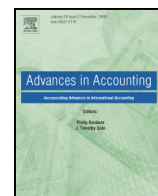




Contents lists available at ScienceDirect

## Advances in Accounting, incorporating Advances in International Accounting

journal homepage: [www.elsevier.com/locate/adiac](http://www.elsevier.com/locate/adiac)

# Examining the spread of high quality reporting through the corporate network☆

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### ARTICLE INFO

#### Article history:

Received 29 June 2015

Received in revised form 29 December 2015

Accepted 14 January 2016

Available online xxx

#### Keywords:

Board interlocks  
Firm centrality  
Reporting quality  
Network  
Audit committee

### ABSTRACT

This paper explores whether high reporting quality spreads through the network formed by shared directors. Consistent with the notion that positive information is generally less impactful than negative information in affecting behavior, I find that a firm's own reporting quality is not affected by sharing a director with a firm that is considered to have high reporting quality. However, I find that a firm's reporting quality improves when the firm shares a director with a high reporting quality firm and a firm that is highly connected in the network (i.e.: central). The results suggest that high reporting quality needs the endorsement of a high status firm such as a central firm to travel through the network. Furthermore, firms that are susceptible to poor reporting are the most receptive to the high reporting quality signal coming through central firms. Altogether, this study documents that central firms are in a position to initiate positive reporting contagion.

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## 1. Introduction

The corporate boardroom network, formed by two firms sharing a common director, allows a firm to directly learn about the practices of another firm and often imitate those practices (Mizruchi, 1996). Interestingly, aggressive reporting that leads to misstatements is a practice that spreads through the boardroom network. However, misstatements, by their nature, are an extreme case of aggressive reporting. And since “extreme” negative practices generally generate a stronger reaction than “extreme” positive practices (Baumeister, Bratslavsky, Finkenauer, & Vohs, 2001), it is unknown if high reporting quality is similarly contagious. Thus, this paper investigates whether high reporting quality spreads through the boardroom network. Consistent with the notion that positive practices are less contagious, I hypothesize and find that high reporting quality is not contagious. Furthermore, I find that certain high status firms can enable the spread of high reporting quality through the corporate network. As such, this study sheds light on how good contagion of reporting practices occurs and furthers our understanding of the impact of networks on accounting practices.

Chiu, Teoh, and Tian (2013) find that a firm is more likely to engage in accounting practices that precipitate a future misstatement if it shares a director with a firm that already employs those practices.<sup>1</sup>

Misstatements represent an extreme version of aggressive reporting (Dechow, Ge, Larson, & Sloan, 2011), as only a fraction of firms have misstatements. To that end, the rarity of a given negative practice makes it particularly conspicuous, which in turn makes it more informative (Kellermann, 1984). Accordingly, when a focal firm, the one at the center of analysis, receives various accounting signals from its boardroom network, the most aggressive practices will be conspicuous. Thus, as these aggressive practices gain attention, their benefits (Healy & Wahlen, 1999) become increasingly magnified, making aggressive reporting normalized in the view of the focal firm (Gino, Gu, & Zhong, 2009).

Importantly though, high reporting quality may not be contagious in the same manner for a few reasons. First, psychology literature has consistently documented that “extreme” positive information generates a weaker reaction than extreme negative information (Rozin & Royzman, 2001). This is partly rooted in the idea that more attention is given to information that can help avoid a loss rather than information that can enable a gain (Kahneman & Tversky, 1979). Accordingly, this suggests that although high reporting quality is associated with favorable outcomes (e.g.: Francis, LaFond, Olsson, & Schipper, 2005), it might not be impactful in the corporate network.

A related reason high reporting quality may not be contagious in the network has to do with the costs and benefits of implementing such reporting. High reporting quality is associated with higher information quality, which lowers information asymmetry, and thus lowers a firm's economic costs (Lambert, Leuz, & Verrecchia, 2007). Conversely, improving reporting quality requires additional investments in a firm's reporting process (Goh, 2009 p. 550). Naturally, how a

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<sup>1</sup> Accounting literature refers to aggressive and high reporting quality reporting. Psychology literature more generally refers to negative and positive practices, so in this paper, these terms will be used interchangeably.

firm evaluates this cost–benefit trade-off will affect how their willingness to adopt high reporting quality.

Thus, my first research question aims to determine whether high reporting quality spreads in the corporate network. I measure reporting quality using the absolute value of abnormal accruals by employing the Modified Jones Model (Dechow, Sloan, & Sweeney, 1995) with the performance adjustment suggested by Kothari, Leone, and Wasley (2005). Using data from 1998 to 2012, I define high reporting quality firms as those firms ranked in the lowest quintile of the absolute value of abnormal accruals. Moreover, aggressive reporting firms are defined as those observations in the top quintile. This design allows me to isolate the highest quality and most aggressive reporting in the network, to compare how contagiousness of reporting at the “extremes.”

The results reveal that being interlocked with a high reporting quality firm has no impact on a firm’s own reporting quality the following year, suggesting that high reporting quality does not spread within the corporate network. However, consistent with prior evidence on the contagiousness of aggressive reporting practices (Chiu et al., 2013), I find that firms that share a director with an aggressive reporting firm have lower reporting quality the following year. This result suggests an asymmetry between the contagiousness of high reporting quality and aggressive reporting practices. Indeed, this result indicates that firms are unmoved to change their reporting practices even after receiving a signal of the highest reporting quality from its network.

The fact that high reporting quality does not travel through the corporate network is an important result in light of the finding of “good” reporting contagion in Chiu et al. (2013). Chiu et al. (2013) show that the number of interlocks a firm has with other non-misstatement firms reduces the firm’s own likelihood of a future misstatement. However, it is important to note even within the pool of non-misstatements, there would be a wide range of reporting quality (Dechow et al., 2011), and it is unclear, ex-ante, if the reporting quality of all non-misstatement firms would be similarly contagious. Thus, the goal of this paper is to determine whether the highest reporting quality in the network, as measured by accruals, is contagious. Consequently, while observing a non-misstatement affects the likelihood of non-misstatement, the results of this paper suggest that observing the highest reporting in the network, as measured by accruals, has no impact on a firm’s own usage of accruals. Accordingly, high reporting quality, as measured in this paper, is not contagious in the same way that non-misstatements are contagious.

Nonetheless, the result is in line with the notion that negative practices are generally more contagious than positive practices (Baumeister et al., 2001). But the question remains whether high reporting quality can spread among firms at all. This leads to my second research question, which examines how high reporting quality can spread. Prior literature documents that status is a key factor in spreading information through a network (Rogers, 2003). This is likely because the practices of high status actors are generally viewed as being more proper, which makes the other actors in the network more inclined to adopt such practices (Bandura, 1986).

A firm’s status is a function of its connectivity to other firms in the boardroom network (Podolny, 1994). Thus, more connected, or central, firms can be potentially influential in the transmission of reporting practices. Furthermore, a firm’s centrality allows it to process and utilize the vast amount of information it collects from its network (Bell, 2005). Accordingly, the ability to vet information enhances the credibility of information that emanates from a central firm (Lieberman & Asaba, 2006). Thus, central firms are well positioned to assist in the spread of high reporting quality.

I create an aggregate measure of firm centrality based on four social network measures and label firms with the highest aggregated centrality scores as central firms. I find that high reporting quality spreads through a network but only when a central firm is involved. That is, a high reporting quality firm’s information is only impactful to the focal firm when that focal firm also has an interlock to a central firm.

However, this result does not hold for other potential status measures such as firm size, further emphasizing the role of centrality as a status maker in the network.

Additional tests show that the effect of centrality to spread high reporting quality is most pronounced in focal firms with high growth, less audit committee member experience and higher ex-ante misstatement risk. Altogether, this indicates that firms that are susceptible to poor reporting practices stand to benefit most from the high reporting quality signal that comes via a central firm. My result does not depend on the type of director forming the interlock, suggesting that the focal firm maybe sorting information according to the status of the sending firm, and not necessarily the status of the linking director. Moreover, the firms that improve their reporting as a result of the high reporting quality signal they receive via central firms also incur higher audit fees, but also have lower betas. This indicates that these firms are indeed bearing the additional costs to improve reporting but that they are also experiencing the benefits of higher reporting quality.

These findings are robust to various tests controlling for the possibility that firms self-select into interlocks with central firms. The results are also robust to controlling for alternate firm networks such as links to high reporting quality through industry or auditor.

This study contributes to the literature on the effects of networks on financial reporting. Consistent with prior studies, I document that aggressive reporting practices spread between firms (Chiu et al., 2013). However, high reporting quality, on its own, does not travel through the network. This suggests an asymmetry of how different reporting styles spread. Furthermore, this study suggests that high reporting quality can spread within the corporate network but only in the presence a central firm. Thus a central firm can endorse high reporting quality practices to facilitate their spread (Rogers, 2003). Consequently, the findings highlight central firms as being able to initiate positive reporting contagion through the network (Davis & Greve, 1997).

The remainder of the paper proceeds as follows: Section 2 outlines the motivation, Section 3 discusses the research design, Section 4 presents the empirical results and Section 5 concludes.

## 2. Motivation

Board interlocks are an important inter-firm communication channel and affect a wide variety of corporate practices such as the adoption of poison pills, and multi-divisional forms as well as the decision to switch stock exchanges (Davis, 1991; Palmer, Jennings, & Zhou, 1993; Rao, Davis, & Ward, 2000). Board interlocks also impact reporting practices. Prior studies have found that stock option expensing, tax shelter adoption and option backdating all spread between firms that are interlocked (Bizjak, Lemmon, & Whitby, 2009; Brown, 2011; Reppenhagen, 2010).

Most related to this study, Chiu et al. (2013) find that aggressive reporting that leads to a misstatement is contagious between interlocked firms. The fact that aggressive accounting practices spread within the corporate network is consistent with the notion that negative practices are generally contagious (Balch & Armstrong, 2010). This contagiousness can be attributed, in part, to the fact that negative events are rare and are thus particularly noticeable (Kellermann, 1984). Accordingly, since only a fraction of the firms report a misstatement, the aggressive reporting that is a precursor to a misstatement would naturally be conspicuous among all the other reporting signals. Once aggressive accounting is noticed, its rewards would be particularly magnified (Balch & Armstrong, 2010; Healy & Wahlen, 1999), which would then enable the adoption of such reporting.

Of course, high reporting quality is associated with its own set of favorable firm outcomes. For instance, firms with high reporting quality tend to have lower costs of debt (Francis et al., 2005) and lower cost of equity (Francis, LaFond, Olsson, & Schipper, 2004) and lower beta. The intuition behind these findings is that higher reporting quality reduces the information asymmetry between the firm and external

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