

The Effect of Real Earnings Management on the Information Content of Earnings

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ABSTRACT

In this study I investigate the effect of real earnings management (REM) on the earnings information content of stock returns. Prior research has established that accounting-based earnings have information content for stock valuation purposes and that managers use accruals management to influence reported earnings and thus affect the information content of those earnings. Little, however, is known about whether REM harms or enhances the information content of earnings and investors' ability to use those earnings for stock valuation purposes. Using a broad cross-section of firms, I identify those with high levels of two common types of REM, abnormal production costs and abnormal discretionary expenses. I find evidence that the information content of earnings is significantly lower for firms which engage in REM. This study contributes to the ongoing streams of literature related to the consequences of REM and how earnings information is impounded in stock prices.