

Discretionary Accounting Accruals: A Methodological Issue in Earnings Management Research

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The success of any earnings management study critically depends on the precise isolation of managed accruals from the normal/unmanaged portion. Accounting researchers have at their disposal several models which separate the managed and unmanaged portions of accruals. The purpose of this paper is three-fold. First, we present eight of the most popular accruals models to the reader. Second, based on our survey of the accruals literature, we provide a critical analysis of each model. Third, based on the recommendations made in prior studies, we suggest a more effective accruals model which reduces the effects of correlated omitted variables, measurement error, and survivorship bias in the computation of discretionary accounting accruals.

INTRODUCTION

Earnings Management Defined

Earnings management – hereafter EM – involves management’s intentional and opportunistic manipulation of financial reports for personal gain.¹ Schipper (1989) defines EM as the purposeful intervention into the financial reporting process to maximize personal gains. EM occurs in three ways: (1) via the structuring of certain revenue and/or expense transactions; (2) via changes in accounting procedures; and/or (3) via accruals management (McNichols and Wilson 1988, and Schipper 1989).

Of the above mentioned EM techniques, accruals management is the most damaging to the usefulness of accounting reports because investors are unaware of the extent of such accruals (Dye 1988, Trueman and Titman 1988, and Sloan 1996). Accounting procedure changes

¹ EM does not always carry with it a negative connotation. Management may engage in EM in order to provide more conservative or realistic earnings figures or in order to provide more realistic earnings numbers in light of Generally Accepted Accounting Principles. Because it is empirically difficult (if not impossible) to separate the EM arising from opportunistic behavior from the EM arising out of conservative behavior, accounting researchers generally take an opportunistic perspective. Thus, managers are posited to opportunistically manage earnings to maximize their own utility at the expense of other stakeholders.