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Effects of directors and officers liability insurance on accounting restatements

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A B S T R A C T

This study investigates the relationship between directors and officers liability insurance (D & O insurance) coverage and the probability of accounting restatements. The results show that when managers are covered by relatively higher levels of D & O insurance, they are more likely to restate their financial reports. Moreover, the findings indicate that D & O insurance coverage is related to core earnings restatements and income overstatements, suggesting that managers' accounting policies are more aggressive when they have fewer legal liability concerns. Overall, these results provide consistent evidence that reducing managerial legal liability has the effect of encouraging managers to misstate reported earnings.

1. Introduction

Recent accounting scandals have been preceded by or have resulted in restatements (Ettredge, Scholz, Smith, & Lili, 2010). Moreover, worldwide media coverage regarding the collapses and scandals of corporate giants, such as Enron, WorldCom, and Olympus, appear to have shaken the confidence of investors. In the wake of these scandals, many of these companies saw their equity values drop along with their credit ratings (Agawal & Chadha, 2005). In recent years, as stock market valuations have increased, managers have had more incentives to maintain earnings momentum, thus increasing market prices (Barth, Elliot, & Finn, 1999; Myers, Myers, & Skinner, 2007). Moreover, such situations have allowed them to beat analysts' targets (DeGeorge, Patel, & Zeckhauser, 1999; Burgstahler & Eames, 2001).[1] However, litigation concerns tend to constrain aggressive financial reporting by managers. Prior research indicates that earnings restatements increase the risk of securities class actions (Kinney & McDaniel, 1989; Jones & Weingram, 1997; Sen, 2007), and that managers have incentives to conservatively report their financial situation to reduce expected legal liability (Stammerjohan, 2003; Watts, 2003; Chung & Wynn, 2008). Therefore, the objective of this study is to investigate the relationship between accounting restatements and directors' and officers' liability insurance (D & O insurance) coverage.

When a corporation announces a financial restatement, directors and officers face increased legal responsibilities, heightened time commitments, and lower investor tolerance for performance and governance failures. All of these factors potentially trigger and increase the litigation risk for directors and officers arising from shareholder suits. For the most part, earnings restatements are inherently difficult to defend since the defendants concede (by announcing the restatements) that they misrepresented material information regarding the company's financial condition and performance (Palmrose & Scholz, 2004). While the causes of a

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[1] Previous studies on earnings management have traditionally focused on incentives provided by explicit contractual arrangements such as bonus plans and debt covenants (e.g., Watts & Zimmerman, 1990; Dechow & Skinner, 2000).

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restatement may vary, according to Huron's 2004 Annual Review of Financial Reporting Matters, aggressive accounting policies are responsible for approximately 60% of financial restatements.[2] Prior studies indicate that, if managers are aggressive in earnings management, class action securities litigation will then increase, thus resulting in serious settlements (Stammerjohan, 2003; DuCharme, Malatesta, & Sefcik, 2004; Lev, Ryan, & Wu, 2008; Jones & Wu, 2010; Lin, Officer, Wang, & Zou, 2013). Thus, due to higher litigation risk faced by directors and officers, it could be extremely costly to manipulate financial reporting (Tillinghast–Towers Perrin, 2002).

Although accounting litigation, especially that precipitated by a restatement of earnings, is undoubtedly painful, the personal legal liability of directors and officers will be lessened if their company purchases D & O insurance and provides permissible cash indemnification. D & O insurance, which reimburses directors and officers for defense costs, judgments and settlements, is generally available even in cases where a company admits that its financial statements are materially misleading. Indeed, D & O insurance is intended to protect directors and officers against shareholder litigation by providing assurance that their personal assets will not be at risk (Boyer & Stern, 2012, 2014). Accordingly, most empirical studies find that D & O insurance is associated with managerial opportunism (Chung & Wynn, 2008; Wynn, 2008; Chen & Li, 2010; Lin et al., 2013). Since D & O insurance insulates directors and officers from the threat of litigation resulting from their decisions on behalf of the firms, it could induce unintended moral hazards and alter the risk attitudes of managers to act in the best interest of themselves (Chung, Hillegeist, & Wynn, 2015; Gillan and Panasian, 2015; Hwang & Kim, 2013). Therefore, due to the lower deterrent effect of shareholder litigation, managers have more incentives to choose an aggressive accounting policy when his/her personal legal liability is covered by D & O insurance and cash payments for indemnification.

To examine whether D & O insurance leads to low-quality financial reporting, this study employs accounting restatements to detect aggressive financial accounting practices and the effects of excessive. Because accounting restatements could capture extreme accounting outcomes, using accounting restatements to represent aggressive accounting increases the power to detect the effect of excessive D & O insurance coverage.

In addition, it focuses on a sample of Taiwanese companies. Taiwan provides an ideal setting to investigate D & O insurance coverage and accounting restatements for several reasons. First, D & O liability insurance is publicly disclosed in Taiwan, whereas D & O insurance coverage is not disclosed in the United States. In response to an increase in the number of shareholder claims against corporations, in 2002, the Taiwanese Securities and Futures Bureau (TSFB) announced a new ruling titled, “The Corporate Governance Best-Practice Principles for Listed Companies.” The ruling stipulates that a listed company takes out liability insurance for its directors and executives. Second, generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) in Taiwan are very similar to those under U.S. regulations since they are modeled after the U.S. GAAP and GAAS. Thus, the causes and types of accounting restatements in Taiwan during the 2007–2012 research period are generally the same as those in the United States.

The empirical evidence shows that reducing managerial legal liability has the effect of encouraging managers to misstate reported earnings, and even violate GAAP. In addition, D & O insurance may not be randomly assigned to firms, and excessive D & O insurance coverage has a tendency to mitigate managerial legal liability concerns and consequently increase the likelihood of core earnings restatements and income overstatements. Furthermore, there are potential endogeneity problems in this study. More specifically, one might be concerned that D & O liability insurance and accounting restatements appear to be related since they are both driven by complexities and fundamental firm risks. In other words, firms with more complexities or higher fundamental risks tend to have greater levels of D & O liability insurance coverage, and these firms have more difficulty selecting proper accounting policies.

To address the issue of potential endogeneity, this study employs a series of econometric analyses. First, it applies the matching sample approach based on the complexity of operations (i.e., number of subsidiaries or accounts receivable, and inventory). Second, it utilizes Heckman's (1979) model to control for self-selection bias. Regardless of the econometric methods used in the study, the documented results are not sensitive to potential endogenous D & O insurance purchases.

This study's findings contribute to the aggressive accounting literature by providing evidence regarding the association between managerial legal liability coverage and earnings restatements. Although extensive prior research examines whether a variation in managers’ legal liability exposure is associated with opportunistic accounting choices (Stammerjohan, 2003; Boubakri, Boyer, & Ghalleb, 2008; Chung & Wynn, 2008; Wynn, 2008), an empirical investigation of the relationship between managers’ legal liability exposure and accounting restatements is lacking. Thus, the study provides the empirical evidence that managerial legal liability coverage is a determinant of earnings restatements. Next, this study conjectures and finds that excessive D & O insurance coverage increases the incidence of earnings restatements more than excessive cash indemnification, meaning that D & O insurance will mitigate managerial legal liability concerns about earnings restatements, especially for core earnings restatements and income overstatements. Finally, this study explores and documents the significant effect of D & O liability insurance coverage on the incidence of accounting restatements by focusing on restatements arising from the violation of GAAP.

This study differs from prior studies that examine the impact of D & O insurance on earnings quality since it employs various measures to proxy for earnings quality, including discretionary accruals and earnings conservatism (Boubakri et al., 2008; Chung and Wynn, 2008; Wynn, 2008). High accruals and less conservatism may proxy for the poor quality of financial restatements. However, they may not arise from a violation of GAAP. The distinctiveness of the present study is its exclusive focus on restatements arising

[2] In 2004, the five categories of aggressive accounting issues included: revenue recognition (16.4%); equity accounting (16%); reserves, accruals, and contingencies (14.1%); capitalization/expense of assets (7.7%); and inventory (3.5%). Two other categories comprise accounting for mergers or acquisitions, and securities transactions.