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Earnings manipulations by real activities management and investors' perceptions

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ABSTRACT

The focus of this paper is to identify the practice and the investor's perception regarding real activities management in Brazil. The study explores hypotheses related to (i) identification of different types of real activities management, and (ii) investors' perceptions of the effects of this manipulation. Data were acquired from Economatica® covering the period from 1989 to 2012 inclusive. Panel data regressions were conducted to test information efficiency (using the Mishkin test). The results provide evidence of the occurrence of earnings manipulation by real activities management and indicate that the market fails to evaluate the effect of earnings management through certain types of manipulation of real activities.

1. Introduction

The term "earnings management" is used to describe the decision that some managers take to employ accounting methods or to direct operational activities in such a way as to affect earnings with the intention of meeting specific objectives in terms of the results reported in financial statements.

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In turn, the earnings management methods employed for such ends can be classified in terms of whether they affect the process of accruals-based accounting or impact on normal operational activities (Enomoto et al., 2013). The first approach is known as “accrual-based management” (ABM) and the second as “real activities management” (RAM).

Earnings management is a relevant subject in the academic literature (Kothari, 2001). One reason for this interest is the fact that the earnings is used for a variety of purposes, such as in contractual obligations (e.g. debt covenants), asset valuation and for executive remuneration and bonus plans (e.g. executive equity compensation). Therefore, accounting data provide relevant informational content and are employed by a wide range of stakeholders. For example, creditors use the numbers reported to assess aspects related to firms' financial health, credibility and viability (Ge, 2010). In turn, shareholders use earnings, among other indicators, to monitor operational performance. However, their conclusions on a given entity's performance may be erroneous if they are unable to identify and adjust for the effects of earnings management that is embedded in the financial statements. This distortion will become clear in future results, when the entity's performance does not match their estimates.

In general, earnings management affects the quality of earnings, masking the underlying economic transactions. When control mechanisms such as auditors, regulatory authorities and others are ineffective, opportunities arise for management to manipulate earnings with the objective of hitting certain targets related to reported results (Healy and Wahlen, 1999), such as meeting analysts' expectations, avoiding losses, maintaining a growth trend or “smoothing out” the levels of reported earnings (Xu, Taylor and Dugan, 2007).

There is already evidence that managers practice discretionary earnings management through manipulation of accruals, generally with no impact on company cash flow (Sajadi et al., 2011). However, it is a recent finding that earnings manipulation is also accomplished through real activities, i.e. by taking actions that deviate from normal operational practices. In Brazil, the subject has received almost no attention, with research limited to a very small number of studies, such as one by Martinez and Cardoso (2009). In effect, almost all of the studies conducted into earnings management in Brazil have concentrated on manipulation through accruals.

This study is a first step toward filling this gap by dealing with identification of results manipulation through decisions affecting real operational activities and stakeholders' perceptions of this method of earnings management. The next section describes the scope of the study and its contributions to current research. It is understood that manipulation of results can create information asymmetries between stakeholders and company managers and that the two strategies for earnings management – accruals-based and real activities management – can possibly be used in combination to manipulate the accounting numbers reported.

In this context, the objective of this study is to identify whether earnings management by real activities related to manipulation of sales, discretionary expenses and production costs has an impact on the results disclosed in financial statements. This general objective can be subdivided into the following specific objectives: (i) to determine whether manipulation through real activities takes place in companies on the Brazilian capital market; (ii) to determine whether investors are able to identify the practice of real activities earnings management. The study will focus on aspects related to (1) manipulation of results through real activities; (2) investors' perceptions with relation to the occurrence of the practice of real activities management.

2. Literature review

2.1. Earnings management through decisions affecting real activities

Earnings management is one of the most debated subjects in finance and accounting. Interest in this research avenue is growing and goes back to seminal work such as Schipper (1989) and Healy and Wahlen (1999). Schipper (1989, p. 92) considered that earnings management consisted of “a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain”.