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Financial status, corporate governance quality, and the likelihood of managers using discretionary accruals

Sebahattin Demirkan; Harlan Platt

+ Author & Article Information

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Purpose

The purpose of this paper is to investigate, using data on US manufacturing firms, how and when corporate governance affects managers' decisions to use discretionary accruals and thereby artificially influence company financial reports.

Design/methodology/approach

Three-stage least squares is employed to study the relationship between financial status, corporate governance and financial reporting discretion. The sample spans the years 2001-2003 during a severe downturn in the US stock market. Financial status is measured with the Altman *Z*-score.

Findings

A significant difference is found between firms not classified as healthy or failed (i.e. the mid-range group) and the two extreme categories when examining governance quotient using a well-known index. A positive relationship is found between discretionary accruals and the governance index. Strong governance appears to reduce the incidence of mid-range firms engaging in accruals management. The least healthy and the most distressed companies have the weakest relationship with discretionary accruals. By contrast, mid-range firms are more likely to resort to discretionary accruals.

Practical implications

Non-executive members of boards of directors are warned to be particularly vigilant about discretionary accruals with firms transitioning between healthy and high-failure risk.

Originality/value

The relationship between firms' financial health and discretionary accruals reveals an agency problem in credit markets with financially

by documenting the role of corporate governance on discretionary accruals and financial status.

Keywords: Corporate governance, Financial reporting, Financial performance, United States of America, Manufacturing industries