The Mispricing of Real Earnings Management

in the Post-Sarbanes-Oxley Era

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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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List of Abbreviations

AEM   -   Accrual-based earnings management

CEO   -   Chief executive officer

CFO   -   Cash flows from operations

EMH   -   Efficient Market Hypothesis

GAAP   -   Generally accepted accounting principles

COGS   -   Cost of goods sold

IASB   -   International Accounting Standards Board

MBE   -   Meeting or beating earnings benchmarks

NASDAQ   -   National Association of Securities Dealers Automated Quotations

NYSE   -   New York Stock Exchange

PCA   -   Principal component analysis

REM   -   Real activities earnings management

ROA   -   Return on assets

R&D   -   Research and development expenditures

SEC   -   Securities and Exchange Commission

SEO   -   Seasoned equity offerings

SG&A   -   Selling, general and administration expenses

SIC   -   Standard industrial classification

SOX   -   Sarbanes-Oxley Act

TCL   -   The Corporate Library database

UK   -   United Kingdom

US   -   United States