Notes

1 Accounting analysis is sometimes also called quality of earnings analysis. We prefer to use the term accounting analysis because we are discussing a broader concept than merely a firm's earnings quality.

2 Thus, although accrual accounting is theoretically superior to cash accounting in measuring a firm's periodic performance, the distortions it introduces can make accounting data less valuable to users. If these distortions are large enough, current cash flows may measure a firm's periodic performance better than accounting profits. The relative usefulness of cash flows and accounting profits in measuring performance therefore varies from firm to firm. For empirical evidence on this issue, see P. Dechow, "Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accounting Accruals," *Journal of Accounting and Economics* 18 (July 1994): 3–42; and A. Charitou, C. Clubb, and A. Andreou, "The Effect of Earnings Permanence, Growth and Firm Size on the Usefulness of Cash Flows and Earnings in Explaining Security Returns: Empirical Evidence for the UK," *Journal of Business Finance and Accounting* 28 (June/July 2001): 563–594.

3 For example, a recent study shows that accounting adjustments made by Moody's (credit) analysts help to explain stock prices and analysts' target prices and recommendations (G. De Franco, F. Wong, and Y. Zhou, "Accounting Adjustments and the Valuation of Financial Statement Note Information in 10-K Filings," *Accounting Review* 86 (2011): 1577–1604). Further, Abraham Briloff wrote a series of accounting analyses of public companies in *Barron's* over several years. On average, the share prices of the analyzed companies changed by about 8 percent on the day these articles were published, indicating the potential value of performing such analysis. For a more complete discussion of this evidence, see G. Foster, "Briloff and the Capital Market," *Journal of Accounting Research* 17 (Spring 1979): 262–274.

4 For a complete discussion of these motivations, see *Positive Accounting Theory,* by R. Watts and J. Zimmerman (Englewood Cliffs, NJ: Prentice-Hall, 1986). A summary of this research is provided by P. Healy and J. Wahlen, "A Review of the Earnings Management Literature and Its Implications for Standard Setting," *Accounting Horizons* 13 (December 1999): 365–383; and T. Fields, T. Lys, and L. Vincent in "Empirical Research on Accounting Choice," *Journal of Accounting and Economics* 31 (September 2001): 255–307.

5 The most convincing evidence supporting the covenant hypothesis is reported in a study of the accounting decisions by firms in financial distress: A. Sweeney, "Debt-Covenant Violations and Managers' Accounting Responses," *Journal of Accounting and Economics* 17 (May 1994): 281–308.

6 Studies that examine the bonus hypothesis generally report evidence supporting the view that managers' accounting decisions are influenced by compensation considerations. See, for example, P. Healy, "The Effect of Bonus Schemes on Accounting Decisions," *Journal of Accounting and Economics* 7 (April 1985): 85–107; R. Holthausen, D. Larcker, and R. Sloan, "Annual Bonus Schemes and the Manipulation of Earnings," *Journal of Accounting and Economics* 19 (February 1995): 29–74; and F. Guidry, A. Leone, and S. Rock, "Earnings-Based Bonus Plans and Earnings Management by Business Unit Managers," *Journal of Accounting and Economics* 26 (January 1999): 113–142.

7 For empirical evidence that CEOs of firms with scheduled awards make opportunistic voluntary disclosures to maximize stock award compensation, see D. Aboody and R. Kasznik, "CEO Stock Option Awards and the

Timing of Corporate Voluntary Disclosures," *Journal of Accounting and Economics* 29 (February 2000): 73–100.

8 L. DeAngelo, "Managerial Competition, Information Costs, and Corporate Governance: The Use of Accounting Performance Measures in Proxy Contests," *Journal of Accounting and Economics* 10 (January 1988): 3–36; and M. Erickson and S. Wang, "Earnings Management by Acquiring Firms in Stock for Stock Mergers," *Journal of Accounting and Economics* 27 (1999): 149–176.

9 The trade-off between taxes and financial reporting in the context of managers' accounting decisions is discussed in detail in *Taxes and Business Strategy* by M. Scholes and M. Wolfson (Englewood Cliffs, NJ: Prentice-Hall, 1992). Many empirical studies have examined firms' LIFO/FIFO choices.

10 Several researchers have documented that firms affected by such situations have a motivation to influence regulators' perceptions through accounting decisions. For example, J. Jones documents that firms seeking import protections make profit-decreasing accounting decisions in "Earnings Management during Import Relief Investigations," *Journal of Accounting Research* 29(2) (Autumn 1991): 193–228. Similarly, W. Beekes finds that UK water and electricity companies make profit-decreasing accounting choices in years of regulatory price reviews in "Earnings Management in Response to Regulatory Price Review. A Case Study of the Political Cost Hypothesis in the Water and Electricity Sectors in England and Wales," Working paper, Lancaster University, 2003. A number of studies find that banks that are close to minimum capital requirements overstate loan loss provisions, understate loan write-offs, and recognize abnormal realized gains on securities portfolios (see S. Moyer, "Capital Adequacy Ratio Regulations and Accounting Choices in Commercial Banks," *Journal of Accounting and Economics* 12 (1990): 123–154; M. Scholes, G.P. Wilson, and M. Wolfson, "Tax Planning, Regulatory Capital Planning, and Financial Reporting Strategy for Commercial Banks," *Review of Financial Studies* 3 (1990): 625–650; A. Beatty, S. Chamberlain, and J. Magliolo, "Managing Financial Reports of Commercial Banks: The Influence of Taxes, Regulatory Capital and Earnings," *Journal of Accounting Research* 33(2) (1995): 231–261; and J. Collins, D. Shackelford, and J. Wahlen, "Bank Differences in the Coordination of Regulatory Capital, Earnings and Taxes," *Journal of Accounting Research* 33(2) (Autumn 1995): 263–291. Finally, Petroni finds that financially weak property-casualty insurers that risk regulatory attention understate claim loss reserves: K. Petroni, "Optimistic Reporting in the Property Casualty Insurance Industry," *Journal of Accounting and Economics* 15 (December 1992): 485–508.

11 P. Healy and K. Palepu, "The Effect of Firms' Financial Disclosure Strategies on Stock Prices," *Accounting Horizons* 7 (March 1993): 1–11. For a summary of the empirical evidence, see P. Healy and J. Wahlen, "A Review of the Earnings Management Literature and Its Implications for Standard Setting," *Accounting Horizons* 13 (December 1999): 365–384.

12 In "Stakeholders' Implicit Claims and Accounting Method Choice," *Journal of Accounting and Economics* 20 (December 1995): 255–295, R. Bowen, L. DuCharme, and D. Shores argue that, based on theory and anecdotal evidence, managers choose long-run income-increasing accounting methods as a result of ongoing implicit claims between a firm and its customers, suppliers, employees, and short-term creditors.

13 Financial analysts pay close attention to managers' disclosure strategies; Standard and Poor's publishes scores that rate the disclosure of companies from around the world. For a discussion of these ratings, see, for example, T. Khanna, K. Palepu, and S. Srinivasan, "Disclosure Practices of Foreign Companies Interacting with US Markets," *Journal of Accounting Research* 42 (May 2004): 475–508.

14 See P. Healy and K. Palepu, "The Fall of Enron," *Journal of Economic Perspectives* 17(2) (Spring 2003): 3–26.

15 For detailed analyses of companies that made such changes, see R. Schattke and R. Vergoossen, "Barriers to Interpretation: A Case Study of Philips Electronics NV," *Accounting and Business Research* 27 (1996): 72–84, and K. Palepu, "Anatomy of an Accounting Change," in *Accounting and Management: Field Study Perspectives,* edited by W. Bruns, Jr. and R. Kaplan (Boston: Harvard Business School Press, 1987).

16 Examples of this type of behavior are documented by J. Hand in his study, "Did Firms Undertake Debt-Equity Swaps for an Accounting Paper Profit or True Financial Gain?" *The Accounting Review* 64 (October 1989): 587–623, and by E. Black, K. Sellers, and T. Manley in "Earnings Management Using Asset Sales: An International Study of Countries Allowing Noncurrent Asset Revaluation," *Journal of Business Finance and Accounting* 25 (November/December 1998): 1287–1317.

17 For an empirical analysis of inventory buildups, see V. Bernard and J. Noel, "Do Inventory Disclosures Predict Sales and Earnings?" *Journal of Accounting, Auditing, and Finance* (Fall 1991).

18 For research on accounting and economic incentives in the formation of R&D partnerships, see A. Beatty, P. Berger, and J. Magliolo, "Motives for Forming Research and Development Financing Organizations," *Journal of Accounting and Economics* 19 (April 1995): 411–442. An overview of Enron's use of special purpose entities to manage earnings and window-dress its balance is provided by P. Healy and K. Palepu, "The Fall of Enron," *Journal of Economic Perspectives* 17(2) (Spring 2003): 3–26.

19 For an empirical examination of asset write-offs, see J. Elliott and W. Shaw, "Write-offs as Accounting Procedures to Manage Perceptions," *Journal of Accounting Research* 26 (1988): 91–119.

20 R. Mendenhall and W. Nichols report evidence consistent with managers taking advantage of their discretion

to postpone reporting bad news until the year-end. See R. Mendenhall and W. Nichols, "Bad News and Differential Market Reactions to Announcements of Earlier-Quarter versus Fourth-Quarter Earnings," *Journal of Accounting Research,* Supplement (1988): 63–86.

21 K. Peasnell, P. Pope, and S. Young report evidence that independent outside directors prevent earnings management. See K. Peasnell, P. Pope, and S. Young, "Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?," *Journal of Business Finance and Accounting* 32 (September 2005): 1311–1346.

22 The role of insider transactions in the collapse of Enron are discussed by P. Healy and K. Palepu, "The Fall of Enron," *Journal of Economic Perspectives* 17(2) (Spring 2003): 3–26.

23 This type of analysis is presented in the context of provisions for bad debts by M. McNichols and P. Wilson in their study, "Evidence of Earnings Management from the Provisions for Bad Debts," *Journal of Accounting Research,* Supplement (1988): 1–31.

24 This point has been made by several accounting researchers. For a summary of research on earnings management, see K. Schipper, "Earnings Management," *Accounting Horizons* (December 1989): 91–102.

25 See H. Daske, L. Hail, C. Leuz, and R. Verdi, "Mandatory IFRS Standards Reporting around the World: Early Evidence on the Economic Consequences," *Journal of Accounting Research* 46 (2008): 1085–1142.

26 See J. Chang, "The Decline in Value Relevance of Earnings and Book Values," unpublished dissertation, Harvard University, 1998. Evidence is also reported by J. Francis and K. Schipper, "Have Financial Statements Lost Their Relevance?," *Journal of Accounting Research* 37(2) (Autumn 1999): 319–352; and W.E. Collins, E. Maydew, and I. Weiss, "Changes in the Value-Relevance of Earnings and Book Value over the Past Forty Years," *Journal of Accounting and Economics* 24 (1997): 39–67.

27 See G. Foster, "Briloff and the Capital Market," *Journal of Accounting Research* 17(1) (Spring 1979): 262–274.

28 See S. H. Teoh, I. Welch, and T. J. Wong, "Earnings Management and the Long-Run Market Performance of Initial Public Offerings," *Journal of Finance* 53 (December 1998a): 1935–1974; S.H. Teoh, I. Welch and T.J. Wong, "Earnings Management and the Post-Issue Underperformance of Seasoned Equity Offerings," *Journal of Financial Economics* 50 (October 1998): 63–99; and S. Teoh, T. Wong, and G. Rao, "Are Accruals During Initial Public Offerings Opportunistic?," *Review of Accounting Studies* 3(1–2) (1998): 175–208.

29 See P. Dechow, R. Sloan, and A. Sweeney, "Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC," *Contemporary Accounting Research* 13(1) (1996): 1–36; and M.D. Beneish, "Detecting GAAP Violation: Implications for Assessing Earnings Management among Firms with Extreme Financial Performance," *Journal of Accounting and Public Policy* 16 (1997): 271–309.