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The Mispricing of Real Earnings Management

in the Post-Sarbanes-Oxley Era

A dissertation presented in partial fulfilment of

the requirements for the degree of

Doctor of Philosophy

in

Accountancy

at Massey University

Auckland

New Zealand

Lei Cai

2013
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Abstract

Recent studies document that there has been a shift towards real activities earnings management (REM) because accrual-based earnings management (AEM) is under enhanced scrutiny since the enactment of Sarbanes-Oxley Act of 2002 (SOX). The prior literature contends that for REM, firms reduce certain real activities to cut costs, and that such reductions can lead to adverse effects on future performance.

This study examines whether investors efficiently price or misprice REM in the post-SOX environment. I conduct a two-stage analysis. First, I estimate the REM of firms using the methods adopted in the extant literature. Since the corporate governance literature suggests that the level of earnings management of firms is influenced by the corporate governance features of firms and managerial incentives arising from certain firm features, I moderate the REM indicators to take into account the effects of these features on investors’ perceptions of earnings management practices of firms. Since AEM coexists and competes with REM, I make similar estimations for accruals management. Second, I evaluate the effects of REM on both current-year stock returns and future performance.

Since REM is expected to have adverse effects on future firm performance, REM is likely to be negatively associated with future firm performance, and in an efficient market it would be priced negatively in the year in which it is reported. However, I find a positive association between REM and current-year stock returns, and a negative association between REM and future firm performance. This result indicates that the market places a positive connotation on income-increasing REM, but the actual effects of REM on future performance are negative. The inference is that the market misprices reported earnings in the year when REM is conducted.
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<thead>
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<th>Abbreviation</th>
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<tbody>
<tr>
<td>AEM</td>
<td>Accrual-based earnings management</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief executive officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Cash flows from operations</td>
</tr>
<tr>
<td>EMH</td>
<td>Efficient Market Hypothesis</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally accepted accounting principles</td>
</tr>
<tr>
<td>COGS</td>
<td>Cost of goods sold</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>MBE</td>
<td>Meeting or beating earnings benchmarks</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>National Association of Securities Dealers Automated Quotations</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
</tr>
<tr>
<td>PCA</td>
<td>Principal component analysis</td>
</tr>
<tr>
<td>REM</td>
<td>Real activities earnings management</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on assets</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and development expenditures</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SEO</td>
<td>Seasoned equity offerings</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>Selling, general and administration expenses</td>
</tr>
<tr>
<td>SIC</td>
<td>Standard industrial classification</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>------------------------------</td>
</tr>
<tr>
<td>SOX</td>
<td>Sarbanes-Oxley Act</td>
</tr>
<tr>
<td>TCL</td>
<td>The Corporate Library database</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
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