

Additional Evidence on Cosmetic Manipulation on Reported Research and Development Expenses

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Abstract

Prior studies document that in addition to reported earnings and revenues, U.S. firms round up the reported research and development (R&D) expenses to achieve key reference points. The findings suggest that firms view R&D expenditures as an investment rather than an expense. This study provides further evidence on this cosmetic manipulation on R&D. We find that the degree of rounding manipulation on R&D is more severe than in reported earnings and revenues in profit firms. However, loss firms tend to engage more in revenue manipulations than in R&D. We also find that similar to the firms listed in the major U.S. stock market, OTC firms tend to manipulate their reported R&D expenses, with the cosmetic manipulation being more severe in the OTC market than in the major markets. The findings suggest that enhanced regulations constrain the rounding manipulations. This study also documents that auditors from the Big Four can constrain the rounding manipulation on R&D. In addition, it provides evidence that rounding manipulation on reported R&D exists in the industries of mining, manufacturing, wholesale & retail business, information, professional service & admin and support, and art, entertainment, food & other services.

Keywords: earnings management; earnings quality; OTC market; R&D expense; rounding phenomenon