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The relation between disclosure quality and reporting quality: A discussion of Cassell, Myers, and Seidel (2015) ☆

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ABSTRACT

I use the opportunity of commenting on Cassell, Myers, and Seidel (CMS) to discuss the broader issue of the relation between disclosure quality and reporting quality. Three aspects of this relation are worth exploring: (1) joint decision making, (2) incentives, and (3) temporal variation. I place CMS in the context of this research and point out avenues for future research.

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Introduction

Cassell, Myers, and Seidel (2015, CMS) examine the relation between the transparency of disclosures about activity in the bad-debt allowance, inventory allowance, and deferred tax assets allowance accounts and accruals-based earnings management. The study finds that firms manipulate earnings through accruals to a smaller degree when they provide transparent disclosures about activity in these allowance accounts. The authors also find that the placement of such transparent disclosures, whether in a summary schedule presented after the financial statements and notes or spread throughout the notes to the financial statements, does not provide additional information about firms' accruals-based earnings management. The findings suggest that users of financial reports may use firms' disclosure behavior as a signal of firms' reporting behavior.¹

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¹ In this discussion paper, "reporting" means the reporting of accounting numbers in a company's financial statements and "disclosure" means the firm's presentation of information outside of the financial statements, such as in the notes, the Management Discussion & Analysis, and press releases.

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CMS is distinctive in three ways. First, CMS is one of a few studies that investigate the reporting of *individual* accounts for evidence of earnings management (Jackson & Liu, 2010; Marquardt & Wiedman, 2004; McNichols & Wilson, 1988; Schrand & Wong, 2003). Studying individual accounts for earnings management behavior not only overcomes some measurement problems that researchers face (e.g., what do unmanaged earnings look like? Which aggregate earnings do managers target?), but also provides insights into *how* earnings are managed.

Second, CMS is one of a limited number of studies that examine the disclosure of particular corporate activities. The vast majority of disclosure studies focus on management earnings forecasts (MEF)—managers' projections of a summary operating performance measure. This focus is due to the importance of earnings in measuring performance and the availability of machine-readable data. In practice, managers provide many types of disclosures beyond MEF, either voluntarily or with discretion in deciding what to disclose and how to disclose mandatorily required items. Yet, very few studies have examined the disclosure of particular corporate activities (e.g., capital expenditures, inventory management, and warranties) and data in these studies are typically hand collected (Brown, Gordon, & Wermers, 2006; Cohen, Masako, Huang, & Zach, 2011; Sun, 2012). Examining particular activities complements traditional MEF research and helps

investors, regulators, and practitioners understand a firm's disclosure strategy as a whole.

Last, and more important, CMS is one of a few archival studies that investigate the relation between financial reporting and disclosure. Because the *same* management makes the reporting and disclosure decisions, such investigations may uncover signals that investors can glean from one type of managerial behavior and use to better understand the other type of managerial behavior. Financial reporting and disclosure differ in two main respects. First, annual financial statements are audited; quarterly financial statements are closely reviewed by auditors even though they are not audited. In contrast, disclosure is not audited, except for the notes to the financial statements in annual reports. From the perspective of auditor involvement, managerial discretion is larger for disclosure than for reporting. Second, reporting is quantitative, whereas most disclosure is qualitative. Managers have more discretion in qualitative representation, because they can decide on the length, tone, complexity, modifications, etc. beyond the numeric presentation, than in quantitative representation. Given these differences, managers' decisions in disclosure settings can reveal a wealth of information for investors to gauge the implications of financial reporting. On the other hand, managers' reporting decisions may help investors better understand corporate disclosures.

Three aspects of the relation between disclosure quality and reporting quality are worth exploring: (1) joint decision making, (2) incentives, and (3) temporal variation.² The joint-decision-making nature of the relation leads to two interesting questions. Is disclosure quality a stronger signal for reporting quality or vice versa? Do managers use their discretion in reporting and disclosure as complementary or substitutive tools?

Incentives are key to understanding and predicting how managers use their reporting and disclosure discretion. Are incentives present in the suspected cases of managerial misuse of discretion? What are the incentives that lead managers to use discretion in reporting versus the incentives that lead them to use discretion in disclosure?

Temporary variation or the lack of it can be considered a constraint to managers' use of discretion. How feasible is it for managers to use their discretion in reporting or in disclosure in the same way from year to year? To what extent can a sticky corporate policy for the strategy of reporting explain temporal variation in the disclosure strategy, and vice versa?

In my view, the most important contribution of CMS is to shed light on the relation between disclosure quality and reporting quality. This contribution, however, seems to be incidental. CMS couch their study in the "detection" story instead of in the joint decision of reporting and disclosure. They argue that the likelihood of detection decreases when a required disclosure is not transparent and therefore predict that firms whose disclosure of the allowance accounts is not transparent are more likely to

manipulate the reporting of these accounts. CMS ignore the fact that the same management simultaneously makes the reporting and disclosure decisions. In addition, CMS implicitly assume that managers have incentives to report higher earnings and do not identify situations when such incentives are especially strong or absent. Moreover, CMS do not address the issue of stickiness in corporate reporting and disclosure. These comments are less about the shortcomings of CMS, but more about the opportunities for future research.

In the next three sections I discuss extant literature; the contribution of CMS; and future research opportunities related to the joint decision making, incentives, and temporal variation aspects of the relation between disclosure quality and reporting quality. Then, I discuss a few execution issues in CMS. A short summary follows.

Joint decision making

Examining managers' reporting or disclosure choices has been a tradition in accounting research (Fields, Lys, & Vincent, 2001; Healy & Palepu, 2001). These choices, however, are often examined as standalone managerial decisions. Managers may adopt an overall strategy for financial reporting and disclosure and decide on the mix of the elements in their communication package. This perspective has seldom been explicitly taken in prior research.³ The lack of research into the relation between reporting and disclosure might be due to the view that financial reporting is the primary source of information to the capital markets (Gigler & Hemmer, 2001, p. 472). A secondary reason could be the high costs of collecting disclosure data in the first three decades of archival financial research. The fact that multiple reporting and disclosure decisions are made by the same management under the same incentives *around the same time* has been largely ignored in prior accounting research.

Only a few analytical papers have investigated the relation between financial reporting and disclosure. In a principal-agent setting, Gigler and Hemmer (2001) conclude from the contract design point of view that it may be optimal for firms that lack accounting conservatism to disclose the yet-to-be-reported financial numbers early. In a risk-neutral valuation setting, Einhorn (2005) shows that the voluntary disclosure of a value-relevant signal does not depend on the realization of the mandatorily disclosed value-relevant signal (e.g., earnings), but depends on the variance-covariance structure of the voluntary signal, mandatory signal, and firm value. Also in a risk-neutral valuation setting, Bagnoli and Watts (2007) demonstrate that a firm's voluntary disclosure decision depends on its reporting: if the earnings report contains good (bad) news, managers voluntarily disclose the variance of earnings components only when the variance is small (large). These studies have different or even conflicting predictions due to different model assumptions.

² In this discussion paper, "high quality" means that managers use their discretion to convey the economic information at the firm. CMS operationalize "disclosure quality" as disclosure transparency and "reporting quality" as the degree of upward earnings management.

³ Exceptions include Clarkson, Kao, and Richardson (1999) and Lu and Tucker (2012).

A few archival studies provide evidence on the sequential relation between corporate reporting and disclosure. Lang and Lundholm (1993) find that the Association for Investment Management and Research (AIMR) disclosure scores, which reflect the quality of mandatory and voluntary disclosures assessed by financial analysts, are higher for firms with lower value relevance of reported earnings (measured by the earnings response coefficient, ERC), suggesting a substitutive relation between reporting and disclosure. Lennox and Park (2006), however, find a positive association between the ERC and managers' issuance of earnings forecasts. Both studies examine the voluntary disclosure decision conditional on a firm's historical properties of reported earnings and the difference in their findings might be attributed to the limitations of AIMR scores. In contrast, Kasznik (1999) examines the effect of voluntary disclosure on subsequent earnings reporting and finds some evidence that firms manipulate reported earnings to meet the previously disclosed earnings forecasts.

Three novel archival studies explore the *contemporaneous* relation between reporting and disclosure. Gong, Li, and Xie (2009) find that the unintentional errors in accruals and MEF, which are issued around the same time as reported accruals, are positively correlated. Feng, Ge, Li, and Nagarajan (2014) examine intentional managerial behavior and find that firms manipulating earnings use MEF concurrently to delay the detection of earnings management, although such orchestrated efforts have severe consequences once misstatements are exposed. Francis, Nanda, and Olsson (2008) are the closest to CMS and report that firms with higher earnings quality provide more expansive voluntary disclosures. They measure disclosure by coding items in the annual report and their finding suggests a complementary relation between reporting and disclosure quality. This relation disappears, however, when Francis et al. use alternative proxies for voluntary disclosure and they find that the issuance and precision of MEF and the number of conference calls during the fiscal year are negatively associated with earnings quality, suggesting a substitutive relation. These puzzling results imply either that specific types of voluntary disclosure (e.g., annual report, MEF, and conference calls) play different roles in managers' overall communication package or that the composite scores used by Francis et al. do not measure a firm's overall voluntary disclosure.

CMS extend this line of research by examining the contemporaneous reporting and disclosure of *specific* accounts. By examining specific accounts for which managerial discretion in reporting and disclosure is high, CMS identify a conceptual relation that is more direct and an empirical relation that is subject to fewer measurement errors than prior research. Although the findings of CMS may not necessarily generalize to other reporting and disclosure items, understanding pieces of a puzzle would be helpful for readers to understand the whole.

One weakness of CMS is that the authors view their study in the traditional misstatement framework instead of the joint-decision framework. The misstatement framework includes three elements: incentives, opportunities, and detection. CMS focus on detection and argue that

when managers do not manipulate the allowance accounts, they can afford transparent disclosure of these accounts. Otherwise, transparent disclosure would increase the detection rate of misstatements in these accounts. CMS examine the extent of earnings management conditional on the disclosure transparency of these accounts or the lack of transparency. In contrast, in the joint-decision framework managers simultaneously decide on the reporting and disclosure of these accounts. Therefore, how managers report the accounts could serve as a signal of how managers disclose these accounts and vice versa. In this framework, a simultaneous empirical analysis would be more appropriate.

The comment of one conference participant was related to this weakness of CMS. The participant pointed out that the original title of the study suggested causality but that the authors had not conducted the reserves causality analysis. Although reverse causality could be addressed by additional empirical analysis, the real underlying issue is that the authors take the perspective of financial misreporting with a focus on detection instead of the perspective of joint decision making.

The joint-decision perspective invites interesting questions for future research. For example, researchers may identify situations in which the signal gleaned from reporting for disclosure is stronger than the signal gleaned from disclosure for reporting or vice versa. It is also interesting to identify situations in which reporting and disclosure are used as complements and situations in which they are used as substitutes.

Incentives

Incentives are key to understanding and predicting how managers use their reporting and disclosure discretion. Some managerial incentives are driven by valuation considerations and others are driven by evaluation. Managerial incentives could also be related to stakeholders other than shareholders and creditors, such as customers, suppliers, and the Internal Revenue Service. A major reason why investors may learn from one type of managerial decision about another type is incentive consistency: multiple decisions are made by the management under the same, perhaps non-transparent, incentives.⁴

In general, when managers have discretion over reporting and disclosure choices, they prefer the choices that help them project a picture of *steady* earnings growth (Gordon, 1964). Managers may not always seek to report higher earnings, however. Managers may prefer to understate earnings when (1) the excess earnings would not translate into extra compensation for the current period or would not be sustainable in the future, (2) the management has just taken over the firm, (3) firms want to avoid political or union attention, or (4) firms want to avoid renegotiations with major suppliers and customers. Moreover, given the reversal property of accounting

⁴ An interesting study by Goodman, Neamtiu, Shroff, and White (2014) examines the relation between management forecast quality and investment efficiency based on the intuition that managers use the same forecasting skills in both tasks.

accruals, it is infeasible for managers to use their discretion to report higher earnings year after year.

Therefore, studies of managerial discretion are remiss if they ignore managerial incentives. The problem is more severe when earnings management or disclosure management is more difficult to identify and measure. CMS do not discuss managerial incentives and most of their empirical analyses assume that managers prefer higher reported earnings. Although CMS' focus on specific accounts allows them to sharpen their measures of reporting and disclosure quality, the lack of discussion of managerial incentives and the failure to incorporate incentives into their empirical analysis is a shortcoming of the study. Future research could incorporate managerial incentives in the investigations of the relation between disclosure quality and reporting quality.

Temporal variation

The interaction between a company and the capital markets is a multi-period game. Managers' past reporting and disclosure practices may constrain their practices in future periods (Barton & Simko, 2006). Perhaps to maintain flexibility, managers rarely declare their philosophy or policy for corporate disclosure. Investors, however, form expectations of corporate disclosure from a firm's past practices. The theorized benefits of disclosure in improving risk sharing and stock liquidity and in reducing the cost of capital arise from managers' commitment to a corporate policy of high-quality disclosure (Diamond, 1985; Diamond & Verrecchia, 1991). The commitment benefits are perhaps the reason why disclosure practices are often sticky from year to year. Chen, DeFond, and Park (2002) find that after firms start to include balance-sheet data in their earnings announcement press releases, two thirds of the firms continue to do so. Lansford, Lev, and Tucker (2013) report that firms largely continue their practices of either disaggregating MEF or not disaggregating it in the subsequent year. If firms deviate from past practices, the change is a signal to investors. For example, Houston, Lev, and Tucker (2010) and Chen, Matsumoto, and Rajgopal (2011) document serious consequences when firms stop providing quarterly MEF.

In contrast, a firm's discretionary use of accounting choices to boost reporting earnings cannot be persistent in theory because most accounting accruals reverse in the subsequent accounting cycle. To counter the reversal of accruals and continue to report desired earnings, managers have to become increasingly aggressive in using their discretion—a slippery slope to fraudulent reporting (Schrand & Zechman, 2012).

As in most prior accounting research, CMS treat each firm-year as standalone and do not discuss the temporal variation properties of the reporting and the disclosure of the bad-debt allowance, inventory allowance, and deferred tax asset allowance accounts. The lack of discussion of disclosure stickiness and the implications of stickiness is a shortcoming of CMS.

The investigations of reporting and disclosure stickiness and the implications of stickiness are promising areas for

future research. To what extent can a fairly sticky corporate disclosure strategy predict a reporting strategy that has to exhibit temporal variation? Do managers use their discretion differently depending on the constraints of temporal variation in the use of discretion? Under what circumstances are the constraints less binding, and does the relation between disclosure quality and reporting quality change accordingly?

Execution issues

In CMS, the estimate of discretionary aggregate accruals using the modified Jones model for the transparent and non-transparent disclosure samples combined is close to zero or only slightly negative, whereas prior research reports a much larger magnitude of negative discretionary accruals using the same model specification (Kothari, Leone, & Wasley, 2005; Tucker & Zarowin, 2006). In addition, CMS's estimate of discretionary accruals using the model specification of Ball and Shivakumar (2006) is positive and of fairly large magnitude. In contrast, the estimate of discretionary (current) accruals in Hope, Thomas, and Vyas (2013) is negative. Conference participants pointed out these empirical discrepancies, although there are no theoretical grounds for the mean or median of discretionary accruals (which empirically are residuals of regression estimations) of a large sample to be either significantly positive or negative. The discrepancies may be because CMS select firms that report material balances of the three allowance accounts and therefore derive a sample that is different from those used in prior research. Future research may examine why prior research documents systematically negative or positive discretionary accruals for samples that are supposed to represent the population of interest before researchers even consider subsamples of incentive suspects. The investigation would refine our understanding of the generalizability of findings related to discretionary accruals.

The reported deferred tax assets (DTA) allowance in Appendix A of CMS is surprisingly high and right-skewed. After scaling by total assets, the mean (median) for the transparent-disclosure group is 0.238 (0.021) and that for the non-transparent-disclosure group is 2.642 (0.147). The large magnitude of the allowance is concerning even though it is mathematically possible. When the mean allowance is 2.642, for example, the gross DTA should be even larger. DTA arise from the benefits of paying less tax in the future due to net operating losses or higher taxable income than financial income in past fiscal periods. Thus, DTA are a cumulative number of a percentage of flow measures. It is unusual for the cumulative effects of such flow measures to be many times larger than a firm's total assets—a stock measure. In comparison, the mean of the DTA valuation allowance is only 13.1% of the gross DTA in Schrand and Wong (2003, Table 1). CMS provide a note in Appendix A about the large magnitude of this allowance account. It would be helpful to readers if the paper also provides information about the number of firms with unusually large magnitudes of the allowance, the characteristics of these firms, and the robustness of findings after

excluding these observations. As Miller and Skinner (1998) point out, the DTA due to net operating loss carryforwards is the most important component of DTA. Firms with net operating loss under the tax rules might be quite different from firms that record DTA due to higher taxable income than financial income in past periods. Future research may separate these two types of firms and examine managers' use of discretion in the DTA allowance from these two different sources.

The sample of CMS excludes observations when firms provide transparent disclosures for some, but not all, of three material (disclosed) valuation allowance accounts. The exclusion of "partially transparent" observations is reasonable because CMS focus on the dichotomy of transparent disclosure versus non-transparent disclosure. Given the fact that managers have three major allowance accounts in their "tool box," however, it would be interesting to examine the phenomenon of partial transparency. In particular, why do managers select a particular allowance account to manipulate earnings and withhold information? How do investors interpret partial transparency differently from full transparency and no-transparency? These are opportunities for future research.

Conclusion

CMS ask an interesting question about the relation between disclosure quality and reporting quality. To answer this question, the authors have painstakingly hand-collected a large set of data and provided preliminary evidence that a firm's decision on how transparently it discloses activity in the bad-debt allowance, inventory allowance, and deferred tax assets allowance accounts can serve as a signal to investors of managers' misuse of discretion in reporting these allowance accounts and in their overall accruals reporting. Despite some shortcomings, CMS make a nice contribution to the accounting literature. I expect more future research to explore the relation between disclosure quality and reporting quality.

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