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CEO Oath and Corporate Misconduct

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MISSISSAUGA

When executives pledge integrity: The effect of the accountant's oath on firms' financial reporting

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Research Question

Do executives' pledges of integrity improve firms' reporting quality?

Motivation

- “Traditional” corporate governance mechanisms often fail
- Integrity oaths have existed for over 2,000 years
- Recent momentum in the use of integrity oaths
 - Low-cost strategy to potentially improve compliance
 - Executives’ integrity is a determinant of firms’ compliance
 - Failure of other mechanisms in deterring misconduct
- Uncertain if requiring an oath has any effect on executives’ behavior
 - Code of ethics reminder, implicit social contract
 - Still a lot of misconduct. Misconduct driven by personal characteristics

Related Literature

- Regulatory tools to improve financial reporting
 - Regulatory resources, transparency, controls, accountability (e.g., Cohen et al. 2008, Kedia and Rajgopal 2011, Duro et al. 2018)
 - SEC requirement for CEOs and CFOs to state under oath the accuracy of financials (Griffin and Lont 2005, Bhattacharya et al. 2007)
 - Ethics and compliance trainings (e.g., Kowaleski et al. 2020, Park 2020)
- Behavioral economics
 - Truth-telling experiments – moral code reminders (e.g., Ariely 2012, Mazar et al. 2008)
 - What determines whether an individual lies?

Setting

- Dutch accounting oath
 - Accountants in the Netherlands must register with the Royal Netherlands Institute of Chartered Accountants or NBA
 - On May 17, 2016, the NBA's board required that all active "CPAs" take a professional integrity oath
 - Objective: improve auditing quality
 - Side effect: some CEOs and CFOs required to take the oath
- Consequences of non-compliance
 - Losing one's license
 - Potential reputational costs

The Oath

I am aware that as a professional accountant I am bound to act in the public interest. I will exercise my profession with an attitude of professional skepticism. When exercising my profession as a professional accountant I am guided by fundamental principles of integrity, objectivity, professional competence, and due care and confidentiality. I will comply with the laws and regulations applicable to my profession. My professionalism implies that I will not execute any acts of which I know or ought to know that these could bring the accountancy profession into disrepute. So help me God / I promise / I declare.

Hypothesis Development

- Oath can improve financial reporting:
 - Reminder of code of ethics and laws
 - Change understanding of the norms – implicit social contract
 - Commitment device
- Oaths can be ineffective:
 - No new ethical requirements
 - No change in costs: same punishment and detection
 - Execs' behavior is driven by personal characteristics

Empirical Challenges

Ideal scenario:

- Random assignment of oaths between treatment and control subjects

Our setting:

- 2016 law required all Dutch “CPAs” to pledge an integrity oath
- Law only introduced oath (but no other changes)
- Oath was unexpected when the executives obtained their accounting degree, eliminating *selection effects*
- *Quasi-natural experiment*: As-if random assignment of oath-takers among firms with a registered accountant as CEO or CFO
- CEOs and CFOs that do not hold a Dutch professional accounting degree are not required to pledge an integrity oath, serve as the control group

Data and Methodology

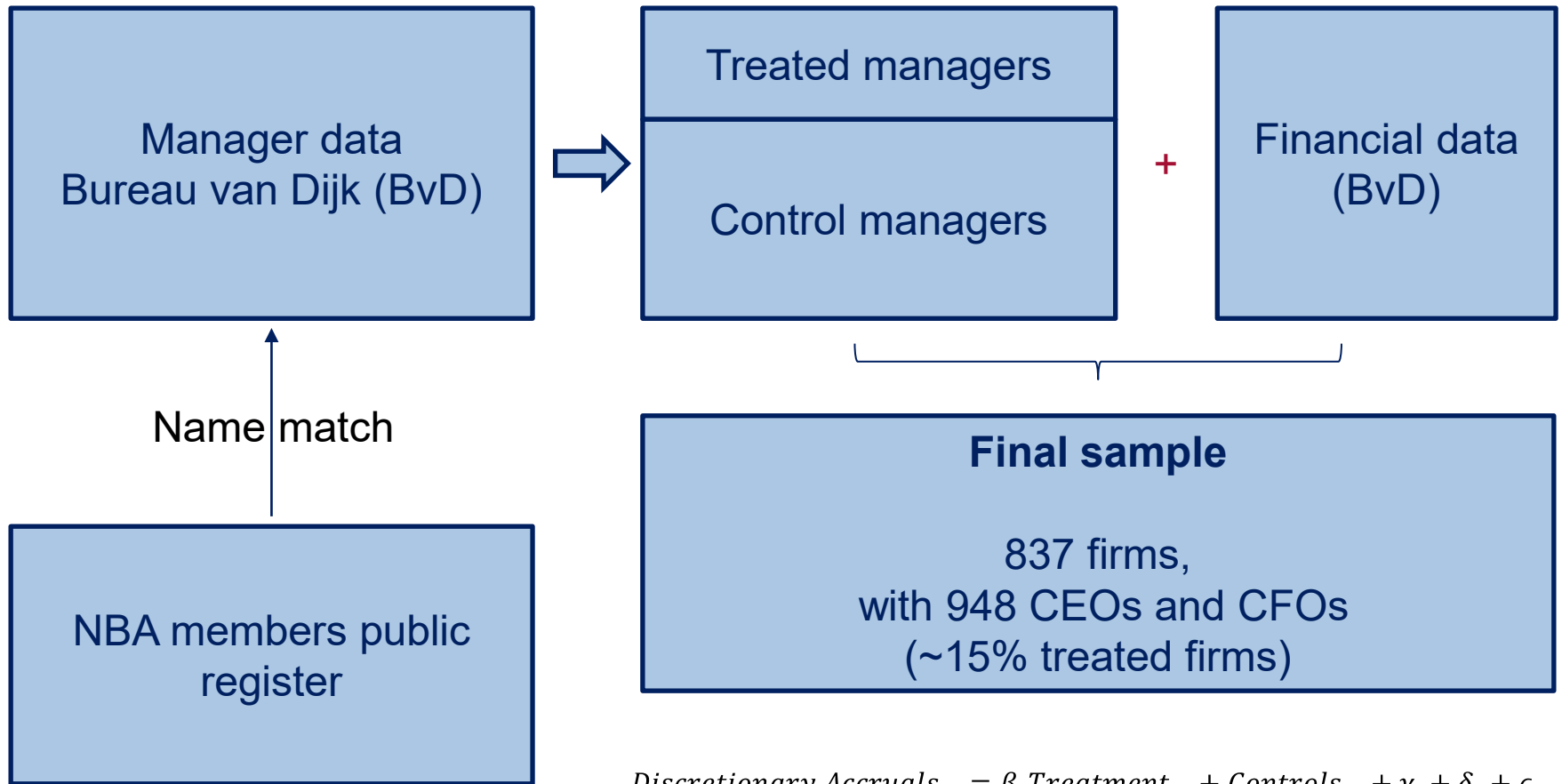
- Identify 7,579 CEOs and CFOs of Dutch private and public firms
 - Cross-reference with Dutch accountants' register (27,893 individuals)
 - 40 CEOs and 84 CFOs with an accounting degree (~15% treated firms)
 - Manufacturing, wholesale trade, administrative services

- Difference-in-differences (3 yr pre & 3 yr post)

$$Earnings\ Management = \beta_1 Treatment_{i,t} + Controls_{i,t} + \gamma_i + \delta_t + \epsilon_{i,t}$$

- Earnings management measures:
 - Discretionary accruals: residual from modified Jones model as per Dechow et al. (1995)
 - Real earnings management: abnormal production costs and abnormal discretionary expenses (Roychowdhury 2006)
 - M-Score (Beneish 1999)

Data and Methodology



$$\text{Discretionary Accruals}_{i,t} = \beta_1 \text{Treatment}_{i,t} + \text{Controls}_{i,t} + \gamma_i + \delta_t + \epsilon_{i,t}$$

Results – Accruals Earnings Management

Dependent Variable	Discretionary Accruals		
	CEO + CFO	CEO	CFO
Treatment			
Variables	(1)	(2)	(3)
Treatment	-0.021** (0.009)	0.007 (0.013)	-0.031*** (0.010)
Market Share	-0.003 (0.094)	-0.001 (0.094)	-0.002 (0.094)
NOA	-0.008 (0.006)	-0.008 (0.006)	-0.008 (0.006)
Size	0.042*** (0.011)	0.042*** (0.011)	0.042*** (0.011)
ROA	0.245*** (0.042)	0.243*** (0.042)	0.246*** (0.042)
Leverage	-0.194*** (0.028)	-0.192*** (0.028)	-0.195*** (0.028)
Firm FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Adj. R ²	0.02	0.02	0.02
Observations	4,559	4,559	4,559

- Effect of oath on firms with CEO or CFO accounting degree:
 - Income increasing discretionary accruals decrease by ~0.16 SDs

Results – Real Earnings Management

Dependent Variable	REM Prod			REM Disx			REM		
	CEO + CFO	CEO	CFO	CEO + CFO	CEO	CFO	CEO + CFO	CEO	CFO
Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Treatment	-0.052*	-0.009	-0.063**	-0.059**	-0.014	-0.070**	-0.113**	-0.012	-0.139***
	(0.027)	(0.051)	(0.030)	(0.026)	(0.039)	(0.031)	(0.049)	(0.087)	(0.053)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R ²	0.84	0.84	0.84	0.87	0.87	0.87	0.88	0.88	0.88
Observations	1,868	1,868	1,868	2,069	2,069	2,069	1,868	1,868	1,868

- Effect of oath on firms with CEO or CFO accounting degree:
 - Cutting of discretionary production costs decrease by ~0.12 SDs
 - Cutting of discretionary expenses decrease by ~0.13 SDs

Results – M-Score

Dependent Variable	M-Score		
	CEO + CFO	CEO	CFO
Variables	(1)	(2)	(3)
Treatment	-0.045 (0.068)	0.185 (0.121)	-0.139** (0.070)
Controls	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Adj. R ²	0.10	0.10	0.10
Observations	4,559	4,559	4,559

- M-score is a comprehensive measure of misstating likelihood
- Examining egregious reporting choices:
 - Decrease of 0.139 in M-score (~5.5%) for CFOs with accounting degree

Additional Analyses

- Performance pressure cross-sectional test
- Enhancing identification
 - Falsification tests
 - Randomly assigning CFOs to placebo firms
 - Placebo treatments in Belgium – CEOs and CFOs with accounting degree
 - Propensity score matching
 - Alternative control group: inactive accountants and business background
 - Concurrent events – changes to the Dutch Corporate Governance Code
 - Using only private firms
 - Excluding firms with intangible assets and extraordinary income
 - Different fixed effects structures (industry x year)
 - Alternative accruals models (Dechow and Dichev, 2002)
 - Alternative window (dropping 2016)
 - Future performance

Enhancing Identification – Falsification 1 (placebo)

Dependent variable	$\widehat{\beta}_1$ <i>Actual data</i>	β_1 <i>Random data</i>	$H_0: \beta_1 > \widehat{\beta}_1$ [p-value]
(1) Discretionary Accruals	-0.031***	0.0002	[0.007]
(2) REM	-0.139***	-0.0002	[0.016]
(3) REM Prod	-0.063**	0.0010	[0.051]
(4) REM Disx	-0.070**	-0.0001	[0.015]
(5) M-Score	-0.139**	-0.0017	[0.068]

- Randomly assign accountant CFOs to firms

Enhancing Identification – Falsification 2 (Belgium)

Dependent Variable	Discretionary Accruals			REM		
	CEO + CFO	CEO	CFO	CEO + CFO	CEO	CFO
Variables	(1)	(2)	(3)	(4)	(5)	(6)
Treatment	-0.094 (0.128)	-0.117 (0.123)	-0.042 (0.082)	-0.045 (0.063)	-0.042 (0.067)	-0.079 (0.085)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R ²	0.18	0.18	0.18	0.72	0.72	0.72
Observations	725	725	725	396	396	396

- Use Boardex to identify executives of Belgium firms with accounting background
- No effect

Concern 1: Accounting vs non-accounting firms

- Are there systematic differences between firms led by an executive with an accounting degree vs. other type of degrees/background?
 - DiD usually mitigates this concern
 - But maybe another event happened and accountants reacted better...

Propensity Score Matching

Dependent Variables	Discretionary Accruals	REM
Variables	(1)	(2)
Treatment	-0.017* (0.010)	-0.119* (0.058)
Controls	No	No
Firm FE	No	No
Year FE	No	No
Adj. R ²	0.00	0.00
Observations	929	159

- Control observations are determined via propensity score matching
- Effects hold

Inactive “CPAs” and business background as control

Dependent Variable	Discretionary Accruals			REM		
	CEO + CFO	CEO	CFO	CEO + CFO	CEO	CFO
Variables	(1)	(2)	(3)	(4)	(5)	(6)
Treatment	-0.042*	-0.019	-0.061***	-0.062	0.053	-0.489***
	(0.021)	(0.029)	(0.017)	(0.147)	(0.143)	(0.077)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R ²	0.06	0.13	0.03	0.90	0.93	0.89
Observations	776	291	503	313	94	213


- Control observations are firms with an executive with an inactive accounting degree or business background
- Effects hold

Concern 2: Concurrent events


- Another event might have taken place at the same time
 - 2016 amendment to the Dutch Corporate Governance Code
 - Only affects publicly traded firms
 - 2016 amendment to the Title 9 provisions
 - Primarily relate to the reporting of goodwill and extraordinary income
 - Small and micro companies are excluded from these amendments

Alternative Samples


Dependent Variable	Discretionary Accruals			Discretionary Accruals			Discretionary Accruals		
	CEO + CFO	CEO	CFO	CEO + CFO	CEO	CFO	CEO + CFO	CEO	CFO
Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Treatment	-0.022** (0.010)	0.007 (0.014)	-0.031*** (0.011)	-0.020 (0.022)	0.090 (0.061)	-0.042** (0.020)	-0.027 (0.026)	0.003 (0.019)	-0.063*** (0.016)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R ²	0.02	0.02	0.02	0.05	0.05	0.05	0.40	0.40	0.40
Observations	4,292	4,292	4,292	1,371	1,371	1,371	372	372	372



Private firms



No Intangibles and no extraordinary income



Small firms (<50 employees)

- Effects do not seem to be driven by other concurrent reporting changes

Limitations

1. Recency of the rule

- Only examine the first three years after the oath-taking
- Possible that effects fade over more extended periods

2. Dutch setting

- Cultural characteristics may influence the magnitude of the effect
- However, it shares many cultural similarities with other European countries and even the U.S.

Conclusions

- First to examine, in isolation, effect of an integrity oath on financial reporting
- Oath is effective in changing executives' behavior
 - Spirit of the law vs. letter of the law
 - Less accruals-based *and* real earnings management
- Important implications
 - Low-cost measure to achieve higher quality reporting
- Results complement and extend insights of experimental studies in behavioral economics to accounting reporting setting