

The study of relationship between earning management through real activities and cash flow operation in companies accepted in Tehran Stock Exchange

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Abstract: The main goal of this research is to study whether is there any relationship between the criteria of earning management through real activities (non-ordinary cash flow, non-ordinary production and non-ordinary arbitrary costs) and cash flow operation? Statistical population of the present research is all companies accepted in Tehran Stock Exchange which 103 companies were selected by randomized sampling method. Regarding to that the collected data for hypotheses were of combined data kind; panel analysis method and the integrated least squares regression were used to test the hypotheses and to estimate the coefficients. Research results indicate that at confidence level of 95 percent, there is a relationship between the criteria of earning management through real activities and cash flow operation and this relationship is of the inverted kind.

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1. Introduction

Through selection of special accounting policies, change in accounting estimations and management of the assumed items, the managers balance the reporting profits.

One of the fundamental goals to formulate accounting standards is that the consumers can make relatively relevant and correct decisions by relying on financial statements. Therefore, the accounting profession needs that method of reporting in which the benefits of all customers would desirably be observed. On the other hand, to achieve special goals which satisfy logically the benefits of a special numbers, the managers report the profit in such a way that is contrary to the goal satisfying general benefits of the customers. The auditors are responsible to confirm the desirability of financial statements within the framework of accounting standards while accounting standards give authority to the managers to select the accounting method in some cases. In fact, the problem is resulted from this issue that earning management causes sometimes the financial statements to be confusing, while in terms of placing within the framework of accounting standards, financial statements have no difficulty and the auditors cannot criticize financial statements in this respect. Therefore, regarding to that profit is one of the most important factors in decision-makings; users' awareness of being reliable the profit can assist

them to make better decisions. (stolowy and Bereton, 2004).

Manipulation in cash flow operation by manager is not easily possible unless he delays or proceeds consciously and intentionally cash flow related to incomes or costs. In this research, it is assumed that earning management rate depends on operational activities. On the other hand, when operational activities are weak (based on cash flow operation), companies intend to follow earning profit strategies.

Regarding to benefits opposition between the managers and investors; sometimes, the profit is managed by the managers and therefore, the reported profit is different from real earning. In this case, users of financial statements should have more precision in their decision-makings and they should perform more cautious.

Since the distance between earning management and the reported deceptions is not very high, and since the main task for the auditors is not to discover the deception, the results of this research remind the risk of fraud presence in companies which have performed earning management both to the customers and the auditors (Mashayekhi and Safari, 2006). One of the goals of financial statements is to reflect the results of management supervision or their calculation in respect of resources which are available for them. The users of financial statements to make economic decisions intend often to evaluate

the task of management accounting or supervision. The above-mentioned economic decisions include cases such as sale or maintenance of investment in business unit and re-selection or replacement of managers. The users of financial statements examine and evaluate the task for management supervision regarding to financial statements. Profit and loss statement is one of the financial statements which enjoy a high significance in evaluation of the task for management supervision. Profit and loss statement reflects the performance of business unit and involves the efficiency resulted from the resources under controlling of business unit's management.

Since preparation of financial statements is assumed by business unit's management, it is possible to perform earning management due to different reasons (Pour Heydari and Aflatouni, 2006). On the other hand, by considering the assumption of benefits opposition between managers and owners, the managers of economic agencies enjoy the required motivation to manipulate the profit by the goal of maximizing their wealth. Regarding to the authority which they have especially in implementation of the lagged items, the managers seek to be informed about the method of affecting these factors on their wealth until by implementing them parallel with their benefits, they would maximize their wealth as much as possible. Of course, sometimes, the benefits of managers will be guaranteed when the benefits of stock holders shall be guaranteed. As a result, the managers have strong motivation to maximize shareholders' wealth, because they regard their benefits owed to increase in stock holders' welfare. Therefore, the managers embark to perform earning management and to increase stockholders' wealth; not because of this that stockholders' asset shall be maximized, but because they intend to guarantee their own benefits. Especially, when this event occurs those managers' salaries and benefits are a function of increase in stockholders' asset. In this case, the managers will embark to perform earning management by more motivation. On the other hand, the owners of business units may be the incentives of managers in order to exert earning management in order to exert earning management in direction of their interests (Bahar Moghaddam, 2006).

According to definition of Noronha et.al. earning management is a chain of objective manipulations in the process of external financial reporting, from legal activities to fraudly violation of the accepted accounting principles in order to mislead some stockholders about the performance of business unit (Noronha, Zeng and Vinten, 2008).

A review on the performed studies in respect of earning management indicates that the managers

can manage the current term profit in two methods. In first method, the managers manipulate the profit through arbitrary undertaking items. In this method, the accounting procedures are based on the accepted accounting Principles but the effort is made until real economic performance shall be shown ambiguous. (Gunny, 2005)

This method of earning management is generally performed at the end of fiscal year and after accomplishment of most of real transactions. In this method, the price of undertaking items influenced but it has no direct effect on cash flows. (Roychowdhury, 2006)

On the other hand, sometimes, the managers manipulate the profit by real activities. Especially, the time and rate of real activities such as production, sale, investment and financial supply activities can be changed to achieve the desired profit goal. For example, the reported profit can temporarily be increased through excess production, elimination of arbitrary costs or delaying them and also decrease in prices at the end of year in order to transfer the sale of future fiscal year to the current year. Generally, this manipulation of real activities indicates to earning management through real activities. In general, the decisions of earning management through real activities are made by managers before earning management through undertaking items (which occurs generally at the end of fiscal year).

When the managers use both earning management methods as a substitution for each other, the application of each of these, methods depends on their relative cost in views of managers (Zhang, 2007).

Various studies have discussed the manipulation of managers in reporting process not only in estimations and selection of accounting methods but in operational decisions. Manipulation of real activities through excess production was studied by Thomas and zhang (2002).

The results of their research show that the managers have produced more than the required value for sale and normal level of the inventory which this results in decrease in the finished price for the sold item and consequently, increase in profit (Thomas and Zhang, 2002).

Also, there is various evidence which real activities' management emphasizes on decrease in the costs of research and development in order to decrease the costs. According to the results of performed researches in respect of earning management, most managers intend to use the manipulation of real activities for earning management even though this damages to future value of company (Graham et al. 2005).

Also, Yu showed that companies with strong motivations manipulate real activities more than other companies for earning management (Yu, 2008). Now, this question is posed whether when operational activities are weak (based on cash flow operation), the managers use manipulation of real activities by goal of increase in profit? In response to this question that why instead of using earning management through undertaking items, the managers intend to use earning management through real activities, various reasons are presented. First, managers in earning management through undertaking items may have a limited flexibility (on the other hand, in reporting the arbitrary undertaking items, company's ability may be limited). For example, company operations and manipulation of undertakings during last years, can create a limitation for the undertaking items management (Barton & Simko, 2002). Generally, it can be said that if a company has used earning management through the undertaking items more than other industrial companies in the past, it will enjoy lower flexibility to exert earning management through the undertaking items during future years. Therefore, it has more inclination towards earning management through real activities. Second, selection of adventurous accounting methods for undertaking items, especially in studies of stock exchange, guarantees a high risk. Third, essentially, earning management through the guaranteed items should be performed at the end of fiscal year, while the auditors don't permit some accounting operations at that time period. On the other hand, operational decisions are under control of managers; but the selection of accounting methods will be addressed by the auditor (Gunny, 2005).

In this research, the following hypotheses are reviewed:

Primary hypothesis:

There is a relationship between earning management through real activities and cash flow operation.

Secondary hypotheses:

First hypothesis: There is a relationship between non-ordinary cash flow and cash flow operation.

Second hypotheses: There is a relationship between non-ordinary production and cash flow operation.

Third hypotheses: There is a relationship between non-ordinary arbitrary costs and cash flow operation.

2. Material and Methods

This research is placed within the domain of verification researches of accounting. Regarding to that historical data has been used in hypotheses testing; it is classified into pseudo-experimental research group.

Also, since the goal of performing this research is to study the relationship between earning management through real activities and cash flow operation; regarding to the nature and method which are used in this research, it is regarded as a kind of descriptive-correlational research.

In addition, in terms of statistical analysis, this research will use the integrated regression. Meanwhile, data analysis and testings are performed by aid of Excel, Eviews and SPSS softwares. All companies accepted in Teheran's stock exchange during the years 2004-2009, constitute statistical population of this research. By consideration of several criteria and using of census method, the companies accepted in Tehran's stock exchange were studied and a sample including 103 companies was obtained. The required data for this research was collected by compact disc of stock reporting, novel achievement (Rahavard-e-Novin) software as well as the reports published by organization of exchange and securities. Then, Excel page was used and the required variables were calculated. Due to being data as integrated, panel analysis and pooled least squares (PLS) regression through SPSS software was used for hypothesis testing and coefficients estimation. For analysis of regression coefficients, t-student test was implemented and for total regression, F-test was applied. It should be mentioned that the following tests were performed before regression analysis:

- 1- Normality of dependent variables (using of kolmogorov-Smirnov Test).
- 2- Homoscedasticity of variances for different levels of independent variable (using of Scatter plot diagrams).
- 3- Lack of self-correlation between model remainings (using of Durbin-Watson Test).
- 4- Appropriateness of linear pattern and lack of irrelevant points.

2-1- Internal and external validity of Research

Internal validity of research is related to study this question whether independent variables have really changed the dependent variable or not? The following cases may have negative effect on internal validity of research:

- 1- Historical events simultaneous with the study time, structural changes in Iran's economy including fluctuation in oil price, change in exchange rate, prices liberation policy, business ages (stagnation and prosperity), change in state supports of industries and change in conditions of bank loans are some factors which cause to mistake research results. Although one method for omission of these factors is to separate the studied age; for example, into two periods of prosperity and stagnation and then to perform statistical tests, but

modeling the effect of these factors is out of limitations of the present research.

- 2- Inflation has influenced on the numbers of companies' profits. Although the effect of inflation on the profits of all sampled companies as well as during the studied years has not been the same, but the process of variables' growth due to inflation can mistake the research result.
- 3- Difference in the characteristics of the sampled companies such as the structure of ownership, kind of product, size and degree of competition.

External validity means the capability of generalization or indicator-being of research findings. The characteristic of companies which are selected as sample, determines the value of generalization of research findings. First, the samples are selected from companies accepted in Tehran Stock Exchange (TSE). Second, the selection is based on the existence of data for the studied period. Third, the sampled companies in terms of size, ownership, product and competition are necessarily neither the indicator of the all companies in Tehran exchange, nor the indicator of all active economic units in the country. Therefore, acceleration of findings should be performed by caution.

2-2- Descriptive Statistics

In the following table, the values of central and distribution parameters for research variables are calculated.

Table 1. Descriptive statistics

Parameter statistical variable	Number of observations	Mean	Standard Deviation	Distribution	Skewness
1. CFO_{it}/A_{it-1}	618	0.27	0.21	0.78	0.43
2. $PROD_{it}/A_{it-1}$	618	0.49	0.34	1.67	1.08
3. $DISEXP_{it}/A_{it-1}$	618	0.15	0.42	2.96	1.53
4. Beta	618	0.40	0.24	0.87	0.86
5. Size	618	0.32	0.18	1.53	0.64
6. BM	618	4.06	0.26	1.07	0.96

2-3- The quality of validity testing of research models

The hypotheses of this research are modeled within the framework of specified regression relationships and therefore, it is necessary before testing these regression relationships and the analysis of their results, fundamental assumptions of these relationships should be studied.

Therefore, in this section, the following four essential issues in respect of regression relationships of research will be studied which are as follows:

- 2-3-1- Normality of research data.
- 2-3-2- Appropriateness of linear pattern and lack of irrelevant points.
- 2-3-3- Lack of self – correlation.

2-3-4- Homo scedensity of variances.

2-3-1- Normality testing of research data:

One of the most important pre-assumptions of regression models is to have normal distribution for model remainings. If model remainings are abnormal, the validity of some tests will be under question which are used for the factors. Therefore, the distribution of remaining in processing each regression model should be controlled. In estimation models, it is assumed that the remainings and following it, dependent variable, are randomized variables. Therefore, dependent variable distribution follows the remainings' distribution. In this research, the examination of data normality will be performed by kolmogorov-Smirnov testing. In is obvious that based on the results of this test, if significance level is above 0.05, the normality of data distribution is confirmed. Therefore, to examine the normality of dependent variable using Kolmogorov-Smirnov test, the following statistical hypotheses should be tested:

$$\begin{cases} H_0: \text{Asymp. Sig (2-tailed)} \geq 0.05 \text{ rejection of research claim} \\ H_1: \text{Asymp. Sig (2-tailed)} < 0.05 \text{ research claim} \end{cases}$$

$$\begin{cases} H_0: \text{Dependent variable doesn't follow normal distribution.} \\ H_1: \text{Dependent variable follows normal distribution.} \end{cases}$$

2-3-2- Test of appropriateness of linear pattern and lack of irrelevant points

In order for test of appropriateness of linear pattern and lack of irrelevant points, the distribution scattering charts are used. Regarding to that these diagrams don't represent a specified pattern (for example; crescent- shaped, diameter-shaped and ...), the appropriateness of linear pattern and lack of irrelevant points is confirmed.

2-3-3- Testing of data non-self-correlation

The issue of self-correlation between the remainings is one of the other cases to violate classic assumptions of linear models. It means that to estimate the parameters of linear models, it is assumed that the remainings are not dependent to each other. Durbin-Watson parameter tests this issue whether the remainings are dependent to each other or not. Experimentally, it was determined that whenever the value of this parameter approaches to 2 (from left to right), there is not the problem of remainings' self- correlation. In this research, in some cases where there was the problem of remainings' self-correlation, auto-regression model was used to solve this problem.

2-3-4- Testing of homoscedensity of variances

The last fundamental point which was tested in this research in respect of regression relationships, is the issue of homoscedensity of variances in the remainings' diagrams against R^2 values. If this diagram depicts a special pattern, one of the fundamental assumptions of regression will be under question and it cannot be claimed that data distribution is randomized. Therefore, regarding to that the drawn diagrams don't show a special pattern, the homoscedensity of variances can be hopeful. Generally the results obtained from tests indicate that the realization of all validity pre-assumptions of regression model is usable.

2-4- Significance testing of research models

To calculate non-ordinary cash flow, non-ordinary production and non-ordinary arbitrary costs, the following regression relationships are used:

$$CFO_{it}/A_{it-1} = \alpha_0 + \alpha_1 (1/A_{it-1}) + \alpha_2 (S_{it}/A_{it-1}) + \alpha_3 (\Delta S_{it}/A_{it-1}) + \varepsilon_{it}$$

$$PROD_{it}/A_{it-1} = \alpha_0 + \alpha_1 (1/A_{it-1}) + \alpha_2 (S_{it}/A_{it-1}) + \alpha_3 (\Delta S_{it}/A_{it-1}) + \alpha_4 \alpha_3 (\Delta S_{it-1}/A_{it-1}) + \delta_{it}$$

$$DISEXP_{it}/A_{it-1} = \alpha_0 + \alpha_1 (1/A_{it-1}) + \alpha_2 (S_{it-1}/A_{it-1}) + \lambda_{it}$$

Therefore, we observe that the above-mentioned regression relationships have a significant role in the results of main regression relationships of the research and the presence of a meaningful relationship between them, will have a high effect on the validity of research.

Therefore; here, it is necessary to test the significance of these models. For this same reason, testing of the following statistical hypotheses is recommended in this section:

$$\left\{ \begin{array}{l} H_0 : \alpha_0 = \alpha_1 = \alpha_2 = \alpha_3 = \alpha_4 = 0, \text{ there is no meaningful} \\ H_1: \text{Taking all coefficients of the model together, is not zero, there is a meaningful model.} \end{array} \right.$$

In this section, to test the significance of each model completely, F-test will be used and if the significance level of F is less than $\alpha = 0.05$, the above- mentioned zero hypothesis (H_0) will be rejected at confidence level of 95 percent and its opposite hypothesis which confirms the significance of model, will be accepted. Since for the models of the present research, level of significance is less than $\alpha = 0.05$; therefore, the significance of model will be confirmed.

3. Results

H_1 : There is a relationship between non-ordinary cash flow and cash flow operation. In table 2, F-statistics represents general significance of R^2 regression model at confidence level of 95 percent.

Regarding to R^2 of the processed model, it can be claimed that about 22 percent of changes in cash flow operation (as dependent variable) is explained by non-ordinary cash flow as one of the criteria of earning management through real activities. According to the prediction, the coefficient and t-statistics of non-ordinary cash flow variables announces about the existence of a negative and meaningful relationship between non-ordinary cash flow and cash flow operation at confidence level of 95 percent. Therefore, it can be acknowledged that first secondary hypothesis of this research including the existence of a relationship between non-ordinary cash flow and cash flow operation, is confirmed at significance level of 5 percent.

Table 2 Test results for first secondary hypothesis

Dependent variable: CFO				
Method: Pooled least squares				
Sample: 2004-2009				
Included observations:6				
Cross-sections included: 103				
Total pool (unbalanced) observations:618				
White cross-section standard errors & covariance (d.f. corrected)				
Variable	Coefficient	Std. Error	-statistic	Prob.
C	0.412365	0.085123	4.84434	0.0016
Beta	- 0.029845	0.009542	-3.127751	0.0284
Size	0.018451	0.011325	1.629227	0.0046
BM	- 0.010243	0.003125	-3.27776	0.0307
ABCFO	- 0.061325	0.031548	-1.94386	0.0000
R-squared	0.23548	Mean dependent var		0.31254
Adjusted R- squared	0.22845	S.D. dependent var		0.11356
S.E. of regression	0.18452	Akaike info criterion		-0.73454
Sum squared resid	14.54821	Schwarz criterion		-0.48412
Log likelihood	212.548	F-statistic		1.84214
Durbin-Watson stat	1.98451	Prob (F-statistic)		0.0000

3-4-2- Testing of second secondary hypothesis:

$$\left\{ \begin{array}{l} H_0 = \text{There is no relationship between non-ordinary production and cash flow operation.} \\ H_1 = \text{There is a relationship between non-ordinary production and cash flow operation.} \end{array} \right.$$

In table3, F-statistics represents general significance of R^2 regression model at confidence level of 95 percent. Regarding to R^2 of the processed model, it can be claimed that about 19 percent of changes in cash flow operation (as dependent variable) is explained by non-ordinary production as one of the criteria of earning management through real activities.

According to prediction, the coefficient and t-statistic of non-ordinary production variable announces about the existence of a negative and meaningful relationship between non-ordinary production and cash flow operation at confidence level of 95 percent. Therefore, it can be acknowledged that second secondary hypothesis of

this research including the existence of a relationship between non-ordinary production and cash flow operation, is confirmed at significance level of 5 percent.

Table 3. Testing results for second secondary hypothesis

Dependent variable: CFO				
Method: Pooled least squares				
Sample: 2004-2009				
Included observations:6				
Cross-sections included: 103				
Total pool (unbalanced) observations:618				
White cross-section standard errors & covariance (d.f. corrected)				
Variable	Coefficient	Std. Error	t-statistic	Prob.
C	0.356214	0.11254	3.165221	0.0027
Beta	-0.112654	0.02462	-4.575710	0.0421
Size	0.198451	0.12354	1.606370	0.1063
BM	-0.095321	0.03215	-2.964883	0.0267
ABCFO	-0.102354	0.02421	-4.227757	0.0001
R-squared	0.20187	Mean dependent var		0.23542
Adjusted R-squared	0.19562	S.D. dependent var		0.43154
S.E. of regression	0.35621	Akaike info criterion		-0.38542
Sum squared resid	9.8451	Schwarz criterion		-0.26845
Log likelihood	231.542	F-statistic		0.94512
Durbin-Watson stat	1.89652	Prob (F-statistic)		0.00017

Table 4 Testing results for third secondary hypothesis

Dependent variable: CFO				
Method: Pooled least squares				
Sample: 2004-2009				
Included observations:6				
Cross-sections included: 103				
Total pool (unbalanced) observations:618				
White cross-section standard errors & covariance (d.f. corrected)				
Variable	Coefficient	Std. Error	t-statistic	Prob.
C	0.38649	0.21548	1.79362	0.0084
Beta	0.14652	0.06541	2.24002	0.0157
Size	0.07481	0.04512	1.65802	0.001
BM	0.08645	0.10364	0.83413	0.0846
DISEXP	-0.01036	0.00845	-1.22603	0.0028
R-squared	0.23354	Mean dependent var		0.203481
Adjusted R-squared	0.23154	S.D. dependent var		0.175432
S.E. of regression	0.19845	Akaike info criterion		-0.86214
Sum squared resid	17.3268	Schwarz criterion		-0.73481
Log likelihood	242.845	F-statistic		2.76248
Durbin-Watson stat	1.98452	Prob (F-statistic)		0.00000

3-4-3- Testing of third secondary hypothesis:

- H_0 : There is no relationship between non-ordinary arbitrary costs and cash flow operation.
 H_1 : There is a relationship between non-ordinary arbitrary costs and cash flow operation.

In table 4, F-statistic represents general significance of R^2 (R-squared) regression model at confidence level of 95 percent. Regarding to R^2 of the processed model, it can be claimed that about 23 percent of changes in cash flow operation (as dependent variable) is explained by non-ordinary

arbitrary costs as one of the criteria for earning management through real activities. According to prediction, the coefficient and t-statistic of non-ordinary arbitrary costs variable announces about the existence of a negative and meaningful relationship between non-ordinary arbitrary costs and cash flow operation at confidence Level of 95 percent.

Therefore, it can be acknowledged that third secondary hypothesis of this research including the existence of a relationship between non-ordinary arbitrary costs and cash flow operation, is confirmed at significance level of 5 percent.

3-4-4- Testing of primary hypothesis:

H_0 : There is no relationship between earning management through real activities and cash flow operation.

H_1 : There is a relationship between earning management through real activities and cash flow operation.

The results of pervious researches show that manipulation in cash flow operation is not easily possible by management, unless he/she delays or proceeds cash flow related to incomes or costs consciously and intentionally.

In this research, it was expressed that the rate of earning management depends on operational activities. On the other hand, when operational activities are weak (based on cash flow operational), the companies intend to follow profit increasing strategies and in this way, they will use manipulation in real activities. In the present research, since the existence of a relationship between the criteria of earning management through real activities (non-ordinary cash flow with the adjusted- R^2 coefficient of about 22 percent, non-ordinary production with the adjusted- R^2 coefficient of about 19 percent and non-ordinary arbitrary costs with the adjusted- R^2 coefficient of about 23 percent) and cash flow operation was confirmed at significance level of 5 percent and negative coefficient of non-ordinary cash flow, non-ordinary production and non-ordinary arbitrary costs in the models indicate to the inverted relationship; therefore, it can be said that primary hypothesis of research including the existence of a relationship between earning management through real activities and cash flow operation is also confirmed at significance level of 5 percent and the above-mentioned relationship is of the reversed inverted kind of relationship.

Conclusion and Recommendation

Regarding to the performed testings, final conclusion of this research represents that there is a relationship between the criteria of earning management through real activities (non-ordinary

cash flow, non-ordinary production and non-ordinary arbitrary costs) and cash flow operation and this relationship is of the reversed kind. On the other hand, when operational activities are weak (based on cash flow operation), the managers will use manipulation in real activities by a goal of profit increasing.

The applied recommendations:

- 1- Analysis of the collected data shows that managers of economic agencies embark to manipulate the profit in a wide spectrum. This should be addressed by individuals interested in investment in economic agencies and during the study of essential financial statements, particularly profit and loss statement, the problem of possibility exerting earning management (undertaking and real) by the managers should be considered.
- 2- It is appropriate the auditing organization and other legislation and supervision foundations and accounting and auditing associations shall more address the issue of profit manipulation in compiling accounting standards and financial rules and by presentation of necessary guidance (for restriction of managers in exerting earning management), users of financial data should assist increasingly in order to make optimal and conscious decisions.
- 3- By consideration of the hypothesis of effective investment market, the organization of securities exchange can besides the appropriate supervision and enough control on the method of financial reporting of the accepted companies, by presentation of desired guidelines and the efficient management, conduct gradually the investment market from weak state towards semi-strong market and finally the strong market which its result will be the substitution of social welfare instead of personal welfare in the investment market.
- 4- One of the required practices in the current conditions of the country is to establish the authorities and institutions where evaluate the economic agencies and classify them in terms of risk and efficiency. One of the unique advantages of companies' classification is the significant improvement in the method of financial reporting of business units. In addition, the realization of this issue causes managers' errors shall not be ignored by users of financial statements.

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