SHAREHOLDER RIGHTS AND EARNINGS MANAGEMENT

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ABSTRCT

We examine the relationship between shareholder rights and managerial propensity to engage in earnings smoothing. Using a measure of shareholder rights, and after controlling for factors that influence management's decision to manage earnings, we conclude that increases in shareholder rights significantly *increase* management's willingness to engage in earnings management. The results support the notion that direct corrective action by shareholders decreases the likelihood that a firm's management will engage in earnings smoothing.

INTRODUCTION

Strong shareholder rights potentially induce managers to conceal firm losses in fear of disciplinary action and penalties imposed by shareholders. We argue that management of firms that have more democratic governance structures (i.e. strong shareholder rights) are likely to engage in earnings management to avoid the negative consequences of poor financial performance. In other words, management of firms with weak shareholder rights are more insulated from shareholder actions and have a decreased incentive to manage their earnings. For example, Birman (2005) finds that firms with strong shareholder rights, as measured by independent boards and few anti-takeover provisions in place, are more likely to remove CEOs for poor performance. Thus increased exposure to takeovers and/or removal by shareholders initiatives increases managerial incentives to manage earnings.

Specifically, we examine the impact of governance provisions adopted by companies to protect insiders from shareholder punishments. Provisions such as classified boards, advanced notice requirements, supermajority voting, poison pills, and blank check preferred stock, when coupled with state level laws, serve as powerful anti-takeover devices. We argue that when a firm has more entrenching governance provisions in place, the ability of shareholders (outsiders) to punish managers (insiders) is hindered, which results in a reduced incentive to manage earnings. Simply put, strong shareholder rights encourage managers to engage in earnings smoothing when faced with high penalties from shareholders.

PRIOR STUDIES

Recent studies on this relationship can be broadly divided into two groups. Some find a positive linkage between governance practices and earnings management (see Chtourou, Bedard, and Courteau, 2001 and Xie, Davidson, and DaDalt, 2003). Others provide empirical evidence on managerial incentives to smooth/manage earnings to control and accumulate private benefits for themselves (see Gao and Shrieves, 2005 and Lin and Shih, 2003). In the international context, Leuz, Nanda, and Wysocki (2003) find a negative relation between investor protection and earnings management. Their sample covers 31 countries with firms operating under different economies with distinctive legal and institutional characteristics. It is possible that their empirical results are driven by the international differences in private control benefits. For example, in the same vein, Doidge, Karolyi, and Stulz (2005) find that governance mechanisms are driven by firm characteristics in developed countries and by country characteristics in less developed countries. Thus, country characteristics are possibly the primary drivers of the negative relation between investor protection and earnings management.

DATA AND METHODOLOGY

We obtain our sample from the *Investor Responsibility Research Center* (IRRC). As described in Gompers, Ishii, & Metrick (2003) the IRRC provides detailed governance provisions for firms included in Corporate Takeover Defenses (Rosenbaum 1990, 1993, 1995, 1998, and 2000). These data are collected from various sources, some of which include the firm's proxy statements, the firm's annual reports, 10-K and 10-Q filings, and the firm's corporate charter. The IRRC provides charter provisions, bylaw provisions, other firm-level provisions and state takeover laws indicators. The universe of firms included in the IRRC database is constructed from firms in the Standard and Poor 500 Index, in addition to the largest firms listed annually in *Fortune*, *Forbes*, and *Business week*.

Using the Gompers, Ishii, & Metrick (2003) aggregate measure of shareholder rights, we find evidence that managerial entrenchment is significantly negatively related to managerial propensity to manage earnings. A reduced probability of direct corrective action by shareholders impacts the likelihood that a firm's management will engage in earnings management. Using both univariate and multivariate tests, we find statistically significant differences in discretionary current accruals between democratic and dictatorial firms. Through a decomposition of the shareholder rights index, we show that the primary driver of this relationship is state level governance mechanisms.

EMPIRICAL RESULTS AND CONCLUSION

Our empirical findings contrast to the results of Leuz, Nanda, and Wysocki (2003) who find that earnings management decreases with investor protection. We argue that their findings are driven by country characteristics and noises created by international differences in economic development, accounting regulations, and legal enforcement. Doidge, Karolyi and Stulz (2005) show that almost all of the variations in governance ratings across firms in less developed countries are attributable to country characteristics rather than firm characteristics. They find that firm characteristics explain more of the variation in governance ratings in more developed countries. In the international context, firms have little ability to change the governance or legal regime of their home country. Our results indicate that a decrease in shareholder rights leads to decreased incentive to manage earnings. A reduced probability of direct corrective action by shareholders negatively impacts the likelihood that a firm's management will engage in earnings management. Our study contributes to the literature in three ways. First, we use Gompers Index to measure the magnitude of shareholder rights and that the method is relatively easy to use and implement. Second, by explicitly account for the five provisions in the governance index, we are able to shed light on how specific governance provisions drive the incentives of management to engage in earnings smoothing. In particular, we find that there is a negative correlation between State Provisions and earnings management, indicating a complementary effect of State Provisions to low level of shareholder rights. Third, we have better understanding on how governance provisions might provide low incentives for management to mask firm performance. As management becomes less insulated, managers feel more pressure to produce financial results in line with expectations. When these results are not forthcoming, earnings management seems to be a venue that is used to meet expectations.

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