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The economic implications of corporate financial reporting ☆

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Abstract

We survey and interview more than 400 executives to determine the factors that drive reported earnings and disclosure decisions. We find that managers would rather take economic actions that could have negative long-term consequences than make within-GAAP accounting choices to manage earnings. A surprising 78% of our sample admits to sacrificing long-term value to smooth earnings. Managers also work to maintain predictability in earnings and financial disclosures. We also find that managers make voluntary disclosures to reduce information risk and boost stock price but at the same time, try to avoid setting disclosure precedents that will be difficult to maintain.

JEL classification: G35; G32; G34

Keywords: Financial statement; Earnings management; Earnings benchmark; Voluntary disclosure; Information risk; Earnings predictability; Earnings smoothing; Agency costs

1. Introduction

We conduct a comprehensive survey that asks CFOs to describe their choices related to reporting accounting numbers and voluntary disclosure. Our objective is to address the following questions: Do managers care about earnings benchmarks or earnings trends and, if yes, which benchmarks are perceived to be important? What factors motivate firms to exercise discretion, and even sacrifice economic value, to manage reported earnings? How well do various academic theories explain earnings management and voluntary disclosure? We triangulate our answers to these questions with those from analytical and archival empirical research to enhance our understanding of these issues.

We investigate these questions using a combination of field interviews and a survey instrument. Using these methods allows us to address issues that traditional empirical work based on large archival data sources cannot. A combination of surveys and field interviews enables us to (i) get financial officers to rate the relative importance of extant academic theories about financial reporting policies; (ii) discover new patterns of behavior and new explanations for known patterns; and (iii) highlight stylized facts on issues that are relatively hard to document from archival data, such as earnings benchmarks, earnings guidance, and the identity of the marginal investor. Overall, our evidence provides a reference point describing where academic research and real-world financial reporting policies are consistent and where they appear to differ.[1]

[1]An extensive archival and experimental literature addresses earnings benchmarks and motivations for earnings management and voluntary disclosures. Papers that summarize this literature include Fields et al. (2001), Kothari (2001), Healy and Palepu (2001), Dechow and Skinner (2000) and Healy and Wahlen (1999).