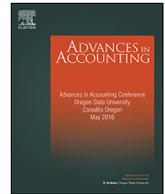




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Does benchmark-beating detect earnings management? Evidence from accounting irregularities[☆]

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ABSTRACT

We examine whether meeting or slightly beating an earnings benchmark (benchmark-beating) is (1) associated with accounting irregularities, an extreme and certain case of earnings management, (2) useful for detecting accounting irregularities both incremental and relative to discretionary accruals and to F-scores (Dechow, Ge, Larson, & Sloan, 2011), and (3) more useful for detecting *opportunistic* accounting irregularities, a more harmful form of earnings manipulation identified in Badertscher, Collins, and Lys (2012), than accounting irregularities in general. We identify an accounting irregularity sample where earnings are restated due to intentional misreporting and construct a control sample where earnings are not restated. We find that benchmark-beating is significantly positively associated with the probability of accounting irregularities after controlling for other determinants of accounting irregularities. In addition, benchmark-beating is useful for detecting accounting irregularities incremental to discretionary accruals and F-scores; benchmark-beating ties with and sometimes outperforms discretionary accruals for detecting accounting irregularities in a one-on-one horse race but is dominated by F-scores. Finally, benchmark-beating is more useful for detecting opportunistic accounting irregularities than accounting irregularities in general. Overall, we contribute to the literature by validating benchmark-beating as a proxy for earnings management.

1. Introduction

We examine whether meeting or slightly beating an earnings benchmark (hereafter, benchmark-beating) is (1) associated with accounting irregularities, an extreme and certain case of earnings management, (2) useful for detecting accounting irregularities both incremental and relative to discretionary accruals and to F-scores (Dechow, Ge, Larson, & Sloan, 2011), and (3) more useful for detecting *opportunistic* accounting irregularities, a more harmful form of earnings manipulation identified in Badertscher, Collins, and Lys (2012), than accounting irregularities in general. The literature documents three earnings benchmarks and measures benchmark-beating by identifying firms whose earnings slightly increase from last year's earnings (the earnings change benchmark), whose earnings are slightly positive (the earnings level benchmark), and whose earnings are equal to or slightly

above analyst earnings forecasts (the earnings forecast benchmark).

Our research questions are important for several reasons. First, a large and growing volume of studies in the accounting literature use benchmark-beating as a proxy for earnings management while evidence that links benchmark-beating to *actual* earnings management is limited (see more detailed discussion in the next section). Dechow, Ge, and Schrand (2010), p.365 make the above point clear when they conclude, after reviewing the vast literature of earnings quality and earnings management, that “[t]he totality of the evidence indicates that the use of small profits as a proxy for earnings management more generally is *unsubstantiated* (emphasis added).” We seek to provide evidence on a link between benchmark-beating and earnings management in this paper.

Second, benchmark-beating and discretionary accruals are arguably the two most widely used proxies for earnings management (Kothari,

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2001) and F-scores are arguably the most powerful detector of earnings misstatements (Dechow et al., 2011). However, little is known about whether benchmark-beating, discretionary accruals, and F-scores capture the same or different aspects of earnings management, and how these three measures compare with one another in terms of detecting earnings management.¹ If benchmark-beating captures the same aspects of earnings management as discretionary accruals and F-scores, the coefficient on benchmark-beating could become insignificant, in an earnings management detection model where benchmark-beating is an explanatory variable, after including discretionary accruals and F-scores as additional explanatory variables. On the other hand, if benchmark-beating captures aspects of earnings management different from discretionary accruals and F-scores, the coefficient on benchmark-beating will remain significant after including discretionary accruals and F-scores as additional explanatory variables. In such a case, benchmark-beating has detective power for earnings management *incremental* to discretionary accruals and F-scores. Relatedly, it is also of interest to examine which measure, out of these three, is *relatively* superior in a one-on-one horse race to detect earnings management. Dechow et al. (2011, p. 23) highlight the need to compare different measures of earnings management by calling for future research “to analyze the role of governance, compensation, insider trading, short selling, incentives to *meet and beat* analyst forecasts, and so on and to determine the *relative* importance of these variables (emphases added) over financial statement information in detecting overstatements of earnings.” We answer this call in Dechow et al. (2011).

Third, understanding the incremental and relative ability of benchmark-beating in detecting earnings manipulation with respect to discretionary accruals and F-scores is of importance in its own right. Benchmark-beating is a parsimonious and *timely* metric, which can be determined by even naïve investors as soon as a firm's earnings are announced without relying on earnings of any other firm in the industry. In sharp contrast, one must wait weeks or even months after a firm's earnings announcement until the release of that firm's financial statements *and* the releases of financial statements of *all* other firms in the same industry to estimate that firm's discretionary accruals and F-score because prior literature commonly estimate discretionary accruals and F-scores in the cross-section in each year and industry.² Moreover, many “average” investors may not have the resources, time, and skill to estimate discretionary accruals and F-scores. Given benchmark-beating's lead in timeliness and ease of implementation, discretionary accruals and F-scores must dominate benchmark-beating in detecting accounting irregularities for them to remain viable contenders for detectors of earnings management. Thus, it is important to compare the efficacy of benchmark-beating, discretionary accruals, and F-scores in detecting accounting irregularities.

Fourth, accounting literature shows that some earnings management is for opportunistic reasons. For example, Badertscher et al. (2012) find that originally reported (or manipulated) earnings and accrual components are less predictive of future cash flows than the restated (or non-manipulated) counterparts for their opportunistic manipulation subsample whereas the opposite is true for their non-opportunistic manipulation subsample. These findings suggest that opportunistic manipulation is more harmful than non-opportunistic manipulation. Therefore, the detection of opportunistic manipulation is

potentially more valuable to investors, auditors, creditors, financial analysts, regulators, and other stakeholders. The extant literature, however, has not examined whether benchmark-beating, discretionary accruals, and F-scores can detect opportunistic earnings management. We fill this void by investigating whether benchmark-beating is more useful in detecting opportunistic accounting irregularities than accounting irregularities in general.

One important reason for why the extant literature has provided only limited evidence on a link between benchmark-beating and actual earnings management is the difficulty of measuring earnings management, which is largely unobservable. Prior studies that use, for example, discretionary accruals and earnings response coefficients (ERCs) to examine the relation between benchmark-beating and earnings management provide only circumstantial evidence due to the inability of discretionary accruals and ERCs to unequivocally capture earnings management. We overcome this difficulty by using a sample of accounting irregularity firms where earnings are known to be restated due to intentional misreporting.³ Since we know these firms violated U.S. GAAP and were required to restate their earnings, we can unequivocally identify these firms as earnings manipulators and precisely measure the amounts of their earnings manipulations. This allows us to provide evidence on the link between benchmark-beating and *actual* earnings management.

We construct an irregularity sample, based on Hennes, Leone, and Miller (2008), that consists of firms that restated their earnings during 1999 to 2005 due to intentional misreporting.⁴ We also construct a control sample of firms from the COMPUSTAT universe during the same period that did *not* restate their earnings. We conduct several sets of tests. First, we compare the benchmark-beating samples (i.e., firm year observations where earnings meet or slightly beat one of the three benchmarks) with the non-benchmark-beating samples. We find that the percentages of intentional misreporting are higher in the benchmark-beating samples than the corresponding non-benchmark-beating samples. This finding provides univariate evidence that benchmark-beating is positively associated with accounting irregularities, i.e., benchmark-beating firms are more likely to be earnings manipulators than non-benchmark-beating firms. We then follow the research design of Jones, Krishnan, and Melendrez (2008) and Dechow et al. (2011), and provide multivariate evidence on the association between benchmark-beating and accounting irregularities using a logistic model. We find that benchmark-beating is significantly positively associated with irregularities after controlling for common determinants of accounting irregularities, suggesting that benchmark-beating can detect accounting irregularities, similar to discretionary accruals tested in Jones et al. (2008) and F-scores tested in Dechow et al. (2011).

Second, we successively add discretionary accruals and F-scores into our accounting irregularity detection model. We find that benchmark-beating remains significantly positively associated with accounting irregularities after incorporating discretionary accruals, F-scores, or both as additional explanatory variables. This suggests that benchmark-beating has *incremental* detective power for accounting irregularities beyond discretionary accruals and F-scores, which further implies that these three measures capture different aspects of earnings management and that they are complements to one another in detecting accounting irregularities.⁵ In addition, we conduct a one-on-one horse race

¹ By construct, these three measures capture different aspects of earnings management. Specifically, benchmark-beating captures incentives to manage earnings to beat benchmarks, discretionary accruals capture manipulated earnings that are not related to cash flows, sales, and other operating activities, while F-scores capture fraudulent misreporting. However, it is ultimately an empirical question whether these three measures are incremental to one another in detecting earnings management.

² Francis, Schipper, and Vincent (2002, p. 538) report that only a small percentage (2.6%) of firms disclose detailed statements of cash flows concurrently in their earnings announcement press releases. Researchers thus need to wait weeks after a firm's earnings announcement until the release of that firm's statement of cash flows to estimate that firm's accruals using the statement of cash flow approach (Hribar & Collins, 2002).

³ Although SAS No. 99 of American Institute of Certified Public Accountants (AICPA, 2002) classify intentional misstatements as “fraud,” we follow Hennes et al. (2008) and use the more inclusive term “irregularities.”

⁴ We thank Karen Hennes, Andrew Leone, and Brian Miller for generously sharing this dataset.

⁵ Assume that we have two firms and these two firms have similar discretionary accruals and similar F-scores with each other. Based on discretionary accruals and F-scores only, these two firms have equal probability of committing financial misreporting. Benchmark-beating having *incremental* detective power for accounting irregularities means, if one firm meets or slightly beats an earnings benchmark whereas the other does not, the benchmark beater has a higher probability of committing financial misreporting

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