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A Study of the Relationship between Product Market Competition and Earnings Management

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Abstract

The product market competition is one of the factors contributing to earnings management. It forces managers to manipulate the firm's earning for opportunistic reasons. Intense competition in product market forces manages to manipulate corporate earnings so that by reduction of financial pressures via acquisition of low-cost external financial resources and reduction of capital costs, the product prices are lowered; this in turn gives the firm a competitive advantage by which it acquires a greater share of the market and raises above other competitors. On this basis, the present paper studies the relationship between intense competition in the product market and earnings management. As far as the dimensions of competition are concerned, market size, entry costs, and centralization are the three factors used to measure the competition in product market. In order to examine the hypotheses, the financial statements of 77 companies listed in Tehran stock exchange in 5 industry levels over the time period 2002-2011 are analyzed using regression analysis. The results reveal that factors of entry cost and industry concentration have a significant relationship with earnings management. However, in contrast with existing research literature, the relationship between market size and earnings management is not confirmed.
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1. Introduction

In the modern literature of economic development, there are numerous instances of discussions about the structure of the market in which the producers are active. One of the most important subjects in such discussions is providing

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an appropriate medium for competition between economic actors. In this sense, introduction of competition into markets and business activities is known as a cure for inefficiency and under-development (Mehrabani, 2012).

The emphasis on competition is of course an age-old idea. Ever since Adam Smith's (1776) quote "monopoly is a great enemy of good management" until Caves (1980), who states that economists have a "vague suspicion that competition is the enemy of sloth" this idea that competition is an important crucial factor of economic growth has been preserved and advertised (Karuna et al., 2012).

Nowadays, competitiveness is considered to be a main global issue. It is known as a means to achieve desirable economic growth and sustainable development. Competitiveness is the ability to attain a stable and appropriate position in international markets. In an age when globalization is increasingly on the rise, competitiveness is an important subject among policy-makers, industries, and firms all over the world (Shur Chuluu, 2000).

However, despite great benefits of competitive market for nations' economy, recent studies suggest that intense product market competition increases the likelihood of risk taking and fraudulent behaviors by firm managers. Shleifer (2004) explains that if a firm manages to reduce its tax payments and other costs through corruption and bribe, its competitors are forced either to do so or exit the market. Therefore, the impact of intense competition on unethical behavior can extend to earnings manipulation in firms. It seems that earnings management is one of the ways through which company executives can confront pressures and threats of intense competition. On this basis, in order to help stakeholders and those who benefit from accounting information and to expand the existing literature on the subject, the following question is explored in this study:

What is the nature of relationship between intense competition in product market and earnings management?

2. Theoretical basis and research hypotheses

2.1. Product market competition and earnings management

Although the idea that as a crucial part of a business environment earnings management can be beneficial to shareholders, evidence points out to the fact that firms' earnings are intentionally manipulated in order to manage shareholders' opinions. This behavior is exacerbated when competition is greater in the industry, thus leading to firms in the industry managing earnings on average (Bagnoli & Watts, 2010). Shleifer (2004) argues that when the product market competition is intense, in order to increase the firm's stock value, managers are forced to manipulate the earnings in order to keep the actual investors and motivate potential investors to invest in the company. Further, if managers' freedom in decision-making and authority in choosing accounting methods are accompanied by great competition, it gives them greater latitude to engage in such opportunistic attempts (earnings management) especially concerning actions that are less observable or understandable due to their complex nature (Christie, Joye, & Watts, 2003; Kole & Lehn, 1997).

Linck, Netter, and Shu (2010) suggest that using earnings management firm managers can alleviate financial pressures and acquire financial resources with lower costs. Therefore a firm with lower costs of capital can better price products and acquire a larger share of the market (Karuna et al., quoted from Linck, Netter, and Shu, 2010).

Based on these discussions, the main hypothesis of this study is presented as follows:

The main hypothesis: intense competition in product market increase earnings management in the firms.

Product market competition and earnings management can be assessed and measured in various ways. In this study, the three factors of size of the industry, entry costs, and industry concentration are used to measure product market competition. Also in order to measure earnings management, the modified Jones model has been employed. In this model, the extent of using discretionary accruals is the criterion for measurement of earnings management.

2.2. Industry size and earnings management

The industry size reflects the market demand and the density of consumers in the industry. When the demands for a product with a certain price increase then the sales of that product naturally rise. Then due to likelihood of its profitability more firms inter the industry and the industry size becomes bigger. This in turn intensifies the competition in that industry (Karuna et al. 2012; quoted from Sutton, 1991).

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