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The relationship between cash flow forecast and earnings management in firms

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ABSTRACT

The vast area of managers' authority and their different activities and utilizing realization and adjustment principles and using estimation, and forecasting are among factors that affect earnings' quality. It should be noticed that one of the most important information accessed by investors regarding different financial and economic decision makings is the financial report extracted from accounting systems of firms. Thus, we should consider that maybe one of the most important criteria in decision making by investors in stock market regarding purchase, sales, or holding stocks is their time perspective and their future predictions of profitability specifically the production of operating cash flows. Evidences show that cash flows prediction results in creating limitations in opportunistic earnings management. When management publishes cash flow forecasts, it commits to present a certain combination of income by using accruals in return to cash flows that leads to a reduction in degree of freedom in earnings management. There are several reasons why studying the effect of cash flows forecast is important for earnings management. Previous researches have shown that re-representing income imposes a great deal of expense on stockholders and managers who have caused this behavior with financial misbehaviors. Even if the companies increase their expectation level of management or decrease optional costs to encounter cash flow forecasts, these activities would be costly. Therefore, maybe it would not be an appropriate alternative to manipulate earnings' elements to achieve the goals. Accordingly, we expect that presenting cash flow forecast would limit firms' ability to achieve the target earnings. Thus, the present research has three hypotheses.

First hypothesis: by presenting cash flow forecast, earnings management will decrease through earnings' elements.

Second hypothesis: by presenting cash flow forecast, real activities' earnings management will increase.

Third hypothesis: by presenting cash flow forecast, expectations' management will increase towards target earnings.

The time period for this research was 8 years (from early 2004 to late 2011). Firms investigated in this research were 115 firms.

By analyzing the collected data, we dealt with studying and testing research hypotheses. Results of analyses showed that on the whole the first and second research hypotheses were approved and the third research hypothesis was rejected. Based on findings in this research it can be suggested to investors in Tehran Stock Exchange to rely on firms the present their cash flows and it can be shown that the earnings presented show firms' real earnings. The investors and creditors should pay more attention to firms' cash flow because it is one of managers' control tools to reduce earnings management. The investors should consider the factors and real signs of real earnings management and pay attention to their effects on cash flows as an index of firm's performance when they are making decisions to invest in firms. Regarding that real earnings' management discovering is done by auditors with much difficulty, it is suggested that Iranian Official Accountants' assembly and auditing organization, as active agents in accounting field in the country, should inform firms under investigations about future outcomes of earnings management through manipulating real activities, by training their own auditors. Stock Exchange Organization should introduce those firms that tend towards real earnings management by an appropriate informing format to investors and potential investors and let them invest or refuse investment consciously and based on their own short-term and long-term goals in such companies. Obligating firms enlisted in Stock Exchange to present cash flow forecasts results in increasing information transparency and increasing qualitative levels of researches.

1. Introduction

Earning is one of the fundamental elements in financial statements and has always been noticed by users and it has been used as a criterion to assess activity consistence, efficiency, and reviewing the structure of contracts of economic units' agents. In fact, earning is a tool to overcome measurement problems and to assess entities' performance.