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Unusual Patterns in Reported Earnings: Additional Evidence

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Using Benford's law, this study extends Thomas (1989) and documents pervasive evidence that managers of U.S. firms tend to engage in earnings manipulative activities of rounding earnings numbers to achieve key reference points. Similar to Thomas (1989), we find that the first digit of earnings numbers is often emphasized by the management. We also find that key reference points are not limited to the first digit. The second, third, or even fourth digits are sometimes used as the reference points of the rounding earnings behavior. Finally, our results show that the incentives of rounding earnings numbers are negatively associated with the distance of pre-rounded earnings to the next reference point. The findings of the study have significant implications to external auditors and the audit committees of the firms.

INTRODUCTION

In his speech delivered to New York University in 1998, Arthur Levitt, former Chairman of the SEC, warned that earnings management by corporate America is eroding the quality of the financial reporting process. Since earnings have been regarded as the most important item in the financial reports to investors, analysts, boards, and senior executives, standard setters are very concerned with how earnings numbers are derived (Burgstahler and Dichev 1997; Beaver 1998). Following the debacle of Enron and WorldCom, earnings management has attracted unprecedented attention by regulators, accounting academics, and the investment community at large. The passage of Sarbanes-Oxley Act in 2002 is one significant step toward aiming at enhancing the quality of the earnings numbers. Meanwhile, it is imperative that more evidence be documented regarding the pervasiveness of earnings management.

One stream of research examines the distribution of reported earnings and hypothesizes that managers have incentives to round up reported earnings when the pre-rounded earnings are