

**The Impact of Earnings Management on the Value-Relevance
of Earnings and Book Value: A Comparison of Short-term
and Long-term Discretionary Accruals**

**A dissertation submitted to the Faculty of Business
in candidacy for the degree of Doctor of Philosophy**

by

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STATEMENT OF SOURCES

To the best of my knowledge and belief, the work presented in this thesis is original, except as acknowledged in the text. All sources used in the study have been cited, and no attempt has been made to project the contributions of other researchers as my own. Further, the material has not been submitted, either in whole or in part, for a degree at this or any other University.

Catherine Whelan

Date

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ABSTRACT

Earnings and book value are commonly used as the basis for firm valuation. However, the reliability of earnings, as indicated by earnings management, may affect its relevance in determining firm value. This thesis investigates the link between earnings management and firm valuation by assessing the impact of earnings management on the value-relevance of earnings and book value.

Three different sources of earnings management are investigated: total discretionary accruals, short-term discretionary accruals, and long-term discretionary accruals. Total discretionary accruals are estimated using the Jones model (Jones 1991). New models are developed to estimate short-term and long-term discretionary accruals. These models enable investigation of the differential impact of earnings management via short-term versus earnings management via long-term discretionary accruals. The primary proposition is that earnings management via long-term discretionary accruals has a greater impact on the value-relevance of earnings and book value than earnings management via short-term discretionary accruals.

For firm's whose discretionary accruals indicate earnings management, the value-relevance of earnings is expected to be lower than for firms without earnings management. Moreover, in the presence of earnings management, it is expected that there will be a shift from a reliance on earnings to a reliance on book value in the valuation process. This would be reflected in a decrease in the value-relevance of earnings and an increase in the value-relevance of book value.

This thesis provides evidence that earnings management plays a role in the valuation process. A major contribution of this study is the development of models to enable the estimation of short-term and long-term discretionary accruals, thereby extending the earnings management literature by addressing the differential effect of short-term versus long-term discretionary accruals. The results clearly demonstrate that low reliability of information reduces its value-relevance. This link between the integrity of accounting information and its usefulness to market participants supports the need for ongoing regulatory activity to improve the integrity of the financial reporting process.

Preliminary results demonstrate the value-relevance of earnings and book value using Australian data. The effect of earnings management on the relative value-relevance of these accounting measures depends on the source of earnings management. Earnings management via total discretionary accruals has no impact. When examined independently, earnings management via either short-term or long-term discretionary accruals reduces the value-relevance of earnings but has no impact on the value relevance of book value. Examination of both measures simultaneously reveals the differential impact of short-term versus long-term discretionary accruals. Earnings management via short-term discretionary accruals has no impact, whereas earnings management via long-term discretionary accruals reduces the value-relevance of earnings and increases the value-relevance of book value. Therefore, it is concluded that earnings management via long-term discretionary accruals has a greater impact on the value-relevance of earnings and book value than earnings management via short-term discretionary accruals.

TABLE OF CONTENTS

STATEMENT OF SOURCES	ii
ACKNOWLEDGEMENTS	iii
ABSTRACT	iv
TABLE OF CONTENTS	vii
TABLE OF ILLUSTRATIONS	ix
CHAPTER 1 INTRODUCTION	1
1.1 OVERVIEW	1
1.2 EARNINGS MANAGEMENT AND THE RELIABILITY OF EARNINGS	2
1.3 EARNINGS, BOOK VALUE & EARNINGS MANAGEMENT: SHORT-TERM AND LONG-TERM DISCRETIONARY ACCRUALS	4
1.4 ADDRESSING THE PROBLEM	7
1.5 CONTRIBUTION TO KNOWLEDGE	8
1.6 ORGANIZATION OF THE THESIS	9
CHAPTER 2 THEORY DEVELOPMENT	11
2.1 INTRODUCTION	11
2.2 MODEL OVERVIEW	11
2.3 CONCEPTUAL BASIS FOR THE MODEL.....	14
2.3.1 Value-relevance of Earnings	14
2.3.2 Value-relevance of Book Value	16
2.4 EARNINGS MANAGEMENT	18
2.4.1 Discretionary and Non-discretionary Accruals	19
2.4.2 Short-term and Long-term Discretionary Accruals	21
2.5 LIMITATIONS OF THE MODEL	24
2.6 SUMMARY	25
CHAPTER 3 RESEARCH DESIGN	27
3.1 INTRODUCTION	27
3.2 OVERVIEW OF RESEARCH DESIGN	27
3.2.1 Value-relevance Model.....	28
3.2.2 Earnings Management Model.....	29
3.2.3 Extended-Earnings-Management Model.....	31

3.3	SAMPLE AND DATA COLLECTION PROCEDURES.....	34
3.4	OPERATIONALIZATION OF THE DEPENDENT CONSTRUCT	34
3.5	OPERATIONALIZATION OF THE INDEPENDENT CONSTRUCTS.....	36
3.6	OPERATIONALIZATION OF THE MODERATING CONSTRUCT.....	36
3.6.1	Total Discretionary Accruals.....	41
3.6.2	Short-term Discretionary Accruals.....	43
3.6.3	Long-term Discretionary Accruals.....	44
3.6.4	Indicator of Earnings Management	45
3.7	CONTROL VARIABLES.....	47
3.8	ANALYSIS PROCEDURES	47
3.8.1	Preliminary Analysis	47
3.8.2	Determination of Earnings Management Dummy Variables.....	48
3.8.3	Tests of the Hypotheses.....	48
3.8.4	Sensitivity Analysis	50
3.9	SUMMARY.....	51
CHAPTER 4 ANALYSIS AND HYPOTHESIS TESTS.....		55
4.1	INTRODUCTION	55
4.2	SAMPLE SELECTION	55
4.3	UNIVARIATE ANALYSIS	60
4.3.1	Descriptive Statistics	60
4.3.2	Correlation Coefficients	66
4.4	DISCRETIONARY ACCRUALS.....	68
4.5	TESTS OF HYPOTHESES	72
4.5.1	Value-relevance Model.....	72
4.5.1.1	Assessing the Assumptions	74
4.5.2	Earnings Management Model.....	75
4.5.2.1	Hypothesis 2A	76
4.5.2.2	Hypothesis 2B	78
4.5.2.3	Hypothesis 2C	80
4.5.2.4	Assessing the Assumptions	82
4.5.3	Extended-Earnings-Management Model.....	83
4.5.3.1	Hypothesis 3	83
4.5.3.2	Hypothesis 2B and Hypothesis 2C	87
4.5.3.3	Assessing the Assumptions	88

4.6	SENSITIVITY ANALYSIS	90
4.6.1	Control variables	90
4.6.2	Earnings Management Allocation by Median Benchmark.....	95
4.6.3	Alternative Measures of Earnings	99
4.7	SUMMARY OF THE FINDINGS	105
CHAPTER 5	CONCLUSIONS.....	109
5.1	INTRODUCTION	109
5.2	SUMMARY OF THE RESEARCH.....	109
5.3	SUMMARY OF THE RESEARCH CONCLUSIONS	114
5.3.1	Value Relevance	114
5.3.2	The Impact of Earnings Management	118
5.3.3	Short-term versus Long-term Discretionary Accruals.....	124
5.4	LIMITATIONS OF THE RESEARCH	126
5.4.1	Threats to Internal Validity	126
5.4.2	Threats to External Validity	129
5.5	IMPLICATIONS OF THE RESEARCH.....	130
5.5.1	Regulatory Implications	130
5.5.2	Practical Implications	132
5.5.3	Educational Implications	133
5.5.4	Research Implications	134
5.6	SUMMARY	135
REFERENCES	136
APPENDIX 1	143
APPENDIX 2	144
APPENDIX 3	146

TABLE OF ILLUSTRATIONS

FIGURES

Figure 2-1: Earnings Management Valuation Model	13
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TABLES

Table 2-1	Studies on the value-relevance of book value versus earnings	16
Table 3-1	Definition of Variables	52
Table 3-2	Summary of Models	53
Table 3-3	Summary of Hypotheses	54
Table 4-1	Sample for Value-relevance Model – Equation [1]	56
Table 4-2	Sample for Earnings-Management Model – Equation [2] Earnings Management via Total Discretionary Accruals	58
Table 4-3	Sample for Earnings-Management Model – Equation [2] Earnings Management via Short-term Discretionary Accruals	58
Table 4-4	Sample for Earnings-Management Model – Equation [2] Earnings Management via Long-term Discretionary Accruals	58
Table 4-5	Sample for Extended-Earnings-Management Model – Equation [3]	59
Table 4-6	Samples for Tests of Hypotheses	60
Table 4-7	Descriptive Statistics – Market, Accounting and Control Variables Sample for Value-Relevance Model – Equation [1]	61
Table 4-8	Descriptive Statistics – Market, Accounting and Control Variables Sample for Earnings-Management Model – Equation [2] Earnings Management via Total Discretionary Accruals	62
Table 4-9	Descriptive Statistics – Market, Accounting and Control Variables Sample for Earnings-Management Model – Equation [2] Earnings Management via Short-term Discretionary Accruals	62
Table 4-10	Descriptive Statistics – Market, Accounting and Control Variables Sample for Earnings-Management Model – Equation [2] Earnings Management via Long-term Discretionary Accruals	62
Table 4-11	Descriptive Statistics – Market, Accounting and Control Variables Sample for Extended-Earnings-Management Model – Equation [3]	64
Table 4-12	Descriptive Statistics – Accruals	65

Table 4-13	Pearson Correlation of Earnings with Price & Book Value with Price Samples for Value-relevance and Earnings Management Models	66
Table 4-14	Pearson Correlation of Earnings with Price & Book Value with Price Sample for Extended-Earnings-Management Model	67
Table 4-15	Estimation of Jones Model for Total Accruals	69
Table 4-16	Estimation of Short-term Accrual Model	69
Table 4-17	Estimation of Long-Term Accrual Model	70
Table 4-18	Comparison of Mean Absolute Discretionary Accruals for Earnings Management and Non-Earnings Management Firms	71
Table 4-19	Value-relevance of Earnings and Book Value	73
Table 4-20	Equation [1] - Tests for Heteroscedasticity	75
Table 4-21	Value-relevance of Earnings and Book Value: A Comparison of Results Using White's t-statistics	75
Table 4-22	Earnings-Management Model Earnings Management via Total Discretionary Accruals	77
Table 4-23	Earnings-Management Model Earnings Management via Short-term Discretionary Accruals	79
Table 4-24	Earnings-Management Model Earnings Management via Long-term Discretionary Accruals	80
Table 4-25	Earnings-Management Model A Comparison of Results Using White's t-statistics	82
Table 4-26	Extended-Earnings-Management Model Earnings Management via Short-term and Long-term Discretionary Accruals	85
Table 4-27	Hypothesis 3: Wald Tests	87
Table 4-28	The Impact of Earnings Management via Short-term and Long-term Discretionary Accruals on the Value-relevance of Earnings and Book Value: A Comparison of Results Using White's t-statistics	89
Table 4-29	Hypothesis 3: Wald Tests Using White Standard Errors	89
Table 4-30	Value-relevance Model: Impact of Control Variables	91
Table 4-31	Earnings Management Model: Impact of Control Variables	92
Table 4-32	Extended-Earnings-Management Model: Impact of Control Variables	93
Table 4-33	Hypothesis 3 Wald Tests: Impact of Control Variables	94
Table 4-34	Earnings Management Model: Alternate Earnings Management Allocation Methods	96
Table 4-35	Extended-Earnings-Management Model: Alternate Earnings Management Allocation Methods	98

Table 4-36	Hypothesis 3 Wald Test: Alternate Earnings Management Allocation Methods	98
Table 4-37	Value-relevance Model: Alternative Measures of Earnings	100
Table 4-38	Earnings Management Model: Alternative Measure of Earnings	101
Table 4-39	Extended-Earnings-Management Model: Alternative Measures of Earnings	103
Table 4-40	Hypothesis 3 Wald Tests: Alternative Measures of Earnings	104
Table 4-41	Summary of Hypotheses and Results	105
Table 4-42	Sensitivity Analysis - Comparison of Results	107
Table 5-1(A)	Summary of Propositions, Hypotheses and Findings	116
Table 5-2(B)	Summary of Propositions, Hypotheses and Findings	117