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The Misuse of Free Cash and Earnings Management: An Analysis of the Extent to Which Board Tenure Mitigates Earnings Management

Authors : Michael McCann

Abstract : Managerial theories propose that, in joint stock companies, executives may be tempted to waste excess free cash on unprofitable projects to keep control of resources. In order to conceal their projects' poor performance, they may seek to engage in earnings management. On the one hand, managers may manipulate earnings upwards in order to post ‘good’ performances and safeguard their position. On the other, since managers pursuit of unrewarding investments are likely to lead to low long-term profitability, managers will use negative accruals to reduce current year’s earnings, smoothing earnings over time in order to conceal the negative effects. Agency models argue that boards of directors are delegated by shareholders to ensure that companies are governed properly. Part of that responsibility is ensuring the reliability of financial information. Analyses of the impact of board characteristics, particularly board independence on the misuse of free cash flow and earnings management finds conflicting evidence. However, existing characterizations of board independence do not account for such directors gaining firm-specific knowledge over time, influencing their monitoring ability. Further, there is little analysis of the influence of the relative experience of independent directors and executives on decisions surrounding the use of free cash. This paper contributes to this literature regarding the heterogeneous characteristics of boards by investigating the influence of independent director tenure on earnings management and the relative tenures of independent directors and Chief Executives. A balanced panel dataset comprising 51 companies across 11 annual periods from 2005 to 2015 is used for the analysis. In each annual period, firms were classified as conducting earnings management if they had discretionary accruals in the bottom quartile (downwards) and top quartile (upwards) of the distributed values for the sample. Logistical regressions were conducted to determine the marginal impact of independent board tenure and a number of control variables on the probability of conducting earnings management. The findings indicate that both absolute and relative measures of board independence and experience do not have a significant impact on the likelihood of earnings management. It is the level of free cash flow which is the major influence on the probability of earnings management. Higher free cash flow increases the probability of earnings management significantly. The research also investigates whether board monitoring of earnings management is contingent on the level of free cash flow. However, the results suggest that board monitoring is not amplified when free cash flow is higher. This suggests that the extent of earnings management in companies is determined by a range of company, industry and situation-specific factors.

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