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Management reporting incentives and classification credibility: The effects of reporting discretion and reputation

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Abstract

In this study we investigate how the level of discretion in the reporting environment and management's reporting reputation influence the extent to which management's reporting incentives are important in determining the perceived credibility of management's classification choices. Consistent with prior research, we show that users view incentive-inconsistent classifications as more credible than incentive-consistent classifications. We extend this finding by showing that the strength of this relationship (i.e., the extent to which users consider the consistency between the classification and management's reporting incentives) depends on the level of discretion in the reporting environment and management's reporting reputation. We find that users rely less (more) on the consistency between management's reporting incentives and the classification in a mandated (discretionary) reporting environment and when managers have a good (poor) reporting reputation. We conclude by discussing the implications of our findings and potential future research.

Introduction

Prior research has shown that financial statement users (hereafter users) consider the consistency between management's reporting incentives and management's disclosures (hereafter incentive consistency) when assessing the credibility of the disclosures (Hirst, Koonce, & Simko, 1995). In this study we investigate how the level of discretion in the reporting environment and management's reporting reputation influence the importance of incentive consistency in explaining the credibility of management disclosures. Consistent with prior accounting and finance research, we assume that managers possess private information about the true economic identity of the transactions and events represented in the financial statements, and we define credibility as the extent to which users perceive that management's disclosures represent

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management's unbiased beliefs about the true nature of the transactions and events.[1]

Hirst et al. (1995) find that users view incentive-consistent information as less credible than incentive-inconsistent information. We show that this result holds in our setting and then extend it by arguing that the strength of the link between incentive consistency and the perceived credibility of a firm's disclosures depends upon both the level of discretion in the reporting environment and management's reporting reputation. The link is weaker in mandated reporting environments and for managers with good reporting reputations because in both cases users tend to believe the disclosures, discounting the importance of whether they are incentive consistent. We argue that in mandated environments, users rely less on incentive consistency because in such environments management structures transactions in advance to achieve desired disclosure treatment and ex post has limited ability to bias the disclosure. We argue that users rely less on incentive consistency when determining the credibility of disclosures provided by managers with good reporting reputations because users realize that such managers have more to lose by misreporting.

We test our arguments in an experiment where users assess the credibility of a firm's choice to classify a hybrid security as a liability or equity.[2] Our experimental firm has a debt/equity ratio above the industry average and is approaching technical violation of debt covenants, providing management an incentive to classify the hybrid as equity.[3] We manipulate three variables: (1) classification is either inconsistent with management's reporting incentives (liability) or consistent with management's reporting incentives (equity); (2) classification is either discretionary or mandated by accounting standards, and (3) management's reporting reputation is either good or poor. Consistent with Hirst et al. (1995), we predict that users consider incentive-inconsistent classifications to be more credible than incentive-consistent classifications. We extend Hirst et al. (1995) by predicting that the incentive consistency of management's classification choice will interact with both the level of discretion in the reporting environment and management's reporting reputation. Specifically, the incentive consistency of management's classification choice will have a smaller effect on user credibility assessments in the mandated reporting environment and when management has a good reporting reputation. The results support the predictions.

In general, the results demonstrate that users con sider information helpful in assessing management's reporting incentives (e.g., industry benchmarks) when evaluating the credibility of management's classification choices. The results further demonstrate that the extent to which users rely on such information depends on two factors: the level of discretion in the reporting environment and management's reporting reputation. As the level of discretion decreases or management's reporting reputation improves, users tend to reduce their reliance on the information helpful in assessing management's reporting incentives when assessing the credibility of management's classification; incentive consistency becomes less important.

These findings have implications for both accounting standard-setters, who can influence the level of discretion in the reporting environment, and management, who can influence its reporting reputation. Accounting standard-setters are continually faced with the difficult question of how much discretion to allow in the financial reporting environment. For example, the recent debate over

[1] This definition of credibility is consistent with prior work in psychology (e.g., see Birnbaum & Stegner, 1979). Similarly, in a recent accounting paper, Mercer (2004) defines disclosure credibility as "investor perceptions of the believability of a particular disclosure".

[2] We define hybrid securities as financial instruments that contain undefined characteristics of debt and equity (i.e., they are neither true debt nor true equity) and whose mix of attributes are sufficiently complex (or incompletely defined) to present uncertainty about their true nature. We rely on the fact that different firms classify hybrid securities with similar characteristics differently, and focus our attention on how users interpret such classification rather than attempting to explain the strategic reasons why management might make a particular choice.

[3] Benish and Press (1993) show that violating a debt covenant has significant economic implications in terms of debt restructuring costs and higher future interest costs.