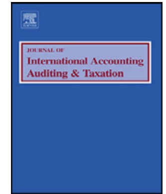
Journal of International Accounting, Auditing and Taxation 22 (2013) 26–38

Contents lists available at SciVerse ScienceDirect

Journal of International Accounting, Auditing and Taxation



The incidence of earnings management on information asymmetry in an uncertain environment: Some Canadian evidence

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ARTICLE INFO

Keywords:
Corporate governance
Earnings management
Environmental uncertainty
Information asymmetry

ABSTRACT

In this study, we investigate the association between earnings management and information asymmetry considering environmental uncertainty. Results show that a complex and dynamic environment weakens the relationship between discretionary accruals and information asymmetry measured as share price volatility and bid-ask spread. More specifically, the positive relationship between earnings management and information asymmetry is weakened for diversified firms, those intensively investing in R&D, and those facing high sales volatility. This highlights the difficulty for investors to assess earnings management in an uncertain environment. Finally, in such a context, discretionary accruals are more likely to be detected by investors for firms cross-listed on a U.S. stock exchange, a more liquid and transparent stock market compared with the Canadian stock market.

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1. Introduction

In this paper, we investigate the association between earnings management and information asymmetry considering environmental uncertainty. The theory of the firm (e.g. Child, 1972; Williamson, 1975) recognizes that environmental uncertainty places significant constraints on firms, affecting strategy and decision-making. Although firms are constrained by the nature of their environment, managers do have opportunities to respond strategically to uncertainty (Ghosh & Olsen, 2009). One of these opportunities is earnings management. The extent of opportunistic earnings management is likely to be higher when information asymmetry is high (Dye, 1988; Trueman & Titman, 1988). In turn, earnings management could increase the uncertainty for investors about the distribution of a firm's future cash flows, which would create information asymmetry between informed and less informed investors (Bhattacharya, Desai, & Venkataraman, 2012).

Two dimensions generally characterize environmental uncertainty: complexity and dynamism (Child, 1972; Thompson, 1967). According to Thompson (1967) and Terreberry (1968), a complex environment is one in which interactive relationships relevant for decision making require a high degree of abstraction in order to produce manageable mappings. A dynamic environment is one in which relevant factors for decision making are in a constant state of change.

Prior research suggests that complexity of the environment increases the difficulty for investors to assess earnings management (Lim, Ding, & Thong, 2008). Financial reporting is expected to be more complex for firms with diversified business and geographical operations. Hence, we expect earnings management to increase with the level of diversification and to be more difficult to detect by stock market participants.

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1061-9518/$ – see front matter © 2013 Published by Elsevier Inc.
http://dx.doi.org/10.1016/j.intaccaudtax.2013.02.002

Moreover, dynamic firms, especially those investing intensively in R&D, contribute to information asymmetry (e.g. Aboody & Lev, 2000). In such an asymmetrical context, we can argue that earnings management is more likely to occur (e.g. Francis, LaFond, Olsson, & Schipper, 2005) and less likely to be detected by market participants. Dynamic firms are also characterized by sales volatility, which affects managerial decisions (e.g. Child, 1972; Cyert & March, 1963; Williamson, 1975). It is assumed that it is in managers' interests to reduce the variability of reported earnings (Ghosh & Olsen, 2009; Gul, Chen, & Tsui, 2003) but in a volatile environment, earnings management is expected to be more difficult to detect because of a lack of stability in accounting figures. Therefore, we can expect earnings management occurring in a dynamic environment to affect information asymmetry to a lesser extent than in a stable environment.

The Canadian institutional environment may provide managers unique earnings management opportunities. A notable difference distinguishes the Canadian from the U.S. equity market. In the U.S., ownership in publicly traded firms is highly dispersed while in Canada, ownership is highly concentrated. In firms with concentrated ownership, there is a real possibility that dominant shareholders may mistreat or expropriate outside shareholders by earnings manipulation. Therefore, differences in earnings management opportunities may exist between Canada and the U.S. However, by listing their shares in the U.S., Canadian firms bond themselves to better disclosure and governance practices (Stulz, 1999). We expect earnings management practices to differ between Canadian firms and U.S. firms as well as their impact on information asymmetry. We consider that Canada provides a unique context to assess the incidence of earnings management on information asymmetry, especially in an uncertain environment.

Our main findings are the following. First, we observe that environmental complexity and dynamism lead to earnings management, especially for firms not cross-listed on a U.S. stock market. Second, in such contexts, earnings management affects information asymmetry to a lesser extent. Third, our findings suggest that in the presence of complexity and dynamism, discretionary accruals are more likely to be detected by investors for firms listed on a U.S. stock exchange. This result is consistent with the view that the U.S. stock market is more liquid and transparent than the Canadian market in the way information is collected and analyzed, and thus is in a better position to detect earnings management in a context of uncertainty. Finally, the quality of corporate governance is associated with less earnings management. Overall, our findings support the view that accrual anomaly is partly driven by investors' failure to correctly assess future earnings implications of accruals (Gong, Li, & Xie, 2009).

Compared with prior research, the present study innovates by investigating how the level of complexity and dynamism affects the stock market's assessment of earnings management. By combining an analysis of specific environmental incentives to engage in earnings management with an assessment of the incidence on information asymmetry, this study contributes to the understanding of earnings management implications. Results also suggest the importance of controlling for the endogenous nature of earnings management, namely corporate governance mechanisms.

The remainder of the paper is organized as follows. Section 2 presents the theoretical background and develops hypotheses. The study's methodology is described in Section 3. Results are presented in Section 4. Finally, Section 5 provides a discussion of the potential implication of the results.

2. Background and hypotheses

2.1. Stock market assessment of earnings management

Prior research shows a relationship between earnings management and information asymmetry in the market place. Measuring accruals management as the standard deviation of residuals from regressions relating current accruals to cash flows, Francis, LaFond, Olsson, and Schipper (2004) and Francis et al. (2005) find that earnings management is associated with higher information asymmetry, leading to higher costs of debt and equity. They also show that investors put more importance (in the determination of the cost of capital) on accruals that reflect intrinsic features of the firm's business model, relative to accruals that reflect a combination of pure noise and opportunistic choices and management's attempts to make earnings more informative. In the same vein, Liu and Wysocki (2007) argue that the documented relationship between accrual management and the cost of capital is driven primarily by the volatility of firms' operating activities that are not related to accounting choices and less subject to managerial manipulation.

However, prior evidence also suggests that investors' ability to assess earnings management may be imperfect. The market's inability to fully detect earnings management is associated with an increase in the heterogeneity of market beliefs (Ronen & Yaari, 2008). The accrual anomaly is characterized by stock markets overweighting the accrual persistence. Pincus, Rajgopal, and Venkatachalam (2007) find that stock prices tend to overweight the role of accruals persistence, especially discretionary accruals. The authors observe negative abnormal returns in year $t+1$ for firms with positive discretionary accruals in year t. This is particularly the case for countries having common law traditions such as Australia, Canada, the UK and the U.S. Soares and Stark (2009) reach the same conclusion for a British sample (1989–2004) since they find that average annual abnormal returns generally decline as prior period accruals move from low to high. This outcome is consistent with the accruals anomaly since investors overweight the persistence of accruals and underweight the persistence of cash flows in predicting the next period's earnings. An explanation of the accrual anomaly is that, as documented by Lev and Nissim (2006), investors avoid extreme-accruals firms because of their attributes such as small size, low profitability, and high risk. Lev and Nissim also observe that the high information and transaction costs associated with the implementation of a

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