





► Volume 62, Issue 6 ► Value Destruction and Financial Reportin ....

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Financial Statement Analysis

## Value Destruction and Financial Reporting **Decisions**

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Whereas much previous research focused on the use of accounting for earnings

management, such as accrual decisions, we provide new evidence of the widespread use of "real earnings" management. Real earnings management, which might include deferring a valuable project or slashing research and development expenditures, is almost always value decreasing.

The survey, administered in the fall of 2003, explored both earnings management and voluntary disclosures in some depth. In addition, from the fall of 2003 to early 2005, we interviewed 22 chief financial officers (CFOs), which added to our understanding of corporate decision making.

Our results indicate that CFOs believe that earnings, not cash flows, are the key metric watched by investors and other outsiders. They consider the two most important earnings benchmarks to be quarterly earnings for the same quarter last year and the analyst consensus estimate.

CFOs believe that hitting earnings benchmarks is very important because such actions build credibility with the market and help maintain or increase the company's stock price in the short run. To avoid the severe market reaction to a failure to deliver on the earnings expectations of analysts and investors, CFOs are willing to sacrifice long-term economic value (such as delaying a valuable project). In contrast, executives say that they are hesitant to use legal—that is, within GAAP—accounting adjustments to hit

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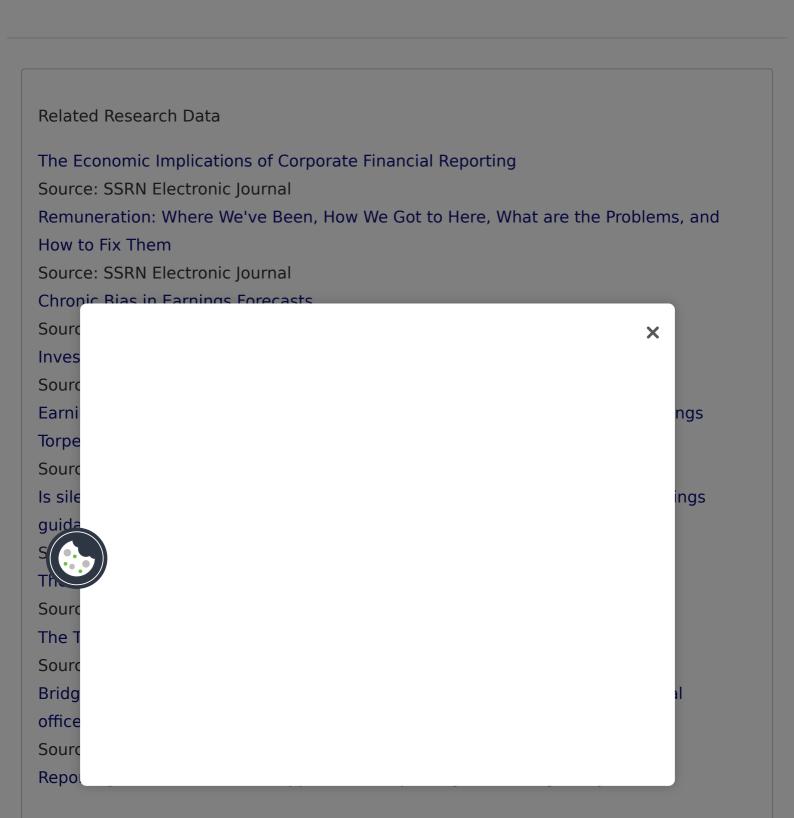
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## Notes

- <sup>1</sup> The survey is posted at <a href="http://faculty.fuqua.duke.edu/~jgraham/finrep/survey.htm">http://faculty.fuqua.duke.edu/~jgraham/finrep/survey.htm</a>.
- <sup>2</sup> Examples include a 12 percent response rate reported by <u>Trahan and Gitman (1995)</u> and a 9 percent response rate reported by <u>Graham and Harvey (2001)</u>.
- <sup>3</sup> This report may be found at <u>www.sec.gov/news/studies/soxoffbalancerpt.pdf</u>.



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