Do Firms Round Up Operating Cash Flows?

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Abstract

This study examines the rounding phenomenon in operating cash flows for firms listed in the three major U.S. stock exchanges (i.e., New York Stock Exchange, NASDAQ, and American Stock Exchange) and the U.S. Over-the-Counter (OTC) market. It finds that firms listed in the three major stock exchanges round-up earnings, but they do not round-up operating cash flows; while firms listed in the OTC market round-up both earnings and operating cash flows. Further sub-sample analysis reveals that even though both profit firms and loss firms round-up cash flows, the magnitude of round-up is higher for loss firms than for profit firms. Overall, the results from this study provide consistent evidence that firms have incentives to round up operating cash flows to paint a rosy picture of the firms' performance; however, it is more difficult to round-up cash flows than to round-up earnings. Therefore, in an environment where the rules and disclosure requirement is strict (i.e., the three major U.S. stock exchanges), firms do not have the opportunities to round-up cash flows; but in an environment where the rules and disclosure requirement are less strict (i.e., the OTC market), firms actually do round-up cash flows in practice. This study provides the first piece of empirical evidence on the rounding of operating cash flows, filling a void in the rounding phenomenon literature; it also sheds light on the effectiveness of the disclosure requirement in the three major stock exchanges to mitigate firms' activities to manipulate accounting numbers.

Keywords: earnings management, earnings quality, operating cash flows, OTC market, rounding phenomenon