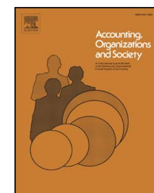
Accounting, Organizations and Society xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Accounting, Organizations and Society

journal homepage: www.elsevier.com/locate/aos



Management deception, big-bath accounting, and information asymmetry: Evidence from linguistic analysis

Ole-Kristian Hope[a,b], Jingjing Wang[a,*]

[a] Rotman School of Management, University of Toronto, Canada
[b] BI Norwegian Business School, Norway

ARTICLE INFO

Keywords:
Management deception
Big-bath accounting
Linguistic analysis
Information asymmetry

ABSTRACT

Accounting big baths are pervasive in practice. While big baths can improve the information environment and reduce information asymmetry, they can also degrade the information environment and obscure operating performance. In this study, we examine the role of management ethics. Specifically, we investigate whether managers' truthfulness (or conversely, deceptiveness) affects how investors perceive big baths. Using linguistic analysis on earnings-conference calls to measure managerial deception and employing a difference-in-differences research design with propensity-score matching, we find that information asymmetry is significantly higher following big baths taken by deceptive CEOs, compared with big baths taken by less deceptive CEOs.

1. Introduction

How does a firm's information environment change after accounting big baths? Prior literature provides evidence on both positive (Elliott & Shaw, 1988; Francis, Hanna, & Vincent, 1996; Haggard, Howe, & Lynch, 2015) and negative (Bens & Johnston, 2009; Kirschenheiter & Melumad, 2002; Kothari, Shu, and Wysocki 2009; Moore, 1973) consequences of big baths on the information environment. As managers have discretion regarding whether to incur a large write-off, and can decide the timing and amount of the write-off, management's incentives are important in studying the effects of big baths. However, such incentives are unobservable. Investors may use managerial characteristics to infer management incentives. Among the most salient managerial characteristics in this setting is truthfulness; thus this study examines how truthfulness (or conversely, deceptiveness) affects investors' perceptions of big baths.

According to upper-echelons theory (Hambrick & Mason, 1984), the ethical attentiveness throughout the organization is instilled by its leaders (Patelli & Pedrini, 2015). A series of accounting fraud scandals over the last decades put leadership ethics at the forefront of the heated debate on financial-reporting truthfulness (Mihajlov & Miller, 2012; Tourish & Vatcha, 2005). Ethics is an intrinsic part of managers' behavior (Solomon, 1992). As firms' high-level decision makers, top managers are likely to follow a cognitive and rational approach that revolves around moral judgments about the issues when making ethical decisions, just as an individual making a choice when facing an ethical dilemma (Albert, Scott, and Turan 2015; Kohlberg, 1981; Reynolds, 2006; Vitell, Lumpkin, and Rawwas 1991; Weber, 1990). Big baths are managerial decisions that can be the result of managers' ethical considerations of the firms' welfare, or can be the result of managers' incentives to maximize their personal utility. Being truthful or deceptive to investors and other stakeholders also indicates management's ethical choice of how they view their responsibility to the firm's stakeholders.

On one hand, big baths can manifest themselves as exceptionally large negative discretionary accruals. On the other hand, big baths can consist of one-time, large write-offs, and may include restructuring charges, asset impairments, and litigation losses. These write-offs are generally reflected as “special items” in the financial statements. There are two ways to look at a big bath. If a company reports a loss that is larger than expectations, it could be the case that there are certain issues within the firm that warrant such actions and that managers are truthfully conveying such information to the capital market and other stakeholders. In line with that view, some analysts interpret big baths as managers' positive response to existing problems (Elliott & Shaw, 1988). Big baths can also “clear the air” (Haggard et al., 2015). That is, by writing off assets when their carrying values are less than the market values, the reported values of the assets are realigned with their economic values. As a result, firm-level information asymmetry following a big bath should decrease.

However, big baths are sometimes used as an earning-management technique to shift current earnings to future periods. As Levitt (1998) points out, if big-bath charges are overly conservatively estimated with “extra cushioning,” they can miraculously be reborn as income when future earnings fall short. Big baths can also be used to secure bonus

* Corresponding author.
E-mail addresses: okhope@rotman.utoronto.ca (O.-K. Hope), Jingjing.Wang15@rotman.utoronto.ca (J. Wang).

https://doi.org/10.1016/j.aos.2018.02.004
Received 17 April 2017; Received in revised form 26 February 2018; Accepted 27 February 2018
0361-3682/ © 2018 Elsevier Ltd. All rights reserved.

payments. Often, managers' rewards are tied to meeting certain performance targets. In an economic downturn, managers may follow the big-bath approach by bundling as much bad news into the current period as possible, aiming to make their targets easier to achieve in the next period.[1] In cases of new management, big-bath accounting can be used to mitigate top executives' job-security concerns.[2] The new manager can benefit from taking a big bath, blaming the low earnings on the previous manager so as to display an improved financial performance in future (Moore, 1973).

From investors' perspectives, the action of taking big baths by a firm is observable, but the motivations behind the action are not entirely clear. Hou (2015) finds that in a well-diversified market, idiosyncratic information risk is priced when information is subject to managers' discretion and thus ambiguous. Can investors infer the motivations of managers by observing their types – truthful or deceptive – and associating their actions with the types? By taking advantage of newly-developed technologies, investors are now analyzing the linguistic patterns displayed in management speech. Investors have been using algorithmic textual analysis, CIA lie-detection techniques, and more recently, audio analysis of management speech, to seek an edge with stock calls, sector sentiment, and overall market direction.[3]

Earnings-conference calls, in which managers discuss their firms' financial performance with analysts and investors, are important information sources to search for signs of management deception. If a manager is discovered to be deceptive when discussing her firm's financial results, and the firm takes a big bath at the time, will investors perceive this big bath to have low credibility? Will investors associate this big bath with such motivations as meeting earnings targets or securing bonus payments? If this is the case, we would expect to observe an increase in information asymmetry following big baths taken by deceptive managers. Conversely, if a firm's manager takes a big bath and she is considered truthful, investors may perceive this big bath as having high credibility. In this case, the information asymmetry may decrease.

A primary reason both practicing accountants and researchers care about information asymmetry is that it reflects the information environment.[4] Clearly an important issue related to big baths is whether these accounting events improve or deteriorate the firm's information environment. However, to broaden the scope of our study, in additional analyses we also test for trading volume (another commonly employed outcome variable in this line of literature).

This study builds on Larcker and Zakolyukina (2012) who find that certain words are significantly associated with management deception. For instance, deceptive CEOs use more "reference to general knowledge" and "extreme positive emotion" words, and use fewer "anxiety" and "shareholder value" words. The linguistic approach proposed by Larcker and Zakolyukina (2012) is based on psychological theories linking deception to linguistic behavior (Vrij, 2008), and is built up by applying a well-developed and frequently used psychosocial dictionary – LIWC. There are an increasing number of applications of LIWC analyses in deception detection, and also in personality, forensic, clinical, relationship, and cultural assessments (Chung & Pennebaker, 2012, chap. 12). Providing further validity to Larcker and Zakolyukina (2012), Loughran and McDonald (2013) demonstrate that the credibility of managers is diminished by having an overly positive S-1 in the IPO process, consistent with Larcker and Zakolyukina (2012) who find that deceptive CEOs use significantly more positive emotion words in conference calls. Another piece of evidence substantiating the usefulness of CEOs' linguistic patterns in signifying deception is provided by Hobson, Mayew, Peecher, and Venkatachalam (2017), who demonstrate that once given instructions on the "cognitive dissonance" in the CEOs remarks, auditors are able to more precisely detect fraudulent companies as well as the unidentified "red flag" sentences in earnings-conference calls.

We use Larcker and Zakolyukina (2012) approach to identify truthful and deceptive managers in this paper, and examine whether the change in information asymmetry around a big-bath event is a function of managerial deception. As CEOs play the largest role in corporate decision making, we focus on the linguistic pattern of CEOs.

In our primary analyses we employ a difference-in-differences research design coupled with propensity-score matching of treatment and control firms. This approach provides strong control for potential confounding events as well as omitted-variable biases. We find evidence that investors are able to discern managers' deception levels from conference calls and that information asymmetry is affected accordingly. Specifically, we find that information asymmetry (proxied using Amihud, 2002 illiquidity measure and bid-ask spreads) increases significantly after big baths taken by deceptive CEOs as compared to those taken by less deceptive CEOs. In additional analyses, we find that this effect is more pronounced when a CEO who has been truthful in the past becomes deceptive in the bath year. Our inferences are robust to a variety of regression specifications and other robustness tests.

The study adds to the big-bath line of research by examining a potentially important factor that could affect the impact of big-bath taking on information asymmetry. Second, our study contributes to research on how investors use ex-ante credibility of CEOs to interpret financial reporting quality (e.g., Loughran & McDonald, 2013). We do this by applying textual-analysis techniques to accounting issues to infer management's intentions using subtle linguistic cues. Finally, the study adds to management-ethics research by examining management deception and its associated capital-market consequences in the setting of big-bath taking, an economically important event as documented in prior research.[5] This paper thus also contributes to the literature by studying the financial outcomes of CEO idiosyncratic characteristics and psychological patterns.

2. Prior literature and hypothesis development

2.1. Big-bath literature

Prior research has examined the timing, motivation for, and consequences of taking big baths. Moore (1973) finds that discretionary accounting decisions that reduce income are more likely to be made in a period of management changes. The write-offs, many of which have substantial economic consequences, reflect decisions by corporate management. Kirschenheiter and Melumad (2002) construct a theoretical model to demonstrate that managers under-report earnings the most when the news is sufficiently "bad." Management, on average, delays the release of bad news to investors (Kothari, Shu, and Wysocki 2009). Mendenhall and Nichols (1988) find that most bad news, including large write-offs, takes place in the fourth quarter and that the market reaction for fourth-quarter bad news is smaller than the reaction to similar news in other quarters.[6]

[1] This big-bath approach is discussed in the article "why honesty is the best policy" in the special report section of The Economist, March 7, 2002.

[2] "Some new bank CEOs take an earnings bath when they start," The Wall Street Journal, March 3, 2014.

[3] A discussion on the topic of "how to tell if a CEO is lying" can be found at http://www.CNBC.com, July 7, 2015.

[4] For example, Haggard et al. (2015) use the terms information environment and information asymmetry interchangeably.

[5] Maak and Pless (2006) call for research that focuses more on the identification and measurement of leadership styles that lead to responsible leadership. The extent to which CEOs influence accounting choices is fundamental to the understanding of how organizations work, but this linkage is poorly understood (Mackey, 2008).

[6] There are different types of write-offs. Write-offs in PP&E and inventory accounts are typically considered less reflective of earnings manipulation, while restructuring charges and write-offs of goodwill are considered more reflective of such a motif (Francis et al., 1996). Similarly, write-offs of long-lived assets after the adoption of SFAS 121 are less reflective of firms' fundamentals and such big baths are associated with managers' opportunistic actions (Riedl, 2004). Bens and Johnston (2009) find that before EITF No. 94-

Download English Version:

https://daneshyari.com/en/article/11020639

Download Persian Version:

https://daneshyari.com/article/11020639

Daneshyari.com