Corporate Capital Investment, Accounting Methods and Earnings: A Test of the Control Hypothesis

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The purpose of this paper is twofold: first, I measure the effect of corporate capital investment decisions on the firm's earnings in the years following the capital investment. This relationship between investment and earnings is determined largely by two factors controllable by management: (1) the accounting methods used by the firm to measure its earnings and (2) the investment projects selected. The second purpose of this paper is to test a joint hypothesis about the effect of the type of control (manager or owner) of the firm on the investment-earnings relationship. Briefly, I find that the capital expenditure significantly reduces the earnings reported in the following year. Whether the firm is under a significant ownership control, however, seems to make little difference to this relationship between investment and earnings. Thus the selection of accounting methods and investment projects does not seem to be affected by the type of control of the firm. Measurement of investment-earnings relationship is presented in the first section. The control hypothesis is tested in the second. Implications of these results and further work now in progress are discussed in the concluding section.