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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.

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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

to manage public impressions and may engage in earnings management in an attempt to transform both the corporate image and the image of the organizational leader, thus reducing the impact of the negative attention (e.g. Davidson et al., 2004). Therefore, shareholder activism could increase the public scrutiny faced by the firm, and its managers may feel more compelled to signal managerial quality by alternative or symbolic means, such as engaging in earnings management.

Hypothesis 1. Shareholder proposals will be positively related to earnings management.

3.2. Largest institutional owners and earnings management

Prior research has investigated the impact of large owners in a variety of settings such as firm valuation (Thomsen & Pedersen 2000), productivity (Hill & Snell, 1988), corporate strategy (Bethel & Liebeskind, 1993; Hoskisson et al., 1994, Wright et al., 2002), and executive compensation (Dharwadkar et al., 2008) (see Appendix B for an illustrative review of empirical research on large owners' impact on firm level outcomes). Among institutional investors, large shareholders are especially likely to monitor in order to protect their sizeable investment (Brav et al., 2008; Del Guercio & Hawkins, 1999). First, large owners because of the magnitude of their equity stakes and the penalties associated with market exit are more likely to hold onto their shares, and thus have higher incentives to monitor their investments (Johnson & Greening, 1999; Ciccotello & Grant, 1999; Maug, 1998). To the extent that large owners focus on the long term success of the firm, they are in a position to curb managerial myopia by encouraging managers to invest for the long-run profitability (Dharwadkar et al., 2008). Second, only shareholders with large positions are likely to obtain a large enough return on their investment to justify the costs of monitoring (Gillan & Starks, 2007; Shleifer & Vishny, 1986). Expanding this logic, Schnatterly and colleagues (2008 : 219) hypothesize and find that "*only the largest of a firm's institutional owners, and no other institutional owner, is perceived to hold information advantage*".

In addition to considering the vested interests that large owners have in firm performance and constraining managerial opportunism, their monitoring abilities should be taken into account as well. Empirically, prior research has found that firms with larger owners are less likely to be identified by the SEC as fraudulently manipulating earnings (Dechow et al., 1996). Furthermore, Edmans (2009) argues that large owners will '*see through*' accounting manipulations and deter them. Consistently, Yeo et al. (2002) find that there is a positive relationship between large owners' stockholdings and earnings informativeness. Thus, we argue that the higher the ownership stake of the largest institutional investor, the higher would be its incentives to monitor the focal firm, and thus will be more likely to constrain self-serving manipulations of accounting numbers by managers in a two-fold manner: first, by increasing the risk of detection that managers face, and second, by reducing the pressures for short-term performance. Hence:

Hypothesis 2. Ownership by the largest institutional investor will be negatively related to earnings management.

3.3. Audit committee independence

So far we have argued that monitoring and involvement by shareholders will be related to the firm's propensity to engage in earnings management. Prior research, however, has suggested that different corporate governance mechanisms may substitute each other (i.e., Dalton et al., 2003; Walsh & Seward, 1990; Rediker & Seth, 1995). One powerful disciplining mechanism that could substitute for shareholder monitoring and constrain earnings management is audit committee independence (Beasley et al., 2000; Klein, 1998; Uzun et al., 2004). Prior research has argued that many reported financial results are negotiated between the private auditor and the management (Nelson et al., 2003), in particular as legitimate differences of opinion may exist between the two parties. The audit committee's role is therefore, one of an arbiter between the two parties, whose goal is to weigh the divergent points of view and ultimately lead to more accurate reported earnings (Klein, 2002). The ability of the audit committee to oversee the accuracy of financial reporting is a function of its composition, in particular whether the directors are independent from the firm's management (Baysinger & Hoskisson, 1990; Klein, 2002, Le et al., 2006).

Given that different corporate governance mechanisms may be interdependent or substitute each other (i.e., Dalton et al., 2003; Walsh & Seward, 1990; Rediker & Seth, 1995), it is important to explore the impact of audit committee independence in the presence of other governance mechanisms. In particular as the ability of an independent audit committee to curb earnings management may constrain the relation between monitoring by the largest institutional investor and earnings management on one hand, and the relation between shareholder activism and earnings management, on the other. For instance, firms with a strong independent audit committee may stand to benefit less from monitoring by large owners, than firms with a less independent audit committee. Furthermore, while shareholder proposals could increase the pressures that executives face to manage financial impressions in the face of higher public scrutiny, the presence of an independent audit committee could constrain managerial ability to manage earnings.

Hypothesis 3a. Audit committee independence will moderate the relationship between shareholder proposals and earnings management, such that the relationship will be weaker in the presence of independent audit committee.

Hypothesis 3b. Audit committee independence will moderate the relationship between ownership by the largest institutional investor and earnings management, such that the relationship will be weaker in the presence of independent audit committee.

4. Methods

4.1. Data and methodology

We drew our sample from the S&P 500, the Mid-Cap 400, and Small-Cap 600 companies. First, we obtained data from Execucomp for all firms that appeared continuously during the period 2001–2004. We further require that financial data is available from Compustat for at least 15 firms operating in the same 2-digit SIC industry, in order to compute earnings management as the deviation of firms accruals relative to the industry norm. Second, shareholder proposals data were obtained from the Corporate Library. Third, we extracted end-of-year institutional ownership data for the years 2000–2003 from the CDA/Spectrum Thomson Financials 13F database. Institutions with $100 million or more of managed investments must file 13F reports with the SEC. Data for control variables were obtained from Compustat, Execucomp and Institutional Shareholder Services (ISS). We used a lagged design, such that all explanatory and control variables precede in time the dependent variable. Missing data brought our sample to 1305 firm-year observations consisting of 348 firms. We chose panel data analysis for this study because of its ability to clearly isolate the effects of specific actions and treatments both over time and across sections (Hsiao, 2003), as well as its better control over the effects of missing or unobserved variables (De Munnik & Schotman, 1994). We used the xtregar procedure in STATA, which computes Generalized Least Squares and controls for first-order autoregressive disturbance.

4.1.1. Dependent variable

Following the previous research, we measure *earnings management*, or the managerial discretion in determining accounting numbers, by using the modified Jones model (1991). This model has been found to be the most powerful in detecting earnings management among competing models (Dechow et al., 1995), as well as effective (Davidson et al., 2004), and reliable (Guay et al., 1996). Intuitively the model involves the estimation of earnings management as the difference between the firm's actual and expected accruals. Accruals are measured as the difference between reported earnings and operating cash flows (as cash flows are more objective, they are more difficult to manipulate). Expected accruals were computed by regressing total accruals in the firm's 2-digit SIC-code industry on total assets, revenues, property, plant, and equipment, and accounts receivable.

4.1.2. Explanatory variables

4.1.2.1. Shareholder proposals. We measured shareholder activism as the aggregate number of shareholder proposals disclosed on the firm's proxy statement during each sample year. Firms can exclude shareholder proposals that substantially duplicate another proposal that is to be included in the company's proxy materials (i.e. SEC Rule 14a-8(i)(11)), therefore the proposals included reflect different shareholder demands. Data on shareholder proposals were obtained from The Corporate Library database.

4.1.2.2. Largest institutional owner. Following Schnatterly et al. (2008) findings that only the largest institutional owner holds informational advantage, we measure the percentage of shares owned by the largest institutional owner in the firm. Data was collected from the Thomson Financial 13F database.

4.1.2.3. Audit committee independence. Audit committee data were obtained from the Institutional Shareholder Services (ISS). The variable is set to 1 if the Audit Committee is comprised of independent directors and 0 otherwise.

4.1.3. Control variables

With the growing availability of institutional advisory services provided by organizations such as the Institutional Shareholder Services (ISS), the Corporate Library, and Glass–Lewis, smaller shareholders could more easily obtain similar expertise to that possessed by larger owners. Therefore, we control for *firm's corporate governance ranking*, with the Corporate Governance Quotient (CGQ) obtained from ISS. The CGQ ranges from 0 to 100, and incorporates 61 specific criteria (Daily and Dalton, 2004), covering four broad categories such as board of directors, audit, anti-takeover, and executive compensation/ownership (ISS, 2005).

Davidson et al. (2004) propose that earnings management is related to executive succession, as new CEOs face higher pressures to demonstrate improved performance. Therefore we control for *CEO succession* based on Execucomp data. Agency theory also proposes incentive alignment as a solution to the agency problem, thus managerial ownership could affect the potential for opportunistic behavior (Brandes et al., 2006). Consequently we also control for incentive alignment by including *CEO ownership* in the firm, and the proportion of *performance contingent compensation (options and bonus)*, since this part of the CEO pay could suffer if their firms fall short of quarterly earnings forecasts (Zahra et al., 2005). We further control for *firm size* (natural logarithm of firm sales), *performance* (return on equity) and growth (market value to book value of equity), as these could affect the likelihood firms engage in earnings management (Caton et al., 2001; Chung et al., 2005), or alternatively, activists' propensity to focus on the focal firm (Krishnamurthy & Kucuk, 2009). Velury and Jenkins (2006) find that institutional ownership is positively related to the quality of reported earnings, therefore we control for *aggregate institutional ownership*. We also control for firm leverage, and using indicator variables based on the 2-digit industry SIC codes (e.g., Denis et al., 1997), we control for *industry effects*. Finally, we had to consider the possibility of an endogenous relationship between firm growth and earnings management, as fast growing firms are more likely to operate in a munificent environment, and thus may be less challenged in achieving the firm's performance targets than firms operating in declining industries. Following Greve's (2008) methodology, we control for *expected growth*.

4.2. Robustness checks

Since social issue proposals (such as human rights, political influence, employment discrimination, etc.) tend to receive much less voter support than corporate governance proposals (Woidtke, 2002), for robustness reasons we also replicated all analyses using only the number of corporate governance proposals received. As such proposals are more likely to receive higher support by other shareholders, managers may perceive the reputational effects associated with such proposals to be more damaging. The results, available upon request, are substantively similar to results with all shareholder proposals. Furthermore, we re-estimated the models using random effects method in SAS. The results lead to substantively the same conclusions.

5. Results

During the study period the firms in our sample received a combined total of 672 proposals. Although The Corporate Library reports a significant number of shareholder proponents as undisclosed (30.8%), by far the largest group sponsoring shareholder proposals are individuals (31.1%), followed by union pension funds (16.2%), investment companies (9.7%), religious and/or socially responsible investors (6.3%) and public pension funds (5.8%). Less than a quarter of all shareholder proposals have received simple majority vote. Table 1 presents the descriptive statistics and correlations. Consistent with prior research (e.g. Davidson et al., 2004) we find that earnings management is negatively correlated with prior performance ($r = -0.07$, $p < 0.05$).

Table 2 presents our cross-sectional time series regressions with firm-specific and time-specific random effects. Model 1 serves as the control model. Firm size is negatively related to earnings management ($b = -.013$, $p < .001$), while firm growth is positively related to earnings management ($b = .006$, $p < .001$). In line with Davidson et al. (2004) findings, firms experiencing CEO succession are more likely to get involved in earnings management ($b = .014$, $p < .01$). Finally, firms with higher corporate governance ranking are less likely to manage their earnings ($b = -.0001$, $p < .05$). The audit committee independence is not significantly related to earnings management. Klein (2002) posits and finds that audit committee independence is negatively related to earnings management; however she also finds that fully independent audit committees are not significantly related to earnings management. Klein (2002: 398) notes that "*contravene to the new regulations, no significant cross-sectional association is found between earnings management and the more stringent requirement of 100% audit committee independence*". While our results are consistent with Klein (2002) findings in that we do not find a significant main effect between fully independent audit committees and earnings management, we draw attention to the fact that this may be due to the stringent way of measuring audit committee independence.

In Model 2, we introduce the independent variables. Our findings fail to reject Hypothesis 1, which postulated that the number of shareholder proposals received by the firm will be positively related to subsequent earnings management. The coefficient term of

Table 1
Descriptive statistics and correlations.

#	Variable	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13
1	Earnings management	0.05	0.07	1												
2	Size ($ billion)	7.15	13.95	−0.261***	1											
3	Firm growth	1.52	1.30	0.196***	0.029	1										
4	Firm performance (ROE)	0.08	1.42	−0.069*	0.103***	0.041	1									
5	Firm leverage	1.14	4.75	0.021	−0.041	−0.063*	−0.595***	1								
6	CEO ownership	0.01	0.03	0.019	−0.106***	0.024	0.009	0.038	1							
7	CEO contingent compensation	0.56	0.24	0.064*	0.197	0.301***	0.057***	−0.109***	−0.020	1						
8	Change of CEO	0.08	0.27	0.063*	0.042	0.016	−0.002	−0.012	−0.016	0.106***	1					
9	Institutional ownership	0.54	0.15	−0.013	0.182***	0.102***	0.052†	−0.082**	−00.185***	0.210***	0.001	1				
10	Corporate Governance Quotient (CGQ)	53.71	28.42	−0.053†	−0.014	−0.069*	−0.011	−0.003	−0.168***	−0.041	−0.033	0.142***	1			
11	Largest institutional owner	0.09	0.05	−0.049†	−0.121***	−0.149***	−0.026	0.039	−0.026	−0.027	−0.024	0.235***	0.09**	1		
12	Shareholder proposals	0.52	1.14	−0.065*	0.417***	0.004	0.031	0.050†	−0.059*	0.041	0.042	−0.037	0.024	−0.068*	1	
13	Expected growth	1.80	0.92	0.207***	−0.22***	0.235***	−0.039	0.000	−0.01	0.162***	0.007	0.201***	0.046†	−0.006	−0.109***	1
14	Audit committee independence	0.82	0.39	−0.029	0.108***	−0.044	0.009	−0.051†	−0.182***	0.021	0.04	0.132***	0.362***	0.128***	0.057*	0.033

$N = 1305$.
*** Significant at 0.001 level.
* Significant at 0.05 level.
† Significant at 0.1 level.
** Significant at 0.01 level.

shareholder activism is positively related to earnings management (b = .004, $p < .05$). We also find support for Hypothesis 2, which postulated that monitoring by the largest institutional owner will be negatively related to earnings management (b = −.012, $p < .01$). To test our exploratory interaction hypotheses, we used the standard Aiken and West (1991) methodology to create the interaction terms. Both interactions presented in Model 3 are not significant.

Since 82% of the firms in our sample have an independent audit committee, in addition to testing the interactive effects we also conduct split sample analyses as recommended by prior research (i.e., Boyd, 1995; Arnold, 1982; Venkatraman, 1989). Specifically, we reanalyzed the data separately for firms with independent audit committee, and firms without. Model 4 presents the results for the independent audit committee subsample, and Model 5 presents the results for the subsample of firms that do not have a fully independent audit committee. In terms of shareholder activism (Hypothesis 3a), while the coefficient is not significant for the subsample of firms with fully independent audit committee (b = .001, $p > .10$, Model 4), the number of shareholder proposals is positively associated with earnings management (b = .009, $p < .05$, Model 5) for firms that do not have an independent audit committee. Hypothesis 3b postulated that monitoring by large owners will be less effective in constraining earnings management in firms with independent audit committees, as independent audit committees would constrain managerial ability to manipulate financial statements. The coefficient of top owner stake is not significant (b = −.006, $p > .10$, Model 4) for the independent audit committee subsample; however, for firms that do not have an independent audit committee, the top owner stake is negatively associated with earnings management (b = −.019, $p < .05$, Model 5), indicating the increased importance of monitoring by large owners in firms where managerial discretion in financial reporting is not constrained.

6. Discussion

This study explored the impact of shareholder proposals and monitoring by the largest institutional investor on earnings management. Due to the public threat to executives' legitimacy and reputation that shareholder proposals pose, and the challenges that the variety and low saliency of shareholder demands present to executives, we have argued that managers will face incentives to signal their managerial capabilities and thus, may be more likely to engage in financial "window dressing". On the other hand, the largest institutional owners are better positioned to constrain the practice of earnings management by their ability to gauge firm performance against the long-term fundamentals of the firm. Consistently, we find that shareholder proposals are positively related to earnings management, while the largest institutional owner stake is negatively related to earnings management. While we found that different forms of shareholder involvement may result in different and even opposing outcomes, our findings have broader implications for impression management, and indicate that future research on corporate governance and shareholder influence should consider both the symbolic and substantive actions that companies could undertake.

In contrast to the constraining impact of large owner monitoring on earnings management, we found that shareholder activism, as evidenced by shareholder proposals, can increase the firms' motivation to aggressively manage their image through earnings management. Public shareholder activism poses reputation threats to the management of the targeted firm, who in turn could attempt to restore their credibility, and highlight managerial talent by putting their best foot forward and 'beautifying' financial performance (i.e., David et al., 2007). When the firms' legitimacy is questioned, CEOs face incentives to employ ceremonial assessment criteria (Fuller & Jensen, 2005; Stewart, 2005). For example, firms have been shown to

Table 2
Earnings management: the impact of shareholder activism and large institutional ownership.

	Controls	Main effects	Interactions	Independent audit committee	Non-independent audit committee
Independent variables	Model 1	Model 2	Model 3	Model 4	Model 5
Intercept[a]	0.1378***	0.1180***	0.0797**	0.0790***	0.1918***
Size	−0.0129***	−0.0150***	−0.0148***	−0.0078***	−0.0272***
Firm growth	0.0055***	0.0050***	0.0051***	0.0065***	0.0062
Firm performance	−0.0015	−0.0014	−0.0014	−0.0005	−0.0370***
Firm leverage	0.0001	0.0002	0.0002	0.0005	−0.0039**
CEO ownership	−0.0501	−0.0446	−0.0486	−0.0842	0.0154
CEO contingent compensation	0.0126	0.0133	0.0124	0.0085	−0.0047
Expected growth	0.0039	0.0034	0.0035	0.0015	0.0156
Change of CEO	0.0136*	0.0130*	0.0129*	0.0123	0.0072
Institutional ownership	−0.0077	0.0017	0.0034	0.0227	−0.0294
Corporate Governance Quotient (CGQ)	−0.0001*	−0.0002*	−0.0002*	−0.0002*	0.0002
Audit committee independence	0.0062	0.0077	0.0093		
Shareholder proposals		0.0035*	0.0021	0.0009	0.0085*
Largest institutional owner		−0.0122**	−0.0259**	−0.0055	−0.0185*
AC independence × largest Inst owner			0.0082		
AC independence × proposals			0.0018		
Wald X^2	188.8***	204.4***	211.3***	129.1***	215.4***
	$n=1305$	$n=1305$	$n=1305$	$n=1070$	$n=235$

$N=1305$ (348 firms × 4 years).
[a] 24 dummy codes controlling for industry effect at the 2-digit SIC level are not reported here for brevity.
*** Significant at 0.001 level.
** Significant at 0.01 level.
* Significant at 0.05 level.

decouple actually from stated policies and strategies (Westphal & Zajac, 2001). This action results in generating the required impression that seems to comply with stakeholders expectations but does not do so in substance (David et al., 2007), as is the case with earnings management.

6.1. Limitations and future research

In this paper we focus on the largest institutional owner, as Schnatterly et al. (2008) find that only the largest institutional investor holds informational advantages, thus such owners are the likely candidates for constraining earnings management. However, we have not explored situations where conflict of interests may exist between the interests of large owners. Furthermore, while we have focused on shareholder proposals in the current paper, shareholder activism could be either formal or informal (Brandes et al., 2008). Although shareholder proposals are often preceded by attempts at negotiations (Chowdhury & Wang, 2009), public shareholder resolutions and private 'behind-the-scenes' negotiations could be mutually exclusive as well (Prevost & Rao, 2000). For instance, David et al. (2007) found that managers are more likely to settle proposals filed by silent shareholders. To the extent that the former applies, our shareholder activism measure is biased towards proposals that the management did not wish to negotiate, or could not negotiate successfully.

Our results indicate that future research should take into consideration both the substantive and symbolic responses firms implement when facing external pressures. Furthermore, we develop theoretical arguments that both the saliency and the variety of shareholder demands should be taken into consideration when examining ownership implications for firms' outcomes. While one study cannot provide conclusive evidence, our findings that shareholder proposals are positively related to earnings management, while top institutional investor ownership stake is negatively related to earnings management, suggest that researchers examining the impact of different corporate governance mechanisms, and ownership in particular, on firm accounting performance should control for the extent of earnings management.

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Appendix A. Illustrative review of shareholder activism research

Authors	Activism measure	Primary findings
Market reaction		
Barber (2006)	CalPERS focus list	Positive and significant market reaction on date of list announcement
Carleton, Nelson & Weisbach, (1998)	TIAA-CREF proposals and private negotiations	Overall insignificant market reaction; positive reaction for some proposals categories
Crutchley, Hudson & Jensen (1998)	Shareholder proposals from CalPERS	Aggressive activism leads to substantial increases in shareholder wealth while a quieter activism does not
Del Guercio and Hawkins (1999)	Shareholder proposals by public pension funds	Insignificant market reaction. Some proposals by CalPERS have a significant effect
Gillan & Starks (2007)	Shareholder proposals	Insignificant. Individual investors receive less voting support than institutional proponents
Karpoff et al. (1996)	Shareholder proposals	Insignificant, regardless of voting outcome or shareholder identity
Nesbitt (1994)	Shareholder proposals	Insignificant

(continued on next page)

Appendix A. (*continued*)

Authors	Activism measure	Primary findings
Market reaction		
Prevost and Rao (2000)	Shareholder proposals by public pension funds	Repeatedly targeted firms show future reduced performance. Negative and statistically significant market reaction; positive reaction for negotiated
Renneboog & Szilagyi (2007)	Shareholder proposals	Positive market reaction for anti takeover proposals and proposals sponsored by public pension funds. Insignificant market reaction for other proposals
Smith (1996)	Shareholder proposals sponsored by CalPERS	Insignificant. Positive market reactions for firms settling with CalPERS; negative for firms that do not settle with CalPERS
Strickland et al. (1996)	Shareholder proposals by united shareholder association	Insignificant market reaction, but positive for negotiated settlements with targeted firms
Thomas and Cotter (2007)	Shareholder proposals	Small and insignificant stock market reaction
Wahal (1996)	Shareholder proposals by public pension funds	Insignificant market reaction
Woods (1996)	Shareholder proposals by public pension funds	Insignificant market reaction, positive reactions to settlement with CalPERS
Operating performance		
Daily, Johnson, Elstrand and Dalton (1996)	Shareholder proposals by public and private pension funds	Insignificant impact on accounting measures of performance
David et al. (2007)	Shareholder proposals	Negative impact on Corporate Social Performance (CSP)
David, Hitt & Gimeno (2001)	Media communications, proposals, direct negotiations and proxy contests	Positive, albeit indirect impact on R&D inputs, but not on R&D outputs
Del Guercio, Seery & Woidtke (2008)	Just say no campaign (withhold votes)	Improved post-campaign performance; higher rate of CEO turnover in targeted firms
Johnson & Shackell (1997)	Shareholder proposals	Insignificant effect on compensation and pay for performance sensitivity
Johnson, Porter & Shackell, (1997)	Shareholder proposals	Insignificant effect on compensation and pay for performance sensitivity. CalPERS proposals reduce total executive compensation
Opler and Sokobin (1997)	CII (Council of Institutional Investors) focus list	Positive impact on future performance (profitability and share price)
Wahal (1996)	Shareholder proposals by public pension funds	No impact on operating performance
Woods (1996)	Shareholder proposals by public pension funds	Weak impact on operating performance (ROA)
Proposal implementation		
Akyol & Carroll (2006)	Shareholder proposals and direct negotiations	Removal of poison pills under conditions of board independence and insider shareholdings
Bizjak & Marquette (1998)	Shar`eholder proposals	Proposals significantly impact decisions to rescind poison pills
Ertimur, Ferri & Stubben (2010)	Shareholder Proposals	Higher voting outcomes, sponsor's influence and types increases probability of implementation

Appendix A. (*continued*)

Authors	Activism measure	Primary findings
Proposal implementation		
Loring & Taylor (2006)	Shareholder Proposals	Boards tend not to implement proposals even if they receive majority votes. Levels of implementation increasing between 2000 and 2004
Thomas and Cotter (2007)	Shareholder proposals	On average proposals do not receive majority votes
Pound (1988)	Shareholder proposals	Voting outcomes unsuccessful

Appendix B. Illustrative review of large owners/blockholders research

Authors	Measure	Primary findings
Firm performance		
Allen and Phillips (2000)	Blockholders	Positively related to with operating and stock-market performance, more so in the presence of R&D investments and alliances/joint ventures
Ashbaugh-Skaife, Collins and LaFond (2006)	Number of blockholders	Negatively associated with credit ratings
Barclay & Holderness (1991)	Purchase of block shares	Positive market reactions to block purchases; more so when there is no managerial resistance
Bartkus, Morris and Seifert (2002)	Number of blockholders	Negatively related to corporate philanthropy
Bethel, Liebeskind and Opler (1998)	Blockholding acquired by activist	Positively associated with abnormal stock returns
Brav et al. (2008)	13D SEC filings of Activist Hedge Funds	Positive abnormal returns around filing dates, in particular when targeting the sale of the firm or change of its business strategy
Brockman and Yan (2009)	Blockholder ownership	Blockholders decrease stock return synchronicity and increase informed trading
Hill and Snell (1988)	Concentration of stock ownership	Higher equity concentration is positively associated with R&D and firm productivity
McConnell and Servaes (1995)	Blockholder ownership percentage	Blockholder ownership is positively associated with Tobin's Q for high growth firms
Mikkelson and Ruback (1991)	Purchase of block shares	Block repurchases are associated with positive abnormal returns
Moeller (2005)	Blockholder ownership percentage	Positively associated with takeover premiums
Park, Selvili and Song (2008)	Purchase of block by activist shareholder	Positive market reactions upon the formation of activist block
Shome and Singh (1995)	Purchase of block shares	Market reacts positively (higher abnormal stock price) to announcements of equity block purchases
Steen (2005)	Blockholder ownership percentage	Negatively associated with dividend pay outs, but positively associated with the firm's market value
Steiner (1996)	Blockholder ownership percentage	Positively associated with Tobin's Q
Thomsen and Pedersen (2000)	Largest owner percentage	Positively related to market (MBV) and accounting (ROA) performance
Wright et al. (2002)	Blockholder ownership percentage, outsiders	Outside blockholders did not affect risk taking
Executive compensation & ownership		
Bertrand and Mullainathan (2001)	Number of large shareholders	Number of large equity holders reduces CEO pay sensitivity to non-effort related factors

Appendix B. (*continued*)

Authors	Measure	Primary findings
Executive compensation & ownership		
Cheng, Nagar, and Rajan (2005)	Blockholder ownership percentage	Positively associated with directors and officers stock holdings
Dharwadkar et al. (2008)	Largest institutional owner percentage	Negatively related to top executive compensation
David, Kochhar and Levitas (1998)	Non institutional blockhoklder ownership	Negatively related to total CEO compensation and long term incentives
Hartzell and Starks (2003)	Ownership by top 5 investors	Positively related to the pay-for-performance sensitivity of executive compensation and negatively related to total compensation
Khan, Dharwadkar and Brandes (2005)	Largest institutional owner percentage	Negatively related to total compensation and options-based compensation as proportion of total compensation
Mehran (1995)	Blockholder ownership percentage	Blockholder ownership is negatively related to equity based compensation
Corporate strategy		
Bethel and Liebeskind (1993)	Blockholder ownership percentage	Positively associated with corporate restructuring
Bethel, Liebeskind and Opler (1998)	Blockholding acquired by activist shareholders	Positively associated with asset divestitures, negatively associated with mergers and acquisitions
Chen, Harford, Li (2007)	Ownership by top 5 investors	Concentrated holdings by independent long-term institutions are positively related to post-merger performance
Denis et al. (1997)	Blockholder ownership percentage	Negatively associated with corporate diversification
Hoskisson et al. (1994)	Blockholder ownership percentage, number of blockholders	Blockholder equity reduces diversification and increases divestment
Information asymmetry		
Schnatterly et al. (2008)	Largest institutional owner percentage	Positively associated with the bid–ask spread in share prices, indicating informational advantage for the top owner
Yeo et al. (2002)	Blockholder ownership percentage	Block ownership increase earnings informativeness
Zhong, Gribbin, and Zheng (2007)	Blockholder ownership by all outside 5% blockholders	Blockholder ownership is positively associated with earnings management for firms with declining premanaged earnings

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