
The More Capable Management, the Better Earning Quality

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ABSTRACT

Investors are willing to devote their resources to companies with excellent performance and one of the criteria of productivity for the company is profitability. Investor's over emphasize on the profitability reminds that market ignore other indicators of performance. But managers are able to influence on this criterion. Therefore, the quality of the corporate earnings is affected by reports and managers discretion and their ability. Thus, understanding the managers' ability and its application in corporate monitoring, would be effective in economical decisions for the investors. Nevertheless, a professional management is usually complicated and they require a set of specific capability and capacities. Also, companies try to hire qualified managers, in order to achieve higher profitability. Hence, most of the investors prefer to devote their resources to corporate with higher quality of profitability and therefore, according to the importance of prices and manager's earnings investigation on the relationship between management productivity and quality of the profitability is essential for both decision makers and the Board of Directors.

Keywords: Earning Quality, Management Abilities.

Introduction

Securities analysts, corporate managers, investors and capital market participants need information for decision-making on financial issues. They highly focus on the net income as the last item of information of the income statement from the profitability is the final result of the long lasting process of accounting is noted and emphasized by information users (Saghafi, Kordestani, 2004). However, accountants

and financial analysts have different opinion and give different meaning about profitability. Financial analysts differentiate between the reported earnings (accounting earning) and real earning. One of the reasons for this difference is that it's possible that the earning can be manipulated by the managers (Jahankhani, Zarif, 1995). Thus, earning quality asses the financial health

of companies which is considerable for investor's creditors and other users of the financial statements. Many factors affect the quality of corporate earnings. Ability to manage is one of these factors. Professional management is complex and usually requires a set of specific competences. So companies are trying to attract and hire qualified managers, to achieve higher earnings quality. On the other hand, in the present situation that organizations are facing environmental drastic changes, the continuity of manager's performance is required more than ever. And this continuity will be just achieved by considering manager's physical, emotional, psychological and academic health (Farahi, Bujanjani, 2005). On the other hand, it can be stated that manager's action in the use of realization and compatibility fundamentals through estimation and prediction affect the earning. Moreover, due to the greater awareness of the corporate managers, information is expected to be provided and offered in a way that reflects the company's best. Hence, there may be some reasons such as his retention in the company, reward or other factors, the manager planned or unplanned make company look good. In conclusion, corporate earning quality is affected by fundamentals of reports and discretion of managers (Khoshtinat, Esmaeeli, 2006).

Earning quality

The primary goal of earning reports is to provide and offer useful information for someone who is interested in financial reports. But, defining clearer targets is essential for a better understanding of the earning reporting. One of the basic goals which are considered as the most important one in the views of all users of the financial reports is distinguishing between investments and earning as a part

of descriptive process. The clear goal of the earning reports includes the following items:

Use of earning for measuring the application of management.

Use of historical prices for predicting future of the financial unit and distribution of the earning of capitals.

Using earning as a criterion for measuring the achievements and also a sign of manager's future decisions.

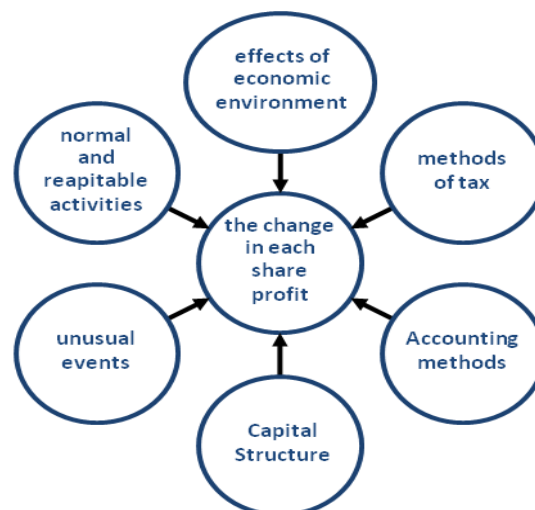
Other goals includes: using earning for recognizing the tasks, investigating the prices of units which and finally evaluating the devotion of resources by economics. However, accounting earning would not always make these cases clear and sometimes are manipulated by managers; therefore to deal with this problem the quality of earning is considered. The theory of earning quality was discussed by financial analysts and stock functionaries for the first time; because they feel that the reported earning wouldn't demonstrate the power of corporate earning as well as it is visualized. They found out that analyses of the corporate financial bills are difficult due to the various weak points in measurement of accounting information. The main question is that why don't the analysts use the absolute earning or the earning of each share of company in their evaluation. The answer is that because in corporate valuation not only the quantity of earning is important, but also we should consider the quality of earning. By earning quality we mean the context of earning improvement and the probability of future earnings. In other words, the value of a share not only depends on the earning of each share in a year, but also depends on our expectations of future profitability and strength and the reliability of future earning (Jahankhani, Zarif, 1995). Earning quality is an important measure for the financial health of the business unit and it

has a multiple mention meaning and has many aspects (Bellovary et.al, 2007) accordingly, various definition and different criteria for measurement has been discussed. Some of these definitions for earning quality are:

Schipper and Vincent (2003) consider a number of concepts which derived from temporal earning, as earning quality: stability, capability of prediction and variability. Dechow and Dichev (2002), Francis et.al. (2005) call the quality of accruals, earning quality and consider earnings with higher quality of the accruals as earnings with higher quality. Penman and Zhang (2002) and Richardson (2003), discuss the stability of the earning as earning quality. Mikhail et al., (2003) consider Quality of benefit to the extent that the company's earnings and cash flow in future are linked and therefore, they noted the prediction value. Some research, such as Logs et al., (2004) and Ball and Shivakumar (2005) consider the earning as high quality when management of earning is low and bad news about the

company's situation in stock price at that time is reflected.

Hence, there is not any clear definition for earning quality. One of the possible reasons for the variation in the definitions of earnings quality can be obtained at the different aspects of the concept. For this reason, the issue of earning quality is a complex issue and so far no researcher could propose a single definition or a complete index for this concept (Hermanns, 2006). Although many researchers have executed much research about earning quality, only one or two dimension in each research have been applied (Waild, 1996; Myers et al., 2003). Most of these models and definitions are similar but not any of them have a comprehensive view of earning quality (Bellovary et al. 2006). Given that there are many different criteria for evaluating the earning quality, different measures also can affect this issue. In the following figure, six factors which has a roll in evaluating the earning and the relationship between this issue and changes in earning of each share is proposed by Hawkinz:



Among all the mentioned factor, except in one (the effects of economic environment) all the factors involved in the evaluation of earning quality and earning of each share

changes, can be manipulated by managers and accountants. Therefore, we should pay attention to the management and it's capability to use earning better.

Management and its effects on the quality of earning

Investors are among the most important variables determining the fate of long-term economy, thus, in order to provide a suitable context for absorption and overwhelming presence of them and their reliance, we would need various tools, criteria and information which stock analysts can get. On the other hand, it can be stated that investors are eager to devote their resources to companies with excellent application and one of the productivity criteria for company is profitability. Therefore, most of the investors devote their resources to companies with higher quality of earning and according to that it's essential to investigate the relationship between productivity of management and quality of earning with the decision makers view (Farahi Bouzanjani, 2005). So firstly we should debate about how management can affect the quality of earning and then the relationship between quality of earning and management capability would be investigated, hence in this sector, we discuss about how management affect the quality of earning. Stock analysts, corporate managers, investors and participants in investment market mostly focus on the net income as the last information of the income statement. The over emphasis on the earning shows that market ignore other index of performances (Saghafi and Kordestani, 2004), but manager's action in using realization and accordance principles and prediction are factors which affect the earning. On the one hand, due to greater awareness of the company's manager, it's expected to provide information which reflects the company's position better. On the other hand, for the reasons such as his retention in company, receiving bonuses and other factors, the manager planned or

unplanned may make company look good (Khoshtinat, Esmaeli, 2006). Therefore, the quality of corporate earning is affected by reports and manager discretion and capabilities. By doing this, they minimize the reported quality of earning, because people whose decisions are based on these earnings may make mistake and financial analysts won't be able to predict the profitability of economic entity in future. Yoon and Miller (2002) use cash for evaluating the economic performance of the firm in order to reduce and control the manager's manipulation. They believe that cash flow from operations is one of the factors which can't be manipulated by managers and so it is a more realistic criterion of the economic performance of the firm. Thus, it would be concluded that those firms with poor performance have a great motivation to increase their reported earnings through the earning management process and vice versa for the firms with good performance, the probability of adoption of artificial methods for increasing the earning by managers will be reduced (Yoon and Miler, 2002). Accordingly, it can be stated that firms which report lower cash flow, had poor performance and thus they may be evaluated weak by investors. Therefore, in order to avoid this situation, these firm managers have great motivation to report higher earning, increase stock prices, make firm look good, increase manager's bonuses and finally reduce the political costs of the firm (Mashayekhi et al., 2005). Management interference is in calculating the accruals earning. Accruals earning is measured under the influence of accounting procedures which management chose. The accepted accounting principles give the autonomy to managers for choosing different methods of accounting and consequently management is independent in earning recognition

schedule and also determining the prices. The manager may increase the corporate profitability for reasons such as job security, bonuses, enhancing corporate value and other factors, in order to offer an optimum picture of company (Nasrollahi and Arefmanesh, 2010), in other words, when the sale growth decrease, manager is under pressure to report the profitability according to financial analysts prediction. This pressure causes an increase in accruals which is associated with the increase in inventories and receivables. With the reduction in sale, the earnings growth will reduce, hence the management wants to preserve the earnings growth, begin to manipulate the profitability which in turn detracts the quality of earning (Xie, 2001). As a result, accruals will increase and the distance between the operational earnings and cash flow from operations will enhance, moreover the reported earning has poor quality in economic decisions. Indeed, the accordance between the quality of earnings and cash flow demonstrate the quality of accruals and so this reduction in accordance and quality leads to an increase in the risk of corporate information (Francis *et al.*, 2005). Consequently, it can be noted that the quality of earning is considered as a criteria for measuring the manager performance and results which demonstrate the management future. Quality of earning is part of accounting earning that depends on manager's wisdom and performance (Bollo and Talbi, 2010). Process management is effective use of human and material resources in planning, organizing, mobilizing resources, guidance and a control system which is executed based on the value system to achieve organizational goals. With the significant advances in science, the behavioral sciences are fundamentally

transformed and provide new unique achievements (Rezaeian, 1997). As a result, quality of effective management has a vital role in valuation and productivity in future business of company and operational management qualification is among the important factors of productivity and effectiveness of operation and earning prediction in future. A qualified manager is a beneficial source for the company and considered as an intangible asset for that (Bulo and Talebi, 2010). Hence, eligible managers are expected to report higher profitability after controlling internal effects (Demerjian *et al.*, 2010). Therefore, the recognition of management capability and its application in controlling the company can be useful for investors in economic decisions and considered as an important criteria for someone who use the accounting information which can be helpful in investor's financial decisions. Consequently, management would be affective on quality of earning. But professional management is complex and need a set of special abilities and capacities and companies also hire qualified managers, to achieve the higher quality of earning (Mousazade and Adli, 2009). However, there are studies in international context which examine this relationship. On the other hand, in this situation which organization face environmental severe changes, manager's continues performance is crucial, which is not possible without manager's physical, mental, emotional and scientific health (Farahi and Boujanjani, 2005). We will note some of the capability of managers in the following.

Behavioral variables of manager's capability

As the behavior is concern which is related to human affairs in organization,

manager's capability will examine by various behavioral variables such as: ability, skill, and job attitude, leading style and people personality. Organizational ability means the ability of a person in doing things of an organizational post which need both physical and mental capability. Physical ability is of high importance in works which doesn't require much skill and proficiency. Mental ability includes things that one need to do mental works and it has seven dimensions which are: numerical attitude, verbal comprehension, perceptual speed, inductive reasoning, deductive reasoning, spatial perception and person memory. The second behavioral variables are skill. Management skill includes technical, human and perceptual skills. By technical skill we mean his ability in using the specialized knowledge in context of corporate operation execution. Human skills include ability of work and understanding and motivating in individual or group. In human skill, manager's communicational skill, motivational skill and the ability to participate individuals is investigated. Manager's conceptual skills include the analysis of complicated problems and interpretation and process of information for choosing the best solution. In conceptual skill, manager should be able to recognize the environment and interpret the information. The third variable is job attitude. Job attitude in this section include job satisfactory, job dependency and organizational commitment. Leadership style is the fourth variable. Leadership style is referring to leader-follower features. In the continuum of the leadership style which is proposed by Herchi (1992), it includes dictatorship style, authority, and harmony, democratic and consensual. Manager's personality is the fifth variable. Personality is a set of

clear features such as risking which distinguishes individuals. Among the important factors that could lead to the success of each individual, are the individual's abilities and capabilities. We should accept that all humans are created equally, naturally this doesn't mean that all the human have some special abilities as they born, but means that they have equal rights to develop their abilities and they are able to get required skill through different training (Green burg, 1997).

Manager's success or failure

It's a long time that theorists of management are looking for the answer of this question that why some of the managers are successful even under a lot of pressure and some others fail. They have got some incomplete answers by now and the reasons for this situation are high bonuses, suitable culture and target based management. While some authors argue that a successful strategy in the context of excellent sustained performance must focus on the totality of human existence. Indeed manager's excellent performance causes a systematic and comprehensive training. Actually, the differences between enable and disable human are created once they decide to learn skills and abilities and try to develop them. The human struggle ultimately lead to a successful working life , but it's important to be noted that in fertilization of inner potential we should move in talent development path which should be wise. This means that development of the abilities should be based on the different criteria according to the human being dimensions (Farahi, Boujanjani, 2005). Farahi after investigating different views of researchers about manager's required abilities, recognize and classify four categories of manager's ability as the main components which managers mostly need

them in Iranian organizations. In the following the components of these dimensions along with a brief definition of each is proposed.

Intellectual-mind ability: one of the abilities in management literature which is considered for managers is intellectual-mind abilities. Actually in organization, the more intellectually developed are managers, the more they can deal with the problems and use the opportunity for the benefit of organization. All approaches to improve and enhance human capabilities mostly emphasize on techniques such as redesign process and knowledge management or through the learning of complex technologies. Unlike traditional education, modern education focuses on perceptual capabilities (skills, concentration, and time management, positive thinking and critical).

Physical ability: the simplest definition of energy is the ability to do works. The training process begins from the physical level, because the main source of energy is human body and the best model for physical strength may be lifting weight. Decades of research in exercise science has proven that the key to increasing strength is a phenomenon called "additional compensation" which is based on creating a balance between work and rest ratios. Constant and increasing pressure on managers working life is not a problem, but unbroken uniformity is problematic. In fact, they tolerate a lot of mental and emotional and physical stress and that causes poor performance.

Psychological ability: most managers are reluctant to talk about psychological level of performance pyramids. In fact, the word "psychological" caused conflicting emotion and have no authenticity with high-performance. The energy sector is the

mental ability to flip a deep and fundamental values of the individual and by definition, a strong sense of purpose will emerge. This ability make individual be consolidate in difficult situation and it is associated with powerful resource of motivation, focus, consistency and rapid recovery for him. Scientific findings stated that for having a relationship with high values and motivated resources require setting aside regular and periodic endless list of things to do and work commitments and devote sometime to reflection and thinking. Preoccupied managers are willing to live in a routine situation and neglect their professional works by doing argent works. Some exercises that will give people the opportunity to think more deeply include writing daily feelings and thoughts, meditation, prayer and giving service to others.

Scientific ability: considering science along with the hardware dimension lead to desired quantitative and qualitative achievements in both dimensions of efficiency increase and effectiveness increase. Today, science has proven that having the scientific ability caused the development and prospers in the social aspects. In fact, understanding the truth of science and manager's knowledge increase has organizations to put themselves and others in the development path of organizational science.

Conclusion

Process management is effective use of human and material resources in planning, organizing, mobilizing resources, guidance and control systems which is executed based on the value system to achieve organizational goals and the quality of effective management is vital in valuation and profitability in corporate future and the qualification of operational management is one of the important

factors for productivity and effectiveness and earning prediction in future. Therefore, recognizing the management ability and using it in controlling the company can be effective and useful for investors in their economic decisions and is considered as an important criterion for people who use the accounting information which is a significant help in investor's financial decisions. Hence, a positive relationship between management abilities and quality of earning, demonstrate a path for improvement of the earning quality and the influence of management on the earning quality according to the prices and manager's benefits is crucial for the board of directors.

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