Abstract

We propose and empirically test a new hypothesis that managers rationally choose between specific channels of earnings management to meet earnings benchmarks. Prior research documents that managers are ready to interfere with the neutrality of financial reporting process to report earnings above zero, earnings above last year's earnings, and earnings above analysts' forecast. However, there is a controversy over whether this earnings management to meet or beat earnings benchmarks is intended to distort investors' view by delaying the disclosure of bad news or whether it is intended to communicate managers' private information about the firm's strong future performance. We argue that the credibility of the earnings management signal crucially depends on the cost of its imitation. As revenue management is more costly to imitate than cost management, we argue that managers who intend to send a credible signal about their firm's future performance likely boost revenues rather than depress costs. To test this prediction, we use a recently developed model of discretionary revenues that is arguably more powerful in detecting earnings management than traditional techniques. The empirical results are consistent with our predictions for the most important earnings benchmark – the consensus of analysts' earnings forecasts – and they are weaker for the less prominent earnings benchmarks. We provide some evidence on the use of revenue management to meet or beat last year's earnings, and no evidence on the use of revenue management around the zero earnings threshold. Taken together, our results contribute to the information economics and financial accounting literatures by documenting managers' rational choice between earnings management channels around the most important earnings benchmark, which implies that inflated earnings in those settings communicate managers' private information rather than obfuscate the firm's current performance.

JEL Classification	G32, C58, M41
Keywords	Earnings Benchmarks, Earnings management, Discretionary Revenues

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