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Earnings Management Choice: An Empirical Study on the Impact of Earnings Management on Stock Returns

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Abstract: Accounting inevitably involves making choices- tradeoffs, decisions between available alternatives. This study focuses on an accounting choice, specifically earnings management strategies along with their corresponding economic consequences. Prior studies have already provided evidence that firms make choices between two earnings management strategies- accounting-based and real activities-based and these strategies are being used as substitutes depending upon the relative costs involved. The focus of this study rests on *how does a particular earnings management strategy choice (e.g accounting-based, real activities-based, or both) affect capital market incentives for firms*. In order to fully explain or capture the 'true' economic consequence of earnings management, it should not be dealt in isolation- considering only one strategy at a time, when in fact both can be used simultaneously. Second, the increasing use of accounting information by investors and financial analysts to aid in valuing stocks creates an incentive for managers to manipulate earnings to influence stock performance. It is therefore interesting how capital markets respond to evidences of earnings management. The results of the study suggest that earnings management does not significantly affect short-term stock returns. It appears that incentives around earnings management are already well understood by market participants and thus, do not respond to evidences of earnings management. Furthermore, it appears that investors are able to "see through" financial information and thus, are able to manage their expectations in the presence of earnings management.

Key words: earnings management; accruals; accounting choice; stock returns

1. INTRODUCTION

1.1 Background of the Study

Earnings management has been broadly classified in the literature either as accounting-based or real activities-based. Accounting-based earnings management (AEM) focuses on pure accounting choice where managers exercise discretion and judgment to alter financial reports. On the contrary, real-activities based earnings management (REM) focuses on management actions deviating from normal business practices, where transactions and activities are structured to meet desired outcomes or thresholds (Roychowdhury 2006).

Accounting inevitably involves making choices- tradeoffs, decisions between available alternatives. This study focuses on an accounting choice, specifically earnings management strategies along with their corresponding economic consequences. Prior studies have already provided evidence that firms make choices between two earnings management strategies- accounting-based and real activities-based (Cohen et al, 2008; Cohen et al, 2010) and these strategies are being used as substitutes depending upon the relative costs involved (Zang, 2012).

The focus of this study rests on *how does a particular earnings management strategy choice (e.g accounting-based, real activities-based, or both) affect capital market incentives for firms*. The question is of importance for two reasons. First, in order to fully explain or capture the 'true' economic consequence of earnings management, it should not be dealt in isolation- considering only one strategy at a time, when in fact both can be used simultaneously. Second, the increasing use of accounting information by investors and financial analysts to aid in valuing stocks creates an incentive for managers to manipulate earnings to

influence stock performance. It is therefore interesting how capital markets respond to evidences of earnings management.

1.2 Literature Review

Earnings management (EM), as defined by Healy & Wahlen (1999) involves management's use of judgment through financial reporting and structuring transactions to conceal the true economic performance of an entity. Earnings management motives are broadly classified as either opportunistic- which exemplifies the classic agency problem; or signaling- which signals private information to capital markets (Beaver, 2002). Though managerial intent behind earnings management is difficult to detect, a vast majority of earnings management literature focuses on the opportunistic motive of managers to engage in earnings management.

Table 1- Earnings Management Motivations

Motivation	Authors	Context	Years	Country
External Financing	DuCharme et. al,(2001)	Stock Financing and IPO	1988-1987 1993-2000	US China
	Fung et. al (2008)	Stock Financing- SEOs	1981-1998	US
	Chou et al (2009)	Bond Issuance	2000-2002	US
	Marquardt (2004)	Bond Issuance		
Regulation	Li (2011)	Capital Market Regulation	1988-2002	China
	Christensen et al (1999)	Industry Regulation	1989-1992 1993-2000	US China
	Fung et. al (2008)	Regulatory Thresholds		
Firms' Opportunism	Coles et al (2006)	Stock Options	1999-2000	US
	Hribar, et al (2006)	Stock Repurchase	1988-2001	US
	Koerniadi (2008)	Stock Dividends	1989-2003	New Zealand
Individual Opportunism	Bartov & Mohanram (2004)	Stock Option	1993-2001	US
	Beneish & Vargus (2002)	Insider Trading	1985-1996	US

There exists a wide array of motivations to push managers towards earnings management as shown in Table 1. Managers engage in earnings management to increase proceeds from external financing either thru stocks (DuCharme, Malatesta, & Sefcik, 2001;Fung, Leung, & Zhu, 2008) or bonds (Chou, Wang, Tsai, & Chien, 2009; Marquardt & Wiedman, 2004). Regulation also provides for an incentive to engage in earnings management, with a primary goal of meeting regulatory thresholds or earnings benchmarks (Li, 2011; Christensen, Hoyt, & Paterson, 1999). Firms' opportunism also motivates earnings management. EM allows firms to avoid compensation charges (Coles, Hertzel and Kalpathy 2006); avoid earnings per share dilution (Hirbar, Jenkins and Johnson 2006) and avoid cash dividend payments (Koerniadi and Tourani-rad 2008). From an individual perspective, income-increasing EM increases manager's wealth (Beneish & Vargus, 2002; Bartov & Mohanram, 2004).

Authors	Dependent Variable	Independent Variable	Reaction
DuCharme et. al (2001)	Firm Value at IPO Date	Discretionary Accruals	Positive
Kimbro (2005)	Market Adjusted Abnormal Return	Discretionary Accruals	Positive
Beneish & Vargus (2002)	12-month size adj returns	Discretionary Accruals	Positive
Baber, et. al (2006)	3-Day Cum. Returns	Discretionary Accruals	Negative
Balsam, et. al (2002)	17-Day Window CAR	Discretionary Accruals	Negative
Haw, et. al (2005)	Market Adj Abnormal Ret	Discretionary Accruals	Negative
Ching, et. al (2006)	Calendar Month Return	Discretionary Accruals	No response
Coles, et. al (2006)	5-Day Window Abnormal Return	Discretionary Accruals	No response
He, et. al (2010)	3-year BHAR	Discretionary Accruals	Negative
He, et. al (2011)	3-year BHAR	Discretionary Accruals	Negative
Chou, et. al (2010)	3-year BHAR	Discretionary Current Accruals	No response

Table 2. Summary of Investors' Reaction to Earnings Management

Given the presence of increasing capital market incentives to engage in earnings management, existing literature has examined associations between security returns and measures of discretionary accruals both in the short and long window respectively. In the short-run, conflicting evidence was observed as to how capital markets respond to discretionary accruals. DuCharme, Malatesta, & Sefcik (2001) and Kimbro (2005) reported a positive relationship between firm value at IPO date and discretionary accruals, in support of the value relevance hypothesis wherein an increase in income due to earnings management increases initial firm value. In the short-run, income-increasing accruals are mispriced by investors due to their perception that income-increasing accruals are of high quality, leading to positive market reactions on earnings management (Beneish and Vargus 2002). Accrual components, which are less substantive in nature, tend to deceive investors in the short-run (Baber, Chen and Kang 2006).

On the contrary, Balsam, Bartov, & Marquardt (2002) emphasized a negative stock price reaction to earnings management because investors re-assess reported figures using other financial information and the re-assessment lead to a substantial change in stock prices. Furthermore, further studies revealed that market participants are aware of the incentives to manage reported earnings and they adjust for earnings management when provided with the necessary information to do so (Baber, Chen and Kang 2006). It is as if, investors are able to "see through" the quality of managed earnings and thus, adjust their investment decisions (Haw, et al. 2005). Furthermore, this is supported by the disappointment hypothesis. On the other hand, other studies revealed that the stock market does not respond to evidences of earnings manipulation. The stock market is not fooled by the use of discretionary accruals to manage earnings (Ching, Firth and Rui 2006). Varying market reactions to accruals earnings management in the short-run is often associated with investor sophistication, which is an assumption under the efficient markets hypothesis. However, investor sophistication seems to be a questionable assumption because it varies as to how investors recognize earnings management and respond to it (Balsam, Bartov and Marquardt 2002).

In terms of long-run market response to earnings management, the literature also provides for mixed evidence. Firms conducting earnings management through the use of income-increasing accruals experience reversals of these accruals in subsequent years leading to investor disappointment, which is eventually reflected through lower stock returns (DuCharme, et. al, 2001, He, et al 2010, He, et al 2011). On the contrary, Ching et al (2006) asserted that earnings management is priced at a specific event date such as seasoned equity offerings and thus, subsequent stock returns in the long run are no longer affected. In addition to that, in the long-run, in the absence of a major event for the firm, there is little incentive and opportunity to engage in earnings management (Chou, et al. 2009). Conflicting results obtained by the abovementioned studies both in the short and long run posts for further investigation. However, a major limitation of EM research is measurement of EM itself. Existing techniques to measure EM lack power and are often misspecified due to the poor ability of the models to fully isolate discretionary accruals. Furthermore, the applicability of EM measurement techniques varies across different circumstances and conditions, which some of the researchers failed to consider.

Apart from using accounting measures to manipulate earnings, managers also resort to real activities or transactions. In a survey conducted by Graham (2005), evidence was documented revealing that CEOs engage in real activities manipulation to deliver earnings. This is further supported by evidence indicating that managers manipulate sales, overproduce inventory and reduce discretionary expenses to avoid incurring losses or missing analyst forecasts (Roychowdhury 2006). In addition, firms also manipulate research and development expenditures (Monde et, al, 2000; Bens et. al, 2003; Pozza et al, 2007) and income from asset disposals (Bartov, 2003) to smooth reported earnings or avoid earnings per share dilution.

In terms of market reaction to real activities manipulation, firms engaging in real activities manipulation to meet earnings forecasts experience better operating performance than those firms not engaging in real activities manipulation and missed earnings forecasts (Gunny 2010). On the contrary, real activities manipulation has only short-lived benefits. Firms that engaged in real activities manipulation experience worse operating and stock market performance in the long-run, implying long-term negative consequences of real activities manipulation (Bhojraj et. al, 2009).

Most earnings management research only focuses their analysis on earnings management tool at a time. However, given the fact that earnings management is a strategy, managers most probably use multiple earnings management techniques at a time. Thus, in order to fully explain the economic consequences of earnings management, it should not be dealt in isolation using a single strategy to manipulate earnings (Fields, Lyz and Vincent 2001). Using the passage of SOX as a major event, Cohen et, al (2008) documented that managers shifted from using accruals to real-activities based earnings management in one period to reduce the probability of regulatory scrutiny. Evidence from Zang (2012) also indicated that there is a tradeoff involved in the choice of either accounting-based or real activities-based earnings management depending upon the relative costs involved-accounting practice scrutiny, firm characteristics, financial performance, and both strategies are used as substitutes

Examining a specific earnings management strategy at a time- either accounting based or real activities based, does not lead to definitive conclusions. In order to draw a more accurate picture of earnings management, both ways should be examined, specifically with how managers' trade-off these activities, in order to explain the economic implications of their accounting choice.

1.3 Hypotheses Development

Investors tend to misprice discretionary accruals as they perceive such to be of high quality (Beneish and Vargus 2002). Accruals are also less substantive in nature and thus tend to deceive investors in the short-run (Baber, Chen and Kang 2006). In terms of real activities manipulation, stock prices fail to reflect the implications of earnings management in the short-run (Gunny, 2010). Thus, two hypotheses formulated are as follows:

H1: Discretionary accruals significantly affect short-term stock returns

H2: Real activities manipulation significantly affects short-term stock returns

In the short-run, firms engage in earnings management techniques to improve performance measures, to convey a better picture of the firm to its stakeholders, thus in the presence of earnings management strategies, it is hypothesized that:

H3: Both discretionary accruals and real activities manipulation significantly affect short-term stock returns

2. METHODOLOGY

The study focuses on publicly listed firms in the Philippine Stock Exchange (PSE) as of December 31, 2013. The study covers a five-year period from 2009-2013, across four industries listed in PSE. Both Financial and Holding sectors were excluded due to the unique nature of their business operations and regulatory environment. Furthermore, firms should have been listed from 2009-2013 in order to be part of the sample.

Table 3- Sample Composition

Sample Composition	
Industrial Sector	48
Property Sector	32
Services Sector	36
Mining Sector	22
Total Sample Size (firms)	**138**

Discretionary accruals was used as a proxy for accounting-based earnings management. Discretionary accruals was measured as the difference between the firm's actual accruals and normal accruals. The CS Jones Model (1991), as used by Zang (2012) is adopted to estimate the level of normal accruals as follows:

$$\frac{Accruals_t}{A_{t-1}} = b_0 + b_1\left(\frac{1}{A_{t-1}}\right) + b_2\left(\frac{\Delta S_t}{A_{t-1}}\right) + b_3\left(\frac{PPE_t}{A_{t-1}}\right) + e_t \qquad \text{(Eq. 1)}$$

where:

Accruals = total accruals for year (t) omputed as the difference between net income from continuing operations and net cash flows from operating activities in year t (See Collins and Hribar, 1999);

A_{t-1} = the total assets in year (t-1)

ΔS_t = the change in net sales from year t-1 to t

PPE_t = gross property, plant and equipment at year t.

The above regression is estimated for each industry and year to reflect the economic conditions for each industry in a given year. The estimated residuals will be the proxies for accounting-based earnings management, AEM.

Following Roychowdhury (2006), real activities based manipulation will be measured through discretionary expenditures such as

research and development (R&D), advertising and selling, general and administrative (SG&A). A normal level of discretionary expenditures will first be estimated as follows

$$\frac{DISX_t}{A_{t-1}} = b_0 + b_1(\frac{1}{A_{t-1}}) + b_2(\frac{S_{t-1}}{A_{t-1}}) + e_t \quad \text{(Eq. 2)}$$

where:
$DISX_t$ = the sum of R&D, advertising and SG&A in year t;
A_{t-1} = the total assets in year t-1;
S_{t-1}=the net sales reported in year t.

The above regression is estimated for each industry and year. The estimated residuals will be the proxies for real activities-based earnings management, REM.

To test how capital markets react on the presence earnings management, the following equations are used:

$$ASR_{it} = b_0 + b_1 AEM_{it} + b_2 ROA_{it-1} + b_3 MtoB_{it-1} + b_4 \ln TA_{it-1} + b_5 IND + e_{it} \quad \text{(Eq. 3)}$$

$$ASR_{it} = b_0 + b_1 (AEM + REM)_{it} + b_2 ROA_{it-1} + b_3 MtoB_{it-1} + b_4 \ln TA_{it-1} + b_5 IND + e_{it} \quad \text{(Eq. 4)}$$

$$ASR_{it} = b_0 + b_1 (AEM + REM)_{it} + b_2 ROA_{it-1} + b_3 MtoB_{it-1} + b_4 \ln TA_{it-1} + b_5 IND + e_{it} \quad \text{(Eq. 5)}$$

where:
ASR = the firm's annual stock return, measured as the annual change in stock prices
AEM = accruals-based earnings management proxied by the residuals from equation 1
REM = the real activities-based earnings management proxied by the residuals from equation 2
ROA = return on assets which is used as a control for firm performance
MtoB = market to book ratio to control for growth rate
lnTA = natural log of total assets to control for firm size.
IND = industry in which the sample firm comes from.

Equation 3 addresses how stock the market responds to evidence of accounting based earnings management while equation 4 captures the stock market's response to evidences of real activities based earnings management. Most importantly, equation 5 captures how the stock market responds to evidences of both real and accounting-based earnings manipulation. A panel regression was used for equations 3-5 to see the effects of time and firm-specific differences in the sample size.

3. RESULTS AND DISCUSSION

Table 4- Descriptive Statistics

	n	Mean	StDev	Min	Max
ASR	634	0,29534	1.31000	-15.49374	18.50000
AEM	669	-0.00328	0.13697	-0.73357	0.86504
REM	636	0.00218	0.14604	-0.24989	3.07375
AEM+REM	623	0.00056	0.20333	-0.78623	3.14583
lnTA	687	14.85428	2.00302	9.19898	20.00000
ROA	684	0.04342	0.13848	-0.83860	0.60330
MtoB	642	2.87629	9.81264	-6.41000	154.67000

3.1 DISCRETIONARY ACCRUALS AND ANNUAL SOTCK RETURNS

A panel regression was conducted to ascertain whether discretionary accruals affect stock returns in the short run. Based upon the results of the procedures performed, the naïve model was chosen as the best model for the analysis. The said model is also free from herteroskedasticity, multicollinearity and autocorrelation. The results were displayed as follows:

Table 5- Naïve Model- Regression of Annual Stock Returns on Accounting-Based EM

	Industrial	Service	Property	Mining
Constant	-0.06094	-0.00854	-0.03829	-0.05969
	(0.43556)	(0.43732)	(0.43588)	(0.44843)
AEM	-0.45996	-0.45482	-0.44856	-0.45682
	(0.42119)	(0.42069)	(0.42102)	(0.42110)
lnTA	0.02205	0.02149	0.01955	0.02268
	(0.02911)	(0.02906)	(0.02931)	(0.02959)
ROA	0.53949	0.56775	0.57709	0.54702
	(0.42554)	(0.42490)	(0.42645)	(0.42499)
MtoB	-0.00579	-0.00544	-0.00552	-0.00587
	(0.00592)	(0.00592)	(0.00593)	(0.00592)
IND	0. 03419	-0.13143	0.09854	0.00338
	(0.11411)	(0.12138)	(0.12674)	(0.15013)
R^2	9.72%	11.78%	9.34%	8.35%

*This table displays the coefficients estimated under a naïve model, with the standard errors enclosed in a parentheses. *,**,***- denotes significance at 10%, 5% and 1% confidence levels.*

The results of this section reveal that discretionary accruals, as measured using the Jones Model, *do not significantly affect annual stock returns*. It further implies that discretionary accruals have very little explanatory power in explaining short-term stock returns. This result is contrary with the findings of Baber et al (2006) and Balsam (2002) who both found out that in the short-run, discretionary accruals significantly affect stock returns.

The results obtained have the following implications. First, there is a lack of response from the market given evidences of abnormal levels of discretionary accruals. The level of discretionary accruals during the periods covered is more of a result of changes in business operations and working capital, rather than intentional earnings manipulation to affect return on securities or mislead investors. Second, the study is conducted in the absence of any specific event (e.g IPO, SEOs,) that can be a strong motivation with transparent incentives to engage in earnings management. It can be inferred that, in the presence of limited opportunity or incentives to use accruals to manage earnings, accruals-based EM is not aggressively utilized and thus, its impact is not reflected (Chou, 2010).

Third, managerial incentives for accruals earnings management would vary from year to year. Managers do not solely focus on capital market incentives that could drive engaging in accruals earnings management because other motivations are present, such as changes in compensations structures and contractual motivations such as debt covenant violations, thus it is possible that aside from capital market incentives, there are other more pressing motivations that firms consider. Lastly, the fact that there can be a measurement error in isolating discretionary accruals using the Modified Jones Model is also considered. The model can suffer from considerable imprecision, that is a limitation faced by researchers adopting the model (Guay, et al, 1998).

3.2 REAL ACTIVITIES MANIPULATION AND ANNUAL SOTCK RETURNS

Aside from discretionary accruals, earnings management may also be facilitated through the use of real activities. In this study, discretionary expenses (advertising, selling, general and administrative and research and development) were used to proxy for real activities manipulation and how the market reacts in the presence of such manipulation. A panel regression was also conducted, and the tests revealed that the naive model is best suited for the analysis.

Table 6-- Naïve Model- Regression of Annual Stock Returns on Real Activities-Based EM)

	Industrial	Service	Property	Mining
Constant	-0.17199	-0.10649	-0.11522	-0.19672
	(0.46545)	(0.46783)	(0.46561)	(0.47577)
REM	-0.86839	-0.92218	-0.85410	-0.84514
	(0.69859)	(0.69798)	(0.69567)	(0.69594)
lnTA	0.02996	0.02883	0.02829	0.03197
	(0.03099)	(0.03095)	(0.03117)	(0.03136)
ROA	0.34158	0.37139	0.37292	0.35418
	(0.41840)	(0.41744)	(0.41915)	(0.41771)
MtoB	-0.00588	-0.00559	-0.00569	-0.00610
	(0.00571)	(0.00571)	(0.00572)	(0.00572)
IND	0. 03646	-0.14704	0.07860	0.04639
	(0.11940)	(0.12879)	(0.13275)	(0.15925)
R^2	8.21%	11.00%	8.65%	7.70%

*This table displays the coefficients estimated under a naïve model, with the standard errors enclosed in a parentheses. *,**,***- denotes significance at 10%, 5% and 1% confidence levels.*

The findings for this section show that real activities manipulation through cutting down discretionary expenses does not significantly affect the firms' annual stock returns. However, it is to be noted that the effect of real activities manipulation on cumulative stock returns is negative. As firms would increase their reduction in these discretionary expenses, it will lead to a reduction in their returns. This is in contrast with the findings of Gunny (2010) whose results lead to concluding that real activities earnings management affect short-term operating performance. However, it is to be noted that the above study focused on the consequences of real activities management in relation to results of operations and not in terms of capital market reactions.

The said findings have the following implications: First, there exists an inherent difficulty faced by external parties from the firm, in terms of their ability to distinguish operating decisions which are opportunistic in nature with

those which were made in good faith. The definition used as discretionary expenses includes necessary expenses incurred by the firm. For instance, Selling, General & Administrative expenses are considered discretionary. However, to a certain extent, portions of SG&A Expenses are necessary business expenses that are to be incurred in the revenue generating process. There exists a thin line that could separate legitimate cutting down of discretionary expenditures from intentionally reducing them to manipulate earnings and influence security returns for the firm.

Second, essential to real activities manipulation is each firm's unique business model in terms of its activities and environment, which hinders a timely understanding of its financial information (Francis & Hassan, 2012). For instance the level of discretionary expenditures could vary across firms due to differing degrees of innovations, and variations in discretionary expenditures could not solely be attributed to an opportunistic motivation to influence earnings but could also be driven by firm-specific or industry-specific circumstances that uniquely exists for such firm or industry. Third, the lack of a significant impact of discretionary expenditures on stock prices could be attributable to the little value or importance placed by market participants on information about discretionary expenditures alone. Lastly, there are other ways in which real activities manipulation could have been facilitated such as overproduction of inventories to reduce cost of goods sold or excessive granting of discounts to increase sales, which were not explored in this study.

3.3 DISCRETIONARY ACCRUALS AND REAL ACTIVITIES MANIPULATION ON ANNUAL SOTCK RETURNS

After considering the individual impact of accruals-based and real activities-based earnings management on stock returns, the last part of this paper considers both strategies used simultaneously to capture the true economic consequence of earnings management. Following Zang (2012), we first examine the correlation between both earnings management strategy. The results of the Pearson correlation suggest a positive correlation between AEM and REM, significant at a 5% confidence level. This further implies that, both earnings management strategies act as complements that are being used simultaneously by firms. Firms face different costs and constraints for both earnings management strategies that lead to their differing abilities to use both strategies (Zang, 2012). Aside from that, there is also a timing difference in using both strategies wherein real activities manipulation are realized within a fiscal year, while accruals-based earnings management can be adjusted at the end of the year. Managers can adjust their level of accruals-based earnings management depending upon the outcome of their real activities earnings management.

Table 7- Naïve Model- Regression of Annual Stock Returns on Accounting-Based and Real Activities-Based EM

	Industrial	Service	Property	Mining
Constant	-0.09392	-0.03699	-0.07866	-0.11838
	(0.46916)	(0.47173)	(0.46926)	(0.47979)
REM+AEM	-0.59949	-0.60450	-0.59056	-0.59309
	(0.37266)	(0.37175)	(0.37193)	(0.37208)
lnTA	0.02431	0.02310	0.02224	0.02597
	(0.03126)	(0.03122)	(0.03142)	(0.03163)
ROA	0.55961	0.58324	0.59017	0.56668
	(0.44165)	(0.44088)	(0.42264)	(0.44094)
MtoB	-0.00567	-0.00530	-0.00541	-0.00582
	(0.00609)	(0.00609)	(0.00610)	(0.00610)
IND	0. 02010	-0.12998	0.08458	0.04316
	(0.12054)	(0.12992)	(0.13420)	(0.16370)
R^2	8.50%	11.43%	8.98%	8.78%

*This table displays the coefficients estimated under a naive regression, with the standard errors enclosed in a parentheses. *,**,***- denotes significance at 10%, 5% and 1% confidence levels*

The results of the panel regression, with the naïve model as the chosen model for the analysis, reveal that when combined together, both real activities manipulation through discretionary expenditures and accruals based earnings management, negatively but insignificantly affect annual stock returns. This implies that firms do not necessarily engage in such activities with a motivation to directly influence its stock returns. It appears that both measures are more of operations-related that can influence the firm's operating performance rather than its stock prices. Furthermore, it can be inferred that information conveyed by discretionary accruals and reductions in discretionary expenditures are less useful for market participants in assessing the value of a firm's securities.

In addition, the lack of security returns' response to both evidences of earnings management implies investors' lack of concern towards earnings management or the lack of a facility to distinguish and understand earnings management (Baber, 2006). It appears that stock market participants encounter a considerable difficulty towards disentangling earnings management and its consequences leading to a somehow indifferent reaction given possible evidences of earnings management. Aside from such, the case of the Philippine stock market should also be considered. In a developing country, financial systems are not well established. The presence of frequent economic and political instabilities hinders the stock market to be continuously efficient (Ozdemir, 2008). Moreover, there exists an information asymmetry, which becomes a major source of market inefficiency due to low quality financial disclosures provided to capital market participants.

4. CONCLUSIONS

This study attempts to provide evidence as to how earnings management affect annual stock returns of publicly listed companies in the Philippines using financial data from year 2009-2013. Earnings management was dealt through accounting-based EM, as proxied by discretionary accruals, and real activities EM, as proxied by reductions in discretionary expenses. This study also attempted to take a further step in analyzing how the combined effect of both EM strategies is reflected through stock returns.

The results reveal that earnings management in the form of accruals or real activities, or a combination of both does not significantly affect the firms' stock returns in the short-run. However, results revealed that both earnings management strategies discussed above are being used by firms. First, we contextualize the results within the Philippines- an emerging economy in its region. It appears that capital market incentives do not serve as a strong motivation for firms to engage in earnings management. In a country like the Philippines, it would be relevant to consider other motivations that encourage earnings management strategies. Furthermore, it should be considered how motivations of firms vary across time periods that could explain the lack of capital market reaction towards earnings management.

The results of this study posts for further questions on earnings management research in the Philippines. First, it would be interesting to explore other real activities earnings management- aside from cutting discretionary expenditures. Second, the economic consequences of using both strategies calls for further research, perhaps, in terms of developing a model that will accurately capture the combined effect of both strategies. Lastly, other motivations that drive earnings management can be considered for they may be of more significance and relevance as compared to capital market incentives alone.

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