Relationship of Investment Levels with Earnings Management; Evidence from Pakistan

By

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Abstract

This study is all about earnings management and its relationship with firm's investment levels.

In this study, investment levels are observed against the discretionary revenues (discretionary revenue in this study is used as a proxy for earning's manipulation), Tobin's Q, cash flows generated from operations, prior investment levels and prior growth in fixed assets.

This study comprises of nine years data(2008 – 2016) of five manufacturing sectors of Pakistan (Textile, Cement, Sugar, Fertilizer and Oil and Gas). Data is takendirectly from the published financial statements of the public listed companies (listed on Pakistan stock exchange).

Results of this study show that investment levels are significantlyrelated with the current period earnings manipulation, Tobin's Q, cash flows generated from operations and prior period investment levels, but there is no significant relationship between current investments levels with initial growth in fixed assets. Results also showthat firms tend to have higher investment levels than expected during the period in which earning is manipulated. Current period investment levels are not significantly related with the previous period's earnings manipulation and also not with the future period's earnings manipulation.

Keywords: Earnings management, Investment Levels, Revenues, Tobin's q, Cash flow

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List of Abbreviations

Abbreviation	Description
$INV_{i,t}$	Current investment level
$Q_{I,t}$	Tobin's Q
DREV	Discretionary revenue
CF	Cash flows generated from operations
MVE	Market value of equity
BVE	Book value of equity
TA	Total assets

Chapter1

Introduction

Earnings are managed by firms depending upon different motives for example to obtain loans from banks, to keep the share prices at a certain level and to obtain other personal benefits(Daniel, 2004). Other than that, annual targets are set for the management and their bonuses and salaries are also linked to the achievement of those objectives. Earnings of a firm are managed by many ways for example by manipulating accruals, discretionary revenues and by managing real activities (operations). Accruals are managed to achieve the specified earnings targets. Existence of pre-managed earnings is more likely in firms having profits rather than losses before management of accruals (Barua, 2006).