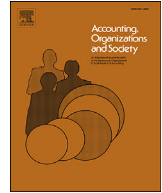
Accounting, Organizations and Society 52 (2016) 50–62

Contents lists available at ScienceDirect

Accounting, Organizations and Society

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



Earnings benchmarks, information systems, and their impact on the degree of honesty in managerial reporting☆

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A R T I C L E I N F O

Article history:
Received 16 May 2012
Received in revised form
9 September 2015
Accepted 10 September 2015
Available online 20 October 2015

Keywords:
Honesty
Capital budgeting
Earnings
Information system
Prosocial behavior

A B S T R A C T

This paper provides experimental evidence about how the interaction between a company's earnings and its information system influences the degree of honest reporting by managers in a capital budgeting task. Specifically, the results show that participants overstate cost less when the manager's cost report determines whether the firm earns a gain or loss than when their report does not affect whether the firm earns a profit or loss (i.e., the firm always earns either a profit or loss regardless of the cost report). Further, the results suggest that the impact of the earnings situation on the degree of honesty depends on whether the firm uses an information system that improves its ability to detect misreporting. Specifically, the earnings situation has less effect on the degree of honesty when the firm uses an information system. This is because the information system decreases honesty when the manager's report determines whether the firm earns a profit or loss but increases it otherwise. This study provides important insights into the conditions under which information systems can crowd out prosocial behavior.

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1. Introduction

Research has demonstrated that in settings where managers are able to misrepresent cost reports, many managers still produce honest reports because their dishonest reporting may negatively affect the wealth of others (Evans, Hannan, Krishnan, & Moser, 2001). More evidence is however, needed on when managers more strongly pursue this motive to act honestly. This study shows that the company's earnings situation can serve as an important contextual feature. Specifically, I presume that the degree of honesty is higher when the manager's cost report determines whether the firm earns a gain or a loss than when the manager's report does not affect the firm's earnings situation. Studying the effect of managerial influence on company's earnings is important. While many studies on earnings management have explored the impact of important earnings benchmarks on external reporting (Burgstahler & Dichev, 1997), the effects of these benchmarks on internal decisions like budgeting have received scant attention.

The lack of attention in prior studies is partially based on their focus on companies that earn profits from a manager's production (e.g., Rankin, Schwartz, & Young, 2003, 2008). I argue that considering the firm's profit situation can enrich our understanding of why information systems to detect misreporting are sometimes not effective (Christ, Emett, Summers, & Wood, 2012; Salterio & Webb, 2006). I predict that information systems and the earnings of the firm interact such that the beneficial effects on honesty of the firm's earnings situation are mitigated once an information system is present. I use a capital budgeting task to test this prediction. The firm's earnings situation is manipulated as the first between-subject factor. In the gain/loss condition, the participant's cost report can determine whether the company earns a gain or a loss. In the two other conditions, labeled as the positive earnings condition and the negative earnings condition, the participant's cost report cannot affect the firm's profit situation; that is, the firm always earns a profit or a loss regardless of the manager's cost report. The second

☆ The author would like to thank the editor Mike Shields and two anonymous reviewers for their helpful comments. I would further like to thank Nathalie Beckers, Jan Bouwens, Bart Dierynck, Stefan Hollander, Laurence van Lent, Donald Moser, Bernhard Reichert, Jeroen Suijs, Kristy Towry, Michael Williamson, Andrew Yim, Huaxiang Yin, and Rick Young for their helpful suggestions. I further acknowledge the useful comments of participants at the European Accounting Association Conference 2010 (Istanbul) and the Management Accounting Section conference 2011 (Atlanta) and seminar participants at Tilburg University, VU University of Amsterdam, KU Leuven, and the University of Bern. This paper was formally titled "Reference Points and Budget Requests: Can Controls Destroy Honesty in Managerial Reporting?" Experimental materials available on authors request.

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http://dx.doi.org/10.1016/j.aos.2015.09.002
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between-subject factor manipulates the absence or presence of information systems that improve the firm's ability to detect misreporting. Across all conditions, the pecuniary benefits of dishonesty for participants (and its costs for the firm) are held constant.

In the absence of an information system, the results show that the degree of honesty is greater when the participant's cost report can determine whether the firm earns a loss or profit (the gain/loss condition) than in the positive or negative earnings condition. In the gain/loss condition, a larger fraction of participants remain honest or even underreport their costs and thus sacrifice money to avoid losses and keep the company profitable. The reporting feature of deliberately understating costs has not received much attention but can be economically relevant (Erat & Gneezy, 2012). Results further show that reporting behavior does not differ between the positive and negative earnings conditions. Similar to earlier work (Evans et al., 2001; Hannan, Rankin, & Towry, 2006), many managers produce partially honest reports in these conditions. The results also show that the effect of the firm's earning situation interacts with the use of an information system that improves the firm's ability to detect suspicious reporting. Specifically, the information system decreases the degree of honesty when the manager's report determines whether the firm earns a profit or loss but increases it otherwise (i.e., the positive or negative earnings condition).

This study provides important insights into the conditions under which controls can reduce prosocial behavior. Prior work has shown that reliance on control systems to reduce misreporting may crowd out some of the preferences for honesty but nonetheless has shown that the firm's profit is still higher with a control system than without one. Rankin et al. (2008) showed that opportunities for principals to reject budget requests reduce the level of misreporting and thus are beneficial to the firm's profit. Hannan et al. (2006) also showed that when information systems are used to improve the firm's ability to detect misreporting, honesty is increased compared to when they are not used. This study, however, shows that the otherwise positive effects of information systems may not always materialize. It also offers a rationale for this crowding-out effect using the self-concept maintenance theory of Mazar, Amir, and Ariely (2008). In the gain/loss condition participants start to produce small dishonest reports, which the firm cannot detect as misreporting, once an information system is present instead of reporting behavior that could be beneficial to firm profit. If their reporting behavior has less influence on the firm's earnings situation, such as in the negative or positive earnings conditions, information systems to detect suspicious reporting still tend to reduce misreporting by reducing the range of dishonest reports.

The findings concerning these earnings benchmarks also offer many practical insights. Strong variations in earnings are often caused by changes in the economic condition, such as temporary fluctuations in prices or profit margins, or by the type of product that the business unit produces. For example, business units producing new products or products with spillover effects on other products are often close to breakeven.[1] If companies feel that the manager can make a difference between experiencing losses or profits, it may be tempting for them to install systems that help the company to detect misreporting. Such detective forms of controls are often part of the firm's internal control procedures (Christ et al., 2012), and resorting to such systems maybe a natural response in case profits start to erode. The results show, however, that information systems to detect misreporting can be less effective, in particular when profits are under pressure.

Besides earnings levels, many other situations in a company may alter participants' views of the repercussions of their misreporting for the organization. Business units need to achieve certain targets before bonus pools are paid out to employees, firms need to meet or beat analyst expectations, and certain actions can hurt only a few but also many other business units. Prior work by Church, Hannan, and Kuang (2012) showed for example that people report more dishonest and thus care less about the firm when benefits of misreporting are shared with other managers in the company. This paper shows that considering these repercussions of managerial dishonesty on the firm is important, as doing so may help organizations to utilize their controls more effectively.

2. Theory and hypothesis development

Evans et al. (2001) showed that many agents in capital budgeting produce partially honest reports even when financial incentives for misreporting are fully present. Based on the finding that individuals value honesty, follow-up studies have focused on incentive mechanisms, monitoring systems, or other types of control systems that can help companies to improve honest reporting. For example, prior studies have investigated competition among agents or whistle-blowing by fellow agents in relation to honesty (Brüggen & Luft, 2011; Zhang, 2008) or examined the effects of social norms or peer behavior (Tayler & Bloomfield, 2011; Cardinaels & Jia, 2015). Other studies examine changes in economic incentives, opportunities for principals to reject budget proposals, or systems to reduce information asymmetry between the business owner and the agent in relation to truthful reporting (Evans et al., 2001; Hannan et al., 2006; Rankin et al., 2008).

However, fewer studies have focused on the organizational settings in which managers more strongly pursue honest reporting without touching upon costly incentive devices or control systems. An exception is, for example, Church et al. (2012), who documented that people are more honest when they fully bear the consequences of their dishonesty than when the benefits of their dishonesty are shared with other organizational members. This paper examines if the firm's earnings situation can also serve as an important contextual factor which may affect reporting behavior by managers. Considering this variation may offer additional insights into the crowding-out effects of information systems to detect misreporting. The first section will argue that participants overstate costs less when their reports can make a difference between gains or losses for the firm than in two other conditions where the company always realizes either positive or negative earnings regardless of the cost report. Next, I will discuss how the firm's profit situation interacts with information systems that companies use to detect misreporting.

2.1. The firm's earnings situation and the effect on honesty

Given the information asymmetry that exists between the agent and the principal in a capital budgeting context, agency theory would predict that the company's earning situation would not matter because agents will always try to profit from dishonesty. This study predicts that the degree of honesty - measured by the level of cost overstatements - is higher when participants' cost

[1] New products like, for example, new generations of smart phones are often not profitable. Nevertheless, once demand increases and learning takes place, profits start to accrue. Products with spillover effects are, for example, ink-jet printers. Typically these printers are sold for a small loss, but business units producing the cartridges that are used with them make a profit. Because firms often commit to a customer base, they sometimes need to accept small losses when prices are under pressure. On average, such firms expect to be profitable by serving their customer base, but temporary price fluctuations can lead to losses, profits, or profits that are close to zero. From a decision-control perspective (Zimmerman, 2009), various types of cost allocations and transfer-pricing policies may further lead to differences in the division's contribution to organizational profits.

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