Journal of Accounting and Public Policy xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Accounting and Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol

Full length article

Managerial entrenchment and earnings management

Fabrizio Di Meo[a,*], Juan Manuel García Lara[b], Jordi A. Surroca[c]

[a] Universidad de Alcalá, Department of Economics and Business, Plaza de la Victoria, 2, Alcalá de Henares, Madrid 28802, Spain
[b] Universidad Carlos III de Madrid, Department of Business Administration, Calle Madrid, 126, Getafe, Madrid 28903, Spain
[c] University of Groningen, Department of Innovation Management & Strategy, Faculty of Economics and Business, Groningen 9747 AE, Netherlands

ARTICLE INFO

Keywords:
Managerial entrenchment
Earnings management

JEL classification:
G3
M4

ABSTRACT

Agency theorists have long contended that managerial entrenchment is detrimental for shareholders, because it protects managers from the discipline of corporate governance. However, as a competing hypothesis, we argue that entrenchment can also provide benefits for the firm's owners: it leads managers to be less myopic in managing earnings to meet short-term financial reporting goals. Our findings are consistent with this prediction as they suggest that, when there are incentives to manipulate firms' performance, entrenched managers are less prone to engage in earnings management activities that hurt shareholders. Specifically, we focus on firms that just meet or marginally beat earnings benchmarks and document a negative association between managerial entrenchment and both the opportunistic use of accruals and the manipulation of real activities. We also show that earnings management is less detrimental to firm value if the manager is entrenched. Finally, we find that these effects of entrenchment on earnings management are only present for firms domiciled in Delaware.

1. Introduction

The evidence that half of all publicly traded US companies and even a larger percentage of Fortune 500 companies are incorporated in Delaware suggests that this state's corporate law provides unique advantages to firms. What scholars, politicians, journalists, investors, and managers are still debating is whether these advantages benefit shareholders or managers (Dyreng et al., 2013). There is a growing consensus among scholars (e.g., Bebchuk and Cohen, 2003; Kacperczyk, 2009; Wang et al., 2016) that, since the second half of the 1990s, several court decisions shifted power from shareholders to managers, as the former relatively friendly-to-takeovers Delaware's regulation was replaced by a legal system in which firms are largely immune to hostile takeovers threats and managers have, therefore, discretion to expropriate shareholders' rents. This new regulatory environment provides, then, an ideal setting to study the benefits and costs of managers' power.

In this paper, we explore the effects of entrenchment on earnings management, and whether these effects are different for firms incorporated in Delaware and for firms elsewhere. According to a long established stream of agency theory literature, managerial entrenchment represents one of the costliest manifestations of the conflict between shareholders and managers (Jensen and Ruback, 1983). Managers, who place great value on control and derive substantial private benefits from it, may try to keep their jobs, even if they are no longer competent or qualified to run the firm, by engaging in a broad array of practices that neutralize the discipline of corporate governance and control mechanisms (Shleifer and Vishny, 1989). "The extent to which managers fail to experience discipline from the full range of corporate governance and control mechanisms" is what we mean by managerial entrenchment (Berger et al., 1997: 1411). There is a variety of entrenchment practices that managers may deploy, such as poison pills, supermajority

* Corresponding author.
E-mail addresses: fabrizio.dimeo@uah.es (F. Di Meo), jmglara@emp.uc3m.es (J.M. García Lara), j.surroca@rug.nl (J.A. Surroca).

http://dx.doi.org/10.1016/j.jaccpubpol.2017.07.003

amendments, antitakeover devices, staggered boards, or golden parachutes (Gompers et al., 2003). Other authors (e.g., De Miguel et al., 2004) show that intermediate levels of managerial ownership also act as a takeover deterrence mechanism that promotes managerial entrenchment. The use of these practices reduces the probability of the firm to be taken over—and, thus, to receive valuable offers that may benefit shareholders (Pound, 1987; Ambrose and Megginson, 1992)—and the manager to be subsequently dismissed, which explains why CEO tenure has been used by different authors as a proxy for managerial entrenchment (Fredrickson et al., 1988; Shen, 2003). For these reasons, CEOs' strategies to entrench themselves, such as antitakeover devices (Williamson, 1975; Jensen, 1988; Ambrose and Megginson, 1992) and manager-specific investments (Shleifer and Vishny, 1989), are regarded as important sources of expropriation of shareholders' wealth and inefficient allocation of firms' resources.

However, a competing, yet less developed stream of research in the agency theory literature states that CEOs' entrenchment aligns managers' interests with those of shareholders under certain circumstances. Stein (1989), for example, argues that CEOs that are not entrenched and that, therefore, are under market pressure, tend to behave "myopically" by providing signals of the firm efficiency to the stakeholders through short-term value increases. Thus, market-pressured managers are more likely to choose projects that yield short-term results, at the expense of long-term investments that are expected to provide higher benefits in the long run. The adoption of entrenchment practices may therefore reduce such pressure on the short-term in favor of more value-generating long-term investments. Pugh et al. (1992), for example, show that the level of capital expenditures and R & D investment, which are mainly long-term investments, increased subsequent to the adoption of anti-takeover provisions.

Taking these differing perspectives into account, the present study contributes to this discussion on the consequences of entrenchment for shareholders by analyzing a facet of the agency problem left unexplored in existing literature: the quality of accounting information. We argue that, in the presence of incentives to manipulate firms' performance, more entrenched CEOs are less likely to engage in earnings management practices to achieve short-term objectives. Contrarily, market-pressured CEOs, to appear better able before the eyes of the stakeholders and secure their jobs, are more likely to opportunistically use accruals and/or make inefficient operational decisions to make stakeholders believe that the firm is more profitable and/or more valuable than it really is. We therefore predict that entrenchment will reduce the opportunistic use of accruals as well as the manipulation of real activities when there are incentives to achieve short-term financial reporting goals, such as meeting/beating earnings benchmarks. We also argue that managerial entrenchment leads to earnings management practices that are less detrimental to firm value. This occurs as we expect that entrenched CEOs manipulate earnings in a less opportunistic way because they are more concerned about future firm value than non-entrenched CEOs. As a consequence, entrenched managers are more likely to use the flexibility inherent in accruals and in operational decisions to inform stakeholders about future performance, and not to obfuscate current performance at the expense of decreasing firm value.

Through the comparison between the firms incorporated in Delaware and the firms domiciled elsewhere, our study provides important public policy implications. In particular, our comparative analysis of the effects of entrenchment on earnings management in Delaware vis-à-vis the rest of states can shed new light on the debate about whether Delaware corporate law favors managers or shareholders. If Delaware law reduces shareholder wealth because it increases agency costs, as Bebchuk and Cohen (2003) documents empirically, new federal legislation should be enacted to defend the interests of shareholders. On the contrary, if Delaware law protects managers from the capital market's myopia, it may be in the interest of shareholders of companies incorporated elsewhere to adopt the legal regime of Delaware, as the findings of Daines (2001) suggest.

Using a large US sample for the period 1992 to 2011, we find results that support our expectations: when firms just meet or marginally beat earnings benchmarks, CEOs' entrenchment is negatively associated with both accruals-based and real earnings management to increase current income. We also find that earnings management is less detrimental to firm value when CEOs are more entrenched. These results are consistent with earnings management being used in a less opportunistic and more informative way by more entrenched managers. These two effects only appear, though, when we consider firms domiciled in Delaware. When we run our tests on the pool of firms domiciled in other states, we do not find significant results. We also replicate our main tests using a propensity score matched sample (as firms with entrenched and non-entrenched managers can be different per se in performance and earnings management incentives), and the inferences are not affected.

Our results contribute to prior research in several ways. First, we contribute to the research on the consequences of entrenchment. While most of prior literature shows that entrenchment is detrimental for shareholders (among many others: Morck et al., 1988; McConnell and Servaes, 1990; Claessens et al., 2002; Masulis et al., 2009; Gompers et al., 2010), several voices also claim that entrenched managers feel less pressured by capital markets given their lower career concerns (Stein, 1989). These lower pressures lead, in turn, to reduced myopic behavior. Consistent with this view that entrenchment reduces myopic behavior, we find that entrenched managers in Delaware firms engage less in earnings management (either through accruals or through real activities) to meet or marginally beat earnings benchmarks. We are aware of only two papers that offer related evidence: Zhao and Chen (2009) and Zhao et al. (2012). In Zhao and Chen (2009) they find that earnings management decreased after the passage, in several US states during the 1980s, of second generation takeover laws, and that the effects of these laws on earnings management were short-lived. In Zhao et al. (2012) they focus on a very specific governance variable (staggered boards) and analyze its effect on real earnings management. We add to these two studies taking a more holistic approach, with wider measures of entrenchment, and showing that managerial decisions to influence financial reporting outcomes (either through accruals or through real operations) vary with entrenchment, that entrenchment moderates the impact on firm value of these earnings management practices, and that the impact of entrenchment differs across states.

We also contribute to the literature on the effects of accruals-based and real earnings management. Regarding accruals-based earnings management, early research by Holthausen (1990), Subramanyam (1996) and Guay et al. (1996) argues that accruals-based earnings management is not necessarily negative, as it might be informative. While most of the subsequent literature has focused on