. Gunny (2010) defined firm size as natural log of assets. In this study, the firm size is measured by taking natural log of total assets and denoted by SIZE.

Firm growth may also impact profitability. Firms which are able to grow are more profitable and as a result good performance (Nuryaman, 2012). Kim et al.(2010) used Market value of equity plus the book value of debt divided by the book value of total assets as proxy of growth. Leggett et al.(2010), Chen et al.(2010), Gunny (2010) and Gunny (2005) defined growth as Market value of equity divided by book value of equity. Lasfer (2002) used Tobin's-Q to control growth which is defined as Market capitalization plus Total Debt divided by Total Assets. Mustapha and Ahmad (2011) measured Market value of the firm/total assets to control growth. Proxy for growth used in this study is book value of equity divided by market value of equity and denoted by BTM.

Financial strength has a positive relationship with financial performance. Altman(1968) defined a formula to measure financial strength a firm and named it as Z Score. Altman ZSCORE is defined as :

$$\mathbf{ZSCORE} = 3.3 \times (\mathbf{Net\ Income/Total\ Assets}) + 1.0 \times (\mathbf{Total\ Sales/Total\ Assets}) + 1.4 \times (\mathbf{Retained\ Earnings/Total\ Assets}) + 1.2 \times (\mathbf{Working\ Capital/Total\ Assets}) + 0.6 \times (\mathbf{Market\ Value\ of\ Equity\ /Total\ Liabilities})$$

Different trends in industry may have impact on performance. A lot of researchers made use of industry dummies to control industry effects. Ehsan and Kaleem(2012) used industry dummy in their study to control any industry impact. McClelland et al.(2012) and Palmer and Wiseman (1999) used industry dummies in their studies. In this study, industry dummy (ID) is taken to abolish any industry impact.

Dependent variables

Different financial performance measures are used in various studies. Financial performance measures are divided into two classes: accounting based measures and market based measure. Moriones et al.(2013) measured financial performance by using accounting measures ROA and ROE as proxies. San and Heng (2011) used ROA, ROE, EPS, Operating Margin and Net Margin as proxies for financial performance. Sharma(2005) examined the association between ISO 9000 certification and financial performance and used earnings per share as proxy of performance.

Taylor and Xu(2010), Leggett et al.(2010), Gunny (2010), Mizik and Jacobson(2007), Gunny (2005) and Bhojraj(2003) took into account return on assets (ROA) as proxy of performance while determining the relationship between real earnings management and subsequent performance. ROE, EPS and PE are also taken as financial performance measures in this study.

Results and discussions:

Present study is consisted of two steps; identification of real earnings management and then to investigate that what is the impact of real earnings management on subsequent financial performance. Table-1 illustrates year wise percentage of firms which reduced their discretionary expenses from the year 2006 to 2007. These results are found by multiplying residuals of model (A) with-1.

Table-1

Year	Real Earnings Manipulation through Reducing Discretionary Expenses
2006	69%
2007	69%
2008	67%
2009	71%
2010	69%
2011	71%

Results show that in 2006, 69% of manufacturing firms reduced discretionary expenses in order to show higher earnings.

In 2007 it was also 69% and the other results are shown in Table-1. Identification of REM is done, next some statistical analysis is done to examine of REM on future performance.

Panel data analysis technique GLS (Generalized Least square) is used for examination. Stata11 is used for analysis. Data attribute decided whether fixed or random model is being used. Results of the all models are given in Table-2.

Table-2

VARIABLES	1	2	3	4
INDEPENDENT VARIABLES	**ROA_{t+1}**	**ROE_{t+1}**	**EPS_{t+1}**	**PE_{t+1}**
REM1	-0.053	-0.065	-1.54	-48.9
	0.114	0.449	0.406	0.139
CONTROL VARIABLES				
SIZE	0.002	0.005	0.2	5.623
	0.573	0.536	0.249	0.067*
ZSCORE	0.006	0.024	0.353	4.035
	0.121	0.019**	0.096**	0.257
ID	0	0.001	-0.017	-0.821
	0.609	0.784	0.745	0.383
GROWTH	0.006	-0.011	-0.428	-23.901
	0.583	0.706	0.479	0.030**
ROA_t	0.705			
	0.000**			
ROE_t		0.519		
		0.000**		
EPS_t			0.448	
			0.000**	
PE_t				0.56
				0.000**
Durbin Watson	1.774	1.745	1.937	1.84
Wald-Chi-Square	617.56	333.75	72.38	223.25
	0.000**	0.000**	0.000**	0.000**
Panel Data Model Type	Random	Random	Random	Random
R Sqaure	0.594	0.427	0.139	0.324

******significant at 1%** significant at 5%,*significant at 10%; Upper values are beta coefficients and lower are p-values***

In Table 2, model 1 consists of variables REM, LOGASSETS, ZSCORE, ID, BTM and $ROA_{t.}$ Impact of REM on ROA_{t+1} is negative but that is insignificant. Other control variables size, ZSCOE. ID and BTM have also insignificant relationship with the dependent variable. Durbin Watson value is 1.774 which is between 1.5 and 2.5, hence there is no autocorrelation amongst the independent variables. Coefficient of determination of this model is 0.594 which illustrates that next year's performance is 59.8% explained by the given independent variables. Wald chi square value of this model is also strongly significant which depicts that model is valid.

Model 2 examines relationship between real earning management through discretionary expense and future return on equity in presence of control variables LOGASSETS, ZSCORE, ID, BTM and ROE_t. Impact of REM on ROE_{t+1} is negative but insignificant. Control variables size, ID and BTM have also insignificant relationship with the dependent variable (ROE_{t+1}). ZSCORE is significantly negatively related with $ROE_{t+1.}$ R square of this model is 0.427 which depicts that 42.7% next year's return on equity is explained by the given independent variables. There is no autocorrelation among the independent variables as Durbin Watson value is 1.745.

Model 3 contains variables REM, LOGASSETS, ZSCORE, ID, BTM and EPS_t. Impact of REM1 on EPS_{t+1} is negative. Impact of control variables size, ID and BTM have also insignificant relationship with the dependent variable. ZSCORE is significantly negatively related with EPS_{t+1} with p-value 0.096. Durbin Watson value is 1.937 which shows that there is no autocorrelation among the independent variables. Coefficient of determination of this model is 0.139 which depicts that next year's EPS is 13.9% explained by the given independent variables. Wald chi square value of this model is also strongly significant which depicts that model is valid which random effect model is.

Model 4 examines the impact of real earnings management through manipulation of discretionary expenses (REM) on future price earnings ratio. Impact of REM on PE_{t+1} is negative but insignificant. Impact of control variables ZSCORE and BTM have also insignificant relationship with the dependent variable. LOGASSETS is significantly positively related with PE_{t+1} with p-value 0.067. PE_t is significantly related to PE_{t+1} with p-value of 0.000. Durbin Watson value is 1.840 which is more than 1.5 and less than 2.5, thus there is no autocorrelation among the independent variables.

Combining the findings of all models, there is negative impact of real earnings management on all measures of future financial performance but result shows that impact is not significant. Taylor and Xu(2010) also got insignificant result while taking discretionary expenses as measure of real earnings management. Leggett (2010) also found negative relationship but that relationship was significant. Gunny (2005) also found negative but insignificant relation while taking sales, General and administrative expenses measure of real earnings management.

Conclusion

This study examines that what impact can be on future earnings of the firms which are engaged in earnings manipulation through reducing discretionary expense. A sample of 119 manufacturing firms is taken to conduct this study. Real earnings management through reducing discretionary expenses is independent variable; more five variables are added to eliminate the impact of size, growth opportunity, previous year's performance, firm's financial strength and any industry influence. Measurements of performance are taken as ROA, ROE, EPS and P/E ratio.

Study is conducted in two steps. In first step firm's engaged in real earnings management are identified. Findings show that 67% to 71% of Pakistani manufacturing firms are engaged in manipulating earnings through discretionary expenses. In the next step, future performance of the firms is analysed which are involved in real earnings management. Regression results show that firms reduced discretionary expenses to enjoy higher profits in the current period. But in the long it does not seem alarming in form of earnings as results are not significant.

This study would be beneficial for investors and analysts to determine how firm's earnings are boosted. The study would be helpful in understanding that reducing discretionary expenses to accelerate sales are not harmful in the long run. Other types of real earnings management can be checked in future studies, whether these are risky or not. Firms are 119 and selected period is 2004 to 2011. For generalization of results more firms can be taken for more number of years. Future performance is checked only for one year, analysis can be done for more than one year.

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