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The effect of accounting comparability on the accrual-based and real earnings management

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A B S T R A C T

This study investigates whether and how managers' opportunistic earnings management activities are affected by the degree of their firms' accounting comparability with other firms. Using a large sample of U.S. firms, I find that managers' real earnings management (REM) increases whereas their accrual-based earnings management (AEM) decreases with the degree of their firms' accounting comparability with other firms. I also find that this opportunistic behavior to "escape" from AEM to REM facing higher accounting comparability is mitigated when firms' information environment and/or audit quality are better. These findings are robust to various sensitivity tests including the one to address the possible endogeneity of accounting comparability.

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1. Introduction

This study investigates whether and how managers' opportunistic earnings management activities are affected by the degree of their firms' accounting comparability with other firms. Many studies examine the effect of adopting the same accounting standard (e.g., International Financial Reporting Standards) on the comparability of accounting numbers across firms in different countries (Barth et al., 2008; Lang et al., 2010; DeFond et al., 2011). Researchers also extensively investigate the effect of accounting comparability on various outcomes such as management's voluntary disclosure, analysts' coverage expansion and forecast properties, and institutional investors' portfolio structure

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(Gong et al., 2013; Kini et al., 2009; De Franco et al., 2011; Engelberg et al., 2016). However, the paper on the effect of accounting comparability, especially across firms under the same GAAP regime, on managers' earnings management is scant. This study thus aims to fill this gap by exploring whether the extent of managers' opportunistic earnings management is influenced, and how managers' choice of alternative earnings management methods is affected, by accounting comparability.

Current-period reported earnings can be managed in two different ways. First, managers can manipulate reported earnings through discretionary accrual choices that are allowed under the Generally Accepted Accounting Principles (GAAP). This within-GAAP accrual-based earnings management (hereafter AEM) typically occurs toward the end of an accounting period, after most real operating activities are completed (Zang, 2012). While it directly influences the amount of accounting accruals, AEM has no direct effect on cash flows. Second, managers can also manipulate reported earnings by adjusting real activities. Specifically, they can alter the timing and scale of real activities such as sales, production, investment, and financing throughout the accounting period in such a way that a specific earnings target can be met. For example, reported earnings can be temporarily boosted by accelerating the timing of production and sales schedules, by cutting discretionary expenditures, and/or by deferring the timing of their occurrences. Following Roychowdhury (2006), these real operation management activities that deviate from normal business practices with the primary objective of manipulating current-period earnings are referred to as real earnings management (hereafter REM). Unlike AEM, REM can have direct consequences on current and future cash flows (as well as accounting accruals), are more difficult for average investors to understand, and are normally less subject to external monitoring and scrutiny by auditors, regulators, and other outside stakeholders (Cohen et al., 2008).

In their conceptual frameworks for financial reporting, the FASB (2010) and IASB (2010) identify comparability as the qualitative characteristic of financial information that enables users to identify and understand similarities in, and differences among, items. Despite the fact that accounting comparability is one of important qualitative characteristics, the empirical research on it is relatively scarce compared with that on other accounting attributes. One reason is that it is a relative or comparative concept, not an absolute or independent criterion like other accounting characteristics. As a result, the empirical test for comparability has been intractable, especially for large sample of firms within a country, before De Franco et al. (2011) develop an operationalizable measure. I adopt their methodology to investigate the effect of accounting comparability on firms' earnings management in this paper.

I expect that managers' AEM activities are constrained when their firms' accounting is more comparable with that of other firms operating in the same industry. The primary objective of managers conducting opportunistic AEM is to obfuscate their true performance with a view to concealing their private control benefits (Zingales, 1994; Shleifer and Vishny, 1997; Leuz et al., 2003; Haw et al., 2004). If a firm's accounting amounts are more comparable with those of its industry peers, the marginal costs for outsiders (e.g., shareholders, creditors, and regulators) to collect and process accounting information of these peer firms become smaller. As a result, they can evaluate the firm's true performance more accurately because the accounting information of comparable firms is a valuable additional input to analyze the business fundamentals of the firm in question. In other words, the accounting information of the firm becomes more transparent for outside market participants if its accounting comparability increases. The consequence is diminished incentives for, and possibilities of, managers' AEM activities.

I also expect that managers' REM activities will *increase* in their firms' accounting comparability. Prior studies document the evidence that firms switch from AEM to REM under a more stringent regulatory environment (e.g., Sarbanes–Oxley Act) to meet certain earnings targets (Ewert and Wagenhofer, 2005; Cohen et al., 2008; Cohen and Zarowin, 2010). Extending this logic to this study, managers will rely on REM to a greater extent if their ability to use AEM is significantly curbed by their firms' enhanced accounting comparability. Given the level of reported earnings necessary to conceal their private control benefits, managers have strong incentives to make up for the reduced AEM due to higher accounting comparability using the increased REM.

Regressing AEM and REM measures on the accounting comparability estimate developed by De Franco et al. (2011) and other earnings management determinants using a large sample of U.S. firms during 1983–2012 period, I find that AEM decreases but REM increases with the degree of a firm's

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