

## **A Paper on Earning Quality Analysis in Product and Service based Industries of Andhra Pradesh**

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### **1. ABSTRACT**

When any investor goes for investment he sacrifices his present benefits for the sake of future profits. Any investment made is to earn profits by accepting some sort of risk. In the wake of present Scenario of highly publicized financial frauds and failures and accounting manipulations, the emphasis on earnings quality has renewed. That's why investors and creditors from all over the world are turning toward the assessment of the earnings quality of the individual company in which they are trying to invest their investment. A proper quality of earnings analysis encompasses a variety of elements. In order for an earnings measure to be considered of high quality it must reflect cash flow and it must be sustainable. Earnings quality is used in numerous empirical studies to show trends over time; to evaluate changes in financial accounting standards and in other institutions, such as enforcement and corporate governance; to compare financial reporting systems in different countries; and to study the effect of earnings quality on the cost of capital. This heightened attention to the subject of earnings quality had created the need for the study. The secondary data was analyzed using the statistical technique and the obtained results were presented in the form of graphs and tables. Through present study on quality earnings, it was found that various earnings quality proxy's which represent the quality of earnings position in the organization. The quality earnings from a company to company vary according to the parameters they depend on. In the study the quality earnings often are high in personal care industry and leather industry. The results of present investigation show that intellectual capital has positive impact on earnings quality, because relationship between VAIC values and DA is linear and inversely proportional and its lead to conclude that intellectual capital has a positive role in best financial practices and reporting.

**Key Words:** - Calculation of intellectual capital , Human Capital Coefficient , Structural Capital Coefficient ,Capital Employed Efficiency ,

### **Introduction**

In present business Scenarios often the organizations publicize the financial accounting statement and the financial reports for the purpose of the making the information available to all the people that are interested in the organizations financial condition. Also these reports are used by the investors, creditor, share holders etc., so the organizations try to manipulate these accounting reports and financial statements to show artificial profits to them. Because

of these manipulations in the financial statements it increases its earnings that will in turn increase their share price and hides the firm's true conditions.

Earnings quality is one of the most important characteristics of financial reporting systems. High quality is said to improve capital market efficiency, therefore investors and other users should be interested in high-quality financial accounting information. For that reason, standard setters strive to develop accounting standards that improve earnings quality, and many recent changes in auditing, corporate governance, and enforcement have a similar objective.

There are many way through which the organizations are manipulating the financial statements, they use certain approaches that help a firm to hide the true conditions. The investors need to assess the extent to which a firm's reported earnings are free from mistake or manipulation, so they should have an idea about the possible approaches and ways the firms use to lower its earning quality and increase their speculative profits. They are,

- Recording revenue too soon or of questionable quality,
- Recording fictitious revenue,
- Boosting income with one-time gains,
- Shifting current expense to a different period,
- Failing to record or improperly reducing liabilities,
- Shifting current revenue to a later period, and
- Shifting future expenses to the current period as a special charge.

The need for the earning quality method arose out of the increasing complexity of business transactions and a desire for more accurate financial information. First, we need to define what we mean when we say "quality", as earnings quality means different things to different users of financial statements. For example, regulators would view earnings quality as being high if the accounting had adhere to generally accepted accounting principles (GAAP), as GAAP is used by regulators to help ensure high quality in financial statements. Those businesses that generate revenue but not cash are not engaging in profitable activities. When you invest, make sure your company is taking its earnings to the bank. The earning quality is said to be low when the abnormal earnings are very high. Earning quality and abnormal usually has the inverse proportional relationship between them.

Due to the relationship between the accruals and earning quality, which is inverse we can see that high accruals smell of earning manipulations in the firm's earnings. When there are manipulations in earnings of the organization there will be high accrual and abnormal earnings existence. The earning quality will be low and investors call take necessary hedging actions to protect their investment against the risk posed by the firm's financial condition. Accruals may serve as leading indicators of changes in firm's prospects without any manipulation by firm's representative.

The main objective of financial reporting is to provide information about impact of economic events and financial operations on firm's status and performance for user's decision making. Financial analysts, corporate executives, investors and individuals who participate in capital market for their financial and investment decisions attract most of their attention to net profit figure. In the present situations, public confidence in financial reporting was faced with

problems because of undermine its credibility. Increased number of fraud that was accompanied with the bankruptcy of large companies created concerns about the health of earnings quality. In recent years, following the bankruptcy of some large companies in the world, researchers and financial analysts, in addition are considering the earnings quantity, note earnings quality also. Earnings quality is an important aspect of evaluating a firm's financial health, yet investors, creditors and other financial statement users often overlook it. Earnings quality refers to the ability of reported earnings to reflect the company's true earnings. Earnings quality also refers to the stability, persistence and lack of variability in reported earnings. In view of above facts, an attempt has been made to study earning quality of various firms with various approaches, relationship of earning quality with other determinates of earning quality in order to provide complete and true information on earnings of firms to common investors, policy makers, financial institutions and administrators of Governments.

### **2.1 NEED OF THE STUDY: -**

In order to understand a company financial report genuinely, you need to understand the accounting concepts that are used to justify the accounting rules. Basically, these accounting concepts provide rule makers with guidance that will result in financial reports the best help investors, creditors and other financial report user's asses.

- Cash-flow amounts
- Timing of cash flow
- Certainty of cash flow
- Claims on the resources the company uses to produce cash flow (For more insight, they see how Some Companies Abuse Cash Flow.)

High boost up in earnings shows abnormal earnings; these are useful selling of shares, fixed assets and creating artificial profits. This information will create popularity on firm's shares in minds of investors. If investors invest their money on this basis, they will face a huge loss in near long future. So the study of the earnings quality is for the purpose of protecting the investors and any user of the financial reports for their well being. Investors overlook factors outside the financial reporting system that quantify their profits or losses most of the time without even their acknowledgement, by the study of earning quality of the firm we can throne a light on all the other factors that can affect earnings quality and organizations true earnings, by which the investors, creditors, share holders and others depend on the firm's financial well being get benefited.

### **3. OBJECTIVES OF THE STUDY: -**

- 1.To estimate earning quality of selected industries,
2. To develop between intellectual capital and earning quality,
3. To establish relationship between earning quality and stock returns,
4. To develop relationship between values added intellectual co-efficient and its components,
5. To develop between discretionary accruals with other components.

### **3.1 LITERATURE REVIEW: -**

Earnings quality and the quality of financial reporting in general are subjects that, since a few years, receive more and more attention and are the centre of debate for investors, regulators as well as researchers. This heightened attention to the subject of earnings quality is due to the wave of accounting scandals of the early 2000s (manipulation of accounting

numbers). The objective of this literature review is to give an overview of the recent study done on the topic of earnings quality. Hopefully this study will help both researchers and participants involved in the company's financial activities.

There are many literatures published on the different approaches used for assessment of quality of earnings. Earnings quality is used in numerous empirical studies to show trends over time; to evaluate changes in financial accounting standards and in other institutions, such as enforcement and corporate governance; to compare financial reporting systems in different countries; and to study the effect of earnings quality on the cost of capital.

#### **THE RELATIONSHIP BETWEEN INTELLECTUAL CAPITAL AND EARNINGS QUALITY:-**

**Roya Darabi, S.Kamran Rad and M.Ghadiri (2012)**, studied the association between the intellectual capital of firms and their earnings quality. The Research was conducted with 158 accepted companies and 948 firm-year observations from Iran stock market. Empirical studies were conducted based on hypothesis by Value Added Intellectual Coefficient as measures of intellectual capital and taking absolute value of Discretionary Accruals as measures of earnings quality. The results of statistical test show that intellectual capital and its human capital component have a significant positive impact on earnings quality and lead us to conclude that intellectual capital has a positive role in financial practices and reporting.

#### **THE QUALITY OF ACCRUALS AND EARNINGS: THE ROLE OF ACCRUAL ESTIMATION ERRORS: -**

**Patricia M.Dechow and Iliia D.Dichev (2002)**, points out a new measure of one aspect of the quality of working capital accruals and earnings. One role of accruals is to shift or adjust the recognition of cash flows over time so that the adjusted numbers (earnings) better measure firm performance. However, accruals require assumptions and estimates of future cash flows. It is argued that the quality of accruals and earnings is decreasing in the magnitude of estimation error in accruals and derived an empirical measure of accrual quality as the residuals from firm-specific regressions of changes in working capital on past, present, and future operating cash flows. Later documented that observable firm characteristics can be used as instruments for accrual quality (e.g., volatility of accruals and volatility of earnings). Finally, it is showed that measure of accrual quality is positively related to earnings persistence.

#### **LINE-ITEM ANALYSIS OF EARNINGS QUALITY: -**

**Nahum D. Melumad and Doron Nissim (2008)**, discussed about earning quality and the related concepts of earning management, focusing on the primary financial accounts. For each key line item from the financial statements, it is summarized that accountings and economic consideration applicable to that item, discuss implications for earning quality, evaluate the susceptibility of the item to manipulation, and identify potential red flags. The red flags and specific issues discussed for the individual line item provide a frame work for fundamental and contextual analysis by academic researcher and practitioner.

### **3.2 METHODS ADOPTED WITH DETAILED PROCEDURE:-**

#### **SOURCES OF DATA:**

##### **PRIMARY DATA:**

Data observed or collected directly from first-hand Published Data and the Data collected in the past or other is called secondary Data

- Data collected from balance sheets.

**SECONDARY DATA:**

Secondary Data is the Data that have been already collected by and readily available from other sources. Such Data are cheaper and more quickly obtainable than the primary Data and also may be available when primary Data cannot be obtained at all.

- Data collected from internet
- Data collected from books , journals
- Data collected from websites.

**FORMULAS FOR DATA ANALYSIS**

**I. value added intellectual coefficient calculation**

1. Taking ten industries Data for 10 Years.

**2. Intellectual capital:**

Human capital + Capital employed capital and structural capital

**3. Value added intellectual co-efficient:**

$$HCE+SCE+CEE$$

HCE – Human Capital Coefficient

SCE – Structural Capital coefficient

CEE – Capital Employed Efficiency

**3.1. HCE:**

VA: Value added: REVENUE - EXPENSE

HC: Total Investment in terms of Salaries and wages of staff

**3.2. SCE: SC / VA**

$$SC: VA - HC$$

**3.3. CEE: VA / CA**

CA: Book value Net assets

**4. DA: Discretionary Accruals**

$$(DA \text{ it}): \beta_0 + \beta_1VAICit + \beta_2LEVit + \beta_3SIZEit$$

**5. LEVit: a leverage ratio**

$$DEBT / TOTAL ASSETS$$

**6. SIZEit: Book value of total assets in millions**

**II. calculation of stock returns(R)**

$$\text{Stock returns (R)} = (p1-p0)/p0*100$$

Here p1=closing price

P0=opening price

**4. DATA ANALYSIS AND INTERPRETATIONS: -Table: 4.1.1. Earning quality of selected industries for ACC LTD**

Year	TA/A	I/A	REV- REC/A	PPE/A	DA
2010	0.039354	0.000403	1.49	1.527207	-
2011	1.08611	0.000304	1.32	1.238011	-
2012	1.032923	0.000302	1.89	1.400128	-

2013	1.112632	0.00023	1.51	1.10538	0.67056	SUMMARY OUTPUT	
2014	0.97223	0.0002	1.44	1.169082	0.84522		
2015	0.619394	0.000168	1.34	1.145051	1.19079		
2016	-0.07626	0.000105	0.82	0.848893	1.60482		
2017	1.036233	0.000113	1.05	1.084948	0.82233		
2018	1.327345	0.000123	1.33	1.252426	0.94978		
2019	1.53079	0.000135	1.42	1.398217	0.77019		
<i>Regression Statistics</i>							
Multiple R							0.745623
R Square							0.555954
Adjusted R Square						0.333931	
Standard Error						0.427044	
Observations						10	

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	3	1.369958	0.456653	2.504037	0.156106
Residual	6	1.094199	0.182367		
Total	9	2.464157			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	-0.93205	0.993512	0.93814	0.384384	-3.36309	1.498986	-3.36309	1.498986
X Variable 1	-4600.5	1953.427	2.35509	0.056663	-9380.36	179.3614	-9380.36	179.3614
X Variable 2	1.283778	0.78309	1.639375	0.152247	-0.63237	3.19993	-0.63237	3.19993
X Variable 3	0.831254	1.193037	0.696754	0.512033	-2.088	3.75051	-2.088	3.75051

**INTERPRETATION: -**

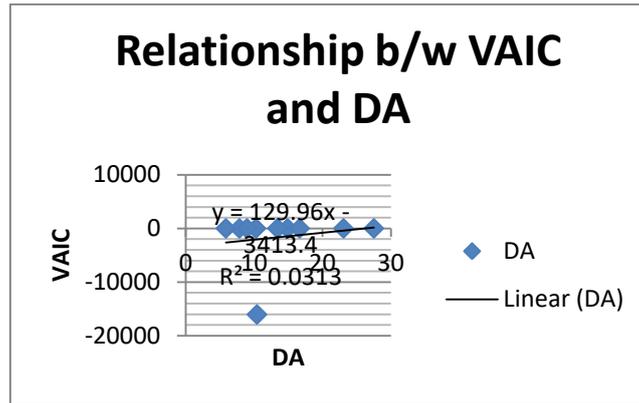
RESIDUAL OUTPUT			
<i>Observation</i>	<i>Predicted Y</i>	<i>Residuals</i>	<i>Standard Residuals</i>
1	0.401448	-0.36209	-1.03847
2	0.392172	0.693938	1.990188
3	1.263045	-0.23012	-0.65998
4	0.872237	0.240395	0.689443
5	0.960577	0.011653	0.03342
6	0.96807	-0.34868	-0.99999
7	0.342162	-0.41842	-1.20002
8	0.792878	0.243355	0.697931
9	1.25532	0.072025	0.206566
10	1.432842	0.097948	0.280911

The QE that calculated for all the above companies are through its proxy formula DA. firstly the values total accruals, asset ,revenue, receivables, fixed cost are the found as per the requirements of multi linear regression equation and latter x1,x2,x3 intercept are found through using software for calculating the regression equation, this intercepted are used to calculate DA value by substituting them in the DA formula.

**Note: -** I have mentioned one sample calculation of earning quality of selected industries and remaining as usual same as above example.

VAIC	DA
10.2965	-1.0728
27.5317	-0.2647
23.08853	-0.9812
14.92007	-0.6706
13.42471	-0.8452
16.67297	-1.1908
10.43654	-16048
7.867315	-0.8223
8.969639	-0.9498
5.89503	-0.7702

**Table: 4.2.1. To develop between intellectual capital and earning quality for ACC LTD**



**Fig: 4.2.1. Relation ship b/w VAIC&DA**

**INTERPRETATION: -**

The relationship b/w VAIC and DA for all the company represent same that the basic will have positive influence of the DA because of the using its in its capital efficiency than the officially does not right to manipulate earning company and if cannot also be seen that the only company that has significant relationship b/w its DA and VAIC is Hawkins.

**Note: -** I have mentioned one sample calculation of intellectual capital and earning quality selected industries and remaining as usual same as above example.

**4.3.1. To establish relationship between earning quality and stock returns: -**

**Table: 4.3.1. To relationship between earning quality and stock returns of ACC LTD**

YEAR	OPENING PRICE	CLOSEING PRICE	STOCK RETURN	DA
2010	245.9	338.7	2281952	1.0728
2011	339.65	534.2	6607890.75	0.2647
2012	538	1085.55	29458190	0.9812
2013	1099	1024.5	-8187550	0.6706
2014	1035	477.9	-57659850	0.8452
2015	479.95	871.5	18792442.25	1.1908
2016	870	1075.6	17887200	16048

2017	1076	1136.35	6493660	0.8223
2018	1145.2	1429.4	32546584	-0.9498
2019	1440	1108.2	-47779200	-0.7702

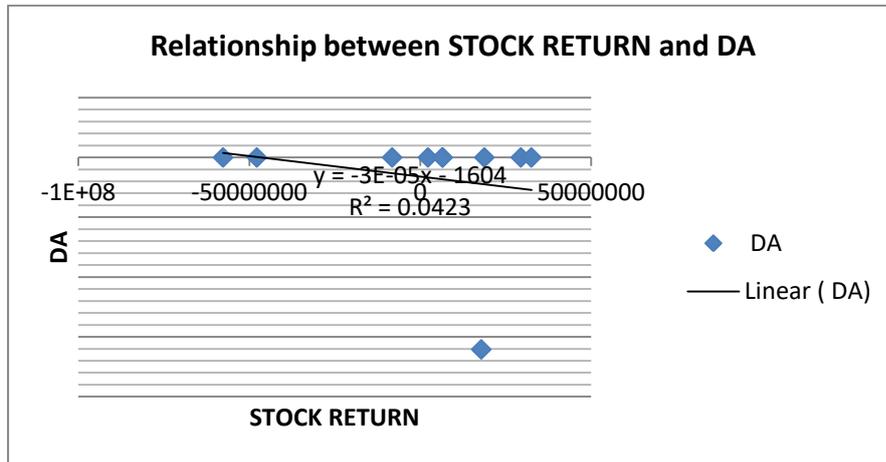


Fig:- 4.3.1.Relation ship b/w stock return&DA

**INTERPRETATION: -**

When the stock returns are high than the respecting QE are low. it can be occurred in the all the above figure of different companies from different from industry that the reasons these because the stock return high that means that the organizations high trainings the goods its stock value by manipulating earning value even through the company’s stock influence EQ know the company has significant relationship b\w stock return and DA.

**Note: -** I have mentioned one sample calculation of earning quality and stock returns of selected industries and remaining as usual same as above example.

**Table: 4. 4.1. (A) Relationship between values added intellectual co-efficient and its components of ACC LTD: -**

Year	HCE	VAIC
2010	2.8374	10.2965
2011	10.25481	27.5317
2012	7.67458	23.08853
2013	5.437814	14.92007
2014	4.90783	13.42471

2015	7.361562	16.67297
2016	4.135335	10.43654
2017	3.010638	7.867315
2018	3.224017	8.969639
2019	2.077726	5.89503

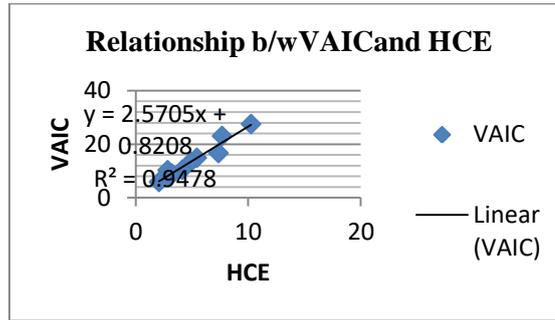


Fig:- 4.4.1.Relation ship b/w VAIC&HCE

**INTERPRETATION: -**

Through the analysis of the obtained scattered diagram that states the r/s b/w VAIC and HCE, VAIC and CEE, VAIC and SCE, it can be seen that there is linear relation to human capital and capital employed with the VAIC. Whereas the r/s b/w VAIC and structural capital is not linear even through it is significant to VAIC due to it R<sup>2</sup> being more than 0.5.

Table: 4. 4.1. (B) Relationship between values added intellectual co-efficient and its components of ACC LTD

Year	SCE	VAIC
2010	0.647565	10.2965
2011	0.902485	27.5317
2012	0.8697	23.08853
2013	0.816103	14.92007
2014	0.796244	13.42471
2015	0.864159	16.67297
2016	0.758182	10.43654
2017	0.667844	7.867315
2018	0.689828	8.969639
2019	0.518705	5.89503

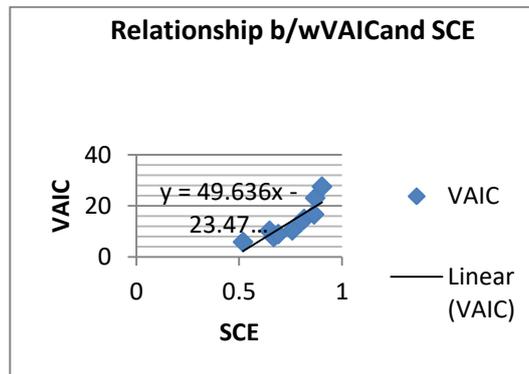


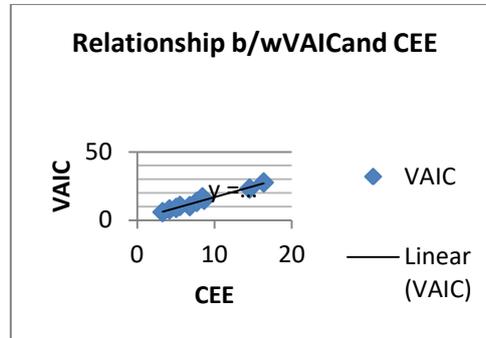
Fig: - 4.4.1.Relation ship b/w VAIC&SCE

**INTERPRETATION: -**

Through the analysis of the obtained scattered diagram that states the r/s b/w VAIC and HCE, VAIC and CEE, VAIC and SCE, it can be seen that there is linear relation to human capital and capital employed with the VAIC. Whereas the r/s b/w VAIC and structural capital is not linear even through it is significant to VAIC due to it R<sup>2</sup> being more than 0.5.

**Table: 4. 4.1. (C) Relationship between values added intellectual co-efficient and its components of ACC LTD**

Year	CCE	VAIC
2010	6.811536	10.2965
2011	16.3744	27.5317
2012	14.54425	23.08853
2013	8.666155	14.92007
2014	7.720635	13.42471
2015	8.447246	16.67297
2016	5.543022	10.43654
2017	4.188833	7.867315
2018	5.055794	8.969639
2019	3.298599	5.89503



**Fig:- 4.4.1.Relation ship b/w VAIC&CEE**

**INTERPRETATION: -**

Through the analysis of the obtained scattered diagram that states the r/s b/w VAIC and HCE, VAIC and CEE, VAIC and SCE, it can be seen that there is linear relation to human capital and capital employed with the VAIC. Whereas the r/s b/w VAIC and structural capital is not linear even through it is significant to VAIC due to it R<sup>2</sup> being more than 0.5.

**Note: -** I have mentioned one sample calculation of value added intellectual co-efficient and its components of selected industries and remaining as usual same as above example.

**Table: 4.5.1 (A) to develop between discretionary accruals with other components for CIPLA: -**

DA	VAIC
-	
0.0727	9.627129
-	
0.0136	17.17806
0.2465	16.77761
0.1067	29.05913
0.0037	21.26945

-	0.0845	25.97181
-	0.1453	21.08523
-	0.1172	14.08475
-	0.3152	17.57769
-	0.0914	16.96061

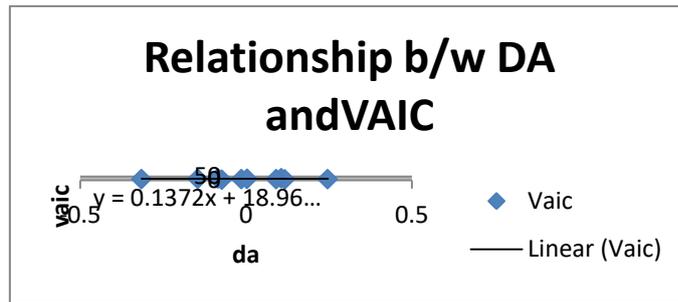


Fig: - relationship b/w DA & VAIC

**INTERPRETATION: -**

The correlation b/w DA and its components is on significant that is components have influence in the company qe because are the 3 companies can be manipulated easily .it can also be seen that the r/s b/w DA and its components is linear.

**Table: 4.5.1. (B)To develop between discretionary accruals with other components for CIPLA**

DA	LEVit
-0.0727	0.142808
-0.0136	0.111536
0.2465	0.191222
0.1067	0.036776
0.0037	0.133875
-0.0845	0.177706
-0.1453	0.000857
0.1172	0.062449
-0.3152	0.001613
0.0914	0.098198

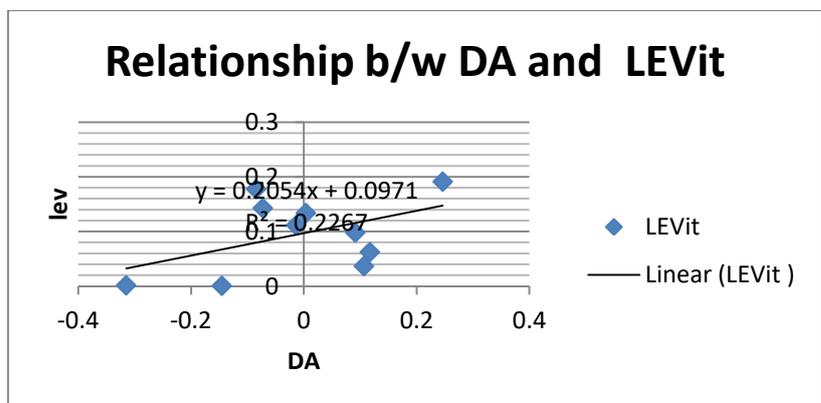


Fig: - relationship b/w DA& LEVIt

**INTERPRETATION: -**

The correlation b/w DA and its components is on significant that is components have influence in the company qe because are the 3 companies can be manipulated easily .it can also be seen that the r/s b/w DA and its components is linear.

**Table: 4.5.1. (C)To develop between discretionary accruals with other components for CIPLA**

DA	SIZEit
-0.0727	1474.64
-0.0136	1748.67
0.2465	2452.18
0.1067	3359.83
0.0037	4336.35
-0.0845	5290.99
-0.1453	5919.16
0.1172	7053.43
-0.3152	7562.48
0.0914	9835.33

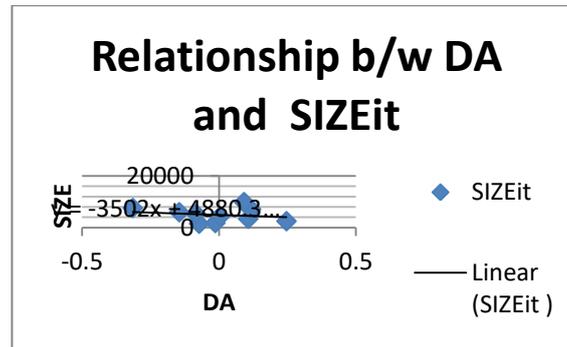


Fig: - relationship b/w DA& SIZEit

**INTERPRETATION:**

The correlation b/w DA and its components is on significant that is components have influence in the company qe because are the 3 companies can be manipulated easily .it can also be seen that the r/s b/w DA and its components is linear.

**Note: -** I have mentioned one sample calculation of discretionary accruals with other components of selected industries and remaining as usual same as above example.

**5. FINDINGS: -**

- Through present study on quality earnings, it was found that various earnings quality proxy's which represent the quality of earnings position in the organization.
- The quality earnings from a company to company vary according to the parameters they depend on. In the study the quality earnings often are high in personal care industry and leather industry.
- The results of present investigation show that intellectual capital has positive impact on earnings quality, because when the VAIC values are negative the DA also is negative and it lead to conclude that intellectual capital has a positive role in financial practices and reporting.
- Earnings with high accruals suggesting low-quality earnings are associated with poor stock returns in that relative year.
- The Human capital efficiency (HCE) and Capital employed efficiency (CEE) both have a positive relation with the VAIC; whereas Structural capital efficiency (SCE) has a inverse relationship with VAIC.

**CONCLUSION: -**

The Study Quality Earnings is useful for the purpose of the investors and any person who are depending on the company's financial statement. It provides the investors a perception on the firms' financial position in real, rather than that reported by the firm itself. The investors suffer when the investment is made only based on the reported earnings shown by the company due to the manipulations done. So through the study the earnings quality of the 30 companies from 6 industries are considered.

The Quality earnings topic arose from the wake of many situations in the present scenario which are representing the manipulations in the reported earnings to promote the companies' shares. It is revealed in the study done that most of the companies try to manipulate the reported earnings at least to a certain extent by adding abnormal earnings to the companies true earnings.

The investors who are trying to invest in any company should not only consider the reported earnings but should also analyze quality of those earnings. In the study some of the companies' like Deccan cements, Idea, Berger paints, Zee, MRF tiers, ACC, Infosys, HCL technologies showed good quality earnings so the small investors should try to invest their investment in these type of companies, whereas speculators can consider the companies like Prism, Bharathi Airtel, Nerolac, Mukta arts, Apollo tiers, Tech Mahindra that have somewhat low earnings quality because they are ready to face risk.

The companies that have good quality earnings are the companies that pay their taxes properly. So government can give subsidies on the taxation in order to encourage the company for maintaining true earnings.

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**TEXT BOOKS: -**

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