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The effect of alternative goals on earnings management studies: An earnings benchmark examination

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A B S T R A C T

Firms' management manages earnings because they have incentives or goals to do so. Earnings management studies have to account for these different goals as tests of earnings management can be compromised by the effect of conflicting goals. I illustrate this in the setting of Dechow et al. (2003). Their study examines whether firms with small profits and firms with small losses (loss-avoidance benchmark) have differing levels of discretionary accruals. Dechow et al. (2003) find that firms just above the loss-avoidance benchmark do not have discretionary accruals that are significantly different than firms just below the benchmark. However, they do not consider firms just below the loss-avoidance benchmark that might be using discretionary accruals to avoid missing an alternative benchmark. I find that after I consider these alternate earnings benchmark goals, firms just above the benchmark have significantly higher discretionary accruals. This provides direct evidence that the 'kink' in the distribution of earnings arises from earnings management. I find similar results for the earnings changes benchmark. These findings highlight the need to consider alternative earnings benchmark goals when examining firms immediately around benchmarks.

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"During the boom years [mid-1990s through early 2000], corporate America increasingly emphasized a short-term focus, fueled by an obsession with quarter-to-quarter earnings… Analysts, some tainted by conflicts of interest, became cheerleaders for the game of 'hitting the numbers'. And winning that game, rather than creating the conditions for sound, long-term strength and performance, became the primary goal. Finally, the perception that uninterrupted earnings growth was the hallmark of sound corporate progress caused too many managers to adjust financial results—in ways that were sometimes large and sometimes small, but in all cases unacceptable—to meet projected results" (Donaldson, 2003).

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1. Introduction

Earnings management studies are common in accounting literature.[1] In many earnings management studies, researchers select firms to be included in a sample because the firms' management appear to be responding to an incentive or goal.[2] However the selected firms may be responding to entirely different goals than the one of interest. These alternative goals may confound research results. In this study I illustrate this issue by examining firms around the loss-avoidance (zero earnings level) benchmark. Prior research shows that firms do not appear to be managing earnings, as measured by discretionary accruals, to meet or beat the loss-avoidance benchmark (Dechow et al., 2003). I find that this lack of results appear to be driven by firms' management responding to alternative earnings benchmark goals.

Extensive research documents that firms manage earnings to beat benchmarks, such as zero earnings level, earnings changes, and analysts' consensus forecasts (Ronen and Yaari, 2008).[3] While the literature recognizes the potential conflict among these benchmarks (e.g. Einhorn, 2007; Graham et al., 2005), to date, research has looked at each benchmark in isolation. In this study, I fill this lacuna by examining the properties of discretionary accruals for small loss firms. I hypothesize that firms with small losses use discretionary accruals to maintain (or establish) positive earnings changes (earnings improvement benchmark), or to meet or exceed analysts' forecasts (analyst forecast benchmark), even if positive earnings are unattainable. Thus firms missing one benchmark may use discretionary accruals to meet an alternative earnings benchmark.

After controlling for alternative benchmarks, I find that firms with small profits have discretionary accruals that are significantly higher than the resulting sample of firms with small losses. These results provide an explanation for the findings of Dechow et al. (2003). In particular, I show that their result seems to be driven by firms from the small loss sample that may have manipulated discretionary accruals upward because of opportunities to beat an alternative benchmark.

Prior research (Ayers et al., 2006) finds that firms do not appear to be managing earnings to meet or beat the earnings improvement (earnings changes) benchmark. I also hypothesize that firms with small negative earnings changes use discretionary accruals to maintain positive earnings (loss-avoidance benchmark) or to meet or exceed analysts' forecasts (analyst forecast benchmark). I examine whether firms that report small increases in earnings (as compared to the previous year's earnings) have higher levels of discretionary accruals than firms with small decreases in earnings. For the full sample of firms with small earnings changes, I do not find that firms with small earnings increases have discretionary accruals that are higher than firms with small earnings decreases. When I control for firms that may be responding to alternative benchmarks (loss-avoidance and analyst forecast), I find that firms with small increases in earnings have higher discretionary accruals than firms with small decreases in earnings.

My study contributes to the literature that attempts to explain whether the kink in the distribution of earnings (i.e. Burgstahler and Dichev, 1997) provides evidence of earnings management (Ayers et al., 2006; Beaver et al., 2007; Dechow et al., 2003; Durtschi and Easton, 2005). The initial explanation was based on the conjecture that unmanaged earnings should have a normal distribution. Hence, an observed deviation from a normal distribution is consistent with earnings management. Mine is the first study to provide direct evidence that the kink arises from firms indeed managing earnings. Previous studies either did not find earnings management (e.g. Dechow et al., 2003), found it for a specific accrual (e.g. Phillips et al., 2003), provided circumstantial evidence (e.g. Jacob and Jorgensen, 2007), or provided alternative explanations that refutes earnings management (e.g. Beaver et al., 2007).[4] A second contribution of my study is that it points out that care needs to be taken by researchers in earning management studies when firms have different incentives or goals than the one of interest—these alternative incentives or goals may affect the measures of earnings management.

[1] Schipper (1989), Dechow and Skinner (2000), McNichols (2000), and Healy and Wahlen (1999) have reviewed this literature.

[2] Often, researchers measure the response using aggregate accruals models such as discretionary accruals (McNichols, 2000).

[3] Ronen and Yaari (2008) discuss this literature in Chapters 4 and 5 of their book. The loss-avoidance (zero earnings level) benchmark describes the goal that firms would rather have a small profit vs. a small loss. The earnings improvement (earnings changes) benchmark describes the goal that firms would like to have higher earnings in the current period as compared to some prior period (usually four quarters ago). The analyst forecast benchmark describes the goal that firms would like to have earnings that meet or beat analysts' consensus forecast of earnings.

[4] This study claims that the kink arises from the convolution of two different distributions.

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