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Board external connectedness and earnings management

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A R T I C L E I N F O

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A B S T R A C T

In this study we explore how board external connectedness is related to firm's earnings management. Board external connectedness is gauged by the percentage of board members with at least one external board membership, and earnings management is gauged by the level of discretionary accruals from the modified Jones model. We postulate that externally connected directors could learn something from their connected firms, and this experience could be translated into monitoring effectiveness which in turn reduces a firm's level of earnings management. We use the sample consisting of 5940 firm-year observations from the listed firms in Taiwan in 2007–2011 sampling period to test the learning-effect hypothesis. The empirical finding supports this hypothesis by showing that board external connectedness is negatively correlated with the level of earnings management and that the negative relation is more conspicuous for the same-industry connectedness. However, the negative relation between board external connectedness and earnings management becomes insignificant when the firm has an external financing plan. Finally, independent directors' same-industry connectedness does reduce the level of earnings management when the firm has an external financial plan.

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1. Introduction

Prior studies of board interlocking illustrate how it affects corporate behaviors such as investment choices, mergers and acquisitions, compensation practices, poison pill adoption, stock exchange listing decisions, and earnings management (Bizjak, Lemmon, & Whitby, 2009; Cai & Sevilir, 2012; Cohen, Frazzini, & Malloy, 2008; Davis, 1991; Fracassi & Tate, 2012; Haunschild, 1993; Hirshleifer & Teoh, 2009; Ishii & Xuan, 2014; Rao, Davis, & Ward, 2000; Stuart & Yim, 2010). A recent study of Chiu, Teoh, and Tian (2013) indicates that earnings management is like a virus that spreads from one firm to another via board connections of shared directorships. These shared directors are like virus carriers in the sense that the directors of the infected firms carry these earnings management behaviors to susceptible firms on whose boards they also sit on. The study implies that board links are positively correlated with a firm's propensity to engage in earnings management.

In this study we explore a similar issue to relate board members' external connectedness to a firm's earnings management. In contrast to the contagion effect illustrated in Chiu et al. (2013), we develop the learning effect hypothesis indicating that externally connected board members could learn experiences from their outside sitting boards. These experiences could be translated into monitoring effectiveness and therefore result in a lower level of earnings management. The results from our sample consisting of 5940 firm-year observations from the listed firms in Taiwan during 2007–2011 verify the learning effect hypothesis. Moreover, we further look into the attributes of the connectedness and find that the monitoring effectiveness in reducing level of earnings management is more conspicuously found for the same-industry connectedness than for different-industry connectedness.

We further follow prior studies to relate earnings management to a certain critical corporate event such as seasoned equity offering (e.g., Dechow, Sloan, & Sweeney, 1996; Rangan, 1998; Teoh, Welch,

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& Wong, 1998). We postulate that firms with external financing plans including seasoned equity offerings and debt offerings would have stronger motives to engage in earnings management so that their seasoned shares or debt could be sold at a higher price level. We find that the factor of having an external financing plan is so strong as to dominate other factors in explaining the level of earnings management: not only board external connectedness but also other factors including firm size, Tobin's Q, supervisors' educational level, and ROA lose their explanatory power when firms have external financing plans.

We further decompose the connectedness by board members' status: outside, inside, independent directors, and supervisors. The results indicate that the external connectedness of outside directors and supervisors is able to significantly reduce the level of earnings management. Moreover, if the learning effect could explain why board external connectedness is negatively correlated with the level of earnings management, we would expect that for these connected board members the learning effect from the same-industry exposure is stronger than that from different-industry exposure. The results support this hypothesis that the same-industry connectedness of outside directors, inside directors, and supervisors is able to reduce the level of earnings management when there is no external financing plan. Finally, we find a special pattern regarding independent directors: they are passive in affecting firm's level of earnings management when firms have no external financing plan. However, their external connectedness in the same industry is negatively correlated with firm's earnings management when the firm has an external financing plan.

There are several differences between our investigation and Chiu et al. (2013). First, we investigate the level of earnings management rather than the inclination of earnings management. Second, we explore board external connectedness rather than board interlock.[1] More importantly, we find a significantly negative relation between board external connectedness and level of earnings management. This is in sharp contrast with the finding of Chiu et al. (2013). The negative correlation is mainly due to the connectedness of outside directors and supervisors, implying that these outside directors and supervisors are able to provide a better monitoring function when they have external connectedness. However, the monitoring effectiveness due to board external connectedness simply disappears when the underlying firm has an external financing plan. The positive relation between external financing plan and earnings management is so strong as to dominate the monitoring effectiveness indebted to board external connectedness. Such relation implies that independent directors play a good goalkeeper when firms have an external financing plan that involves new stakeholders.

The potential contributions of this paper are multifold. First, we document the negative relation between board external connectedness and firm's earnings management and propose the learning effect to account for the negative relation. The relation might sustain in an emerging market where board interlock creates value in terms of an enhancement of monitoring effectiveness. Second, we identify the predominating effect of external financing plans on firms highly motivated to engage in earnings management. Third, we identify board member's status and calculate the external connectedness for each status. An upclose look allows us to get a better understanding of how external connectedness of different board status is related to firm's earning management. Finally, we specifically portray the role of independent directors: we find them passive when there is no external financing plan and active in reducing firm's level of earnings management when there is an external financing plan. The rest of this paper is organized as follows. Section 2 reviews literature and develop testing hypotheses. Section 3 depicts the data and variables. Section 4 reports the empirical results. Section 5 concludes.

2. Literature review and hypothesis development

2.1. Board external connectedness and earnings management

The existing literature relating to board external connectedness could be ramified into four threads: reputation, information flow, busyness, and contagion. The reputation effect proposed by Fama (1980) and Fama and Jensen (1983) indicates that multiple directorships allow directors to develop reputations as monitoring specialists (Fama, 1980; Fama & Jensen, 1983) and increase their prestige, visibility, and commercial contact (Mace, 1971). Supporting evidence for the positive reputation effect of multiple directorships was found in various corporate scenarios.[2] Information flow emerges as a new thread of studies indicating that with the conduit of interpersonal and inter-organizational networks, board external connectedness facilitates information communication, resources exchange, formation of new relationships, and enhancement of existing relationships. Connelly and Van Slyke (2012) indicate that the social context is instrumental for firms to determine what information they must constantly gather and assess. The information will help them identify and evaluate emerging opportunities. Unfortunately, many firms allow themselves to become under-connected and isolate themselves from new sources of information. Other than the benefit of accessing useful information, board external connectedness also mitigates information asymmetry. For example, Cai and Sevilir (2012) find that M&A transactions are benefited from board external connectedness which is further ramified into first-degree and second-degree connection. Butler (2008), Botosan (1997) and Chuluun, Prevost, and Puthenpurackal (2014) find that board external connectedness is negatively correlated with yield spread.

If reputation effect illustrates motives while information flow illustrates the conduits for these externally connected directors to have the firm run properly, the learning effect is jointly developed to contain both motives and conduits and indicates that externally connected directors could learn from their external experiences from serving multiple directorships. Xie, Davidson, and DaDalt (2003) indicate that board members' financial sophistication is an important factor in constraining the propensity of managers to engage in earnings management. If directors could learn from their outside directorships and therefore enhance the capability of monitoring, surveillance, and advising to the incumbent management, their acquired knowledge or sophistication from external connectedness would help detect and reduce the underlying firm's level of earnings management. If the learning effect prevails, we would expect to find that board external connectedness is negatively correlated with firm's level of earnings management.

[1] The two terms are similar in meaning. However, there are two subtle differences between the two terms. First, board external connectedness focuses more on the connected directors while board interlock focuses more on the connected firms. Second, board external connectedness focuses more on directors' outbound relations while board interlock focuses more on reciprocal relations between two connected firms.

[2] The positive reputation effect of multiple directorships, using the proxy of the number of board seats held by an outside director (Brown & Maloney, 1999; Shivdasani, 1993; Vafeas, 1999), is applied to antitakeover provisions (Coles & Hoi, 2003), CEO replacement (Farrell & Whidbee, 2000), CEOs following retirement (Brickley, Linck, & Coles, 1999), financially distressed firms (Gilson, 1990), firms that cut dividends (Kaplan & Reishus, 1990), and firms that are sold (Harford, 2003).

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