The impact of earnings management on the extent of disclosure and true financial performance: Evidence from listed firms in Hong Kong

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ABSTRACT

This paper challenges the notion that seeking to increase disclosure may not necessarily improve firm performance. Using Hong Kong listed firms subject to increase the extent of disclosure, this paper shows that the net benefit of disclosure is contingent on conditions such as the quality and integrity of a firm’s information. We demonstrate that a nonlinear relation exists between disclosure and firm performance when measured performance is adjusted for the impact of earnings management, over the period from 2006 to 2013. The results of our study show that corporate disclosure is likely to result in benefits, but after an optimum level, increasing disclosure reduces true firm performance. This optimum level also falls when differences between other firm’s monitoring environments (e.g., independent boards) are in place. These results indicate that intense monitoring of CEOs offsets the advantage of additional corporate disclosure.

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1. Introduction

A CEO as the most senior corporate officer need to consider his interaction when exercising discretion. In corporate disclosure, a great deal of CEO discretion goes into the construction of disclosing information to inform the market about CEO performance and firm’s activities - information that is intended to keep the CEO disciplined. In literature, CEOs, however, are hypothesized to affect firm-enlarging actions that yield greater job security and compensation for themselves, especially when their interest is not aligned with the interests of outsiders. When these two lines of discussion are considered together, CEOs may prefer the less informative disclosure regime and the quality of information (such as completeness, accuracy, reliability, precision and timeliness) that CEOs are prepared to provide may not be of a quality expected by outsiders. This issue has involved Asian corporate transparency models that were criticized as being relatively inefficient in maintaining fairness and integrity in the stock markets during the East Asian crisis (Greenspan, 1999; Harvey & Roper, 1999; Stiglitz, 1998). Therefore, seeking greater corporate transparency is increasingly important to solving the issue and improving the informativeness of disclosure regime. In the Hong Kong stock exchange (HKSE), public-policy discussions on corporate disclosure, view increasing the amount of disclosure as the key to achieving the desired step-change in transparency (Gul & Leung, 2004; Ho & Wong, 2001). Firms responsible for this change often describe increasing the amount of disclosure as providing the

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information required for enhanced transparency. Therefore, if increased disclosure is good, it is reasonable to ask why owners as outsiders were reluctant to increase the extent of disclosure before regulatory requirements. What is the downside to increasing the amount of information disclosed?

Transparent information environment makes a firm more attractive to all investors. It improves coordination between firms and investors with respect to capital investment decisions and builds a climate of trust that can increase the value of a firm. If CEOs do not disclose any information, investors would lower their views on firm value. As a result, CEOs have incentives to disclose their information to distinguish themselves from CEOs with less favourable information to have a good career reputation (Beyer, Cohen, Lys, & Walther, 2010). Equally, information can improve the ability of shareholders and boards to monitor their CEOs consistently, an ability that may result in a loss of employment for the CEOs. In order to have greater job security and reputation, CEOs must direct their efforts toward increasing firms’ stock prices.

In contrast to prior studies believe that career concerns, due to disclosure, increase worthwhile activities in companies, this study argues that CEOs’ activities to achieve greater job security and reputation may be cumbersome and ungainly with the possibility of misrepresentation. In this view, the career concerns can give CEOs an incentive to distort information coming from their firms as an exaggerated effort to increase the share price. For example, Hermalin and Weisbach (2012) believe that the career concerns induce the CEO to divert effort to manipulate information about his ability. In line with this, Hirst, Koonce, and Venkataraman (2007) indicate that incredible information has increased substantially after the regulatory reforms related to corporate information and corporate governance. Brennan (1999) finds that the management of target firms in takeovers is more likely to disclose information during contested takeover bids to show that their shares are undervalued. Existing research has also indicated that increasing corporate disclosure may result in costs in terms of the distortion caused by career concerns (CEO actions aimed at signal distortion). For example, Hermalin and Weisbach (2012) believe that the career concerns potentially affect the motivation of CEOs to engage in value-reducing activities intended to make reporting appear adequate. Therefore, CEO career concerns may generate additional asymmetric information costs and agency costs for shareholders, which would lead to deconstructing the equilibrium climate of trust.

While, outsiders and CEOs have opposing preferences regarding the increase of disclosure, one would expect that the opposing preference may capture some of the disclosure benefit via greater compensation. Goldman and Slezak (2006) and Holmstrom (1999) show that opposing preference increases CEOs’ tendency to have greater compensation given the career concerns they face. This tendency to increase compensation comes at a time of public outrage following scandal or financial crisis, which makes it politically infeasible to raise executive compensation immediately. So, it could have exacerbated the incentives for CEOs to window dress financial statements as a way to increase compensation. The use of earnings management to temporarily boost or reduce reported income is one mechanism for increase CEO compensation, which in turn influences operating performance (Cornett, Marcus, & Tehranian, 2008). This study plans to investigate how disclosure influences shareholders’ interest, that is, maximizes shareholders’ economic self-interest. Common firm performance as measured by accounting data is subject to a potential endogeneity bias through the assumptions concerning earnings management (e.g., depreciation, amortization, and accruals) due to increased risk to CEOs’ careers implicit in disclosure levels. Therefore, we examine true performance as the dependent variable to assess whether the increasing amount of disclosure is related to firm performance when the reported performance is deprived of the effects of earnings management. According to the corporate governance literature, the amount of misrepresentation is also affected by other CEO monitoring factors such as independent board (Armstrong, Core, & Guay, 2014; Ferreira, Ferreira, & Raposo, 2011). Therefore, our empirical analysis examines both the average effect of disclosure on true firm performance as well as the interacting effect of independent board on the impact of disclosure. In addition, we contemplate the possibility of a nonlinear relationship between disclosure and true firm performance.

To address any remaining endogeneity issue, we conduct a dynamic panel generalized method of moments (GMM) as suggested by Wintoki, Linck, and Netter (2012), which proves to be a valid methodology. As in earlier studies, this study finds evidence that the extent of disclosure is positively related to firm performance while, adjusting for the impact of earnings management dramatically decreases the impact of disclosure on true firm performance. Our empirical evidence also supports a quadratic relationship between the extent of disclosure and true firm performance. These results are consistent with previous theoretical literature arguing that there is an optimal level of disclosure and that, CEOs’ costly and counterproductive efforts to distort information dominates beyond the optimal level. Consequently, attempts to mandate levels beyond this optimum decrease profits.

Furthermore, our results show that the positive relationship between the extent of disclosure and true firm performance is stronger in firms where more independent directors are on the board. In nonlinear model, however, the optimum level between interaction of the extent of disclosure with independent board and true performance is lower than the optimum level between the extent of disclosure and true performance. These findings tend to reinforce the message that the benefits of improved monitoring do not flow wholly to shareholders, and companies in a different monitoring environment have a different optimal level for the extent of disclosure. The remainder of this paper is organized as follows. The literature and related issues are discussed in the next section, followed by an introduction to the models adopted for our firm performance.

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1 The reports of Conference Board (2003) show that nearly 40% of investors rate corporate profit projections as not credible after the Sarboues-Oxley Act.
2 Hermalin and Weisbach (2012) indicate that CEOs change their investment strategy toward myopic behaviour to improve reported performance, for example, substituting away from longer term investments, such as R&D, toward shorter term investments or actions that affect reported numbers sooner.
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