

## **Correlation between the Presence of Accountants in the Board of Directors and Discretionary Accruals: The Case of Philippines**

Angelito C. Descalzo,\* Stephany. Cabaccan, Jonathan Dob, Ralph Fermante, Christian Reyes, Adrian Simangan and Judy Ann Tuzon\*\*

*This study examines how the presence of an accountant in the Board of Directors of a particular corporation is correlated to the discretionary accruals recognized in its financial statements. The discretionary accruals of the top twenty publicly listed firms in the Philippines from years 2009 to 2014 were calculated using the Healy and Modified Jones Models, and board compositions of the firms were evaluated and reviewed. Thereafter, a correlation analysis is applied to determine whether or not there is an association between the two variables. Results suggest that the amount of income-decreasing discretionary accruals and total discretionary accruals are negatively correlated to the percentage of accountants in the board, while there is no correlation between the percentage of accountants in the board and income-increasing discretionary accruals recognized in the financial statements.*

**Field of Research:** Accounting

### **1. Introduction**

Financial statements provide managers of particular enterprise information they need to make sound decisions. This particular report also provides means for outside parties like creditors to assess whether a company has the capability to meet its obligations, government authority, especially the Bureau of Internal Revenue, to determine the company's tax obligation, and others. Based on this premise, financial statements need to be truthful in what they contain.

Discretionary accruals can be perceived through two different perspectives. The first perspective, called "signaling hypothesis," indicates that discretionary accruals improve earnings information because of their predictive value about future cash flows. However, a second perspective holds that discretionary accruals may also be used to misstate the same information. This hypothesis is called the "opportunism hypothesis" (Farshadfar & Monem, 2011). Decision makers cannot make a right economic decision if the information is misleading and this may lead to the detriment of the company's operation. It must not 'mask' or hide the true result of operations and its current position.

Following scandals such as that involving Enron and WorldCom, the public were astonished and lost their confidence in financial reports because the companies they thought were

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\*Prof. Angelito C. Descalzo, Department of Accountancy, Business Law and Taxation, College of Business Administration, University of the East-Manila, Philippines. Email: acdescalzo@aol.com

\*\*Stephany Cabaccan, Jonathan Dob, Ralph Fermante, Christian Reyes, Adrian Simangan, Judy Ann Tuzon, College of Business Administration, University of the East-Manila, Philippines. Email: stephanycabaccan@gmail.com

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successful were actually a fraud. Consequently, the United States Congress soon passed the Sarbanes-Oxley Act in 2002 to protect the public from further fraudulent misstatements of financial statements by companies.

In the Philippines, the Revised Code of Corporate Governance 2009, issued through SEC Memorandum Circular No. 6, specifies that the Audit Committee of the Board of Directors (board) shall consist of at least three directors who shall preferably have accounting and finance backgrounds. These regulatory requirements brought about by the increasing importance of corporate governance strengthen the relationship of board composition to company performance and to its issued financial statements.

It has been observed, particularly in the United States, that companies continue to do earnings management through the use of discretionary accruals, where management takes advantage of the loopholes in accounting policies and procedures, to mask the true outcome of the company's operations. As a result, the quality of reported earnings and other financial information is reduced.

Integrity of financial reporting is under the oversight of the board. It is responsible for the firm's affairs to ensure the protection of the rights of the stakeholders. Thus, they control and monitor the managers' behavior to guarantee the quality of information in the financial statements.

This study, therefore, focuses to investigate solely on the presence of an accountant or accountants in the board and its correlation to the company's discretionary accruals, while centering on the use of discretionary accruals in the financial statements of the top twenty (20) publicly listed firms in terms of market capitalization in the Philippines. The data include the profiles of the board members, whether there are accountants in the board or not, as well as, the financial statements from the years ended December 31, 2009 to 2014.

Although, prior studies provide evidence that effective internal monitoring constrained managers to manage reported earnings opportunistically (Siam, et al., 2014) and that implementation of corporate governance mechanisms decreased the degree of earnings manipulation through the use of accruals with the discretion of the management (Lin & Wu, 2015), this study tries to evaluate if there is an association between the presence of an accountant or accountants in the board and discretionary accruals of these selected Philippine corporations right after the issuance of the revised Code of Corporate Governance.

The findings will benefit the users particularly to shareholders of publicly listed firms who are in the best position of choosing whether it is necessary to elect an accountant as director or not, and how likely a firm with an accountant as director would engage in opportunistic discretionary accruals.

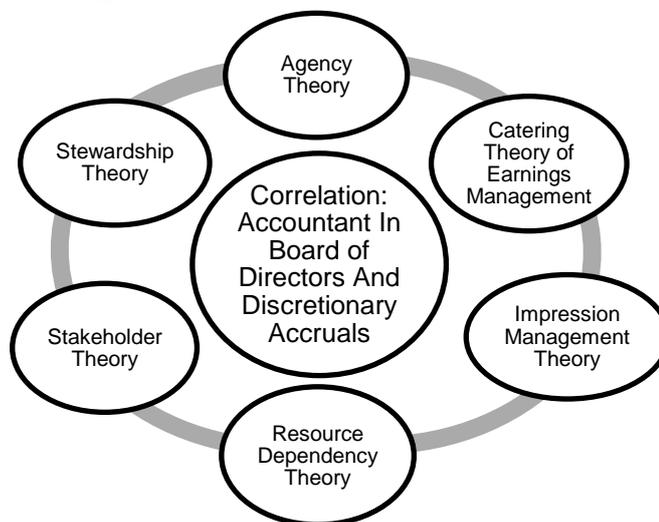
The presentation of facts is organized as follows: Section 2 discusses the various theories that explain why the research problem under study exists and a visual presentation of variables that interrelate with one another that will be subjected to empirical investigation to prove its relationships; Section 3 summarizes the reviewed literatures and studies relating to earnings management and the use of discretionary accruals; Section 4 identifies the research method and the computational models utilized in determining the relationship between the presence of an accountant in the board and discretionary accruals of selected publicly listed entities in the Philippines; Section 5 presents the computed findings of the

study; and Section 6 summarizes the association between the (1) Percentage of Accountants and Income-Increasing Accruals, (2) Percentage of Accountants and Income-Decreasing Accruals, and (3) Percentage of Accountants and both Income-Increasing and Income-Decreasing Accruals, as well as, the conclusions based on the results of the study.

## 2. Theoretical Framework

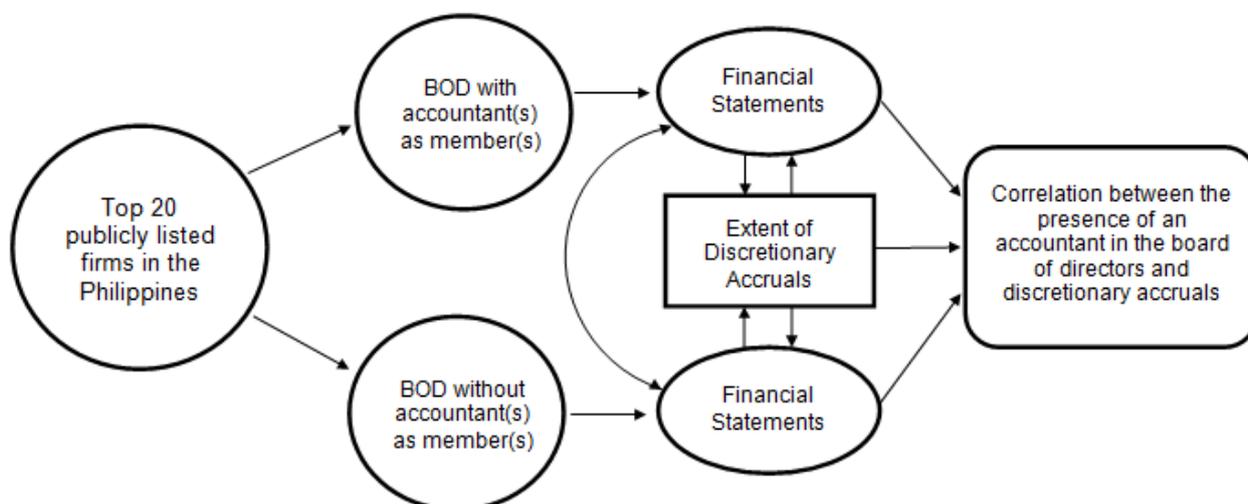
This section focuses on theoretical framework considered in this study:

Figure 1. Theoretical Framework



Agency Theory provides that the main role of the board is to obtain the necessary information to monitor the performance of the company (Berle & Means, 1932). Although the Stewardship Theory emphasizes that the board's role is to develop strategy rather than monitor performance (Davis, et al., 1997), they are chosen based on their ability to manage and leverage external relationships and they add value because of their background, skills, and contacts to whom an organization depends on for survival under the Resource Dependency Theory (Mintzberg, 1983, Pfeffer & Salancik, 2003). It is for this reason that the board works to understand and represent the differing needs of different groups and individuals who have a stake in the organization and not only to the shareholders under the Stakeholder Theory (Donaldson & Preston, 1995). According to the Impression Management Theory, however, there is a conscious or subconscious process in which people or a particular enterprise attempts to influence or control other people's perception. It is being done to make the perception consistent with a certain goal (Goffman, 1959). Moreover, Catering Theory of Earnings Management theorizes that earnings management is driven by the prevailing investor demand and that managers try to cater those demands thus the occurrence of earnings management (Rajgopal, et al., 2007) for which managers should be held accountable because all managers of a company may not always act in the best interest of the company either as a result of self-seeking behavior or because of incompetence (Berle & Means, 1932).

Figure 2. Conceptual Paradigm



From the selected publicly listed entities in the Philippines, profiles of board members were assessed to know the qualifications of its members. From the figures acquired from its financial statements, the extent of discretionary accruals was computed using the Modified Jones Model. Correlation analysis was then conducted to determine whether or not there is a relationship between the presence of an accountant in the board and discretionary accruals in the financial statements of the selected Philippine entities.

The study intends to answer the following questions:

1. Is there a tendency for a company to take advantage of recording accruals to increase its income if there is an accountant in the board?
2. Is there a tendency for a company to take advantage of recording accruals to decrease its income if there is an accountant in the board?
3. Is there a significant correlation between an accountant's presence in the board and the discretionary accruals?

### 3. Literature Review

There are two kinds of earnings management may be present in a firm: real earnings management one that involves earnings manipulation of business activities effected by management operating decisions, and accrual earnings management that is achieved by taking advantage of available discretions in the current accounting standards through accruals, whether they be income-increasing or income-decreasing (Roychowdhury, 2006). Discretionary accrual is done subject to the judgment of the management as opposed to non-discretionary accrual which are required by accounting standards (Farshadfar & Monem, 2011) and are influenced by this misalignment of interests (Beaudoin, 2008).

Psychological factors can change manager's beliefs about earnings management when they choose to engage in it. The managers tend to rationalize their behavior when they are exposed to an egregious example of earnings management; they compare their behavior against the egregious example and conclude that what they did was relatively harmless and appropriate (Brown, 2014).

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Holding of multiple directorial positions by the independent directors, and the managerial ownership of the board are significant enough to limit the incentives for earnings management (Banderlipe, 2009).

However, there exist only a small number of studies concerning earnings management which examine data from the perspective of Philippine companies. With this motivation in mind, this study will add to the list of literatures by concentrating on the relationship between discretionary accruals and the presence of an accountant in the board of directors of publicly listed firms in the Philippines based on data provided by financial statements starting year 2009.

From the limitations of the previous studies, the hypothesis is stated as:

There is no correlation between the presence accountants in the board of directors and the recognized discretionary accruals in the financial statements of the selected publicly listed firms.

### 4. The Methodology and Model

In determining the relationship between the presence of an accountant in the board and Discretionary Accruals of a company, all available audited financial statements of the selected publicly listed companies after the passage of the Code of Corporate Governance in 2009 up to year 2014 were included in the study in order to have a more reliable data for a time series analysis.

The study computed discretionary accruals (considered as variables) using the Healy and Modified Jones Models from the financial statement figures following these procedures:

- (1) Compilation of Financial statements and Profiles of the board of the companies  
Information from available data on the different companies was gathered including the financial statements for the years 2009-2014. The list of the board of the respective companies was obtained from their annual reports. The profiles of the board members were then sourced from articles, publications, etc., which are available in local libraries and on reliable online sources to determine if there actually is/are accountant/s who are members of the board.
- (2) Computation of Discretionary Accruals

Based on the first model of computing earnings management, Healy Model, it would start with Total Accruals scaled by Total Lagged assets and computed as follows:

$$ACR_T = \frac{(\Delta CA_t - \Delta CL_t - \Delta Cash_t + \Delta STD_t - Dep_t)}{A_{t-1}}$$

Computation of total accruals was based on current year's financial statements and restated last year's financial statements if there is any. For computing non-discretionary accruals, the modified Jones model was used and estimated as follows:

$$\frac{TA_t}{A_{t-1}} = \alpha \left( \frac{1}{A_{t-1}} \right) + \beta_1 (\Delta REV_t - \Delta REC_t) + \beta_2 (PPE_t) + \varepsilon$$

- (3) Computation of Percentage of Accountants in the board  
The number of graduates of or major in Accounting or an equivalent degree program was added and divided by the total numbers of board of the companies to get the percentage of directors who are accountants relative to the total number of directors. The percentage of Accountant in the board is designated as x-value and the computed discretionary accrual is designated as y-value.

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### (4) Computation of the Significance of the Correlation

To determine the significance of the correlation coefficient,  $p$ -value is computed using Microsoft Excel Data Analysis tool.

## 5. The Findings

**Table 1. Percentage of Accountants in the Board of the Top 20 Publicly Listed Firms for the years 2009 to 2014**

COMPANY NAME	2009	2010	2011	2012	2013	2014
SM Investment Corporation	13%	13%	13%	13%	13%	13%
SM Prime Holdings Inc	0%	0%	0%	0%	0%	0%
PLDT	0%	0%	0%	0%	0%	0%
JG Summit Holdings Inc	10%	10%	10%	10%	10%	10%
Ayala Land, Inc	33%	33%	33%	33%	33%	33%
Ayala Corporation	29%	25%	14%	14%	14%	14%
Universal Robina	13%	13%	13%	13%	13%	13%
BDO Unibank	21%	8%	17%	17%	7%	8%
Meralco	0%	0%	0%	0%	0%	0%
Bank of the Philippine Islands	20%	20%	20%	20%	20%	27%
Aboitiz Equity Ventures	11%	11%	11%	11%	11%	11%
Aboitiz Power Corporation	11%	11%	11%	11%	11%	22%
Globe Telecommunication	9%	8%	0%	0%	0%	0%
Metrobank	10%	18%	46%	31%	36%	31%
Jollibee	0%	0%	0%	0%	0%	0%
GT Capital Holdings Inc.	0%	0%	0%	0%	0%	0%
LT Group, Inc	27%	27%	27%	27%	36%	25%
San Miguel Corporation	8%	14%	13%	13%	13%	13%
DMCI Holdings	18%	18%	18%	18%	18%	18%
MPIC	0%	0%	7%	7%	7%	7%

Ayala Land (33%) has the largest percentage of an accountant in the BOD among the top 20 publicly listed companies for 2009, Ayala Land (33%) for 2010, Metrobank (46%) for 2011, Ayala Land (33%) for 2012, Metrobank and LT Group, Inc. (46%) for 2013, and Ayala Land (33%) for 2014. This table also shows that SM Prime Holdings, Inc., Philippine Long Distance Telecommunication (PLDT), Meralco, Jollibee, and GT Capital Holdings have no presence of an accountant (0%) in their BOD from the years 2009 to 2014 and Metro Pacific Investment Corporation (MPIC) has no presence of an accountant (0%) in their BOD for the years 2009 and 2010.

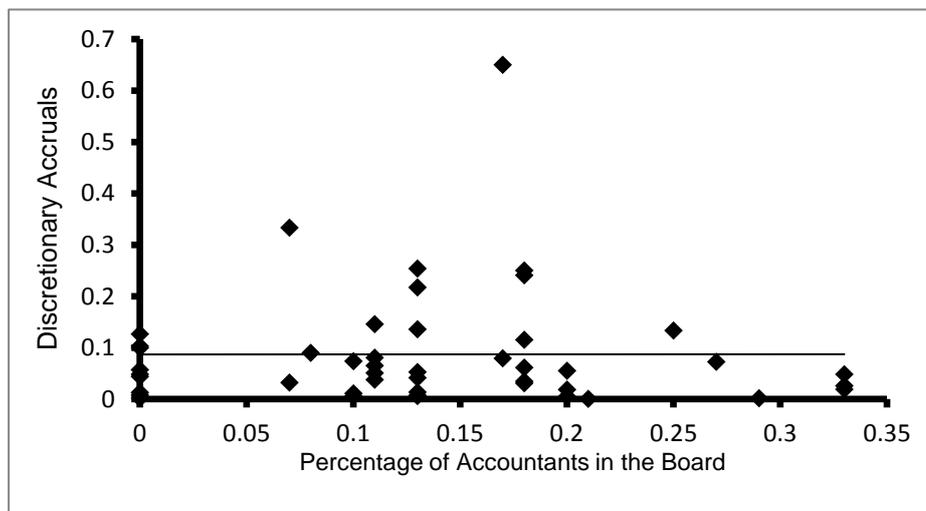
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**Table 2. Computed Total Accruals for the Years 2009 – 2014 (in millions)**

COMPANY NAME	2009	2010	2011	2012	2013	2014
SM Investments Corp.	(625)	(19,177)	(5,171)	18,572	7,570	4,669
SM Prime Holdings, Inc.	(5,959)	(3,957)	(6,270)	(5,392)	8,448	14,751
PLDT Company	(32,252)	(34,490)	(28,262)	(15,388)	(45,392)	(25,422)
JG Summit Holdings, Inc.	(19,914)	(7,104)	2,107	(14,462)	(58,923)	33,988
Ayala Land, Inc.	2,689	(4,791)	(1,644)	2,734	12,817	(15,597)
Ayala Corporation	328	(7,343)	(5,430)	(15,375)	(64,162)	(14,187)
Universal Robina	6,794	(179)	(11,805)	1,902	(17,860)	859
BDO Unibank	169	(388,605)	652,143	88,076	416,883	154,350
Meralco	(25,443)	(3,282)	(4,105)	(23,308)	(16,646)	(10,023)
Bank of the Phil. Islands	12,236	(54,419)	48,200	(8,370)	5,094	(34,460)
Aboitiz Equity Ventures	(11,213,502)	3,922,197	3,821,889	(5,095,696)	(9,003,748)	(6,838,856)
Aboitiz Power Corporation		496,733	(159,958)	(10,705,693)	(48,407)	(5,488,908)
Globe Telecom, Inc.	(22,006)	(16,373)	(17,253)	(21,565)	(41,067)	(21,559)
Metrobank	8,337	(50,545)	(2,413)	(7,069)	(337,040)	(69,869)
Jollibee Foods Corp.	(1,566)	29	74	(1,681)	(1,019)	5,598
GT Capital Holdings, Inc.		196	4,998	389	(1,823)	13,315
LT Group, Inc.			90	5,567	(36,143)	92,786
San Miguel Corporation	(12,826)	155	10,166	23,049	(6,443)	(44,832)
DMCI Holdings	(4,620)	852	304	1,875	(998)	(1,677)
MPIC	9,435	(14,512)	(4,282)	(755)	5,714	(7,182)

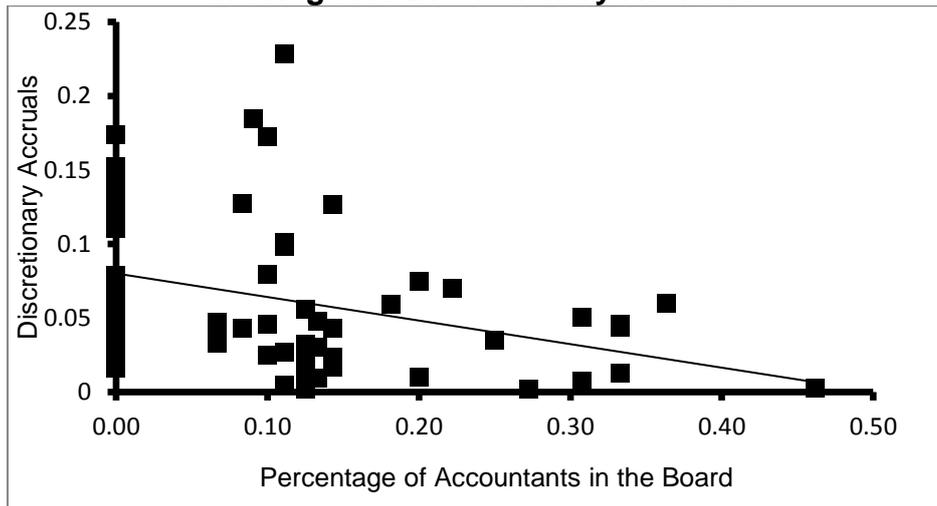
The accruals reflect the restatement in the firm's financial statements, if there be any. The result shows both positive and negative accruals. Positive figures indicate that the firm uses income increasing accruals while negative figures indicate that the firm uses income-decreasing accruals.

**Graph 1. Association of Percentage of Accountants in the Board and Positive Discretionary Accruals**



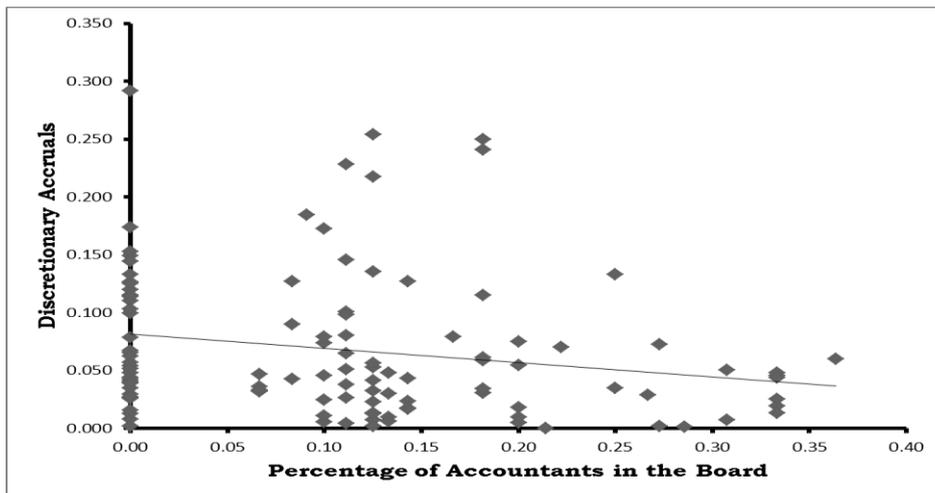
Based on the plotted points, the line shown in the graph is almost a horizontal line which indicates that there is no association between the income-increasing (positive) discretionary accruals and percentage of accountants in the board.

**Graph 2. Association of Percentage of Accountants in the Board and Negative Discretionary Accruals**



Based on the plotted points, the line shown in the graph is downward sloping which indicates the inverse association between the income-decreasing (negative) discretionary accruals and percentage of accountants in the board.

**Graph 3. Association of Percentage of Accountants in the Board and Discretionary Accruals**



Based on the plotted points, the line shown in the graph is downward sloping which indicates the negative association between the total discretionary accruals and percentage of accountants in the board.

Based on the above results, the stated hypothesis is therefore accepted to be true that there is no correlation between the presence accountants in the board of directors and the recognized discretionary accruals in the financial statements of the selected Philippine publicly listed firms.

## 6. Summary and Conclusions

Correlation is used for the following association between variables: (1) Percentage of Accountants and Income-Increasing Accruals, (2) Percentage of Accountants and Income-Decreasing Accruals, and (3) Percentage of Accountants and both Income-Increasing and Income-Decreasing Accruals. Results show that there is no correlation with an  $r$  of 0.0009 in association (1), negative correlation with an  $r$  of -0.3438 in association (2), and a negative correlation with an  $r$  of -0.2020 in association (3). With a 95% level of confidence, the computed  $p$ -values for associations 1, 2, and 3 are 0.9954, 0.0047, and 0.0335, respectively.

There are more negative discretionary accruals than positive discretionary accruals which indicate that more firms use income-decreasing accruals than income-increasing accruals. From the results of the data analysis, it can be concluded that:

1. There is no association between the percentage of accountants in the board and income-increasing accruals, but this result is found to be insignificant.  
There are lesser discretionary accruals in firms where the percentage of accountants in the board is higher, regardless of whether it is income-decreasing or income-increasing accruals.
2. There is an inverse association between the negative discretionary accruals and percentage of accountants in the board and that the correlation is significant.  
Companies tend to take advantage of income-decreasing accruals in order to avoid paying higher corporate income taxes for as long as it is within the permissible options provided for in the National Internal Revenue Code of the Philippines.
3. Over-all, there is a moderate negative correlation between the percentage of accountants in the board and discretionary accruals. However, the association is significant because the computed  $p$ -value is lesser than 5%.  
The presence of accountants in the board, however, may actually make some Philippine companies less prone in taking advantage of recognizing income-decreasing accruals thus resulting to a fairer presentation of financial statements.

Shareholders who are detached from the day-to-day operations of a company have no choice but to rely on information provided through the financial statements issued by the company in making decisions such as who to vote into the board. It is therefore in the best interest of shareholders that these financial statements are prepared strictly in accordance with prevailing financial reporting standards. However, there are still some grey areas in certain accounting standards that management sometimes takes advantage of to make it appear like the company is performing better than it actually does.

It is important to note that board composition will affect the quality of financial statements prepared by management however special attention and importance must be given to the role of the Audit Committee. Through this committee, whose members must preferably have accounting and finance backgrounds, proper oversight in the preparation of these statements, as well as other management activities, may be achieved. Although the number of members in the committee is limited to only three, their presence should have a significant impact on the way companies implement earnings management and present discretionary accruals.

Audit committee's work includes reviewing financial statements quarterly and annually in public companies, and members are expected to discuss complex accounting estimates and judgments made by management and the implementation of new accounting

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principles or regulations. Regular interaction with senior financial management must also be done and committee members must be in the best position to comment on the capabilities of these managers. Should significant problems with accounting practices be identified or alleged, a special investigation may be directed by the committee, using outside consulting services if warranted.

Furthermore, external auditors are also required to report to the committee regarding their views on management's selection of accounting principles, accounting adjustments arising from their audits, any disagreement and/or difficulties encountered in working with management, and any identified fraud or illegal acts (IIA & Price Waterhouse, 2000). With the enormous tasks placed on the audit committee, it is only fitting that certified public accountants be chosen as members.

Thus, shareholders must take into account not only the wealth and educational background, but also the character and expertise of an individual whom they would be voting for to serve as a member of the board.

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