Do Analysts fully understand the Implications of Real Activities Manipulation?

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I. INTRODUCTION

The extent to which earnings management by firms is related to investor perceptions in the market continues to attract interest of accounting researchers. To date, a large set of prior studies examine whether investors and analysts fundamentally understand and communicate the information about earnings management using accruals. For example, Kim and Schroeder (1990) find the evidence consistent with analysts’ anticipation of discretionary accrual of firms with earnings-based bonus plans. Cores et al. (2006) also find that earnings management around the cancellation and subsequent reissue of executive stock options can be appropriately anticipated by analyst and investors.

Although there is some evidence that some market participants can rationally understand accruals management, there is also considerable evidence that the market does not see through what is communicated by accruals. Sloan (1996), Collins and Hribar (2000) and Xie (2001) find that the market overprices the implications of the accruals component that drives a predictable earnings reversal in the subsequent year. Bradshaw et al. (2001), Burgstahler and Eames (2003), and Elliott and Philbrick (1990) provide that even analysts, a professional investment intermediary specializing in interpreting accounting information, do not alert investors to the subsequent earnings problems that are associated with unusually high accruals.

While prior evidence of the market’s mispricing has concentrated mostly on accrual-based earnings management, managers can choose from alternative set

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of management methods to overstate earnings, i.e., real activities manipulation (Jiambalvo 1996). Real decision, in particular, might involve adjusting operating, financing and investment decisions undertaken primarily by the desire to increase short-term reported earnings, rather than by the desire to increase firm value.

In line with this stream of research, I examine the investors’ rationality to see through the implications of the current earnings management using real activities manipulation. This research question is important for two reasons. First, since most earnings management is achieved via real actions as well as accruals, examining only one earnings management method cannot explain the overall effect of firm’s earnings management. Graham et al. (2005)’s survey provides a surprising finding that a majority of managers would take real actions such as delaying a new project or cutting discretionary spending to meet short-term earnings benchmarks even if this entails some sacrifice in firms’ value. Consistent with this, a number of prior studies provide empirical evidence that firms are likely to employ real operational activities to manage earnings thereby achieving certain short-run earnings goals (Roychowdhury 2006; Cohen and Zarowin 2010; Gunny 2010; Zang 2012). This evidence shows the importance of analyzing the real activities manipulation as a way of managing earnings in accounting research. Second, real activities manipulation imposes real economic consequence for firms’ long-term value in that real activities manipulation affect cash flow directly and deviate from normal business practices (Roychowdhury 2006; Kim and Sohn 2009; Cohen and Zarowin 2010). Consistent with this, a large body of prior literature provides evidence on the negative association between real activities manipulation and future operating performance (Ben et al. 2002; Zang 2007; Bhojraj et al. 2009; Leggett et al. 2009; Cohen and Zarowin 2010). These empirical results imply that opportunistic managers can use their discretion in real activities to the detriment of shareholders.