

Research Paper

The role of earnings management and windfall profits in investor confidence: Evidence from industrial companies listed on the Tehran Stock Exchange

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Abstract

Profit management is one of the important features of financial reports that affect the optimal allocation of resources; Because profit is considered one of the main inputs of investors' and analysts' evaluation models. The purpose of this research is to examine the role of profit management in gaining capital confidence in companies listed on the Tehran Stock Exchange. The statistical population of the research is the companies admitted to the Tehran Stock Exchange in the period of 9 years from 2012 to 2020, with the exception of investment and mediation companies; Based on this, the rest of the profitable companies in the stock exchange during the investigated time period constitute the statistical population of the research. The statistical sample is selected by systematic elimination. In order to test the hypotheses of the research, the multivariate regression method was used based on the combined data analysis method and the research model of Augster and Wagner (2020) was also used. The results indicate that the management of profit and unexpected profit in the industrial companies of Tehran Stock Exchange has a negative and positive effect on attracting investor's trust, respectively.

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Extended Abstract

Introduction

In recent years, the topic of earnings management has attracted significant attention within accounting research. Based on management's objectives, earnings management can manifest as income increases, decreases, or smoothing. There are numerous potential reasons for engaging in earnings management; for example, a company reporting stable profits can enhance investor confidence. In other words, earnings management can positively influence stock value and the cost of capital (Zalata et al., 2022). What underscores the importance of this topic is the impact of earnings management on market participants. This study aims to examine the relationship between real earnings management and abnormal stock returns. The following sections include a review of the theoretical background, research hypotheses, and methodology, followed by presenting the findings, conclusions, and discussion.

Investment decisions are among the most critical and vital choices for the survival and growth of companies. However, investment behavior can be influenced by various factors, including dividend policy, company size, and leverage. Among these, dividend policy has a particularly notable negative effect on investment decisions due to its role in internal resource distribution and liquidity reduction. Companies with limited internal funds must choose between investment opportunities and dividend payouts. Many managers forego valuable investment opportunities to maintain dividend payouts. The negative impact of dividends on investment tends to be more severe in firms that have reduced their dividend payments compared to those that have increased them. Therefore, it is expected that in companies that have cut their dividends, the negative effect of dividend distribution on investment will be more pronounced. Additionally, higher financial reporting quality can mitigate the negative impact of dividends on investment (Kowerski & Kaźmierska, 2022). Earnings management disrupts company valuation and investment decisions, potentially leading to adverse economic consequences (García et al., 2019). Earnings management can be considered a serious issue within the accounting literature (Piri, 2022). Furthermore, abstaining from earnings management in the past enhances investors' reactions to future earnings surprises, especially in industries where investor trust has been eroded and where managers have previously had incentives to manipulate earnings (Tarmidi et al., 2021).

Unlike traditional financial theory, which attributes no role to investor sentiments in determining a company's investment decisions, if a stock's return does not reflect its underlying risk, it is instead indicative of investor sentiment. For example, when an investor's expectation of the future return of a stock is overly optimistic, their investment decisions will be influenced by this sentiment. (Mori et al., 2022).

When investors are optimistic, they tend to ignore negative information and react strongly to positive information, resulting in an overvaluation of the stock price. Conversely, when investors are pessimistic, they ignore positive information and react strongly to negative information, causing the stock price to be undervalued relative to its true value. Therefore, investor sentiments lead to mispricing of stocks and influence the level of investment undertaken by companies (Baker et al., 2012).

The findings from previous research indicate that one advantage of real activity manipulation for earnings management is that auditors and regulators (the capital markets) are less likely to scrutinize and investigate such behaviors. Under these conditions, users should pay attention not only to earnings figures but also to the critical factor of earnings management by these companies, in order to optimize returns with minimal risk. Accordingly, the research hypotheses are as follows:

- The role of earnings management in industrial companies listed on the Tehran Stock Exchange has a significant effect on attracting investor trust.

- Unexpected earnings of industrial companies listed on the Tehran Stock Exchange significantly influence investor trust.

Research Methodology:

- This study is applied in nature, aiming to serve practical purposes, and is of a correlational type based on its analytical approach. From the perspective of research classification by objective, it is an applied investigation. The primary goal of applied research is to develop practical knowledge in a specific field. For data analysis and hypothesis testing, a multivariate regression model based on panel data has been employed. To select between the panel data techniques of pooled data and combination methods, the F-Limer test was used. Additionally, the Hausman test was applied to determine between fixed effects and random effects models.

The statistical sample is selected through systematic elimination.

Based on the formulated hypotheses and according to the model adapted from the study by Oogestr and Wagner (2020):

$$CAR_{it} = \beta_0 + \beta_1 EM_{it} + \beta_2 UE_{it} + \beta_3 EM_{it} * UE_{it} + \beta_4 SIZE_{it} + \beta_5 BTM_{it} + \beta_6 LEV_{it} + \beta_7 LOSS_{it} + \varepsilon_{it}$$

Based on the results obtained from the heteroscedasticity test, which indicates the presence of heteroscedasticity in the model, the GLS (Generalized Least Squares) method is used for model estimation.

$$CAR_{it} = \beta_0 + \beta_1 EM_{it} + \beta_2 UE_{it} + \beta_3 EM_{it} * UE_{it} + \beta_4 SIZE_{it} + \beta_5 BTM_{it} + \beta_6 LEV_{it} + \beta_7 LOSS_{it} + \varepsilon_{it}$$

The hypotheses to be tested with this model are as follows:

- The role of earnings management in industrial companies listed on the Tehran Stock Exchange has a significant impact on attracting investor trust.
- Unexpected earnings of industrial companies listed on the Tehran Stock Exchange have a significant influence on investor trust.

Discussion and Conclusion:

The results of the first hypothesis reveal that the role of earnings management in industrial companies listed on the Tehran Stock Exchange has a positive and significant effect on attracting investor trust. The findings related to the primary hypothesis suggest that actions related to earnings management lead to the disclosure of fabricated financial information, as this information does not accurately reflect the true conditions. When investors are unable to properly assess the level of risk and return on their investments, it causes errors in their decision-making process. Consequently, identifying earnings management activities can serve as valuable additional information for users of financial reports, enabling them to take precautionary measures when analyzing financial data.

The results for the second hypothesis indicate that unexpected earnings of industrial companies listed on the Tehran Stock Exchange significantly influence investor trust. The results for this hypothesis suggest that earnings manipulated through smoothing motives by management contain high informational value—they are more reliable, and the greater their reliability, the more useful the information they provide. As a result, this leads to increased effectiveness of the information in decision-making processes by investors.