ABSTRACT. Recent research has linked the reduction of abnormal accruals to corporate governance metrics. The results of these studies, however, are based on samples taken from periods prior to promulgated board independence requirements. In other words, during this time period, management not only had discretion over accounting accruals, but also significant influence over the choice of membership on the board of directors. This study suggests that ethical management practices may be a correlated omitted variable in these studies, thus resulting in causal inference problems in the previous research. We argue that, rather than the board of directors monitoring and reducing abnormal accruals as has been posited, management who was not engaging in abusive earnings management was attempting to signal the market regarding the quality of the firm’s financial information through its choice of board membership.

KEY WORDS: accrual management, corporate governance, earnings smoothing, ethical management

Introduction

The purpose of this article is to examine whether ethical management which was not engaging in inappropriate earnings management practices signaled the quality of its earnings to the market by increasing independent board membership. Healy and Wahlen (1999, p. 368) define earnings management as managers’ use of “judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.” The U.S. Securities and Exchange Commission (SEC) defines earnings management simply as “a material and intentional misrepresentation of results” (SEC, 2003). Both definitions raise questions about management’s ethics pertaining to earnings management practices, a conclusion reached previously by the National Commission of Fraudulent Financial Reporting (1987).1 In fact, earnings management has been labeled “probably the most important ethical issue facing the accounting profession” (Merchant and Rockness, 1994, p. 92). Despite this conclusion in the pre-Enron era, the problem continues. For example, a Business Week story (Byrnes and Melcher, 1998) entitled “Earnings Hocus-Pocus” reports that companies appear to use every accounting game in the book to jazz up their earnings. Similarly, in a House Sub-Committee meeting in May 2002, Chairman Richard H. Baker noted that “there is…extraordinary pressure on management to meet quarterly earnings expectations….“2 Gowthorpe and Amat (2005, pp. 61–63) also note that:

The exercise of power of the preparers is both unjust and unfair to the supposed beneficiaries of the reporting process. The fundamental objective of financial statements is deemed to be the provision of useful information for decision-making, but it appears that accounting regulation is too compromised to fulfil [sic] this purpose properly …. From an ethical perspective these manipulations can be regarded as morally reprehensible.3

Earnings management can be accomplished through many different means, such as modifying the lives of depreciable assets, changing the estimate of how much of accounts receivables will be uncollectible, or altering the estimate of the amount of warranties that will be exercised on the company’s
products. Parfet (2000) notes that management has a portfolio of “good (or ethical)” and “bad (or unethical)” earnings management practices from which to choose. “Ethical” earnings management practices would include, for example, using derivative securities to hedge business risks (an important business purpose). “Unethical” earnings management practices include accrual management (i.e., artificially shifting expenses between periods) to “cosmetically” smooth earnings, or what Arthur Levitt, a former Chairman of the SEC, labeled “the numbers game” (Loonis, 1999).  

Accrual-based accounting is the foundation of current accounting practice; it recognizes that economic transactions occur even when cash is not involved in the transaction. For example, when a customer purchases an item with a credit card, a company recognizes the sale and the related account receivable even though no cash changed hands at the point of sale. While the purpose of accrual-based accounting is to recognize the fact that cash may be due or payable at some future point, the greater a company’s level of accruals, the further the company’s accounting numbers are from actual cash flows. The discrepancy between actual and expected accruals (based upon the size of the company) is defined as “abnormal accruals,” and is tracked by analysts as an important measure of the amount of discretion management is using in its attempt to favorably portray the financial condition of the company. For instance, the SEC (2003) cites hundreds of cases where managers have used accounting maneuvers to manipulate profits so as not to disappoint investors and analysts. Managers can also understate earnings to make reported earnings appear less volatile than the firm’s actual fundamental performance.  

The board of directors is an important internal control mechanism designed to monitor the actions of top management, presumably including the use of accruals to manage earnings. Fama (1980) and Fama and Jensen (1983) suggest that the effectiveness of the board is a function of the composition of the board. They argue that the inclusion of outside directors (those not associated with the company except for sitting on its board of directors) enhances internal control through the corporate board.  

The New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation system (NASDAQ) have both adopted, with SEC approval, the requirement that the majority of the members of a company’s board must be independent. These actions suggest that regulators concur that board independence is an effective corporate governance technique. The use of abnormal accruals to manage earnings has recently been linked to ineffective corporate governance. Klein (2002) and Xie et al. (2003) both conclude that independent boards of directors are effective in monitoring the earnings process based on the negative relation between board independence and accrual management (proxied by the amount of abnormal accruals).  

We argue that this previous research linking corporate governance and abnormal accruals may suffer from a causal inference problem. Rather than independent boards monitoring abnormal accruals, ethical management that was not engaging in abusive earnings management may have instead influenced the nomination of strong independent directors in an attempt to convey private information (i.e., “signal” the market) about the quality of their earnings reporting practices.  

To test the hypothesis that ethical management (i.e., which was not engaging in abusive earnings management) was influencing the nomination of strong independent boards in order to signal their earnings quality, we introduce an alternative measure of earnings management that includes derivative securities for managing risk. Analyzing 513 firms and 1,237 firm-year observations from 1994 to 1996 (a period prior to significant corporate governance reforms), we find that the pervasiveness of accrual management relative to derivatives for earnings management is decreasing in the percentage of independent outside directors. While our results are similar to those of Klein (2002) and Xie et al. (2003), we also find that the value of a firm engaging in less extensive relative accrual management increases with an increase in outside directors.  

Our finding suggests that a commitment to improving board independence serves as a signal of ethical governance, which in turn increases firm value. This result indicates that ethical management may be a correlated omitted variable in studies by Klein (2002) and Xie et al. (2003). Specifically, our results show that their findings may be the result of ethical management influencing the nomination of strong independent directors to signal the market.