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Independent director cash compensation and earnings management

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A B S T R A C T

This study examines the impact of independent directors' cash compensation on firms' financial reporting quality using a sample of Chinese listed companies from 2002 to 2008. Unlike in the U.S. where most listed firms provide stock-related compensations to outside directors, Chinese listed companies compensate independent directors with cash only. This context offers a cleaner setting for examining the effects of independent director cash pay on earnings management. Our study documents a positive association between independent director cash compensation and the magnitude of earnings management. This suggests that compensating independent directors with higher cash pay compromises their independence and reduces their effectiveness in financial reporting oversight. Our results are robust to an array of sensitivity checks. These findings have important implications for both investors and policy makers by showing that independent directors' cash compensation is also a significant determinant of financial reporting quality.

1. Introduction

The earnings management by public companies has attracted considerable attention in the wake of several large accounting scandals involving Enron, WorldCom, and other firms. The revelation of these accounting frauds raises concerns regarding the effectiveness of independent directors' oversight of companies' financial reporting process. Prior studies examining the impact of board independence

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on earnings management have yielded mixed results (e.g., Beasley, 1996; Vafeas, 2000a, 2005; Klein, 2002; Jaggi et al., 2009; Faleye et al., 2011). We contend that independent director monitoring is a function of both the competency and incentives of independent directors (Fama and Jensen, 1983; Yermack, 2004). The latter includes both pecuniary (directors' compensation) and non-pecuniary (reputation, status) incentives. Anecdote evidences suggest that the pecuniary incentives for independent directors exert a significant impact on directors' behavior. For instance, *The Global Principles of Accountable Corporate Governance* released by *CalPERS* stated that "[a]lthough non-employee director compensation is generally immaterial to a company's bottom line and small relative to executive pay, director compensation is an important piece of a company's governance (CalPERS, 2011: p. 52)". The AFL-CIO *Proxy Voting Guidelines* also claimed that "[e]xcessively large compensation packages may also make directors less willing to challenge management out of fear of not being re-nominated (AFL-CIO, 2003: p. 16)". It therefore remains an interesting question whether and how independent director compensation affects financial reporting quality.

The extant research has examined the impacts of independent directors' stock-based compensation on financial reporting quality, and yields mixed results (Beasley, 1996; Vafeas, 2005; Ronen et al., 2006; Cullinan et al., 2008). Little research however has explored the correlation between independent directors' *cash* compensation and financial reporting quality. The distinct differences between cash and stock-based compensations justify this study. Stock compensation is a performance-based pay, while cash compensation for outside directors are typically not closely tied to firm performance. As a result stock compensation can provide better alignment of directors' and shareholders' interests (Fich and Shivdasani, 2005; Ahmed and Duellman, 2007). However, stock-based compensation may also provide misaligned incentives in earnings management by closely tying directors' wealth to equity price. If the market cannot see through earnings manipulation in financial statements and values the company incorrectly, directors compensated with stocks and options may benefit from earnings manipulation by engaging in insider trading. This provides misaligned incentives for directors to engage in earnings manipulation (Ronen et al., 2006; Cullinan et al., 2008). On the other hand, cash compensation for independent directors is not sensitive to equity price, and therefore results in less motivation to inflate earnings. The different impacts of cash and stocks on director incentives suggest that the implications from research on stock-based compensation are not applicable to cash compensation.

There are two mechanisms however relating independent director cash compensation to earnings management. The *incentive hypothesis* posits that high cash compensation will provide independent directors with monetary incentives to effectively monitor management (Adams and Ferreira, 2008) and thus curb the level of earnings management. On the other hand, the *reciprocity hypothesis* posits that high cash compensation for independent directors may compromise their independence because well-compensated directors may reciprocate high cash compensation by reducing oversight of insiders (Vafeas, 2000b; Brick et al., 2006). The net effect of independent directors' cash compensation on earnings management is accordingly an empirical issue.

The Chinese stock market provides an appropriate setting for investigating this issue. Unlike in the U.S. where most listed companies grant stocks and options to their outside directors (Yermack, 2004; Farrell et al., 2008), Chinese listed companies do not grant stocks and options to their independent directors and instead compensate independent directors with cash only. This context provides a cleaner setting for examining the impact of independent directors' cash compensation on earnings management. In contrast, over 93% of U.S. listed firms grant equity-based compensation to outside directors; cash pay merely accounts for 38% of outside directors' total compensation during the period from 1998 to 2004 in Farrell et al. (2008) sample. Outside directors in U.S. listed firms on average hold 0.9% of the firm's equity (Ertugrul and Hegde, 2008). Accordingly, it is difficult to disentangle the impact of cash compensation from that of stock-based compensation on earnings quality in U.S. listed firms.

Using a sample of 1407 Chinese listed firms during the period from 2002 to 2008, we find that independent directors' cash compensation is positively associated with the level of earnings management. This suggests that the *reciprocity effect* dominates the *incentive effect* in China. We further document that the positive relationship is weaker for female directors. Our results are robust to an array of sensitivity tests, including endogeneity concern.

This study contributes to the extant literature in several ways. First, we complement the prior literature by examining the relationship between independent directors' cash compensation and earnings