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Does analyst coverage constrain real earnings management?

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ABSTRACT

This study investigates the impact of analyst coverage on real earnings management, which is measured by using three proxies including abnormal cash flows from operations, abnormal discretionary expenses, and abnormal production costs. We document evidence that real earnings management is significantly higher when firms are followed by more analysts, suggesting that analyst coverage does not constrain real earnings management as effectively as it constrains accrual earnings management. Our findings also imply that firms with high analyst coverage have greater incentives to engage in real activities manipulation.

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1. Introduction

Managers may opportunistically manipulate earnings for their own interests at the expense of shareholders' interests. Prior research suggests that manages have various motivations to engage in opportunistic earnings management. For example, Healy (1985) and Holthausen, Larcker, and Sloan (1995) find that mangers manage earnings to maximize their bonus, while Fudenberg and Tirole (1995) suggest that managers may manipulate earnings to enhance their job security. Nevertheless, it should be noted that earnings management may benefit shareholders as well (Demski, 1998). Tucker and Zarowin (2006) indicate that managers can smooth earnings to communicate private information to investors.

There exist two types of earnings management: accrual vs. real earnings management. By accrual earnings management, we mean that managers manipulate earnings through the accrual process where revenues or expenses are recognized when they are earned or incurred but not exactly when cash for revenues or expenses is received or paid. Accrual earnings management occurs in the accrual process while accounting policies are chosen and accounting estimation is made to intentionally distort reported earnings. Thus, accrual earnings management does not directly affect cash flows, and its effect on earnings will be reversed in the subsequent accounting periods.

Real earnings management is also used to mislead accounting information users into believing that earnings targets had been achieved in the normal course of operations (Roychowdhury, 2006). In this case, managers manipulate earnings by changing the timing or structure of normal operations, e.g., cutting research and development (R&D) expenditures, increasing price discounts, etc. Real earnings management has a direct impact on cash flows, and is detrimental to future operations (Taylor & Xu, 2010). However, real earnings management seems more difficult to be revealed by whistleblowers than accrual earnings management because the former is easier to be camouflaged as normal activities.

Managers trade off accrual vs. real earnings management based on their relative costs (Zang, 2012). The costs of accrual earnings management arise from scrutiny and litigation, while the costs of real earnings management are the deviation from optimal business operations, leading to negative economic consequences. Zang (2012) indicates that managers usually make their decisions on real earnings management prior to the decisions on accrual earnings management, and that there is a substitute relationship between accrual and real earnings management. She documents evidence that managers turn to real earnings management when they face high litigation risk and outside scrutiny.

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Graham, Harvey, and Rajgopal (2005) point out that 80% of surveyed executives may choose to cut discretionary expenditures on R&D and advertising to meet earnings targets, suggesting that real activities manipulation is prevailing in the U.S. Roychowdhury (2006) asserts that managers employ three types of real activities manipulation including *sales manipulation*, *reduction of discretionary expenditures*, and *overproduction* to avoid reporting losses. Cohen, Dey, and Lys (2008) suggest that real earnings management would be more prevalent subsequent to the enactment of the Sarbanes-Oxley Act because accrual earnings management is more likely to be constrained by the enhanced corporate governance.

Recently, researchers have brought attention to the monitoring role of analyst coverage. They find that analyst coverage is negatively associated with earnings management measured by discretionary accruals and the likelihood of meeting or beating earnings benchmarks (e.g., Sun, 2009; Yu, 2008). These findings suggest that analyst coverage plays a vital role in the oversight of financial reporting process. As analysts are motivated to issue accurate earnings forecasts and valuable recommendations and research reports to protect their reputation, increase remuneration, and promote career prospects, they need to acquire corporate information and conduct insightful analysis to uncover the true performance of the company they have been following. Thus, analysts may have the knowledge and opportunities to detect real earnings management. When the company is followed by more analysts, it is more likely that real activities manipulation is brought to light by analysts. Since high analyst followings lead to high likelihood of whistle blowing of managerial manipulation, managers of firms with high analyst coverage could be more concerned with the costs of real earnings management. Hence, high analyst coverage firms may have less real earnings management than low analyst coverage firms.

On the other hand it is also likely that high analyst coverage may lead to more real earnings management. First, managers may have more pressure to meet or beat earnings benchmarks when firms are followed by more analysts. This is because bad news of missing earnings targets will be more rapidly and fully incorporated into stock prices for firms with high analyst coverage, thereafter reducing managers' stock-based compensation and impairing their reputation and future career (He & Tian, 2013). Second, the fact that accrual earnings management is subject to various corporate governance restrictions including analyst coverage (Yu, 2008) may motivate managers to consider real earnings management as an alternative (Zang, 2012). Thus, it still remains an empirical issue whether real earnings management is positively or negatively associated with analyst coverage.

Based on the framework of Roychowdhury (2006) who develops empirical models to detect real activities manipulation, we use abnormal cash flows from operations, abnormal discretionary expenses, and abnormal production costs to measure real earnings management.

These three measures reflect the extent to which manages manipulate earnings through real activities such as sales, discretionary expenditures, and production, respectively. Using a sample of 9086 observations over the period 1996–2006, we find that the absolute value of abnormal cash flows from operations and the absolute value of abnormal production costs are both positively associated with analyst coverage, suggesting that firms engage in more real earnings management when they are followed by more analysts. We also find that negative abnormal cash flows from operations and negative abnormal discretionary expenses are negatively associated with analyst coverage, indicating that firms followed by more analysts engage in more manipulation of real activities to increase reported earnings. Moreover, we find that positive abnormal cash flows from operations are positively associated with analyst coverage, and that negative abnormal production costs are negatively associated with analyst coverage. This suggests that firms with high analyst coverage engage in more manipulation of real activities to manage earnings downward. Combined together, the results are consistent with the notion that high analyst coverage leads to more real earnings management.

This study contributes to the literature in the following ways. First, our study extends a growing research stream on the relation between analyst coverage and real activities by focusing on real earnings management. We measure real activities manipulation in a more comprehensive way, and document more explicit evidence on the association between analyst coverage and real earnings management. Second, this study adds to the research on the monitoring role of analyst coverage in financial reporting. Prior research (e.g., Sun, 2009; Yu, 2008) finds that analyst coverage can effectively constrain earnings management by focusing on accrual earnings management. However, there is little research that explicitly examines the monitoring role of analyst coverage in constraining real earnings management. It is warranted to clarify this issue since analyst coverage may affect accrual and real earnings management differently. Third, this study also contributes to the research on auditor industry specialization and board independence. Extant studies suggest that managers may switch from accrual to real earnings management because the latter is less likely to be constrained by corporate governance mechanisms such as auditor industry specialization and board independence. However, there is little evidence on the effect of these corporate governance mechanisms on real earnings management in the literature. Our study provides sweeping evidence on this issue.

The rest of the paper is organized as follows. Section 2 reviews the literature on real earnings management and analyst coverage. Section 3 develops the hypothesis on the relation between analyst coverage and real earnings management. Section 4 discusses the research design. Section 5 reports the empirical results. Section 6 makes concluding remarks.

2. Literature review

2.1. Real earnings management

Manipulation of real business activities is an alternative way for managers to manage reported earnings, especially when it is difficult to manipulate accruals. In a survey study on financial reporting practices, Graham et al. (2005) find that 80% of surveyed executives admit that they are willing to reduce discretionary expenditures on R&D and advertising to meet an earnings target. Earlier research into real earnings management activities focuses on the opportunistic or unexpected reduction of R&D expenditures to reduce reported expenses. Baber, Fairfield, and Haggard (1991) examine whether concern on reporting favorable trends in net income affects managers' decision to invest in R&D expenditures. They find that R&D spending is lower when it jeopardizes the ability to report positive income or increase income in the current period. Dechow and Sloan (1991) document that CEOs spend less on R&D in their final years of office to improve short-term earnings performance, but the reduction in R&D expenditures is lower when CEOs have high stock ownership. Perry and Grinaker (1994) investigate the relation between unexpected R&D expenditures and unexpected earnings. They find that firms adjust their R&D expenditures to bring reported earnings closer to analysts' expectations. Similarly, Bange and De Bondt (1998) find that firms adjust their R&D budgets to reduce any anticipated gap between analysts' earnings forecasts and reported earnings.

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