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Organization identity and earnings manipulation☆

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ABSTRACT

Management scholars are beginning to provide empirical evidence that organization identity (OI) can be a powerful means of reducing agency costs. We examine whether an individual's identity with the firm influences the agency costs associated with incentive contracts, namely earnings manipulation. Based on OI theory, we expect that managers who identify with the firm gain utility by taking actions that in their view benefits the firm, and experience disutility from taking actions that are harmful to the firm. Drawing on a third-party survey database, we find that performance-based compensation is associated with higher levels of earnings manipulation. Importantly, we also find that managers with incentive-based compensation engage in lower levels of opportunistic earnings manipulation when they identify with the firm.

1. Introduction

Since the early 1950s accounting researchers have documented the agency costs that emerge with the use of incentives-based contracts (e.g., Healy, 1985).[1] Where incentive contracts are implemented to motivate productive effort, concerns have been raised about the potential for managers to engage in earnings manipulation (Dechow & Skinner, 2000; Jensen & Murphy, 2012). While economics-based principal-agent models assume that managers strictly act out of self-interest and their welfare solely relies on income and effort, management scholars have for some time recognized the importance of prosocial preferences as a motivation for behavior. Researchers have more recently begun to use Akerlof and Kranton's (2000, 2005, 2008, 2010) notion of organization identity (OI) to empirically assess its effect on agency costs (Boivie, Lange, McDonald, & Westphal, 2011). Organization identity is powerful in encouraging managers to do the right thing by the firm as their utility increases (decreases) when they act (do not act) in the best interest of the firm. The theoretical underpinnings of OI are useful for understanding how OI works (Akerlof & Kranton, 2008; Heinle, Hofmann, & Kunz, 2012) and perhaps even for understanding why some managers behave with integrity and some don't (see Dikolli, Keusch, Mayew, & Steffen, 2016).

This paper examines whether a manager's OI provides a means of mitigating some of the agency costs associated with the provision of financial incentives. The intent of incentive contracts is to direct managers' attention to actions that will add value to the firm. Managers are incentivized to do so as their compensation depends on some measure of value creation. However, firms are not always successful in designing such contracts. The problem, of course, is that contributions of managers to firm value are imperfectly measured. Incentive contracts can prompt opportunistic behavior designed to improve those measures but which do not improve firm value, what we call earnings manipulation. There is a long history of research documenting how managers make accounting choices to increase the proceeds of their bonus plan (Healy, 1985; Guidry, Leone, & Rock, 1999). Roychowdhury (2006), for example, reports managers offering price discounts to boost revenues and reducing discretionary expenditures to improve reported

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[1] Recent media about the provision of incentive-based compensation to sales employees at retail bank Wells Fargo is a case in point. Likewise, supermarket chain Tesco experienced an accounting fraud with Tesco's current CEO suspending performance-based pay pending the serious fraud office investigation (The Guardian, 29 October 2014) and the conclusion of serious fraud resulting in charging three former Tesco executives: “as senior employees at the supermarket they had abused their seniority for personal gain” (The Guardian, 22 September 2016).

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performance. We draw on the intuition provided by Akerlof and Kranton (2000, 2005, 2008, 2010) to empirically examine the role of OI in mitigating opportunistic reporting choices.

In our study, earnings manipulation (EM) includes choices that result in changes in reported income, which encompasses accounting manipulation (e.g., shifting between accounts) and real earnings management (e.g., postponing necessary investments). Consistent with prior research, we expect a positive relationship between incentives and earnings manipulation (e.g., Healy, 1985). In addition, we examine whether managers who are rewarded by means of incentive contracts and who identify with the firm will engage in less EM than those agents who do not identify with the firm. Managers with higher OI will experience disutility with actions that increase their own wealth but which could potentially be harmful to the firm (Akerlof & Kranton, 2008). We expect that OI will negatively moderate the positive relation between incentives and EM.[2]

Standard economic theory does not distinguish between different sources of motivation which are just considered manifestations of underlying preferences (such as preferences for the task or the reward that follows from successfully completing the task). It is important to note that our line of argument regarding the role of OI is different from other forms of motivation such as intrinsic or extrinsic motivation. Psychology researchers emphasize that intrinsic motivation come from within a person. Deci (1971) describe intrinsic motivation as the desire "to perform an activity when one receives no apparent reward than the activity itself" (p. 105). Organization identity is somewhat different in that those with high OI do not necessarily have to enjoy the activity itself but instead are motivated by a sense of connectedness with their organization (Adler & Chen, 2011; Heinle et al., 2012). It is also a psychological preference that can be influenced or activated by the organization itself (Akerlof & Kranton, 2008).

We test our predictions using data collected by a third-party consulting firm from senior financial controllers. The use of financial controllers is particularly useful given that these individuals are not only managers but also have formal training in accounting and thus have a good working knowledge of how to manipulate earnings (Dichev, Graham, Harvey, & Rajgopal, 2013; Feng, Ge, Luo, & Shevlin, 2011; Ge, Matsumoto, & Zhang, 2011). Indeed, prior literature shows that the incentives of financial executives are particularly important in explaining earnings manipulation (e.g., Jiang, Petroni, & Wang, 2010). The use of survey data enables us to address some of the "vexing questions that have been difficult to address with archival work" (Dichev et al., 2013).

In line with most prior research, the focus of our paper is on organizational identification which is distinct from disidentification. The concept of disidentification is not simply the opposite of organizational identification but is described as a separate variable and a unique psychological state where individuals disconnect themselves from their organizations (Kreiner & Ashforth, 2004). While disidentification may be less prevalent within organizations (due to employee turnover), it should be recognized that our findings only extrapolate to cases where individuals have a neutral or positive identification with their organization.

Consistent with previous literature we find that incentives are positively and significantly associated with EM. More importantly, our findings also show that OI is negative and significant in moderating the relation between incentives and EM. Our results suggest that OI reduces the agency losses associated with incentive contracts. Viewed differently, if an individual does not identify with the firm, then incentives may prompt managers to engage in self-serving behavior that can harm the firm. Given most firms use incentive contracts, our results support the idea that it is possible to use incentives provided the firm implements strategies to ensure that individuals are committed to the firm.

The paper contributes to prior theoretical and empirical literature by documenting the role of OI in controlling agency costs (Akerlof & Kranton, 2008; Boivie et al., 2011). To the extent that incentive contracts prompt managers to take actions that benefit themselves but may be harmful for the firm, it would appear that OI curbs this incentive-induced behavior. We also show how OI and incentives can complement each other. Prior research shows how OI can motivate managers to work towards organizational objectives; incentives tied to performance measures help by directing attention of employees to those action choices that are most desirable (e.g., Malina & Selto, 2001). We show that OI can mitigate the potential for adverse consequences to emerge (e.g., EM) when monetary incentives are used. Our findings also enable us to contribute to the debate concerning incentives and EM, and provide an additional rationale for the ambiguity found in prior studies (Armstrong, Jagolinzer, & Larcker, 2010). These authors call for future research to "consider behavioral explanations in addition to the traditional economic or agency rationalizations" (p. 261). We also contribute to an emerging stream of research attempting to assess the 'manager' effect on reporting choices (Bamber, Jiang., & Wang, 2010; Dikolli et al., 2016; Geiger & North, 2006; Jia, Van Lent, & Zeng, 2014; Schrand & Zechman, 2012).

The remainder of the paper is structured as follows. Section 2 reviews prior literature. Section 3 describes the sample and measures and Section 4 presents the results. The final section provides concluding results.

2. Hypothesis development

For some time researchers have devoted attention to understanding the role of incentive contracts in misreporting and the consequences for external stakeholders (e.g., Dechow, Ge, & Schrand, 2010; Dichev et al., 2013; Fields, Lys, & Vincent, 2001). Of particular concern is that incentive contracts are implemented ex-ante to motivate productive effort, but ex-post these contracts can elicit opportunistic reporting choices that disguise the firm's economic performance and enhance the welfare of corporate executives (Badertscher, Collins, & Lys, 2012). We, first, review the literature on the relation between managerial incentives and earnings manipulation and subsequently explore the role of organization identity (OI) as a potentially factor that mitigates the opportunistic earnings manipulation.

2.1. Incentives and earnings manipulation

A major stream of the accounting literature documents opportunistic reporting choices of managers, consistent with the notion that managers use their reporting discretion to increase their own wealth and this comes at the expense of the firm. Healy (1985) was one of the first to document that managers use income-decreasing accruals when they are below the threshold or above the cap of the bonus plan, while managers select income-increasing accruals when they are within the incentive zone. Guidry et al. (1999) show that business-unit managers choose income-increasing accrual policies when they are in the bonus range. The more recent evidence suggests that managers not only make opportunistic reporting choices to maximize the proceeds from their annual bonus plans, but also do so in response to equity-based incentives. There are

[2] We do not claim that EM is by definition value-decreasing. Some EM is opportunistic while other EM may improve the representational faithfulness and predictive usefulness of accounting information. We assume that EM not induced by incentive contracts is less likely to be motivated by self-interest and that EM induced by incentive contracts is more likely to be opportunistic.

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