EARNINGS TARGET AND THE COMPETING USE OF ABNORMAL R&D AND ABNORMAL ACCRUALS OF R&D INTENSIVE FIRMS

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ABSTRACT

The purpose of this study is to examine the competing use of real earnings management and accruals management in certain specific circumstances of firms where both real earnings management and accruals management are costly and where firms can either use both or any of the two methods of earnings management to meet earnings targets.

A recent study, Zang (2005), examines the competing use of real earnings management and accruals management. She finds that in a broad sample firms tend to use real earnings management before accruals management. This study overlooks the issue that in such a sample firms that are not R&D intensive would find R&D reductions less costly than accruals management. She also overlooks the point that the tendency to use different methods of earnings management depends on how far the earnings are from the earnings targets.

I conduct an examination of the competing use of real earnings management and accruals management in a sample of R&D intensive firms. I use R&D intensive firms because R&D reduction can be costly for them as costs of future earnings generation capacities. I also consider the distance of a firm from meeting its earnings target using the two methods of earnings management.

My results indicate that when real earnings management and accruals management are both costly, firms tend to use both methods. However, as R&D activities are important for R&D intensive firms, they tend to use abnormal accruals more than abnormal R&D to manage their earnings. Based on such findings, I construe that the nature of the firm's activities and the distance of the earnings from the earnings target influence a firm's use of real earnings management and accruals management to meet its earnings target.

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