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Regulation and the interdependent roles of managers, auditors, and directors in earnings management and accounting choice[☆]

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ABSTRACT

In this paper, we examine the growing number of behavioral studies of how financial reporting, auditing, and other corporate governance regulations affect earnings management and accounting choice-related decisions of managers, auditors, and directors. We first describe how experimental and survey studies can add unique insights into our understanding of earnings management and accounting choice. We then organize our review of the literature by the type of regulation (financial reporting, auditing, or corporate governance) and secondarily by which of the three parties are affected. Finally, we point out useful directions for future research and discuss key methodological choices faced by those who will conduct that future research.

1. Introduction

This paper examines recent experimental and survey studies of managers', auditors', and directors' (or audit committee members') decisions that influence earnings management and accounting choice, and how these decisions are affected by financial reporting, auditing, and other corporate governance regulations. We evaluate what we have learned from these studies, point out useful directions for future research, and discuss key methodological choices faced by researchers in this area. Like our earlier review (Libby & Seybert, 2009), we employ a broad definition of earnings management and accounting choice to include: (1) choices of accounting methods; (2) implementation decisions related to estimates, classifications, levels of detail, and display format used in mandatory disclosures; (3) the frequency, timing, and content of voluntary disclosures; and (4) investment, financing, and operating choices based on their accounting (rather than economic) consequences (Libby & Seybert, 2009, p. 291). The experimental and survey studies that we focus on examine the determinants of accounting choice and not their consequences for users and market prices.[1]

Since our earlier review, there has been an uptick in experimental and survey studies of the determinants of earnings management and accounting choice. While the majority of the literature on earnings management and accounting choice uses archival methods to draw inferences, experiments and surveys have different strengths and weaknesses that make them particularly useful for studying certain aspects of accounting choice. First, as Francis (2001, p. 310) notes, most of the earlier accounting choice literature does not include decision makers other than the manager. The need to study the effects of other parties to the process,

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[1] Different portions of the consequences literature have been reviewed recently by Dechow et al. (2010) and Libby and Emett (2014). Studies which examine managers', auditors', and directors' *beliefs* about the consequences of their actions are included where relevant.

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such as auditors and audit committees (or directors), serves as the basis for many recent experimental and survey studies. Indeed, experiments and surveys have a comparative advantage in their ability to tease out the unique contributions of each party. Second, as Libby and Seybert (2009, p. 293) suggest, archival studies are limited to examining the effects of existing regulatory regimes, which makes it difficult to determine which specific elements of the regulatory regime impact the observed accounting choices. In experiments, specific elements of the regulatory regime can be independently manipulated to disentangle their effects on the parties' actions. Experimental and survey researchers can also investigate the effects of regulations that do not currently exist. And third, intermediate process measures are often captured in experiments and surveys, which allow assessment of the impact of specific motives, beliefs, and cognitive processes of the parties involved and how they interact with elements of regulation.

On the other hand, experiments, and to a lesser extent surveys, have limited ability to representatively sample decisions, settings, and actors. This limits their ability to estimate the magnitude or importance of effects. Also, experiments that rely on manipulation of independent variables can only focus on a small number of effects. Furthermore, many variables are held constant, which can limit the generalizability of results or hide important interactions. Surveys are limited in their ability to illuminate non-conscious effects and are subject to a number of forms of response bias (see Nelson & Skinner, 2013, for a detailed discussion). In summary, different methods are useful for addressing different parts of research questions related to accounting choice, and a multi-method approach is often warranted.

The earnings management and accounting choice literature generally views managers' choices as being motivated by managerial self-interest and maximization of current shareholders' interests (Fields, Lys, & Vincent, 2001; Francis, 2001). Tests of the effects of managerial self-interest rely mostly on differences in aspects of compensation contracts. Tests of maximization of current shareholders' interests rely mostly on differences in capital market pressures and differences in the importance of the liquidity benefits of transparency versus loss of competitive advantage (e.g., public vs. private ownership, the need for additional equity or debt financing, and industry competitiveness).

The broader accounting quality literature (see Dechow, Ge, & Schrand, 2010, for a recent review) also recognizes the importance of auditors and directors as potential monitors that may constrain earnings management and accounting choice. In the auditing literature, auditors are often portrayed as balancing their wish to satisfy client management with their wish to avoid both out-of-pocket costs of litigation and regulatory enforcement, as well as the longer-term costs of reputation damage (e.g., Hackenbrack & Nelson, 1996; Watts & Zimmerman, 1978). Similarly, in the corporate governance literature, directors or audit committee members are portrayed as balancing their wish to satisfy management with their wish to avoid litigation and regulatory enforcement costs, including longer-term costs to reputation (e.g., Fama, 1980; Hermalin & Weisbach, 1998).

Consistent with the above description of the various parties' motives, financial reporting, auditing, and corporate governance standards and regulations can be viewed as limits set on the effects of manager, auditor, and director motives. These limits operate by specifying required and prohibited types of behavior. Violation of the limits can be sanctioned through the courts or regulatory processes and the regulations also specify the type and magnitude of the potential sanctions. Many of the standards and regulations still leave room for a good deal of discretion (or judgment) on the part of all three parties involved in accounting choices. And, at the time of their issuance, there is uncertainty surrounding the exact manner in which enforcement agencies will interpret the standards and regulations and impose sanctions for infractions. Enforcement actions and speeches by regulators fill in many of these missing details over time. They also allow the regulators to efficiently react to the changing business environment.

One feature distinguishing the experimental and survey literature is that it places a more significant emphasis on cognitive factors that may affect the manner in which human managers, auditors, and directors form their beliefs and preferences, which determine their choices (e.g., Baker & Wurgler, 2013; Koonce & Mercer, 2005; Koonce, Seybert, & Smith, 2011). These cognitive factors include self-serving attribution bias, different forms of overconfidence, anchoring on regulations formerly in force, manager/auditor/director personality traits, weighting of sunk costs, social identity factors, moral licensing, and others.

There are a number of additional complications in studying the determinants of accounting choice that have been recognized in the behavioral literature. One concern is that each regulation can influence the judgments and decisions of *any or all of the three parties* involved in the financial reporting process. The limits imposed by regulations also affect behavior in concert with cross sectional differences in other attributes of the environment including the compensation scheme for the managers, auditors, and directors, as well as the transparency of their actions. Compounding the issue of cross-sectional differences in the environment, there are reliable individual differences in the manner in which each of these three parties respond to regulations and environmental attributes. Finally, the effects of regulations may also be dependent on other accounting choices that have been made in the current or prior periods. All of these complicating factors suggest the possibility of interesting interactions, and it is an emphasis on these interactions that differentiates much of the behavioral literature.

The remainder of the paper is organized as follows. In Section 2, we review the existing literature and derive the key conclusions from each stream. We organize the literature first based on the type of regulation, and then by the parties affected. In Section 3, we discuss directions for future research. In this section we focus on further research into the aforementioned interactions. Our discussion of future research opportunities also provides some guidance for a greater focus on understanding causal mechanisms and evaluating reporting outcomes, and points out the benefits of taking a broader view of regulation. Section 4 examines key research choices that determine the effectiveness and efficiency of experimental and survey research on accounting choice. These choices include the realism of stimuli, choice of accounting setting, and selection of participants. We then make recommendations concerning different approaches to examining decision processes. Key issues in this regard include the preeminence of clever experimental design, best practices in mediation analysis, and methods to examine non-conscious processes. Section 5 concludes. Our review focuses mainly on papers published in the 2008 through 2014 volumes of *Accounting, Organizations, and Society*; *Contemporary Accounting Research*; *Journal of Accounting Research*; and *The Accounting Review*. We also include several working papers from SSRN, and discuss selected older papers that provide the motivation for the more recent papers.

2. Effects of regulation

As in Libby and Seybert (2009), we discuss how (1) financial reporting regulations, (2) auditing regulations, and (3) other corporate governance regulations affect managers', auditors', and directors' judgments and decisions with respect to earnings management. A key to this organization is recognizing that each regulation can influence the judgments and decisions of *any or all* of the