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## **The Managerial Earnings Manipulation of R&D Expenditures to Avoid Consecutively Missing Earnings Targets: Evidence from Japan**

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### **ABSTRACT**

This paper investigates whether Japanese firms reduce research and development (R&D) spending in response to short-term pressure on earnings and how capital market participants interpret such behavior. It is often insisted that R&D expenditures are the source of innovation and R&D intensive firms have possibility of future growth. However, R&D budgets are changeable and often subject to the managerial incentive to manipulate earnings for the purpose of achieving targets. Especially managerial decision-makings would be strongly affected by such incentives when earnings targets might be less than the salient earnings benchmark such as zero, last earnings number, and managerial earnings forecasts.

In this paper, two hypotheses are statistically tested from 2002 to 2006 using a sample of Japanese firms. From the empirical results, R&D expenditures were found to be sensitive to the lagged earnings performance relative to earnings targets. In particular, failure to beat or meet earnings forecast benchmarks in the previous period increases the R&D reductions in subsequent periods. Revealing a linkage between R&D expenditures and earnings targets, I explore how investors in capital markets interpret earnings in the presence of unexpected R&D budget adjustment. The results suggest that investors discount income-decreasing earnings management related to unexpected R&D budgets adjustment. Especially, investors place low assessments on firms with negative earnings or missing managers' earnings forecasts in the previous periods

Considering that R&D is greatly correlated with the innovation, which would result in the future growth, R&D should be highly evaluated by markets. However, the results in this paper implies that R&D expenditures discretionally managed to avoid missing the targets aren't innovative and that R&D expenditures do not always yield firms' innovation. Therefore investors should know the information contents incorporated in R&D outlays and pay adequate attention to the managerial financial reporting behaviors.

**Keywords:** R&D budget adjustment, Earnings management, R&D forecasts, Forecast revision, Capital market valuation