China Journal of Accounting Research 10 (2017) 141–166

Contents lists available at ScienceDirect

China Journal of Accounting Research

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

Female directors and real activities manipulation: Evidence from China

Jin-hui Luo *, Yuangao Xiang, Zeyue Huang

School of Management, Xiamen University, China

A R T I C L E I N F O

Article history:
Received 23 December 2015
Accepted 14 December 2016
Available online 22 February 2017

JEL classification:
G32
G34
J70
M41

Keywords:
Female director
Gender diversity
Earnings management
Real activities manipulation
Corporate governance

A B S T R A C T

Unlike previous studies that focus on accrual-based earnings management, this study analyzes real activities manipulation and investigates whether female directors on boards of directors (BoDs) affect managers' real activities manipulation. Using a large sample of 11,831 firm-year observations from Chinese listed companies from the 2000 to 2011 period, we find that higher female participation on BoDs is associated with lower levels of real activities manipulation, and that this negative relationship is stronger when female directors have higher ownership. These results hold for a battery of robustness checks. Overall, our findings indicate that board gender diversity may serve as a substitute mechanism for corporate governance to curb real activities manipulation and thus provide interested stakeholders with higher quality earnings reports.

1. Introduction

In recent years, board gender diversity has drawn considerable attention worldwide, especially after the 2008 economic crisis (Sun et al., 2015; Terjesen et al., 2009). Despite the rapid increase in female participation in business in the last decade (Rose, 2007; Srinidhi et al., 2011), female directors are still underrepresented on corporate boards. Some European countries (e.g., Sweden, Norway and Spain) now impose legal requirements on corporations to allocate board seats to women. For example, Spain introduced legislation requiring a 40%

* Corresponding author at: School of Management, Xiamen University, No. 422, Siming South Road, Xiamen, Fujian 361005, PR China.

E-mail addresses: jinhuiluo@xmu.edu.cn (J.-h. Luo), xiangyuangao@hotmail.com (Y. Xiang), vickyhuangzy@163.com (Z. Huang).

http://dx.doi.org/10.1016/j.cjar.2016.12.004
1755-3091/© 2017 Sun Yat-sen University. Production and hosting by Elsevier B.V.

threshold for female board representation by the end of 2015. In this context, the economic benefits of female directors must be determined (Gul et al., 2011). If board gender diversity was known to increase firm value, firms would be willing to accept female directors on their boards even without legislation. The purpose of this study was to explore the role of female directors in curbing managers' real activities manipulation.

Managers have professional responsibilities and ethical obligations to report high quality earnings to outside stakeholders, such as investors and regulators (Krishnan and Parsons, 2008). However, self-serving managers all over the world are inclined to manipulate earnings to beat/meet benchmarks (Burgstahler and Dichev, 1997; DeGeorge et al., 1999; Liu and Lu, 2007). Generally, there are two earnings management strategies: accrual-based and real activities earnings manipulation (Cohen et al., 2008; Cohen and Zarowin, 2010; Zang, 2012). Prior studies of the effect of female directors focus on accrual-based earnings management and produce mixed results (Fields et al., 2001; Srinidhi et al., 2011; Sun et al., 2011). We argue that analyzing only one earnings management strategy fails to capture the overall effect of board gender diversity. In particular, as managers use the two earnings management strategies as substitutes for each other (Achleitner et al., 2014; Cohen et al., 2008; Cohen and Zarowin, 2010; Zang, 2012), a focus on accrual-based earnings management can be expected to lead to inconclusive results. Furthermore, in emerging economies such as China, where investors have a relatively low demand for high quality earnings and firms face low litigation risks (Allen et al., 2005; Chen et al., 2008; Liu and Tian, 2012), it is less costly for firms to manipulate accruals (Kuo et al., 2014). Thus, in emerging economies, female directors may play a more important role in curbing real activities manipulation. Finally, unlike accrual-based earnings management, which is achieved by exercising discretion over accruals in light of accounting principles, real activities manipulation is achieved by altering the timing and scale of operations, investments or financing transactions, which have real adverse economic consequences on a firm's long-term profitability and growth (Achleitner et al., 2014; Bereskin et al., 2014; Cohen and Zarowin, 2010; Gunny, 2010; Kim and Sohn, 2013; Zang, 2012). Given this fundamental difference, we predict that female directors, who are characterized by a lower tolerance of opportunism, less overconfidence and greater risk aversion, and as better monitors (Adams and Ferreira, 2009; Barber and Odean, 2001; Gul et al., 2011; Hillman et al., 2007; Krishnan and Parsons, 2008; Srinidhi et al., 2011; Sundén and Surette, 1998), may play a stronger role than male directors in curbing managers' real activities manipulation. However, few studies examine the potential effect of female directors on real activities manipulation.

Studies of corporate governance must focus on not only how an individual mechanism works, but also how the interaction of different mechanisms mitigates agency problems (Kim and Lu, 2011). That is, understanding how board gender diversity interacts with other mechanisms to curb real activities manipulation is also an important issue. On the one hand, the role of female directors largely depends on their personal characteristics, which may change under certain conditions, as all human beings, regardless of gender, are inevitably emotional and more or less opportunistic. In other words, the effectiveness of female directors in curbing managers' real activities manipulation may be unstable. Therefore, it is important for firms to design firm-level mechanisms that formalize and even enhance the role of female directors. On the other hand, stakeholders have long been interested in mechanisms that can mitigate earnings manipulation and improve earnings quality (Krishnan and Parsons, 2008). Thus, it is meaningful to know whether the role of board gender diversity is unique and irreplaceable. If the role of female directors is unique, stakeholders should voluntarily push firms to increase female board representation, as firms would otherwise depend on traditional mechanisms rather than a gender-diverse board. However, to date, little is known about the interactions between board gender diversity and other governance mechanisms.

To fill these knowledge gaps, we develop a conceptual model of the links between female participation on boards of directors (BoDs) and real activities manipulation. As ownership structure is one of the most cited influences on agency problems (Shleifer and Vishny, 1997), we further examine the moderating effect of stock ownership on the association between female participation on BoDs and real activities manipulation. We test this model in the context of China because it is the largest emerging economy in the world, and despite its severe earnings management (Kuo et al., 2014; Liu and Lu, 2007; Qi et al., 2014), little is known about real activities manipulation there. In general, there is limited evidence from emerging economies on whether BoDs are able to discipline managers' earnings management. Hence, a focus on Chinese firms allows us to extend the boundaries of existing knowledge on the antecedents of real activities manipulation. Moreover, the social status of women in China is assumed to be relatively high due to the policy of gender equality that has been