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Institutional investors, shareholder activism, and earnings management

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ABSTRACT

The widespread practice of earnings management adversely impacts the quality of financial reports and increases information asymmetries between owners and managers. The present study investigates the effect of shareholder activism (as expressed by the proxy proposals sponsored by shareholders), and monitoring by the largest institutional owner on earnings management. Our longitudinal analyses indicate that the number of shareholder proposals received by firms is positively related to subsequent earnings management, yet concurrently, monitoring by the largest institutional owners is negatively related to earnings management. Our findings shed light on the equivocal results reported by prior research regarding the impact of shareholder activism on firm performance, on one hand, and ownership monitoring and performance, on the other.

1. Introduction

The manipulation of the firms' earnings reported in the financial statements, also known as earnings management, is common among public companies (Pfarrer et al., 2008). Healy and Wahlen (1999: 368) note that: "*Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers*". Therefore earnings management could be used to obscure the actual performance of the firm from shareholders and others, as reported numbers are not necessarily reflective of the underlying financial fundamentals of the firm (Klein, 2002). One of the main goals of the Sarbanes–Oxley Act of 2002 (SOX) was to limit earnings manipulations (Securities and Exchange Commission, 2003), in particular as earnings management could exacerbate informational asymmetries between shareholders and management and mislead the market participants regarding the firm's financial situation (Chih et al., 2007). A report by the U.S. General Accounting Office (GAO) indicates that during the period 1997–2002 almost 10% of all public companies restated their financial statements due to accounting irregularities, with an accompanying $100 billion wipeout of market value (Harris & Bromiley, 2007). The prevalence of restatements of financial reports raises the question whether such restatements are not just the tip of the iceberg, with many more firms engaging in the legal, yet questionable, practice of earnings management (Dechow et al., 1995; Healy & Wahlen 1999). Furthermore, prior research has found that earnings management is associated with increased costs of capital (Botosan, 1997; Lang & Lundholm, 1996), and declines in stock prices (Dechow et al., 1996).

While prior research has hypothesized and investigated the impact of shareholder activism on firm performance on one hand, and ownership monitoring and organizational performance, on the other, the impact of shareholder activism and monitoring on earnings management has not been explored. Yet a meta-analysis of ownership literature (Dalton, et al. 2003) reviews 229 empirical studies, the majority of which investigate the effect of ownership on accounting performance, or a derivative of accounting performance thereof. Since managers could misrepresent accounting numbers through earnings management, it is paramount to investigate the impact of ownership monitoring and activism on earnings management. Furthermore, while prior research has explored the benefits of principal monitoring, it has not considered the potentially negative side effects, specifically that managers could respond to shareholder activism and increased public scrutiny by increasing earnings management, in order to signal managerial capabilities and adequate firm performance. Building on Schnatterly et al. (2008) findings that only the largest institutional owner has informational advantages, we explore the impact of such owners on earnings management and in particular their abilities to constrain such impression management practices. Thus, our main research question is: *How do shareholder proposals and monitoring by the largest institutional investor affect earnings management?*

Our contribution to the extant literature is twofold. Despite Westphal and Zajac's (1994) findings that significant numbers of organizations use decoupling of symbolic versus substantive actions

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as an impression management technique, most of the research on shareholder involvement does not consider the implications that firms could respond symbolically to environmental pressures and shareholder demands (see Appendix A and B). While prior research has focused on how shareholder monitoring and activism impacts firm performance, this relationship may be blurred if managers respond to increased shareholder pressures by managing earnings rather than substantively improving firm performance. Furthermore, while the largest institutional owners may be well positioned to constrain earnings management, executives of firms receiving a number of different demands by active shareholders may be more tempted to put their best foot forward by managing the accounting numbers. We propose that both the saliency and the variety of shareholder demands will influence how executives respond to such challenges. Second, by investigating the impact of shareholder involvement on earnings management, we shed light on the prior research's equivocal findings regarding shareholder activism's impact on firm performance (e.g. Gillan & Starks, 2007; Hoffmann et al., 2010; Karpoff, 2001), and ownership and performance respectively (e.g. Dalton et al., 2003). While many studies use accounting measures of performance, prior research implicitly assumes that the reported financial numbers are informative about the underlying financial situation of the firm, or that any distortions apply uniformly across all sampled firms, which may not be the case.

2. Earnings management

The firms' financial reports are a central way by which companies manage their institutional impression (Davidson et al., 2004). As in modern corporations ownership is typically separated from control, investors rely on the information provided by the firms' management, and in particular on furnished financial statements. Yet, as accounting principles often require the exercise of business judgment, such as when selecting a particular accounting method or applying different estimations within the method (Schipper, 1989, Bradshaw et al., 2001), managers have the opportunity to shape financial reports in a desirable direction (Jensen, 2001). The former Securities and Exchange Commission (SEC) Chairman Arthur Levitt has called earnings management a widespread, but too little-challenged custom, which leads to erosion of the quality of earnings, as “managers are cutting corners” and financial reports “reflect the desires of management rather than the underlying financial performance of the company” (Levitt, 1998).

By misleading investors, earnings management could lead to temporary resource misallocation (Bradshaw et al., 2001). Earnings management has been associated with increased costs of capital (Botosan, 1997; Lang & Lundholm, 1996), decline in stock prices (Dechow et al., 1996), and increased firm risk (Chatterjee et al., 1999). Furthermore, prior research has found that firms with high earnings management are more likely to experience declines in subsequent earnings performance (Sloan, 1996), as well as be subjected to SEC enforcement actions for GAAP violations (Bradshaw et al., 2001; Dechow et al., 1996). Similarly, Richardson et al. (2002) find that earnings management is positively related to subsequent earnings restatements.

If firms face significant retributions for engaging in earnings management, especially when it results in subsequent financial restatements, then that raises the question of why do they do it in the first place. Zahra et al. (2005) suggest that pressure and opportunity are the two commonalities for firms engaging in opportunistic behavior. Executives face both significant pressures to meet and/or exceed financial goals, as well as incentives to manage earnings in order to earn contingent compensation and maintain their job security. First, senior managers are under constant market pressures to meet and exceed internal financial goals, as well as financial analysts' expectations (Corvellec, 1997; Caton et al. 2001). Furthermore, firms face pressures to manage earnings in order to meet debt covenants and private debt contracts restrictions, as well as to raise funds in the capital markets at lower rates (Richardson et al., 2002; DeFond and Jiambalvo, 1994). Second, executives may use their informational advantage to smooth earnings, as their bonuses and other performance-contingent compensation could suffer if their firms fall short of quarterly earnings forecasts (Zahra et al., 2005; Matsunaga & Park, 2001), or to obtain other private benefits, such as stock options compensation (Baker et al., 2003). For example, Healy (1985) finds that bonus schemes create incentives for earnings management.

3. Hypotheses

3.1. Shareholder proposals and earnings management

Since the late 1980s, shareholder activism has played a visible role in efforts to reform corporate governance structures and promote improvements in firm performance (Brav et al., 2008; Karpoff et al., 1996; Prevost & Rao, 2000; Ryan & Schneider, 2002; Smith, 1996; Strickland et al., 1996; Wahal, 1996). While some anecdotal evidence corroborates the importance of shareholder activism, for instance the role of Fidelity in the departure of Kay Whitmore as CEO of Eastman Kodak (Gillan & Starks, 2007), empirical research on shareholder activism is equivocal about the impact of shareholder activism on firm performance (see Appendix A for an illustrative review). Prior research finds that shareholder activism announcements often induce insignificant market reactions (Karpoff et al., 1996; Smith, 1996; Wahal, 1996; Thomas & Cotter, 2007), while others report outright negative abnormal returns for shareholder proposals targeting poison pills (Bizjak & Marquette, 1998; Del Guercio & Hawkins, 1999; Prevost & Rao, 2000). The overall weak impact of shareholder activism reflects several related dynamics, such as legal barriers to enforcement of proposals, the variety of demands presented by shareholder proposals and differences in incentives of shareholders' monitoring.

Shareholder activism is not monolithic. Shareholder proposals cover a variety of issues—from governance-related proposals (board of directors, executive compensation, etc.) to social issue proposals (human rights, environmental concerns, etc.). Diverse shareholder proposals, hence, present the demands of a variety of heterogeneous shareholders (individuals, unions, public pension funds, religious and charitable organizations, as well as coordinated investors and investment firms), with varying degrees of equity ownership, monitoring ability, knowhow and sophistication (Barber, 2006; Bizjak & Marquette, 1998; Pound, 1988; Thomas & Cotter, 2007). The small ownership requirement under SEC rule 14a-8 gives small investors an opportunity to exercise their voice, but it also leads to proposals that may be marginally supported by the remaining shareholders. For example, only one of 30 resolutions raised by shareholders at Verizon in a five year period received at least 50% of the vote (Dvorak & Lublin, 2006).

Despite that shareholder proposals may garner limited support from other shareholders, they could nevertheless target executives with well publicized activism attempts. For instance, Evelyn Davis' criticism of Morgan Stanley's board composition (Wall Street Journal, April 6, 2005), and John Chevedden's proposal to curb the power of the founding family in the Ford Motor company (Wall Street Journal, May 11, 2007), have been unsuccessful in terms of receiving a majority vote, but successful in terms of attracting media and other investors' attention (i.e., Davidson et al., 2004). Thus, activists' attempts at change could garner significant public attention and therefore intensify the public scrutiny that managers face, thus challenging the management's legitimacy (David et al., 2007; Prevost & Rao, 2000). As “highly *intense and proactive public campaigns can threaten executives' reputations and professional standing*” (Neubaum & Zahra, 2006: 114), in such instances managers face higher incentives