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Implicit Claim Incentives on the Accounting Choices of Troubled Companies

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This paper uses a multivariate regression analysis to examine the effect of implicit claim incentives on accrual accounting choices in 127 troubled firms. Troubled firms are defined as those that experienced three consecutives losses and reduced dividends.

Bowen et al. (1995) examine implicit claim incentives for a sample that includes both healthy and financially distressed firms. However, some studies suggest that different incentives may affect accounting choices in distressed firms as compared to healthy firms.

The results provided in this paper indicate that troubled manufacturing firms that are highly dependent on suppliers have incentives to adopt income-increasing accounting choices. These income-increasing choices paint a better firm reputation and maximize the terms of trade negotiated with those suppliers. However, implicit claims with customers and employees do not appear to provide incentives to adopt income-increasing accounting choices. This suggests that, for troubled firms, the pay-offs from these incentives are too low to influence managerial behavior.

INTRODUCTION

Earnings management studies rely on agency theory to explain and predict managers' accounting choices. In agency theory, the firm is viewed as a nexus of contracts, which may be either explicit (written) or implicit (unwritten). The incentives of the contracting parties affect accounting choices because accounting numbers are often used in contracts or serve as monitoring mechanisms. Earnings management is a direct intervention in the external financial reporting process with the intent of obtaining some private gain, as opposed to merely facilitating the neutral operation of the process [Schipper (1989)]. In fact the financial press, regulators, and the Securities and Exchange Commission (SEC) have recently expressed serious concerns about earnings management [Heninger (2001)]. Earnings management is believed to erode both the quality of earnings and the quality of financial reporting [Levitt (1998)].