Project Report

On

Earnings Management and Resource allocation

Submitted to

Md. Mohedul Islam

Assistant Professor of Accounting

Department of Business Administration (DBA)

School Of Business (SOB)

Uttara University, Dhaka -1230

Submitted By

Sharmin Jahan Lima

ID No.: 2193061039; Program : MBA For BBA
Section: A, Batch : 50th
Department Of Business Administration(DBA)

School Of Business(SOB)

Uttara University, Dhaka-1230

Date of Submission: 03/09/2020.

LETTER OF TRANSMITTAL

August 03, 2020

To

Md. Mohedul Islam

Assistant Professor of Accounting

Department of Business Administration (DBA)

School Of Business (SOB)

Uttara University, Dhaka -1230

Subject: Submission of Project report.

Dear Sir,

With due respect, I would like to present you this report that I have prepared as a requirement of my MBA Project program titled as **“Earnings Management and Resource allocation ”.**

I have tried my best to prepare thisreport in consistence with the optimal standard under your valuable direction. I made every endeavor to prepare this report and put my best effort to gather relevant information for constructing a complete report I hope that the report will serve its purposes.

I, therefore, hope that your honor would kindly oblige me by accepting my report.

Sincerely,

Sharmin Jahan Lima

ID No.: 2193061039; Program : MBA For BBA , Section: A

Batch : 50th

Department of Business administration (DBA)

School Of Business (SOB)

Uttara University, Dhaka -1230

STUDENT'S DECLARATION

I, the undersigned, declare that this is my original work and has not been previously submitted to any other college, institution or university for academic credit.

Signed:__________________ Date: 03/09/2020.

Sharmin Jahan Lima

ID No.: 2193061039; Program : MBA For BBA , Section: A

Batch : 50th

Department of Business administration (DBA)

School Of Business(SOB)

Uttara University, Dhaka -1230

ACKNOWLEDGEMENT

Fast and foremost I express my gratitude and thanks to Almighty for providing me with all abilities and patience to conduct and prepare this research report. In addition, I would like to thank my parents for their support and blessings in my process of completing this research study.Then, I would like to acknowledge the immense contribution of my academic supervisor, Md. MohedulIslam , Assistant Professor of Accounting, Department of Business Administration, Uttara University, for him patience, support and professional guidance and availability.

TABLE OF CONTENTS

ABSTRACT: This paper examines whether firms manipulating their reported financial results make suboptimal investment decisions. We examine fixed asset investments for a large sample of public companies during the 1978–2002 period and document that firms that manipulate their earnings—firms investigated by the SEC for accounting irregularities, firms sued by their shareholders for improper accounting, and firms that restated financial statements—over-invest substantially during the misreporting period. Furthermore, following the misreporting period, these firms no longer over-invest, consistent with corrected information leading to more efficient investment levels. We find similar patterns for firms with high discretionary revenues or accruals. Our findings suggest that earnings management, which is largely viewed as targeting parties external to the firm, can also influence internal decisions. Keywords: earnings management; investment.

Justification of the study

1.1 Background of the Study

I. INTRODUCTION This paper examines whether earnings management affects resource allocation by studying whether firms manipulating earnings make suboptimal investment decisions. We aim to provide evidence on whether accounting misstatements, potentially motivated by compensation targets or capital market expectations, cause distortions in the investment decisions made within firms engaging in the misstatement—a direct cost to investors. The consequences of earnings management are relevant to the decisions made by investors, managers, directors, and regulators, and to date there is little research that addresses the relation between earnings management in external reporting and its effect on internal decisions. Investment decisions depend on expectations of the benefits of the investment, which in turn depend on expectations of future growth and product demand. Expectations of future growth are The authors thank Dan Dhaliwal, two anonymous reviewers, and workshop participants at the 2005 Stanford Summer Camp, the 2005 UNC/Duke Fall Camp, Lancaster University, and the 2007 Accounting Research Conference at the University of Oklahoma for insightful comments and suggestions. We are grateful to Woodruff-Sawyer & Co. for the use of data on shareholder suits for accounting improprieties. We also gratefully acknowledge the financial support of the Stanford Graduate School of Business and the Kenan-Flagler Business School. Editor's note: This paper was accepted by Dan Dhaliwal. THE ACCOUNTING REVIEW American Accounting Association Vol. 83, No. 6 DOI: 10.2308/accr.2008.83.6.1571 2008 pp. 1571–1603 Submitted: August 2007 Accepted: May 2008 Published Online: December 2008 1571 based on information that includes revenues and earnings. In addition to merely concealing the actual performance during the period, misstated financial results can mask underlying trends in revenue and earnings growth. Thus, overstatements of revenues and earnings are likely to distort expectations of growth by those unaware of the misstatement. One might conjecture that if management chooses to paint a rosier view for investors in the numbers they report externally, then they would not allow this to influence internal investment decisions. However, it is possible that investment decision makers within the firm believe the misreported growth trend—because they are either over-optimistic or unaware of the misstatement—and invest accordingly. Alternatively, investment decision makers might understand the true state of the firm but choose to over-invest in a high-risk approach to turn around performance. Regardless of the reason for the over-investment, truthful reporting might have prevented it. Several parties are typically involved in investment decisions, including managers who make the decision to invest, boards who review the capital budget, and external suppliers of capital. If financial results are reported truthfully, then other parties could step in to curtail the investment. As a result, firms invest more than they otherwise would have, and attempts to meet capital market expectations or meet bonus targets, for example, could affect investors, employees, customers, and a broad set of related parties. Our study provides evidence on whether

earnings management affects resource allocation by examining the capital expenditure decisions of three groups of firms alleged to have manipulated earnings—firms investigated by the SEC for accounting irregularities, firms sued by their shareholders for improper accounting, and firms that restated financial statements. These samples comprise firms that have overstated earnings substantially, which gives us greater confidence that we have identified earnings manipulators and that the magnitude of their earnings manipulation could significantly affect investment decisions. Both of these factors are crucial to the power of our tests. However, because of concerns about potential selection bias and to test whether the effect we find generalizes beyond the most severe cases of earnings manipulation, we also use discretionary revenues to identify firms that manipulated earnings. Our data identifies the period for which manipulation is alleged, and permits us to examine the investment decisions in the years before, during, and subsequent to the manipulation. Under the null hypothesis that earnings management does not result in resource misallocation, firms should exhibit investment levels consistent with their fundamentals. Our study follows an extensive literature that models investment decisions using a linear model relating capital expenditures to investment opportunities. Specifically, these models control for investment opportunities using Tobin's Q and cash from operations. Our tests examine the investment decisions in the manipulation and post-manipulation periods. First, we test whether firms overstating earnings over-invest during the manipulation period. Second, we examine whether over-investment is eliminated once earnings are no longer manipulated. If firms over-invest during the manipulation period for a reason other than the effect of misleading information, then we would not expect a decline in investment after controlling for declining investment opportunities when earnings are no longer manipulated. The findings indicate that firms manipulating earnings do over-invest in the misreporting period. We find significantly greater investment than would be expected based on investment fundamentals. Additional tests using matched control firms suggest that sample firms invest more than they would have had they not overstated their earnings. While sample and control firms exhibit some over-investment before the manipulation period, control firms reduce the level of investment, whereas sample firms continue over-investing during the manipulation period. Finally, 1572 McNichols and Stubbed The Accounting Review November 2008 American Accounting Association the evidence indicates that sample firms curb over-investment following the misreporting period. These findings suggest that an important consequence of earnings management is its effect on firms' investment decisions. Our tests using measures of discretionary revenues allow us to confirm the main findings and also to investigate further the timing of the earnings management and excess investment. Granger causality tests are consistent with earnings management leading excess investment rather than earnings management occurring in response to e.g., to cover up past suboptimal investment. Taken together, our findings across several approaches using multiple measures of earnings management and excess investment support our hypothesis that earnings management affects firms' investment decisions. We seek to provide additional support for this hypothesis by ruling out alternative explanations for our results.
Our evidence does not indicate that over-investment is solely a result of firms obtaining

relatively inexpensive external financing because we see similar patterns of over-investment in firms with low and high levels of external financing. Our evidence does not support the hypothesis that firms manipulating earnings over-invest to pool with more successful firms to thereby avoid detection; we find that sample firms invest more than control firms, which is inconsistent with a pooling argument. Finally, our evidence is not consistent with the notion that firms facing poor returns to past over-investment overstate earnings to mask the poor financial results. First, we find that firms continue to over-invest while they manipulate earnings, which is unexpected for a firm already facing poor investment returns. In addition, using Granger causality tests we find that earnings management leads excess investment. While our findings are subject to the caveat that we do not observe the investment decision process directly, we conclude that the most plausible explanation is that earnings management distorts information used by those involved in firms' investment decisions. These findings contribute to the emerging literature on the role financial statement information plays in investing decisions. Recent studies such as Biddle and Hilary 2006, Verdi 2006, and Bushman et al. 2006 find relationships between properties of accounting information and investment decisions. However, these studies do not address whether intentional distortions in accounting numbers affect investment. Our study also contributes to the literature relating earnings management and resource allocation. Our findings suggest that earnings management can lead to a direct cost to investors in the form of inefficient investments. The layout of the paper is as follows. Section II discusses related literature, Section III describes our hypotheses, Section IV describes our research design, Section V presents our empirical findings, and Section IV concludes.

Research Objective

General objective:

The study aims to examine the impact of Earnings Management and Resources Allocation.

Specific objectives:

Specific objectives are-

a. To identify firms investigated by the SEC for accounting irregularities,
b. How to firms sued by their shareholders for improper accounting.
c. Thefirms that restated financial statements—over-invest substantially during the misreporting period.
d. To identify the various resources allocation.
e. To know the earnings management from investors.

Literature Review

Much of the literature about earning management presents some information about the most important question asked by standards setters, involving whether earning management is commonplace and ordinary or occurs infrequently and rarely, which accruals are the focus of earnings management and what are the effects on resource allocation decisions. This information is necessary to evaluate the pervasiveness of earning management and the integrity and truthfulness of financial reports.

The focus in the past research of earnings management has been mainly on finding whether earning management exists and when. Researchers have examined a wide range of measures of earnings management and samples from firms where the motivations to manage earnings are expected to be high. Studies have shown that earnings management does exist and it occurs for different reasons. These reasons include influencing capital market expectations and valuation, to increase management's compensation, to avoid a violating contracts written in terms of accounting numbers and to reduce regulatory costs and some other reasons that will be discussed in the next parts.

Analysis and finding

Earning management is the process by which management can potentially manipulate the financial statements to represent what they wise to have happened during the period rather than what actually happened (Scott 2009). Earnings management occurs in corporations where managers attempt to present a more favorable financial picture of the company performance through discretionary accruals (Aini, Takia, Pourjalali & Teruya, 2006). Managers use flexible accounting principles to manage earnings (Davidson III, Jiraporn, Kim & Nemec, 2004). Previous studies on earning management mainly (Bauwhede, Willekens & Gaeremynck, 2003). Incentives for earning management include explicit contract such as bonus plans (Gaver, Gaver & Austin, 1995) and debt covenants (DeFond & Jiambalvo, 1994), implicit contract (Bowen, DuCharme & Shores, 1995), capital markets and need for external financing (Teoh, Welch & Wong, 1998a), the political and regulatory process (Han & Wang, 1998) and some specific circumstances such as earnings decreases or losses (Burgstahler & Dichev, 1997). Earnings management may lead to misrepresentation of financial information as a result of conflicting interests between the agent and principle.

Discussion

Earnings management is a practice followed by the management of a company to influence the earnings reported in financial statements. It is executed to match a set target and is different from managing the underlying business of the company. An earnings management strategy uses accounting methods to present an excessively positive view of a company's financial positions, inflating earnings.

Earnings management is used by companies to flatten out earnings variations and present profits that are consistent each quarter or year. Variations in earnings may be common for the operation of a large company. However, they create doubts among investors, as they prefer to invest in stocks of companies that show growth and stability.

The share price of a company usually increases or decreases once the announcement is made and is determined by whether the company meets or fails to meet earnings forecasts. The management tries to influence accounting practices to meet the earnings estimates and hold share prices up.

Summary

- **Earnings management is a method used by a company's management to manipulate its financials.**
- **Companies use earnings management to show consistent profits, flatten out earnings variations, and hold the share price up.**
- **Earnings management happens when a company's management team makes decisions solely to meet expectations or when they alter accounting policies to show an increase in its quarterly or annual earnings.**

Earnings Management Approaches

Companies use several strategies used for earnings management. The most commonly used strategies are as follows:

1. Earnings-focused decisions

Decisions taken by the management are solely focused on meeting earnings estimates. The easiest way for earnings management is to control the company's expenses. Companies look to cut any optional expenses to meet earnings estimates.

Certain activities – such as research, advertising, or staff training – can be suspended temporarily. Companies suspend such activities for a short time, assuming that the business will perform better in the upcoming periods, and the suspended activities can be resumed thereafter.

However, for companies that are performing well, the management focuses on the long-term success of the business and does not usually resort to artificially enhancing the earnings.

2. Biased accounting judgments

Accrual accounting presents opportunities for earnings management; however, a company's management needs to exercise some difficult judgments when accrual accounting is applied.

There are formal policies, accounting manuals, and processes followed at well-performing companies to ensure that the judgments are bias-free. Earnings management happens when the management team distorts judgments and mends policies to meet expectations.

3. Altering accounting principles

U.S. accounting standards provide different rules of accounting for the same transactions. For example, both the inventory cost and fixed asset cost can be accounted for in three different but acceptable ways.

The management of well-run companies chooses the accounting rule that best reflects the implicit economic factors. Earnings management happens when a company's management selects an alternative of a certain accounting standard, which will cause the earnings number to meet the expectations.

Identifying Earnings Management

Chartered Professional Accountant (CPA) companies and the Securities and Exchange Commission (SEC) revelations uncover various types of earnings management used by companies.

Investors should perform due diligence before investing in the stocks of any company. Some investors analyze a company's financial reports and can identify earnings management.

Listed below are the signs that an investor needs to look for to determine if a company is exercising earnings management to manipulate its financials:

1. The company claims an increase in revenue without a corresponding increase in cash flows.
2. The company reports an increase in earnings only in the final quarter of the fiscal year.
3. The fixed assets of the company are expanding beyond the normal standard for the industry or company.
4. The net worth of an asset is inflated by ignoring the use of the true depreciation schedule.

Related Readings

CFI is the official provider of the global Certified Banking & Credit Analyst (CBCA)™ certification program, designed to help anyone become a world-class financial analyst. To keep advancing your career, the additional CFI resources below will be useful:

- Accounting Policies
- Fraud in Audits
- Accounting Profit
- Types of Due Diligence

Financial Analyst Training

Get world-class financial training with CFI's online certified financial analyst training program!

Gain the confidence you need to move up the ladder in a high powered corporate finance career path.

Future forward

Figure 1: The Pathways Commission's Vision Model

Source: The Vision Model at www.PathwaysCommission.org. Since the application of financial reporting standards requires considerable judgment, it creates opportunities for earnings management as well. Although financial statement audit provides confidence that those judgments are reasonable, there are many cases that audit firms could not detect material misstatements or fraud. This is because it is difficult to determine whether there is a tolerable amount of earnings management (Barth, 2018). The reminder of the paper presents, in order, a definition of earnings management, discussion of interrelations among judgment, estimates, and earnings management, the difficulty of identifying earnings management, selected earnings management case examples, and conclusion. 2. Earnings Management 'Earnings management' typically focuses on the artificial increase (or decrease) of revenues, profits, or earnings per share figures through aggressive accounting tactics. The actual situation is, however, more complex. Consider these example definitions of earnings management: • "Purposeful intervention in the external financial reporting process with the intent of obtaining some private gain." • "Use of judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting judgments." 25 Needles Jr. B.E.,Powers M., Senyigit Y.B. • "An intentional structuring of reporting or production/investment decisions around the bottom line impact." (emphasis added) These definitions illustrate that earnings management is a complex process that involves the accounting judgment that underlies not only the income statement but also the other financial statements and related disclosures. It also involves the 'structuring' of business decisions. Healy and Wahlen (1999) more closely address this complexity by stating that earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company or to influence contractual outcomes that depend on reported accounting numbers. Earnings management seems to have short-term benefits for management and boards of directors. Recent research of more than twenty years of SEC accounting manipulation cases shows that CEOs with equity holdings often influence short-term financial results by pressuring CFOs, who do not hold as much equity and do not get involved for immediate financial benefit, to set aside their role as a watchdog of financial reporting quality (Feng et al., 2011). Turner and Vann (2010) have shown that "independent directors of firms that exhibit earnings management benefited significantly greater cumulative percentage increases in the market value of stock and stock options owned either actually or beneficially than did independent directors on the audit committees of companies presenting no evidence of earnings management." Consider the following business decisions by a company seeking to meet its debt covenant requirements: • The company sells its receivables without recourse • The company sells its receivables with recourse • The company sells its receivables with a side agreement to buy them back within thirty days Also, consider the following accounting decisions: • The company records the sale of receivables with the resulting gain or loss • The company records the sale of receivables and makes an optimistic estimate of the probability of recourse • The company records the sale of receivables and makes a pessimistic estimate of the probability of recourse • The company records the sale of receivables and indicates in the footnote disclosures the requirement to re-buy • The company records the sale of receivables and does not indicate in the footnote disclosures the requirement to re-buy As may be seen in Figure 2 (McKee, 2005), every item in the financial statements is the result of the complex interaction of these two decisions by management: A business structuring decision -A financial reporting decision Financial statements are affected first by business structuring decisions that engage the business in economic activities. These decisions result in transactions or changes in value that must then be recorded in accordance with generally accepted accounting principles (GAAP). Because GAAP offers both alternative financial 26 Needles Jr. B.E.,Powers M., Senyigit

Reference

https://www.researchgate.net/publication/328108225_Earnings_Management_A_Review_of_Selected_Cases

https://www.academia.edu/24737844/Techniques_Motives_and_Controls_of_Earnings_Management

https://www.researchgate.net/publication/328108225_Earnings_Management_A_Review_of_Selected_Cases/link/5bb7e2a0a6fdcc9552d46ae9/download