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

Catherine Whelan

Faculty of Business
Bond University
Robina QLD 4229
Australia

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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.
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