INDEPENDENT DIRECTORS IN SWEDEN AND THEIR INFLUENCE ON EARNINGS THROUGH ACCOUNTING AND CASH FLOW MANAGEMENT

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Abstract

Independent directors are considered to be a cornerstone of efficient corporate governance. Recommendations concerning directors' independence are included in governance codes (Hermes, Postma, & Zivkov, 2006), embodying the evolved ideology of good governance (Shukla & Limbasiya, 2015).

In the American context board independence is mainly considered in relations to directors' links to the corporation and its management (Finkelstein, Hambrick, & Canella, 2009), whereas in Europe directors are considered to be independent in the absence of formal ties with both the corporation and its main shareholders (Johanson & Østergren, 2010). Independent directors are supposed to look after the generalized shareholders' interest, profit maximization, as claimed by Fama (1980) and other agency theorists. Thomsen has argued, on the other hand, that independent directors reflect the increasing power of a specific shareholder, the institutional investors (Thomsen, 2006). Thus, of all the

functions performed by directors (Collin, 2008), such as resource provision, conflict resolution and decision making, the most important one performed by the independent director appear to be monitoring.

One important monitoring activity is to secure that the corporation gives relevant information to the investors, i.e., to influence the asymmetric information conditions of the corporation vis-a-vis its investors through influencing the corporation's supply of information. While the annual report and the voluntary information disclosure are important, at the centre of interest is the balance sheet and the earnings statement. Through these two main sources of information, which we refer to as accounting management (AM), the management provides information to investors and could therefore influence their investment choices.

Another important monitoring activity is to secure that the usage of the resources of the corporation is guided by the strategy of the corporation and not by, for example, the bonus interest of a CEO. This activity we refer to as cash flow management (CFM), i.e. monitoring in the domain of operations and the value-creating process of the corporation.

The monitoring activities of the independent directors could be taking place through both AM and CFM. Guided by the general shareholders' interest, they aim to reduce information asymmetry through AM and efficient utilisation of resources through CFM. Our knowledge of these activities is, however, biased towards AM, which has been a focus on numerous studies. Much fewer have investigated monitoring in the CFM domain. And very few have considered both domains.

However, to understand the independent directors' influence and the importance it becomes important to analyse the two monitoring domains simultaneously. Assuming that independent directors are self-interested, they can influence the corporation in a way that promotes their personal reputation (Fama, 1980). In this paper we distinguish between the two domains of monitoring arguing that CFM revolves around long-term action for corporate value creation, and ultimately affects shareholder profit, thus being at the heart of an independent directors' duty. In contrast, AM is a short-term action, influencing actual corporate value at the stock market as well as the director's personal reputation in the labour market. Thus, independent directors have a personal interest in AM, since it can influence their current reputational capital and consequently the opportunity to receive more prestigious directorships at other firms.

Current research exploring the relationship between director independence and monitoring in AM and CFM domains is in a universal agreement that more independent directors will reduce managerial propensity to engage in both AM and CFM. Our argument supports the negative relationship between director's independence and CFM as independent directors will be in a better position to pursue general shareholders' interests. However, the existence of potential personal gain associated with AM puts into question the interest of independent directors to reduce it. Particularly, we argue that instead of reducing the managerial tendency to engage in AM, independent directors can have the same interest as the managers of the firm to engage in AM since AM that increase earning will create a positive image of the corporation and therefore of their work as independent directors. This will enhance their reputational capital at the labour market for independent directors.

Additionally, the correlation between independent directors and AM is blurred by the possibility that AM could not only be guided with what is commonly assumed, some party's self-interest but also by an interest to give a true and fair view. Normally, it is assumed that independent directors reduce information asymmetry through being the knights of the IFRS, promoting the belief that the accounting system of IFRS can produce a true and fair view of the corporation when not burden by accounting management. Another view, less frequently held, is that independent directors promote AM that uses the flexibility of IFRS, in order to adjust to certain situations and specificities of the corporation. While voluntary information can be one mean of improving the informational content of the annual report (Young, 2014), AM is another mean of creating information that can give a true and fair view of the corporation. Some AM could be guided by the independent directors' interest to present the investors with a true and fair view of the corporation. If this is the case, then AM is not only an indicator of managerial and directors' opportunism but an indication of improving the information given to the investors. Thus, we could expect even an increase of AM as a result of the monitoring task performed by the independent directors.

We develop and empirically test two hypotheses:

H_1: There is a negative relationship between directors' independence and CFM.

H_2: There is a positive relationship between directors' independence and AM on a sample of 206 corporations listed 2017 on the Stockholm Stock exchange.

Sweden presents an interesting context to test our ideas. Due to its relatively small size (in our study we capture nearly all population) independent directors' network is dense and highly interlocked, resembling a small world (Sinani et al., 2008) which allows to reduce information asymmetry and thus create a more efficient labour market. In the empirical study, we calculate the two dependent variables by using the modified Jones model (Dechow et al., 1995) for calculating AM and the model proposed by Roychowdhury (2006) to calculate CFM.

Our empirical results indicate that the share of independent directors is positively correlated with AM and negatively with CFM and remain consistent against several robustness checks.

We conclude that independent directors appear to be influential with the board of directors. They appear to do their duty of monitoring by decreasing the level of CFM. The conclusion of AM is harder to make since the correlation can either be due to a reputational activity in the interest of the independent director or due to an action to reduce the information asymmetry between the corporation and the investors through utilising the flexibility in the standardised accounting system, the IFRS. Our theory and empirical results put into question the generally accepted notion that AM is an indicator of opportunism. It could be suggested, on the contrary, that the positive correlation with AM could be an indicator of directors' performing their fiduciary duty of reducing information asymmetry.

One limitation of the study is that it is performed on one single national market. Studies (Zattoni et al., 2017; Johanson & Østergren, 2010) have found indications that independent directors could play different roles in different governance systems. Our findings, that AM is positively correlated with independent directors are contrary to most studies, that show negative correlations. Maybe it could be explained by what Crespí-Cladera and Pascual-Fuster (2014) call optimal independence theory, that independent directors are recruited as a result of a negotiation game between actors of governance, such as the CEO, the board and major shareholders, where the actors in the negotiation are looking for an optimal independence level (Hermalin & Weisbach, 1998). Some studies support this idea (Chou, Hamill, & Yeh, 2018; Krause, Withers, & Semadeni, 2017), and in a more elaborated conception of independence, it has been suggested to constitute the praxis hypothesis of independent directors, that the "…. the will of the dominant coalition directs the recruitment and the way of dealing with the independent directors in the actual board processes" (Collin & Smith, 2019).

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