North American Journal of Economics and Finance 35 (2016) 153–165

Contents lists available at ScienceDirect

North American Journal of Economics and Finance

Independent directors and earnings management: The moderating effects of controlling shareholders and the divergence of cash-flow and control rights

Soushan Wu [a,b,*], Chin-Mei Chen [c], Pei-Ching Lee [d]

[a] Taipei Exchange, Taiwan
[b] National Taiwan Normal University, Taiwan
[c] Department of Public Finance and Tax Administration, National Taipei University of Business, Taiwan
[d] Department of Business, National Open University, Taiwan

ARTICLE INFO

Article history:
Available online 3 November 2015

Keywords:
Independent directors
Earnings management
Controlling shareholders
Divergence of cash-flow and control rights
External auditors

ABSTRACT

The research results on the suppressing effect of independent directors on earnings management are not consistent in existing literature. In addition, it has been argued that using financial statements provided by top management to investigate top management's earnings management is not appropriate. Therefore, the purpose of this study is twofold. First, we used external auditors (including the auditors of Taiwan Stock Exchange Corporation and the auditors of two Big Four accounting firms – Deloitte & Touche and KPMG in Taiwan) as respondents in order to obtain less biased data. Second, we investigate the moderating effects of controlling shareholders and the divergence of cash-flow and control rights on the relationship between independent directors and earnings management. The results show that both the existence of controlling shareholders and the divergence of cash-flow and control rights have significant suppressing effects on the relationship between independent directors and earnings management. Theoretical and practical implications are also discussed.

© 2015 Published by Elsevier Inc.

* Corresponding author at: 321, Sec. 1, Jinan Rd., Taipei 10051, Taiwan.
E-mail addresses: chair@tpex.org.tw (S. Wu), chouchdr@ms36.hinet.net (C.-M. Chen), lpk@mail.nou.edu.tw (P.-C. Lee).

http://dx.doi.org/10.1016/j.najef.2015.10.007
1062-9408/© 2015 Published by Elsevier Inc.

1. Introduction

Earnings management is a strategy used by management for their personal benefits; they manipulate report decisions or accounting numbers within the flexible range of generally accepted accounting principle (GAAP) to exaggerate the corporate's operation performance so that they may conform to the expectations of corporate earnings from the stock market and further influence stock price (Schipper, 1989). Therefore, earnings management may mislead the assumptions of the stakeholders on the operating performance of the corporate or influence contract results based on earning numbers, causing stakeholders who make decisions according to public financial information to undergo wealth loss, and make investors lose faith in financial statements (Healy & Whalen, 1999).

The origin of earnings management is agency problems (Xie, Davidson, & DaDalt, 2003). Agency problems arise because earning goals desired by principles and agents are not entirely the same. Agents may deprive principles of their equity out of the motive for their own interest. Corporate governance is an important mechanism used by principles to reduce self-interested behavior of agents (John & Senbet, 1998).

Much research has discovered that the supervising role of independent outside directors (hereinafter referred to as independent directors) within the corporate governance system can effectively inhibit corporations from issuing untruthful financial statements (Beasley, 1996; Fama & Jensen, 1983; García-Meca & Sánchez-Ballesta, 2009; Klein, 2002; Maug, 1997; Peasnell, Pope, & Young, 2005). However, some research has also found that the relationship between the two is not significant (Park & Shin, 2004). It seems that there are other moderating variables existing between independent directors and earnings management that need to be further clarified.

When there are controlling shareholders who are likely to affect decisions in a corporation, the nature of agency problems will shift from the equity agency problem between ownership and management to the central agency problem between controlling shareholders and minority shareholders (Claessens, Djankov, Fan, & Lang, 2002). The higher control controlling shareholders hold, the higher their cash-flow right separates from control, and the more do they have self-interested motives to expropriate minor shareholders' equity, thus increasing the agency problem between controlling shareholders and minority shareholders (Fan & Wong, 2002). Hence, the existence and character of a controlling shareholder might generate different effects on corporate governance mechanism, and moderate the relationship between independent directors and earnings management.

Past research on earnings management mostly uses discretionary accruals as proxy variables for earnings management (Dechow, Sloan, & Sweeney, 1995; García-Meca & Sánchez-Ballesta, 2009). When the earnings management model is applied to a random sample, all models can effectively detect individual earnings management. However, on economically plausible magnitudes, various models all generate tests of low power for earnings management. These models include Healy Model, DeAngelo Model, Jones Model, Modified Jones Model, Industry Model, etc. The Modified Jones Model is the most efficient model for testing earnings management, but when the Modified Jones Model is used on testing extreme financial performance, it will produce wrong inferences because of the model settings that lead to a larger discretionary accrual error (Dechow et al., 1995). These earnings management models are all based on the numbers from financial statements after earnings management, and so it is difficult for them to precisely calculate the reality of earnings management (Kothari, Leone, & Wasley, 2005).

External auditors bear the mission of overseeing the truth of financial information conveyed (Rittenberg & Schwieger, 2005). Thus, this study is based on external auditors as subjects to explore whether or not the existence of controlling shareholders and the divergence of cash-flow right and control will moderate the relationship between independent directors and earnings management.

2. Literature review and hypotheses

2.1. Earnings management

Schipper (1989) defines earnings management as the planned alteration process of managers intentionally intervening throughout the financial reporting procedure within the range allowed by the GAAP to adjust earnings statements to an excepted level. Healy and Whalen (1999) define earnings

Download English Version:

https://daneshyari.com/en/article/973990

Download Persian Version:

https://daneshyari.com/article/973990

Daneshyari.com