

**Earnings Quality Research:
Advances, Challenges and Future Research**

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Abstract: This discussion makes several observations regarding the earnings quality research reviewed in Dechow, Ge and Schrand (2010) (DGS). I discuss some of the factors that led to the large growth in the earnings quality literature over the past two decades, and note a few of the important contributions from this literature. I also present what I view as several major challenges the literature faces as well as some avenues for future research. In addition, I discuss the difficulties in evaluating such a diverse body of literature, and comment on DGS's major conclusions.

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Earnings Quality Research: Advances, Challenges and Future Research

1. Introduction

Dechow, Ge and Schrand (2010) (DGS) provides a comprehensive and detailed review of the earnings quality (EQ) research and contains numerous penetrating insights. The literature discussed in the review spans several decades, covering nearly 350 studies in more than a dozen topical areas. A distinctive feature of the review is that it includes an in-depth discussion of issues related to the convergent and divergent validity of the proxies most commonly used in the EQ literature. This approach is original to the literature and significantly enhances our understanding of issues related to EQ. DGS is ambitious and exhaustive, and succeeds in providing an excellent overview and critique of the EQ literature.

The purpose of this discussion is to offer a few additional observations on the EQ literature and to comment on some of DGS's major conclusions. My remarks are not intended to be comprehensive but instead are limited to issues in the literature that I find particularly significant.

Section 2 begins with some conjectures about why the EQ literature has grown so rapidly over the past two decades and Section 3 discusses some of the literature's important accomplishments. Section 4 notes several challenges researchers in the area face and Section 5 speculates on potential directions for future research. Section 6 discusses some of the difficulties inherent in reviewing such a broad literature and comments on DGS's conclusions. Section 7 summarizes my observations.

2. Growth in the EQ literature

Research on EQ has grown dramatically over the past two decades. This is particularly true in the earnings management area, which comprises the majority of studies reviewed by DGS. While speculative, I believe the major drivers of the growth in the EQ area are likely to be the confluence of several factors that have both encouraged and facilitated this line of research. A factor encouraging this research was the SEC's harsh allegations during the 1990's of widespread earnings management among public companies (e.g., Levitt, 1998). These assertions depicted managers as routinely engaging in opportunistic earnings management aimed at meeting capital market expectations. This spurred researchers' interest in EQ issues, especially studies related to managers' responses to incentives provided by earnings targets. The SEC allegations were also highly critical of the auditing profession, whom they portrayed as managers' willing accomplices in deceiving the public. Such criticisms encouraged researchers to expand the scope of their studies to include the impact of auditors' incentives on earnings management. This eventually led to a line of research investigating the role of audit quality on EQ issues beyond simply earnings management. Growth in the EQ literature, and particularly earnings management research, continued to accelerate in the wake of the high profile accounting frauds in the early 2000's that culminated in the passage of the Sarbanes-Oxley Act of 2002 (SOX).

Another factor that I believe helped fuel the growth in EQ research is the introduction of the abnormal accruals model in Jones (1991). While it has been and continues to be controversial, the Jones model is noteworthy for providing the

literature with a more-or-less generally accepted measure of abnormal accruals. This “standardization” spurred research in EQ by alleviating the necessity of creating and defending a new proxy in each new study. Methodology papers, particularly Dechow, Sloan and Sweeney (1995), were also instrumental in institutionalizing the Jones model. In addition, several theory papers provided empirical researchers with guidance in formulating their analysis (e.g., Dye, 1988; Holthausen and Verrecchia, 1988; Fudenberg and Tirole, 1995).

More recently, the development and implementation of a set of internationally accepted accounting standards has also stimulated growth in the EQ literature. The International Accounting Standard Board’s (IASB) explicit objective of developing a set of “high quality” accounting standards has naturally focused researchers’ attention on fundamental issues related to EQ. In addition, the widespread adoption of International Financial Reporting Standards (IFRS) has generated interest in international research that compares accounting practices across countries. An important advantage of cross-country studies is that they allow researchers to examine the variation in factors suspected to impact EQ that are necessarily held constant in a single-country setting.

Finally, the introduction of a myriad of new electronic databases has facilitated growth in large sample EQ studies in areas that had previously been limited due to the high costs of hand collecting data (e.g., in the areas of corporate governance, executive compensation, auditing, and the international area, just to name a few).

3. Progression of and Accomplishments in the EQ literature

As it has expanded, the EQ literature has improved on several dimensions. One of the most dramatic improvements has been in the rigor of the EQ proxies, particularly the proxies measuring abnormal accruals. Abnormal accruals is by far the single most popular proxy used in the papers reviewed in DGS and a hallmark of the EQ research is the nearly continual innovations made to these proxies. Indeed, the measure used in the earliest study that employs abnormal accruals as a proxy (Healy, 1985), bears little resemblance to the proxies used in the current literature, which consist primarily of modified versions of the model in Jones (1991).¹ These modified versions generally result from researchers responding to limitations related to the original Jones model (e.g., DeFond and Jiambalvo, 1994; Dechow, Sloan and Sweeney, 1995; Hribar and Collins, 2002; Kothari, Leone and Wasley, 2005). As a consequence, the literature currently has a variety of Jones-related abnormal accruals proxies from which to choose. Importantly, the Jones model has also evolved beyond simply being a proxy for management opportunism and is now used to more broadly capture both intentional and unintentional factors that influence EQ.

EQ researchers are also continually developing new models that compete with the family of models descended from Jones (1991). Competition among models is healthy in terms of moving the literature forward, but most competitors do not survive. Relatively recent exceptions are two abnormal accruals proxies gaining

¹ The evolution of abnormal accruals proxies can be traced from Healy (1985), which uses current period total accruals to measure “abnormal” accruals; to DeAngelo (1988), which introduces an expectation model by looking at the change in total accruals; to Jones (1991), which introduces a multivariate model to extract “normal” accruals.

acceptance in the literature: the proxy introduced in Dechow and Dichev (2002), and one of its variants, developed in Francis, LaFond, Olsson and Schipper (2005). The Dechow and Dichev model attempts to improve on the Jones model by more explicitly mapping cash flows into the accruals generating process. The Dechow and Dichev model was also designed from the outset as a proxy for both intentional and unintentional factors affecting EQ. This contrasts with the Jones model, which was originally designed to capture earnings management. Francis et al. (2005) seeks to improve upon the Dechow and Dichev model, primarily by disaggregating the variation in EQ into the portion resulting from the innate application of the accounting system and the portion resulting from management discretion. Like the Jones model, however, the models in Dechow and Dichev (2002) and Francis et al. (2005) are controversial (as discussed in DGS). Thus, just like the other EQ proxies introduced to the literature, only time will tell if they remain as resilient as the Jones model.

As it has progressed, I believe there are several areas in which the EQ literature has generated significant new knowledge. An important one is in our understanding of the management incentives that impact EQ, such as the literature that finds that managers respond to a wide variety of earnings targets (e.g., Burgstahler and Dichev, 1997; DeGeorge, Patel and Zeckhauser, 1999). Another area of significant advancement is in the international area. This literature provides a wealth of evidence on some of the primary exogenous drivers of EQ, as well as some of its important consequences. Most notably, international studies provide convincing evidence that institutional factors play a critical role in the demand for

and the usefulness of accounting information (e.g., Ball, Kothari and Robin, 2000; Hung, 2000; Ball, Robin and Wu, 2003).

The governance literature related to EQ also makes important contributions. While there are significant problems in interpreting the empirical associations found in governance studies (Larcker, Richardson and Tuna, 2007), the evidence generally suggests that governance-related factors, such as internal controls over financial reporting and audit quality, play a role in determining EQ (e.g., Klein, 2002; Doyle, Ge and McVay, 2007).

There are also a growing number of studies that suggest accounting conservatism, as captured by timely loss recognition (TLR), is an important factor influencing EQ. For example, studies find that TLR is associated with favorable outcomes such as reduced borrowing costs and superior capital investment decisions (Zhang, 2008; Francis and Martin, 2009). While accounting conservatism has a long history in the accounting literature, it is only since Basu (1997) that it has been the subject of rigorous large-sample empirical research.

Finally, while formulating policy is not the goal of the EQ literature, or of positive research in general, there is evidence that is consistent with EQ research influencing standard setters and lawmakers. For example, a recent report on audit quality by the US Department of the Treasury (2008) references numerous EQ studies (e.g., Ogneva, Raghunandan, Subramanyam, 2007; Myers, Myers and Omer, 2003). The Treasury Department also recently published a commissioned study by an academic researcher that summarizes the EQ literature on restatements (i.e., Scholz, 2008). In addition, the Congressional debates leading up to the passage of

the Sarbanes-Oxley Act of 2002 cite several academic studies (e.g., DeFond, Raghunandan and Subramanyam, 2002). Finally, I am aware of several cases in which the Treasury Department and the FASB have sought informal input directly from accounting academics regarding research studies that potentially inform proposed standards (e.g., Dechow, Hutton and Sloan, 1996; Hanlon, Maydew and Shevlin, 2008). Thus, there is ample evidence that policy makers are very much aware of the EQ literature and that it plays a role in the policy making process.²

4. Challenges in the EQ literature

While I think that the literature has made important advances, I also think there are many challenges in studying EQ. One is that all of our abnormal accruals models suffer from the inherent limitation that we are unable to validate the accuracy of their predictions. For example, we are unable to verify whether our estimates of discretionary accruals are the result of management's opportunistic accounting choices, or just an artifact of the particular model we are using. This is a construct validity problem, which means that we are unsure whether these proxies really measure the underlying theoretical constructs they are intended to measure. While creating proxies for phenomena that cannot be directly observed is common in the social sciences, it has important implications for EQ research. One implication is that every test using abnormal accruals proxies is a joint test of the hypothesis related to the research question and the hypothesis that the proxy is a valid

² Section 5 proposes future research to help better understand the nature of this role.

measure. Another implication is that it presents difficulties in evaluating which proxy is “best”, at least on the dimension of construct validity.³

The problem of measuring theoretical constructs that are not directly observable has implications for one of DGS’s primary conclusions. DGS observes that EQ is a function of both the ability of the accounting system to measure the firm’s “fundamental performance” and how the accounting system is implemented. They further assert that researchers rarely attempt to disentangle these two effects. Instead, studies tend to focus on implementation issues, such as accounting errors and earnings management. This is an astute observation and a valid conclusion. However, it is notable that because the firm’s underlying performance is unobservable, disentangling its effects from implementation issues (which are also unobservable) is challenging to say the least. The inability to directly observe the constructs of interest in this setting suggests that disentangling these effects is not really a problem that the literature is likely to “solve” *per se*.

Earnings restatements and SEC Accounting and Auditing Enforcement Releases (AAERs) are potentially attractive alternatives to abnormal accruals as a proxy for EQ. One perceived advantage of restatements and AAERs over abnormal accruals is that they appear to be more direct proxies for EQ. Restatements and AAERs are actual events, rather than error terms from a statistical model that cannot be validated. It is important to note, however, that restatements and AAERs

³ One approach to empirically assess the construct validity of proxies is the multitrait-multimethod matrix analysis, first suggested in Campbell and Fiske (1959). This analysis includes, among other tests, a formal statistical analysis of convergent and divergent validity. DGS does not perform formal statistical tests of convergent and divergent validity, but instead make more casual comparisons using these terms to direct their discussion.

are still only proxies for the underlying construct that most EQ researchers would like to capture (i.e., earnings management). As such, they have important limitations of their own. One such limitation is related to selection bias. In the case of restatements, they only capture poor EQ that has been both discovered and judged by the firm to merit restatement. In the case of AAERs, limited resources provide the SEC with incentives to pursue only the most egregious and high profile securities law violators (Pitt and Harvey, 1990). Such a strategy increases the chances of out of court settlement (thereby avoiding costly litigation) and maximizes the deterrent effect of the SEC's actions. It also suggests that AAERs are likely to comprise only a subset of fraud cases (DeFond and Smith, 1991). Taken together, these selection criteria mean that restatements and AAERs may not be appropriate for EQ studies that wish to capture unintentional errors or earnings management that either falls within the parameters of GAAP, or that goes undetected. Thus, while abnormal accruals proxies have important limitations, restatements and AAERs have limitations of their own.⁴

The above discussion raises the question of whether EQ researchers *should* be interested in studying earnings management that falls short of violating GAAP. In other words, if earnings management is within GAAP, then why should anyone care? Historically, one reason for the EQ literature's interest in studying non-fraud earnings management is the SEC's strong objections to this behavior (e.g., Levitt, 1998). The SEC's concerns seem grounded in the assumption that earnings management misleads investors, which presumably leads to suboptimal asset

⁴ This point is consistent with DGS's argument that the choice of EQ proxy depends upon the research question.

allocation decisions, thereby harming investors. Recent research suggests this may be a valid concern. For example, Hutton, Marcus and Tehranian (2009) finds evidence that earnings management (as measured by abnormal accruals) is associated with a higher incidence of costly stock price declines; and Biddle, Hillary and Verdi (2009) finds that higher quality accruals (as measured by a variation of the Dechow and Dichev model) improves investment efficiency. Similarly, if debt holders value timely loss recognition (TLR), and earnings management is used to avoid covenant violations (e.g., DeFond and Jiambalvo, 1994; Sweeney, 1994; Dichev and Skinner, 2002), then debtholders are also potentially harmed by “within GAAP” earnings management.⁵

Another major challenge in the EQ literature is that it is difficult to draw inferences about user’s preferences from EQ studies. The problem is not simply that there are conflicting preferences across user groups (as DGS discusses in detail), but that the preferences of a given user group may be based on criteria that are not captured in our tests. For example, Basu (1997) finds that TLR is negatively related to earnings persistence. Since equity holders are likely to find more persistent earnings to be of higher quality (as discussed in DGS), this evidence seems to suggest that TLR reduces EQ for equity holders. However, there is also evidence that TLR reduces the costs of borrowing (e.g., Zhang, 2008). Since equity holders benefit from reduced borrowing costs, this evidence suggests that TLR may actually increase EQ for equity holders, at least in the sense that it lowers the cost of debt.

⁵ Another interpretation of the SEC’s abhorrence of “within GAAP” earnings management is that it may be viewed as essentially equivalent to fraud, or at least “fraud light.” That is, it may be too minor to detect or successfully prosecute, but is still perpetrated with the intent of misleading financial statement users.

Thus, equity holders may ultimately prefer TLR even though it impairs earnings persistence. This example suggests that equity holders' preferences regarding TLR involve trading off the costs of reduced persistence with the benefits of lower borrowing costs. Ultimately, however, user preferences are based on trading off the costs and benefits among all of the EQ characteristics. Empirically investigating such tradeoffs is obviously a major challenge.⁶

Finally, while the literature on conservatism has made important advances, as discussed previously, it also faces important hurdles moving forward. One is that while researchers find that conservatism is empirically associated with a variety of outcomes, indentifying the exogenous factors that drive conservatism is difficult. Another issue is the development of widely accepted proxies. While there are now multiple proxies designed to empirically measure conservatism (e.g., Basu, 1997; Givoly and Hayn, 2000; Ball and Shivakumar, 2005; Khan and Watts, 2009), general acceptance of a given proxy or subset of proxies is still evolving.⁷

5. Future directions for EQ research

Going forward, I think there are accounting developments on the horizon about which we know relatively little, and hence are logical prospects for future research. One example is fair-value accounting, which represents a potentially sea-changing development in the accounting environment. Fair-value accounting essentially follows from the explicit rejection of the concept of conservatism by standard setters in the newly proposed conceptual framework for financial

⁶ This observation seems consistent with DGS's conclusion that it is both the decision maker and the setting that determine the appropriate EQ proxy. This example further suggests that our studies may not consider all of the relevant decision settings.

⁷ DGS discusses several other difficulties faced in the EQ literature related to conservatism.

reporting (IASB, 2008). Changing to a fair-value-based accounting system portends a marked shift from the traditional historical cost-based accounting model upon which our existing EQ research is based. How a fair value accounting model is likely to impact EQ, and what EQ will look like under such a model is very much an open question.⁸ Thus, this is an area where future research may be particularly beneficial.

Another development that presents a potentially rich area for future EQ research is the introduction of principles-based accounting standards. This change is expected to accompany the anticipated mandatory adoption of IFRS in the US capital markets, currently scheduled to occur in 2015. While US standards have been criticized as primarily rules-based, IFRS is often lauded as primarily principles-based. A potential implication of this difference is that managers and auditors are likely to have greater discretion in applying IFRS than they currently have in applying US GAAP. A factor that potentially exacerbates this increased discretion is that the IASB has a firm policy of not providing users or preparers with implementation guidance for IFRS. This is in sharp contrast to the voluminous implementation guidance typically provided by the FASB. Thus, the move to IFRS in the US will potentially increase accounting discretion, and the impact on EQ is unclear.

SOX also continues to provide opportunities for EQ research. While there are already a large number of SOX studies, many of them were done before SOX is likely to have reached a state of equilibrium. SOX implemented many fundamental changes to the EQ environment and it will probably take years for its full effects to

⁸ Penman (2009) discusses how the fair valuation of intangibles may impact various EQ factors.

be felt. There is also anecdotal evidence that managers and auditors had difficulties interpreting and implementing SOX in the initial years after its adoption (e.g., DJNS, 2006). These difficulties are one reason why the Public Companies Accounting Oversight Board (PCAOB) issued Auditing Standard No. 5 in 2007, which made significant changes to the guidance initially provided to auditors in Auditing Standard No. 2 (issued shortly after the passage of SOX). Thus, the interpretation and implementation of SOX has changed over the years. In addition, some of SOX's major provisions, such as Section 404, were phased in over several years, and were only recently fully implemented. These factors all suggest that the ultimate impact of SOX on EQ remains somewhat of an open question.

EQ research is also likely to benefit from further exploring the distinctive features of EQ in the debt markets, currently only a small area of the literature. While research on the role of accounting in debt contracting is certainly not new, there is relatively little research on the characteristics of EQ with respect to decision makers in debt markets. Both the growth in debt markets internationally and the recent debt crisis provide strong motivation for further research in this area.

Another potential source of beneficial future research comes from areas that have been somewhat neglected in the literature. One of these areas is fraudulent financial reporting. A strong message communicated by the rapid and enthusiastic adoption of SOX is that users, or at least lawmakers, are especially averse to earnings management that crosses the line into fraudulent financial reporting. However, research that attempts to understand accounting fraud is a relatively small subset of the EQ literature, consisting primarily of studies that examine AAERs

(e.g., Ferroz, Park and Pastena, 1991; Beasley, 1996; Dechow, Sloan and Sweeney, 1996). The relatively small number of papers that investigate fraud may be due to difficulties in obtaining data on fraud other than those reported in AAERs, or because the low base rate for fraud makes statistical inferences problematic.⁹

A related area for potential future research is gaining a better understanding of how the EQ literature impacts policymaking. While there is ample evidence that policymakers are aware of the EQ literature (as discussed above), it is unclear whether or how EQ research actually influences policymakers' decisions. A natural concern regarding the role of EQ in policymaking is that standard setters and lawmakers may selectively cite research in order to achieve political ends. This is consistent with Watts and Zimmerman (1979), which argues that academic research is used in the "market for excuses" to buttress and justify standard setters' preconceived notions. Indeed, this may have been the case during the Congressional debates prior to the passage of the Sarbanes-Oxley Act (DeFond and Francis, 2005). This is also consistent with the evidence in Ramanna (2008), which suggests that the decision to promulgate fair-value accounting for goodwill in FASB 142 was politically motivated, rather than the result of policy makers carefully evaluating and weighing the evidence in the academic literature. Given the overlap between EQ research topics and the interests of policy makers, the EQ literature is a potentially valuable input to policymaking. Thus, a relatively unexplored area for future

⁹ Fraud is a legal term and obtaining representative data regarding legal cases is difficult for many reasons (Palmrose, 1991; Ettredge, 1991). Beneish (1999) uses news sources to identify fraud cases not reported in AAERs, which potentially increases representativeness, but is costly to collect. Abnormal accruals may also potentially capture some portion of undetected fraud cases (Jones, Krishnan and Melendrez, 2008).

research is to better understand whether and how the EQ literature informs policymaking.

Finally, an area of the EQ literature that seems relatively under-researched is so-called “real activities” manipulation, or “transaction” management. The fundamental importance of this area is evidenced in Graham, Harvey and Rajgopal (2005), which concludes that earnings management is not only widely practiced, but that the majority of earnings management results from manipulating real operating activities. Transaction management through select activities such as manipulating R&D expenditures and asset sales has been investigated in several prior studies (e.g., Baber, Fairfield and Haggard, 1991; Dechow and Sloan, 1991; Bartov, 1993). More recently, Roychowdhury (2006) introduced a more comprehensive measure of transaction management that is becoming widely adopted in the literature (e.g., Cohen, Dey and Lys, 2008). The general implications of this research are consistent with the conclusions in Graham et al. (2005), and suggest that managers’ real activities manipulation is relatively commonplace. However, compared to the research that investigates accruals-based earnings management, research on activities management is scarce.

The paucity of research in this area means we know little about whether or how transactions management impacts EQ. At first blush the manipulation of operational activities seems likely to result in sub-optimal investment decisions that harm shareholders. However, this is not necessarily the case. Graham et al. (2005) observe that “...given the reality of severe market (over-) reactions to earnings misses, the executives might be making the optimal choice in the existing

equilibrium [by manipulating real activities].” Thus, the authors suggest the possibility that transaction management may actually benefit shareholders. Somewhat surprisingly, the PCAOB also seems to suggest that transaction management may be desirable when it states: “Some earnings management activities involve *legitimate discretionary choices* of when to enter into transactions that require accounting recognition, not unlike legitimate year-end tax planning decisions made to accelerate deductions or defer taxable income” (*emphasis added*, PCAOB, 2000, paragraph 3.18). The idea that earnings management (in this case transaction management) may be optimal under certain circumstances is not new to the literature. For example, Dye (1988) states: “To assert that shareholders might have a demand for earnings management might seem perverse, since unmanaged earnings are typically considered preferred to managed earnings, *ceteris paribus*. But the assumptions implicit in the *ceteris paribus* qualification are frequently not tenable.” In summary, given its ubiquitous nature, together with our lack of understanding whether or how it impacts EQ, transaction management seems like an important area for further research.

6. Comments on DGS

DGS organizes their review around critiquing the construct validity of the proxies used in the EQ literature. As DGS acknowledges, however, EQ is not well defined in the accounting literature and has come to represent different concepts across the studies that employ this term. While the authors attempt to capture a commonality by using the definition of EQ provided in Statement of Financial Accounting Concepts (SFAC) No. 1, this definition is quite broad. As a result, the EQ

studies evaluated in DGS really consist of a variety of heterogeneous research areas, which presents problems in trying to compare construct validity across studies. For example, one stream of the EQ literature is concerned with measuring “opportunistic earnings management,” while another stream is concerned with measuring earnings “predictability.” But while construct validity is an important problem in developing proxies in the earnings management literature (as previously discussed), the proxy commonly used for predictability (earnings persistence) is essentially the definition of the underlying construct the research is attempting to capture, and hence is not technically a proxy at all. This wide variation in the importance of construct validity makes it challenging for DGS to generalize their conclusions across the research areas they review.

Another difficulty in drawing conclusions about the EQ proxies is the wide variation in the way the proxies are measured. For example, while “abnormal accruals” is often used to proxy for the underlying theoretical construct of earnings management, it can be measured very differently across studies (e.g., Jones model discretionary accruals versus accruals from the Dechow and Dichev model, working capital versus total accruals, and signed versus absolute values). This means that the proxy labeled “abnormal accruals” essentially captures many different proxies. Indeed, the studies that develop modified versions of the Jones model do so with the intention of creating new and different proxies. DGS acknowledges that differences across some of the studies they review may be driven by differences in the way the proxies are measured, and point out specific studies where this may be the case.

However, a more rigorous analysis of construct validity would restrict the comparisons to proxies that are similarly measured.

DGS draws two primary conclusions from their review. One is that EQ researchers do not do enough to disentangle the effects of the firm's underlying performance on EQ, and I comment on this issue in Section 4 above. DGS's other primary conclusion is that no one EQ proxy is superior to the others. However, as DGS acknowledges, this conclusion is not surprising given the heterogeneous set of research areas that comprise the review.

DGS also cautions researchers that because the EQ proxies are decision and decision-maker specific, they should not be treated as substitutes, but that they often are. DGS advises researchers to be more careful in choosing EQ proxies that map into the theoretical constructs they test. The authors are essentially implying that what has become popularly termed "triangulation" is sometimes taken too far. While the authors do not cite specific cases of "improper" triangulation in the literature, I believe that the findings in Carey and Simnett (2006) indirectly exemplify this notion. Carey and Simnett (2006) finds that auditor tenure is positively associated with the propensity to issue going concern opinions (consistent with increased auditor independence), but not with the level of discretionary accruals. While one view of these findings is that the discretionary accruals results do not triangulate with the going concern results, Carey and Simnett (2006) argue that it is not clear that they should. The crux of their argument is that auditors have much greater control over their audit opinion decision than they do over management's discretionary accruals choices. As long as the client is proposing

within-GAAP discretionary accruals, the client is likely to prevail. This is particularly true in the case of distressed clients, who are more likely to resist auditor pressure to reduce earnings, and for whom the issuance of a going concern opinion may reduce the costs of litigation (Carcello and Palmrose, 1991). Thus, Carey and Simnett (2006) is a case where triangulation is not expected and is not found. This is not to suggest that “triangulation” is never justified. For example, when EQ proxies are simply noisy measures of the same underlying theoretical construct, triangulation may rule out the possibility that the observed association is driven by the noise component of a given measure.

7. Summary

This discussion provides several observations on the EQ literature reviewed in DGS and comments on DGS’s major conclusions. I conjecture that key factors responsible for the large growth in EQ literature over the past two decades include the SEC’s harsh allegations of wide-spread earnings management by public companies, the literature’s adoption of the Jones model as a more-or-less generally accepted proxy for EQ, and the development and implementation of a set of internationally accepted accounting standards. I also suggest that a major advancement in the EQ literature is the increased rigor and continual evolution of the abnormal accruals proxies. I further point out that the literature has generated new knowledge regarding a variety of factors that help explain EQ -- such as earnings target incentives, country-level institutions, audit quality, internal controls, and timely loss recognition.

I also caution that the EQ literature faces several inherent challenges, including construct validity problems in the abnormal accruals proxies and difficulties in drawing inferences from EQ studies about decision-maker preferences. In addition, I suggest several areas for future research. These include the effects on EQ of the shift toward a fair value based accounting model, the adoption of a principles-based accounting system under IFRS, and the impact of SOX as it moves closer to a state of equilibrium. I also suggest that further research may be useful for better understanding the role of EQ in the debt markets, fraudulent financial reporting, policy making, and transactions management.

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