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Internal corporate governance, CEO turnover, and earnings management☆,☆☆

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ABSTRACT

The likelihood and speed of forced CEO turnover – but not voluntary turnover – are positively related to a firm's earnings management. These patterns persist in tests that consider the effects of earnings restatements, regulatory enforcement actions, and the possible endogeneity of CEO turnover and earnings management. The relation between earnings management and forced turnover occurs both in firms with good and bad performance, and when the accruals work to inflate or deflate reported earnings. These results indicate that boards tend to act proactively to discipline managers who manage earnings aggressively, before the manipulations lead to costly external consequences.

1. Introduction

The corporate form of organization offers many advantages, including risk sharing and the specialization of management (see Fama and Jensen, 1983b; Demsetz, 1983). But it does so at a cost of agency that results from what Berle and Means (1932) call "the separation of ownership and control." In principle, the firm's internal controls discipline managers and direct them to focus on creating value (e.g., see Fama and Jensen, 1983a). But do such controls work?[3] Much popular opinion holds that they do not. Indeed, the corporate governance provisions

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☆☆ An extensive Internet Appendix reports on numerous robustness tests and extensions of the results reported in this paper. It is available at http://faculty.washington.edu/karpoff/Research/research_index.htm.

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[3] Concern over agency problems dates at least to Adam Smith: "The directors of [joint-stock] companies being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own … Negligence and profusion, therefore must always prevail, more or less, in the management of the affairs of such a company" (Smith, 1963, p. 255).

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of the 2002 Sarbanes-Oxley Act and 2010 Dodd-Frank Act reflect a widespread concern that corporate internal controls do not effectively constrain managers from engaging in self-interested activities that destroy value and harm shareholders.[4]

This paper examines whether internal controls work to discipline one type of self-serving managerial activity—managing earnings. Executives have incentives to distort their firms' reported financial performance to bolster their compensation, gains through stock sales, job security, operational flexibility, or control.[5] The evidence indicates, however, that such distortions can prove extremely costly for shareholders.[6] Earnings management therefore provides a rich setting in which to examine whether internal controls work to discipline managers who engage in self-interested but potentially value-destroying activities.

Our results indicate that earnings management, as reflected in absolute discretionary accruals, increases the likelihood of forced CEO turnover in the subsequent year. In contrast, it has no significant effect on voluntary turnovers. The effect on forced turnover is robust in logistic probability-of-turnover tests, survival analyses, and using various measures of earnings management. We also find that the length of a CEO's job tenure is negatively related to the firm's earnings management during the period in which he or she is the CEO. Thus, not only does earnings management increase the likelihood that the CEO will be fired over the short term; its aggressive use is negatively related to job tenure in general.

We test several explanations for these results. One explanation is that earnings management and forced CEO turnover both result from poor firm performance. We examine this possibility three different ways. First, we use a measure of earnings management that adjusts for firm performance, and include controls for the firm's pre-turnover stock return, operating performance, and sales growth. Even with such controls, the probability of forced turnover increases with earnings management. Second, we examine whether managers are fired for managing earnings only when the firm performs poorly. We find, however, that the impact of earnings management on the probability of forced turnover is similar in firms with both good and poor performance. And third, we examine whether the relation between earnings management and forced turnover occurs primarily when firm earnings fail to meet analysts' forecasts. The effect of earnings management on the likelihood of forced turnover is similar among firms that meet, beat, or miss earnings forecasts—indicating that the relation between earnings management and forced turnover is over and above any connection between turnovers and the failure to meet earnings expectations.

A second possible explanation is that CEO tenure and the optimal use of accruals are endogenous to the firm's operations. In such a case, we would not conclude that earnings management causes managers to be fired, but rather, that earnings management and forced turnover jointly reflect unmeasured aspects of the firm's competitive environment. We conduct four different tests to examine this possibility. First, we construct instrumental variables for earnings management based on operating earnings volatility and special charges. Using these instruments, we continue to find that earnings management is associated with an increased probability of forced turnover, but not of voluntary turnover. Second, we examine whether earnings management persists after a CEO is ousted. If earnings management is endemic to the firm's operating environment, it should persist even after the CEO is forced out. We find, however, that earnings management decreases after forced CEO ousters, implying that it is related at least in part to the ousted manager. Third, we use propensity score matching to compare firms with forced turnover with similar firms that have voluntary or no turnovers. Earnings management is persistently and significantly higher in the firms with forced turnovers. And fourth, we test a specific endogeneity scenario related to CEO compensation. It is possible that firms in which high accruals are optimal also tend to fire their managers frequently. If so, these firms' CEOs should receive higher compensation to offset their high turnover risk. It is even possible that shareholders want the CEOs to manage earnings aggressively, and pay them to do so. The data, however, do not support this explanation, as there is no evidence that managers who manage earnings, and are fired, receive higher *ex ante* pay packages.

A third possible explanation is that CEOs are ousted because the manipulations impose explicit costs on the firm, such as SEC sanctions or earnings restatements. Indeed, previous research indicates that managers face dismissal if their firms restate earnings or are disciplined by the Securities and Exchange Commission for financial misconduct (see Desai, Hogan, and Wilkins, 2006; Agrawal and Cooper, 2008; Karpoff, Lee, and Martin, 2008a). Our results, however, stay robust when we control for, or exclude, firms that subsequently restated earnings, had SEC enforcement actions, or otherwise attracted adverse publicity. Managers who manipulate

[4] Among other directives, Sarbanes-Oxley (SOX) requires audit committees that are comprised exclusively of independent directors, prohibits loans as a part of executive compensation, and requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to certify the firm's SEC's filings. Dodd-Frank requires shareholder advisory votes on managers' compensation, regulates the activities and disclosure of the board's compensation committee, expands the SOX-based rules regarding compensation clawbacks, and authorizes the SEC to allow greater access to the proxy statement for certain shareholders. These directives are based on the argument that internal governance has been ineffective in deterring managerial opportunism. For a critical summary, see Bainbridge (2010).

[5] Safdar (2003), Burns and Kedia (2006), Bergstresser and Philippon (2006), Efendi, Srivastava, and Swanson (2007), and Cornett, Marcus, and Tehranian (2008) conclude that managers manage earnings to boost their compensation. Beneish and Vargus (2002) and Bergstresser and Philippon (2006) report that insider stock sales increase during periods in which firms have abnormally high accruals. DeFond and Park (1997), Ahmed, Lobo, and Zhou (2006), and Mergenthaler, Rajgopal, and Srinivasan (2009) show that managers' career concerns affect earnings management. And DeFond and Jiambalvo (1994) and Sweeney (1994) show that CEOs have incentive to manage earnings to gain operational flexibility and control. See Fudenberg and Tirole (1995) and Hermalin and Weisbach (2008) for theoretical perspectives on these issues.

[6] See Dechow, Sloan, and Sweeney (1996), Palmrose, Richardson, and Scholz (2004), Karpoff, Lee, and Martin (2008b), Hennes, Leone, and Miller (2008), Gande and Lewis (2009), and Karpoff and Lou (2010).