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Insider-trading, discretionary accruals and information asymmetry

Abu Chowdhury [a], Sabur Mollah [b,*], Omar Al Farooque [c]

[a] Stockholm Business School, Stockholm University, Sweden
[b] Hull University Business School, University of Hull, Cottingham Road, Hull HU6 7RX, UK
[c] University of New England, Australia

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ABSTRACT

Using US data for the period from 2004 to 2012 and alternative discretionary accruals measures, we examine whether insiders manipulate earnings in an asymmetric information environment to profit from their informed trades, and whether the intervening information environment influences the relationship between earnings management and insider trading. We show that insider trading dominated by sell trades has a positive association with discretionary accruals. The incremental effect of information asymmetry as well as the interaction with insider trading is also prevalent in this relation, confirming the moderating effect of asymmetric information. Further, we show that the active involvement of some key insiders in high discretionary accruals is for personal benefit more in growth firms than in value firms. Our results also suggest that earnings management allows for insiders' opportunistic, rather than routine, buy and sell trades. Our findings highlight that regulators should oversee and scrutinise both insider trading and earnings management to mitigate the risk of the opportunistic behaviour of insiders to avoid future corporate scandals.

1. Introduction

In this paper, we look into earnings quality by exploring the relation between insider trading and accrual-based earnings management (i.e. discretionary accruals, which has been viewed as a form of agency cost). We posit that insider trading and earnings management have a positive relation in which lower earnings quality maps to an increased level of insider trading. We emphasise that the influence of this positive relation is subject to the firms' quality of accounting information and their financial reporting environment. For firms with high information asymmetry, the relation becomes stronger, while it is weaker for firms with low information asymmetry. The empirical evidence suggests that lower earnings quality implies a greater information asymmetry between investors (outsiders) and management (insiders).

Richardson (2000) suggests a systematic relationship between the magnitude of information asymmetry and the level of earnings management, referring to the fact that when information asymmetry is high, stakeholders do not have sufficient resources or incentives or access to relevant information to monitor managers' actions, which gives rise to the practice of earnings management (Schipper, 1989; Warfield, Wild, & Wild, 1995). Moreover, Cohen, Dey, and Lys (2008) provide evidence

* Corresponding author.
E-mail address: S.Mollah@hull.ac.uk (S. Mollah).

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that the increases in accrual-based earnings management are concurrent with increases in equity-based compensation (stock-option) intended for insider trading. Managers have a tendency to engage in earnings management where shareholders are poorly informed and have limited access to company information (Davidson, Jiraporn, Kim, & Nemec, 2004; Jiraporn, Miller, Yoon, & Kim, 2008). As such, information asymmetry has an incremental chain effect on insider trading and earnings management relations whereby firms with high discretionary accruals tend to have higher information asymmetry, which eventually leads to greater engagement in insider trading. Corporate governance and financial reporting standards deal with such manipulation and self-dealing issues in the context of an asymmetric information environment, given that the decrease in information asymmetry causes to decrease in earnings management (Kanagaretnam, Lobo, & Whalen, 2007). The corporate governance and earnings management literature provides evidence of reducing information asymmetry and earnings management through governance mechanisms (Chang & Sun, 2009; Cornett, Marcus, & Tehranian, 2008; Kent, Routledge, & Stewart, 2010; Xie, Davidson, & DaDalt, 2003). However, the worldwide high-profile corporate collapse involving earning manipulations during the pre/post global financial crisis (GFC) periods raises concerns attributed to earnings management.

Earnings management[1] through the manipulation of firms' accounting accruals has been extensively investigated by researchers. The results show that managerial incentives drive widespread earnings management (Bartov & Mohanram, 2004; Bergstresser & Philippon, 2006; Cheng & Warfield, 2005). Loomis (1999) demonstrates that earnings management covers accurate financial results and obscures facts that stakeholders ought to know. On the one hand, the use of financial information in many managerial contracts may provide incentives for earnings management, which results in lower earnings quality. On the other hand, deliberate earnings manipulation by managers diminishes financial reporting quality and is more reflective of the discretion of management (Levitt, 1998).

Earnings quality becomes doubtful when managers have an incentive to opportunistically manage reported earnings (Dechow & Skinner, 2000; Healy & Wahlen, 1999; Rosenfield, 2000). The opportunistic behaviour of managers changes the shareholders' perception of the reported earnings quality and the degree of the asymmetric information between shareholders and managers. In this context, Levitt (1998) compares the rise in earnings management with the decline in financial reporting quality. This contention implies that the 'absence of earnings management' is an indicator of earnings quality, and an accrual anomaly might be attributable to opportunistic earnings management and deteriorating earnings quality.

Insider trading takes place when an insider uses relevant information regarding a firm to trade in its listed securities (Seyhun, 1998). Empirical studies find that private information access by insiders allows them to outperform the market, thereby enabling them to obtain abnormal returns by trading the shares of their own firms (Betzer & Theissen, 2008; Cheuk, Fan, & So, 2006; Fidrmuc, Goergen, & Renneboog, 2006; Jeng, Metrick, & Zeckhauser, 2003; Rozeff & Zaman, 1988). These studies show that insider trading volume is positively linked to the value of the inside information. Asymmetric information, expressed as the information difference between that of the insiders and the market, is therefore seen as the most essential factor behind the insiders' abnormal returns. Again, consistent with the information signalling hypothesis, insiders might buy (sell) securities when they are aware of some good (bad) news (Louis, Sun, & White, 2010), so insider purchases (sales) should be related to positive (negative) abnormal returns.

Information asymmetry refers to the information gap between informed or more informed and uninformed or less informed traders, whereby informed or more informed traders retain private information, in addition to public information, which has not yet been incorporated into stock prices. Despite having access to public information, uninformed or less informed traders, who trade purely for liquidity reasons, are at a significant information disadvantage when trading with informed or more informed traders. As such, information asymmetry results in conflicts of interest between corporate insiders (i.e. more informed parties) and outsiders (i.e. less informed parties), because managers might not have the incentive to provide precise and informative public disclosures, which underpins information-based trades in their favour. In fact, a high level of information asymmetry between investors can lead to increases in transaction costs and market illiquidity. Amihud and Mendelson (1988) contend that private information-based insider trading leads to a widening of the bid-ask spread (i.e. information asymmetry).

From the agency context, both earnings management and insider trading are closely associated with information asymmetry when informed parties' interests are not aligned to uninformed parties' interests. Lee and Masulis (2009) argue that information asymmetry is associated with the quality of accounting information because the financial statements are the central information source for external investors regarding the performance of the firm. Insider trading can be facilitated by market inefficiency and dis-integrity but is complemented or worsened by several forms of manipulations in the financial reporting system. Thus, the scope of accounting manipulation might motivate insider trading. We argue that there is a relationship between insider trading and accrual-based earnings management (i.e. discretionary accruals). Because these affect the information carried by reported earnings (Sawicki & Shrestha, 2008), information asymmetry plays a vital role in both. In the asymmetric information scenario, managers play a direct role through various mechanisms of manipulation, such as reporting inflated earnings and delaying the release of bad news, and undertake distorted paths to validate overvalued

[1] Earnings management is a deliberate action, and it includes any sort of manipulation that can affect financial reporting either through earnings numbers or any other accounting items, and can be either legitimate (within the Generally Accepted Accounting Principles (GAAP)) or illegitimate (accounting frauds) (Schipper, 1989). Schipper (1989, p.92) also contends that "By 'earnings management' I really mean 'disclosure management' in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain".