

The Effects of Firm Growth and Model Specification Choices on Tests of Earnings Management in Quarterly Settings

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ABSTRACT

Commonly used Jones-type discretionary accrual models applied in quarterly settings do not adequately control for nondiscretionary accruals that naturally occur due to firm growth. We show that the relation between quarterly accruals and backward-looking sales growth (measured over a rolling four-quarter window) and forward-looking firm growth (market-to-book ratio) is non-linear. Failure to control for the effects of firm growth and performance on innate accruals leads to excessive Type I error rates in tests of earnings management. We propose simple refinements to Jones-type models that deal with non-linear growth and performance effects and show that the expanded models are well-specified and exhibit high power in quarterly settings where one is testing for earnings management. The expanded models are able to identify the presence of earnings management in a sample of restatement firms. Our findings have important implications for the use of discretionary accrual models in earnings management research.

JEL Classifications: C15; M40; M41.

Keywords: earnings management, discretionary accruals, firm growth

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