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## Does director interlock impact the diffusion of accounting method choice?

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## ABSTRACT

This paper examines the influence of director interlock on firms' discrete accounting method choices from the perspective of behavior diffusion. We argue that firm managers will imitate their interlocked-partner firm's accounting method choices when choosing their own accounting methods. We find that when there is an interlock relationship between two firms, their accounting method choices, including inventory and depreciation methods, are similar to each other, indicating that accounting method choices can diffuse across firms through director interlock. In addition, such similarity is greater the longer the interlock relationship between the two firms is and as uncertainty increases. Further, the interlock effect on depreciation methods is larger for firms whose interlock directors have accounting backgrounds. Finally after considering sample selection bias, the influence of industry homogeneity, the issue of endogeneity, the influence of interlock direction, using accruals as a measurement of the aggregations of accounting method choices, and so on, our results are still robust.

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## 1. Introduction

How the behaviors of humans or organizations can be influenced by a network of social connections is one of the key issues in social theory (Granovetter, 1985). Social embeddedness theory (Granovetter, 1985) argues that “economic action is embedded in structures of social relations.” Director interlock, as one of the most important social connections among firms, has proved to be a costless and credible channel of information dissemination (Haunschild, 1993; Shropshire, 2010). Based on its information transmission function, director interlock can act as the mechanism for the diffusion of corporate practices and structures (Chiu et al., 2013; Haunschild, 1993; Hu et al., 2013).

Previous studies have investigated whether corporate practices, including accounting and finance choices, diffuse through director interlock, resulting in the similarity of corporate choices such as poison pill strategies (Davis, 1991), earnings management (Chiu et al., 2013; Shi et al., 2013), and executive compensation (Addy et al., 2014; Crespi-Cladera and Pascual-Fuster, 2015). These studies congruously conclude that corporate choices can diffuse through director interlock. However,

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none of these studies concentrates on the more routine and fundamental accounting method choices such as inventory and depreciation methods.

Actually, from an information perspective, prior literature indicates that accounting methods are selected to reveal managers' information and predictions about future cash flows of the firm (Holthausen, 1990; Holthausen and Leftwich, 1983; Watts and Zimmerman, 1990). Thus, these more routine and fundamental accounting methods, such as inventory method and depreciation method, are more relevant to firm values and impact future cash flows. In addition, Holthausen and Leftwich (1983) indicate that systematic accounting methods can cluster simply due to imitation. Given the importance of the information content of accounting method choices to a firm's future cash flows and value, we explore whether director interlock can impact the diffusion of those more routine and fundamental accounting method choices using a sample of public firms listed in the Chinese A-share Shanghai and Shenzhen Stock Exchanges.<sup>1</sup>

We believe data from China provides us an acceptable context (e.g., environmental uncertainty) within which to test the diffusion mechanism of interlock. According to Peng and Luo (2000) and Powell (1990), environmental uncertainty is the primary reason why firms rely on managerial ties when making decisions. First, China is an institutional transition economy characterized by weak institutional support and distorted information. Hence, it is difficult for firms in China to gain useful information from legitimate channels such as analysts and the media. In this situation, one efficient way to gain information and reduce the environmental uncertainty is to take advantage of managers' interpersonal ties (Peng and Luo, 2000). Second, prior literature has suggested that director interlock is an alternative mechanism to a weak institutional environment and may play a more essential role for firms in developing countries (Peng and Luo, 2000; Ren et al., 2009).

We find that accounting method choices (inventory and depreciation methods), indeed, diffuse across firms through networks of director interlock, and the focal firms' choices are positively related to their interlocked partner firms' previous accounting method choices.

To substantiate our results, we investigate how the age of the interlock relationship impacts the effect of director interlock on accounting method diffusion. We hypothesize that as the age of the interlock relationship increases, the information transmitted across interlock firm boundaries becomes more stable and consistent. Our results support this argument. We find that the longer the continuous interlock relationship, the more similar the accounting methods of the two firms.

We also investigate whether interlocking directors' accounting backgrounds moderate the relationship between director interlock and accounting method diffusion. We conjecture that since directors with accounting backgrounds are more likely to understand the importance of accounting choices, they are more likely to influence the accounting choices of their interlock partner firms. We find limited support for this argument. Our results show that when an interlocking director has an accounting background, the focal firm's depreciation method choice is similar to that of the interlock firm. Finally, we also investigate whether the relationship between the focal firm and the interlock firm will be strengthened when environmental uncertainty is higher. Our results indicate that, indeed, it is the case.

Our paper contributes to the current literature in three ways. First, this paper expands the influential factor of accounting method choices. Prior literature studies accounting method choices mainly from the firm-characteristic level. We find that the interlock relationship of managers can also impact firms' accounting method choices. In addition, our results provide further evidence of the positive relationship between director interlock and the diffusion of firm practices. Especially for the diffusion of accounting choices, we provide evidence that inventory and depreciation methods can also diffuse among firms through director interlock. Finally, our study also provides insights on the mechanism (e.g., the age of the interlock relationship and interlocking director background) that strengthens or weakens the diffusion of accounting methods over an interlock network.

Our paper has practical policy implications as well. Regulators and some lobbyists seem to think interlock directorates are not good and have a predisposition to try to eliminate them. For instance, Mary L. Shapiro, Commissioner of the SEC, argues that discouraging interlocking boards is an idea worth exploring. The California Public Employees' Retirement System (CalPERS) suggests to the SEC that the definition of independence in directors should include any relationship, such as interlocking relationship, that may impair a director's objectivity whether in appearance or in fact. These concerns may be legitimate; however, they are naïve and incomplete. Our paper finds that interlocking directorates are a natural solution to instances of high levels of uncertainty, especially for emerging markets such as China. When firms face environmental uncertainty in making decisions, they may imitate what their interlocked partners did previously. Also, interlocking directors can diffuse not only "good" (e.g., corporate strategy) but also "bad" (e.g., financial restatement) management policy decisions. For example, the China Securities Regulatory Commission requires listed firms to disclose interlocking directors' basic information

<sup>1</sup> The reason why we use the discrete fundamental accounting methods but not the aggregate accrual models are: (1) On the discrete accounting method side, different accounting method choices reveal different problems managers face as well the solutions they adopt. For example, depreciation method affects the equipment replacement decision (Louis and Robinson, 2005) and inventory method affects the tax saving decision (Alam and Loh, 2004). These decisions go beyond the earnings management being revealed by accrual methods. (2) On the accruals earnings management side, results based on accrual models indicate only whether earnings management might diffuse across an interlock network. However, they cannot reveal how and what types of accounting principles cause the diffusion of the accrual method across a social network because accrual methods can be changed by various corporate practices. (3) Furthermore, which accounting method and when to adopt it is not a straight-forward question. These are things managers can learn from their peers. For example, The SEC itself has noted that accounting principles are not meant to be a straightjacket and that flexibility of accounting is essential to innovation (Arthur Levitt, the "Numbers Game" speech at the New York University Center for Law and Business (Sep. 28, 1998)). In other words, GAAP "allows" a company to manage earnings by using alternative ways to record the operations of an entity. For instance, managers can change depreciation methods from an accelerated method to a more conservative straight-line method or vice versa; managers can also choose/modify the "suitable" method of inventory valuation (LIFO, FIFO, etc.).

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