

An Empirical Examination of Manipulation in Components of the Income Statement

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Acknowledging the existence of earnings management, this study attempts to discern which components of income are most frequently managed in order to achieve net income objectives. To identify these components, we examine the distribution of income components for firms listed on Compustat with fiscal years ending in 1998 to 2003. Each distribution is compared to a Benford distribution, and deviations from a Benford distribution are attributed to human intervention. We find that components with the most serious deviations include rental income and provisions for loan/asset losses (based on levels of statistical significance), as well as net sales and research and development expense (based on relative size). Those with the least-serious deviations include cost of goods sold, net charge-offs, and interest expense. We also partition the sample for components that can either increase or decrease income and conclude that management seems to prefer to manage income by inflating components that are income-increasing rather than deflating components that are income-decreasing.

INTRODUCTION

Misstatements of net income do not occur autonomously but arise through manipulation of one or more of the components of income. Identification of the components most frequently targeted can help auditors in determining where to focus their testing and can enable investors to navigate the income statement more circumspectly. This study employs an exploratory application of Benford's Law to determine which income statement components appear to be most subject to manipulation.

Prior studies have reported on the frequency with which financial statement components are cited in SEC enforcement actions (e.g., COSO 1999). Other studies have utilized a theory-driven examination of particular financial statement components for evidence of manipulation. While the contribution of these studies is extensive and quite useful, they have some limitations.