EARNINGS MANAGEMENT AND THE EPS INITIATIVE: BENEFITS OF ENGAGED SCHOLARSHIP

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dx.doi.org/10.18374/JIFE-23-3.2

ABSTRACT

The Securities and Exchange Commission (SEC) has adopted research methodologies from academia to enhance its ability to identify registrants potentially engaging in earnings management. For example, the SEC uses techniques such as estimating discretionary accruals and others to flag suspicious activity for further investigation. Due to these efforts, the SEC has taken enforcement actions against four registrants under the EPS Initiative. These successful collaborations demonstrate the value of sharing knowledge and resources between academic researchers and regulatory bodies. Moreover, with the help of advanced data analytics technologies, there is an opportunity for the SEC and scholars to work together to promote greater transparency in registrants' financial reporting, illustrating the importance of engaged scholarship in academic research.

***Keywords**: Earnings management, EPS initiative, engaged scholarship*

1. INTRODUCTION

Earnings management has been a prominent topic in accounting research for decades. As it often takes place covertly, scholars have developed methods to analyze public firms' financial statements and estimate the original values of account balances before any manipulation. Net income comprises two primary components: cash flows and accruals. Scholars focus on accruals, which managers can adjust without impacting cash flows by Generally Accepted Accounting Principles (GAAP). Managers can influence net income by adjusting accruals close to the end of the accounting period, when they may have rough estimates of net income earned.

Because scholars do not have access to a public firm's accounting ledgers, which would reveal suspicious transactions, they have developed econometric models to partition accruals into discretionary and non-discretionary components. Discretionary accruals serve as a proxy for earnings management, and the larger the discretionary accruals, the higher the level of earnings management is suspected. However, it is essential to exercise caution when interpreting the results of these models, as they are subject to model misspecification errors, as noted by Dechow, Sloan, and Sweeney (1995) and Kothari, Leone, and Wasley (2005).

Alternatively, other scholars in the field adopt research methods that do not rely on estimation models, such as analyzing the distribution of digits in account balances on financial statements to detect whether they conform to expected distributions, such as Benford's Law, Quadrophobia, etc. These methods have been used to document earnings management (Benford 1938; Thomas 1989; Das and Zhang 2003; Amiram, Bozanic, and Rouen 2015; Malenko, Grundfest, and Shen 2022). However, these research methods require many observations to ensure the reliability of the estimated values.

Despite the significant academic research on earnings management, however, it has yet to lead to regulatory agencies such as the SEC acting. This can be attributed to a few factors. Firstly, academic research papers are intended for dissemination among scholars to advance new knowledge and may not be easily accessible or relevant to practitioners and regulatory agents. Therefore, effective communication channels need to be established to bridge the gap between academia and practice