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Enhanced Board Independence Reduces Earnings Management

by Mani
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A new study shows that both BoDs and audit committees benefit from more independent directors

Board structure reform mandating increases in board independence are more effective in reducing earnings management when independent directors have easier access to information, notes a new study.

Xia Chan, Qiang Cheng of Singapore Management University along with Xin Wang of The University of Hong Kong have published a report in October 2014 titled: “Does increased board independence reduce earnings management? Evidence from recent regulatory reforms”.

New corporate governance rules

Following widespread corporate and accounting scandals in the late 1990s and early 2000s, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) proposed new corporate governance rules in 2002. These rules which are applicable to listed firms were approved by the SEC in 2003.

The rules mandate the listed firms to have a majority of independent directors on their boards. One of the primary objectives of this reform is to enhance the monitoring by the board, particularly the monitoring of the financial reporting process.

After studying a sample of 1,587 firms with the board data from BoardEx for the period 2000-2005, the study authors explore whether an increase in board independence in response to this reform is associated with a decrease in earnings management. Moreover, in light of the potential ineffectiveness of outside directors’ monitoring due to the lack of information, the authors ascertain whether the impact of the increase in board independence on earnings management varies with the cost of information acquisition.

Board independence: Compliance Vs Non-compliance firms

Xia Chan et al. categorized their sample into those firms which satisfied the regulatory requirement before the reform (compliance firms) and those firms which didn’t have a majority of independent directors prior to reforms (non-compliance firms).

Based on their analysis, the authors observed that on average, compared to compliance firms, non-compliance firms do not experience a significant reduction in earnings management from the pre- to post-regulation period. Moreover, they noticed that the reduction in earnings management for noncompliance firms decreases with information acquisition cost. Non-compliance firms with low information acquisition cost experience a significant decrease in earnings management compared to non-compliance firms with high information acquisition cost.

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Thus, the authors note these results indicate that while the increase in board independence itself does not reduce earnings management, a richer information environment can facilitate independent directors' monitoring, resulting in a decrease in earnings management.

The following table summarizes the results of the authors from the prediction model that explains the change in board independence and audit committee independence between 2000 and 2005.