MANAGERIAL PREFERENCES BETWEEN ACCRUAL-BASED VERSUS REAL EARNINGS MANAGEMENT

Alina Beattrice VLADU*

Abstract. *There is substantial evidence that managers engage in accounting earnings management. An emerging stream of research investigates the tradeoffs and managerial preferences between real earnings management and accrual-based earnings management. In this respect, existing empirical evidence suggests that both types can be substituted for each other in order to manage earnings. However, the research also indicates that the two methods can be used in tandem to achieve a desired outcome. Given that both types be used to achieve accounting outcomes, each form of earnings management may be relevant to be assessed by the users of accounting information. The goal of this paper is to discuss their implications in financial reporting while attempts to fill that void in the earnings management literature in an effort to advance our understanding of managers' financial reporting behavior.*

Keywords: *accrual based earnings management, real earnings management, trade off effect, manipulative behavior.*

JEL Codes: M40, M41.

1. Introduction

Earnings management practices are extensively approached in contemporary research, being considered one of the most significant discussions in accounting arena so far. This paper is part of such trend, analyzing one of the most recent trends of research from this area (i.e. the trade-off between accrual-based versus real earnings management). By revisiting prior results documented in the literature we were able to summarize the most recent publishing trends and to interpret such evidence. While accrual based earnings management was extensively assessed in the literature in previous years (Dechow et al., 2011, 2012), real earnings management comprised a changing balance in the recent period in the detriment of the first category.

* Babeş-Bolyai University, beattrice.vladu@econ.ubbcluj.ro

Our subject is timely and relevant at least for three reasons. First, in the light of the previous accounting scandals, earnings management practices became of highly interest in all discussions developed around the quality of financial statements. Second, there is a broad interest in the findings documented by such literature, given the fact that all users of accounting information need to be informed in the process of decision making. Third, biased earnings are not accepted by the accounting standards and such practices must be limited.

The remainder of this paper is organized as follows. The first segment comprises the overview of our research questions and the research method used, followed by the discussion segment. The conclusion, limitation and scope for future research segment are the last ones approached.

2. Revisiting the research profile, research question and research method

This assessment of the profile of contemporary published earnings management practices is aiming to augment the literature by analyzing and summarizing the evidences of the papers approaching such area of research. As such, the analysis can be used further in order to evaluate, identify and address future research agendas. In doing so, our paper answers one related research question, as following: *What is the scholarship field of trade-off between accrual-based and real earnings management research?*

In terms of research method used for selecting and reviewing the papers selected, a similar method as in Guthrie et al. (2012) was used. In this respect the review process comprised five different stages. Similar to Guthrie et al. (2012) our first stage was used for formulating the core research objectives. The second stage comprised the selection of the journals. In this respect we have selected the traditional top leading accounting journals as documented by Chan et al. (2009). The third stage comprised the selection of the articles. In the search of the papers assessed, specific keywords to accrual-based earnings management, real earnings management and trade-off effect. Our search was concept-centric and not author centric. All PDF versions of the papers were downloaded and stored in an Endnote database together with the referencing details. In the fourth stage, we examined independently the PDF full versions and excluded the papers with only a marginal earnings management focus.

3. Findings and discussions around the preferences of managers regarding the two types of earnings management

There is substantial empirical evidence that managers are using earnings management (Burgstahler and Eames 2006; Roychowdhury 2006; Chen et al. 2011). While accrual-based earnings management refers to managers' opportunistic use of the flexibility allowed under General Accepted Accounting Principles to change reported earnings without changing the underlying cash flows, real-based earnings management comprises managers' opportunistic timing and structuring of operating, investment and financing transactions to affect reported earnings in a particular direction. Such latter demarches results in a sub-optimal business consequences and usually imposes a real cost on the firm.

Despite the fact that both earnings management types are extensively examined in the literature, very few empirical studies examined in the same time both types of earnings management. The core idea is that when we are examining only one types of earnings management practices, the real magnitude of manipulative behavior cannot be assessed thoroughly. In particular, if managers use accrual-based earnings management and real earnings management to accomplish the same objective, examining only one type of manipulation in isolation may lead to an understatement of the overall level of earnings management as stated above (Darrough and Rangan, 2005; Mizik and Jacobson, 2008). If managers' use of accrual-based and real earnings management is offsetting, focusing on either type of manipulation at a time for one purpose will only provide partial evidence and perhaps result in incorrect conclusions.

There is a relatively little analytical investigation and some mixed empirical evidence on how managers choose between accrual-based versus real earnings management. On the one hand, recent empirical evidence document that managers use both types of earnings management to meet earnings targets. The empirical study conducted by Burgstahler and Dichev (1997) document that both cash flow from operations and changes in current accruals are managed to increase earnings, while Burgstahler and Eames (2003) document that both cash flow from operations and discretionary accruals are managed upwards to avoid reporting earnings lower than analyst forecasts.

The empirical study conducted by Zang (2012) provides large sample evidence that managers do trade off using accrual earnings management and real earnings management to achieve their objectives. Similarly, Barton and Simko (2002) and Pincus and Rajgopal (2002) presented evidence that managers use derivatives and discretionary accruals as partial substitutes for smoothing earnings. While such studies attempt to examine the link between accrual-based earnings management and real earnings management by correlating these two decision variables, a comprehensive approach to investigate managers' choice of the types of earnings management is to examine their relation to exogenous firm or to managers' characteristics.

This particular study attempts to fill that void in the earnings management literature in an effort to advance the understanding of managers' financial reporting behavior, by summarizing the main results documented in this area of research.

One of the first empirical studies documenting that the managers usually tradeoff between the two types of earnings management was conducted by Graham et al., (2005). In this regard, although real earnings management has not been as widely studied as accrual-based earnings management, Graham et al.'s (2005) survey finds that managers prefer real activities manipulation.

The main practices of real earnings management comprise actions as reducing discretionary expenditures over accruals manipulation as a way to manage earnings. Such real earnings management activities are significantly different compared to accrual-based ones as they have direct cash flows effects. The results documented by Graham et al. (2005:32) find strong evidence that managers take real economic actions to maintain accounting appearances. Moreover, in particular, 80% of survey participants report that they would decrease discretionary spending on R&D, advertising, and maintenance to meet an earnings target. In this regard, more than half (55.3%) state that they would delay starting a new project to meet an earnings target, even if such a delay entailed a small sacrifice in value.

The main reasons documented in the literature for executives' willingness to manage earnings through real activities than through accruals, comprises various arguments as: accrual-based earnings management are more likely to draw auditor or regulatory scrutiny than real decisions or using accrual manipulation alone can be risky. In regard of the latter argument, when reported income falls below the threshold and all accrual-based strategies to meet it are exhausted, managers are left with no options since real activities cannot be adjusted at or after the end of the fiscal reporting period. On the other hand, when the firm's growth prospects are good, the firm will try to increase current period earnings using accrual-based earnings management but not real earnings management. Also, when the sensitivity of the manager's compensation to stock price and/or market pricing of earnings increases, managers engage in accrual-based earnings management to increase current period earnings. A third case when accrual-based earnings management is preferred by managers is when the cost of using real earnings management is too high.

The theoretical arguments approached in the frameworks are also assessed in empirical studies documenting the existence of the tradeoff between the types of earnings management. In this respect, four empirical studies can be cited: Zang (2012); Baderschert (2011); Burnett et al. (2012) and Roychowdhury et al. (2012).

For instance, Zang (2011) examined if managers uses real earnings management and accrual based earnings management as substitutes in order to manipulate earnings to reach benchmarks. Managers are using as substitutes the two types of earnings management and after identified realized real earnings management, managers modify the level of accrual-based earnings management accordingly. The frequency of comprising such demarches depends on the relative costliness of adopting an earnings management practices (Zang, 2012). The study conducted by Baderschert (2011) investigated the overvaluation of companies and the association with both earnings management types. Since the overvaluation impacts accrual-based earnings management, real earnings management is also affected by the company`s valuation decisions. The empirical study conducted by Baderschert (2011) documented that companies that are in the initial stage of overvaluation engage more frequently in accrual-based earnings management and during later stages subsidies to real earnings management.

Burnett et al. (2012) researched also the trade-off between stock-repurchases and accrual-based earnings management. The goal of the paper was to assess if companies under constrained possibilities to use accrual-based earnings management engaged in real earnings management by using stock repurchases. Roychowdhury et al. (2012) investigated the role accrual-based and real earnings management in the overvaluation in SEO periods. The documented results show that managers are using more real earnings management compared to accrual-based earnings management, despite the negative long-term effect on firm`s performance.

Summarizing the main findings in the tradeoff area of research, it can be concluded that companies are using both types of earnings management strategies to manage their earnings (Cohen and Zarowin, 2010; Dechow et al., 2011; Badertscher, 2011; Kothari et al., 2012).

Real earnings management is considered to be more expensive compared to accrual-based earnings management (Graham et al., 2005; Kim and Sohn, 2013), and it can be used throughout the year, while accruals earnings management is generally more constraint to specific times and periods (Zang, 2012). Unlike accrual-based earnings management, real earnings management has an impact on cash flow which can affect the company on long run (Gunny, 2010). Being more difficult to detect real earnings management, such practices are not normally under the jurisdiction of any existing auditing system and less subject to extensive controls and external monitoring by society, including media scrutiny or other political parties (Kim and Sohn, 2013).

Since all managers of companies are aware of the rewards of meeting or beating earnings target they are motivated to choose among the alternatives earnings management strategies (Bartov et al., 2002). In cases where both earnings management methods are likely to be used, the literature document evidence that managers trade-off between two earnings management strategies based on their relative costs and benefits, using accrual-based and real earnings management as substitutes (Ewert and Wagenhofer, 2005; Cohen et al., 2008; Cohen and Zarowin, 2010; Zang, 2012).

4. Conclusion, limitations and scope for future research

The goal of our paper was to review the most recent field regarding the tradeoff between accrual-based versus real earnings management and to discuss the main findings and is not meant to be a definitive framework for earnings management research area. Moreover this study can be a useful instrument in identifying future areas of research.

In this respect we can assert that previous empirical examined both measures of earnings management, which various incentives to manage earnings are documented all around the world. In this respect, even if accrual-based earnings management practices are documented extensively, recent years have documented more and more real earnings management practices (Cohen et al., 2008; Seybert, 2010; Badertscher, 2011). Despite the fact that both earnings management types are extensively examined in the literature, very few empirical studies examined in the same time both types of earnings management. There is a relatively little analytical investigation and some mixed empirical evidence on how managers choose between accrual-based versus real earnings management. On the one hand, recent empirical evidence document that managers use both types of earnings management to meet earnings targets but further research is necessary in order to understand how managers trade between the two types of earnings management.

Our research has one important limitation. We assessed only published work, excluding working papers or conferences proceedings papers. By doing so, we limited very much our area of interest and the number of papers from earnings management research field.

Further research can examine the effect of financial transparency increase on earnings management types or the impact of ethics. Also, future research designs should bring significant improvements when assessing the existence and magnitude of earnings management types and assessment of the tradeoff effect, given the fact that contemporary research designs are suffering from important measurement errors. Also, future research can concentrate on items of high importance of: income smoothing assessment, the impact of financial crisis over manipulation behavior, personal traits impact over earnings management activities, etc. Those future research agendas can open up new fields of enquiry, addressing either neglected areas of research either consolidating previous areas of earnings management research. Also, future research should also consider exploring previous findings using qualitative research including interviews with managers, investors or other users of accounting information.

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