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Female directors and earnings management: Evidence from UK companies

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ABSTRACT

Since the gender diversity of boards and reporting of earnings are two most debated issues in the corporate world, the paper examined how the presence of women directors on the corporate board influence earnings management practices. We found that firms with a higher number of female and independent female directors are adopting restrained earnings management practices in the UK. We further made a distinction between complex (high debt) and simple (low debt) companies, and the outcomes reveal that female directors have a positive effect on the earnings management in simple companies. The paper contributes to the debate on gender diversity on boards, and its impact on the use of accounting discretion in financial reporting.

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1. Introduction

The literature on board diversity and firms' financial performance (e.g. Adams, Gupta, & Leeth, 2009; Campbell & Mínguez-Vera, 2008; Carter, Simkins, & Simpson, 2003; Erhardt, Werbel, & Shrader, 2003; Farrell & Hersch, 2005) broadly supports the view that the presence of women representatives on the board enhances the firm's financial performance. The recent Davies Report (2011) has provided a business case for gender diversity on boards based on its potential impact on improving performance, accessing the widest talent pool, achieving better corporate governance and being more responsive to the market. However, the issue of improving the gender balance of corporate boards has continued as a worldwide concern. For instance, in the US, women held only 16.9% of Fortune 500 board seats in 2013, and less than one-fifth of companies had 25% or more women directors, while one-tenth had no women serving on their boards (Catalyst, 2013). The Davies Report (2011) further shows the levels of under-representation of women on corporate boards across the globe, ranging from 3.6% in the industrialised Asia-Pacific region to 23% in Sweden and the Philippines; the figure for the UK was 9.6%.

Flexibility in accounting standards allows managers to estimate and project accounting numbers different from the underlying economic conditions of a firm. For instance, under generally accepted accounting principles (GAAP), managers can exercise discretion over accounting-reported earnings to maximise the information value of the firm's earnings. Although this is an accepted strategy used by management in the corporate world for income smoothing, excessive use of this practice is detrimental. Furthermore, it has been acknowledged that managers may have an incentive to manipulate accounting earnings either to maximise the firm's value or obtain some private gain at the expense of shareholders (Beneish, 2001; Christie & Zimmerman, 1994). In the context of a conflict, managers exercise discretion over accounting earnings either to mislead shareholders about the firm's financial performance or to gain some private benefits at the expense of other stakeholders (i.e. opportunistic earnings management) (Healy & Wahlen, 1999). The adaptable behaviour of managers through various reporting methods and estimates reflects an inaccurate picture of the company's financial fundamentals, such as in the accounting scandals involving major corporations such as Enron and WorldCom.[1] In short, the argument is that earnings management reduces the quality of

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[1] In many instances, the 'earning guidance' prevalent in the corporate world is a high-stake game where the management seeks to hit the targets set by analysts, based on extensive private conversations between managers and analysts (Fuller & Jensen, 2010). On the basis of real-world experience, one can argue that opportunistic reasons for earnings management have intentionally influenced stakeholders, with a degree of misinterpretation of company performance.

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earnings because the information in the financial reports does not reflect the underlying economic conditions of a firm.

The paper is organised as follows. The literature on female directors and earnings management, and the key questions, are set out in Section 2, while Section 3 discusses the empirical research methods used. Section 4 presents the results and Section 5 concludes.

2. Female directors and earnings management — the key questions

In business contexts, women are more ethical in the workplace and less likely to engage in unethical behaviour to gain financial rewards (Betz, O'Connell, & Shepard, 1989; Khazanchi, 1995). Gul, Fung, and Jaggi (2009) argue that not only do females demonstrate greater risk aversion and ethical behaviour, but they are also better at obtaining voluntary information which may reduce information asymmetry between female directors and managers. Women are more cautious and less aggressive than men in a variety of decision-making contexts (Byrnes, Miller, & Schafer, 1999), and are less likely to take risks particularly in the financial decision environment (Powell & Ansic, 1997). There is therefore a greater likelihood of a restrained approach to earnings management (Gul et al., 2009). In a similar vein, Krishnan and Parsons (2008) found that the quality of earnings management is higher for firms with more female directors, and argued that women are likely to be more ethical in their judgement and behaviour than men. However, in contrast to these findings, Sun, Liu, and Lan (2011) found no evidence for the impact of female representation on audit committees and earnings management, while Thiruvadi and Huang (2011) found that the presence of female directors on the audit committee is negatively related to earnings management. In light of the differing views, we are enquiring into the relationship between female directors and earnings management in the UK.

In this paper, we further examine whether the gender of the Chief Financial Officer (CFO) affects the level of earnings management. CFOs have a strong role in companies, due to their primary responsibility of financial reporting. Jiang, Petroni, and Yanyan Wang (2010) found that the magnitude of accruals and the likelihood of beating analyst forecasts are more sensitive to CFO equity incentives than to those of the Chief Executive Officer (CEO). Although a significant amount of accounting research has been devoted to testing the association between the effectiveness of corporate governance and audit committees on earnings management (Benkraiem, 2009; Ebrahim, 2007; Klein, 2002; Lin & Hwang, 2010; Xie, Davidson Iii, & DaDalt, 2003), only a few studies have examined the association between gender diversity on the board of directors and earnings management. For instance, Barua, Davidson, Rama, and Thiruvadi (2011) investigated the association between CFO gender and earnings management and found that firms with female CFOs have lower discretionary accruals than firms with male CFOs. Similar findings were provided by Peni and Vähämaa (2010), who examined the association between CFO and CEO gender and earnings management, and found that firms with female CFOs have income-decreasing discretionary accruals, indicating that female CFOs are following more conservative financial reporting rules and standards. However, they found no association between earnings management and CEO gender. In contrast, Gavious, Segev, and Yosef (2012) found that companies with female CEOs have less earnings management than those with males, with a negative relationship between female executives and earnings management. Instead, Hili and Affes (2012) found no association between earnings management and the presence of female directors on boards and audit committees in French and US companies respectively.

Further to this, we explore the effect of female directors on earnings management in both high- and low-debt firms. We identify high-debt firms as those that rely more on debt financing, with larger boards and more independent directors (Coles, Daniel, & Naveen, 2008; Faleye, 2007). In contrast, low-debt firms depend on the firm-specific knowledge of insiders and have smaller boards with a greater number of insiders. The findings of pooled OLS regression reveal that the presence of a number of female directors on the board constrains the level of earnings management. These findings are consistent with the previous studies of Gavious et al. (2012), Peni and Vähämaa (2010) and Krishnan and Parsons (2008), who found that firms with a higher number of women on the board are less likely to manipulate earnings. The key research questions are: (1) is there an association between the number of female directors and earnings management? (2) is this relationship the same in low- and high-debt firms? and; (3) is there an association between CFO gender and earnings management?

3. Methods

It has been argued that managers are more likely to manage earnings through accruals since it is more difficult to be detected by outsiders (Dechow, Sloan, & Sweeney, 1995; Jones, 1991; Kothari, Leone, & Wasley, 2005). In addition, managers can practise their discretion either on long- or short-term discretionary accruals to manipulate earnings. However, Becker, Defond, Jiambalvo, and Subramanyam (1998) argue that managers have greater discretion over current accruals than long-term ones. In this paper, we use the modified Jones model (Dechow et al., 1995)[2] to estimate current discretionary accruals. The following cross-sectional regression equation is used to estimate current accruals.[3]

$$CA_{it}/A_{it-1} = \beta_{it}[1/A_{it-1}] + \beta 1_{it}[(\Delta REV_{it} - \Delta REC_{it})/A_{it-1}] + \varepsilon_{it} \tag{1}$$

where current accruals CA_{it} is net income before extraordinary items minus cash flow from operation for firm I in year t, ΔREV_{it} donates the change in revenue for firm i in year t, ΔREC_{it} is the change in receivable for firm i in year t, and A_{it-1} is total assets at the beginning of the year t for firm me. The residual of Eq. (1) is current discretionary accruals.

After estimating current discretionary accrual, the association between earnings management and the number of female directors on the board is investigated with ordinary least squares (OLS):

$$\begin{aligned} CDA_{it} = {} & \propto_0 + \propto_1 NFEM_{it} + \propto_2 INFEM_{it} + \propto_3 CFO_{it} + \propto_4 SIZE_{it} + \propto_5 OCF_{it} \\ & + \propto_6 ROA_{it} + \propto_7 LEV_{it} + \propto_8 GSALES_{it} + \propto_9 MB_{it} + \propto_{10} LOSS_{it} \\ & + \sum_{k=1}^{n-1} \propto_k INDUSTRY_i^k + \sum_{Y=2005}^{2011} \omega_y YEAR_i^y + \varepsilon_{it} \end{aligned} \tag{2}$$

where CDA_{it} is current discretionary accruals for me in year t. The independent variables in the regression specification model are NFEM, denoting the number of female directors on the board; INFEM, the number of independent female directors on the board; EXFEM, the number of executive female directors on the board; and CFO, a dummy variable equal to one if the CFO of the firm is female, and zero otherwise.

We use control variables in the model for firm-specific characteristics that may affect the level of earnings management. These control variables are: $SIZE_{it}$ measured as the natural logarithm of total assets for firm i in year t; OCF_{it}, net operating cash flow divided by total assets;

[2] Based on the assumption that accruals are likely to result from changes in a firm's economic conditions,Jones (1991) proposes a regression-based model that controls for change in revenue and depreciation. She relates total accruals to the change in revenue (ΔREV) and gross property, plant and equipment (PPT) as follows:

$$TA_{it}/A_{it-1} = \propto_1(1/A_{it-1}) + \propto_2(\Delta REV_{it}/A_{it-1}) + \propto_3(PPT_{it}/A_{it-1}).$$

Given that revenue may be subject to earnings manipulation by managers (e.g. increasing sales recognition near year-end period), using the Jones model will remove part of the discretionary accruals. In response to the limitation of the Jones model, Dechow et al. (1995) developed a modified version of the model by subtracting the change in receivables (ΔREC) from change in revenues (ΔREV) to exclude the element in the change in revenue that is expected to be managed through managerial discretion.

[3] Following the studies of Subramanyam (1996) and DeFond and Jiambalvo (1994), industry groups with fewer than six observations are excluded from the sample.

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