Employee Ownership and Earnings Management

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Overview

• Accounting standards provide managers with significant discretion
  – Choices of accounting standard
    • Example: Inventory Accounting
  – Estimation methods
    • Example: Depreciation

• This discretion is important to ensuring managers can produce financial reports which faithfully represent the financial reality of the firm
  – Management is “in the trenches” for the business
  – Best positioned to know what’s actually happening

• This discretion, however, can also be used opportunistically to “manage” earnings
Background

• Earnings management involves the use of accounting discretion to manipulate financial reports
  – “Big baths” in the form of restructuring charges or write-offs of purchased in-process R&D
  – Premature revenue recognition
  – Channel stuffing
  – Inappropriate expense recognition to create reserves
    • Bad debt expense
    • Litigation contingencies

• Managers have numerous incentives to manage earnings
  – Compensation
  – Earnings forecasts
  – Equity offerings (IPOs and/or SEOs, buyouts)
Background

• Employee ownership creates conditions which may help facilitate management in managing earnings
• ESOPs may entrench management
  – Hollo (1991) – Management tends to become more powerful after the introduction of ESOPs
  – Chaplinsky & Niehaus (1994) and Rauh (2006) – ESOPs are a strong deterrent to takeovers
    • This is despite ERISA restrictions (fiduciary duty, etc.) which prevent their explicit use for this purpose (McLean 1983)
  – Faley et al. (2006) – Employee owners appear to use its influence to “maximize the combined value of its contractual and residual claims”
    • Deviate more from shareholder value maximization
    • Less long-term investment
    • Less risk-taking
    • Slower growth
    • Lower productivity
    • Fewer jobs created
  – Pagano & Volpin (2005) – Workers and management can be “natural allies” in the face of takeover bids
    • Managers can use long-term labor contracts to make the firm unattractive to acquirers
    • Workers will refuse to sell to protect these pecuniary benefits
  – Park & Song (1995) – ESOP firms with large blockholders exhibit stronger performance relative to non-ESOP firms
    • Without blockholders, ESOPs are more likely to entrench management and erode performance
Background

• Employee ownership may also create conditions which
  – Chen & Huang (2006) – Firms tend to invest more in R&D following the introduction of ESOPs
    • These effects grow as ESOPs age (Kumbhakar & Dunbar 1993)
  – Park et al. (2004) and Sengupta et al. (2007) – Firms with ESOPs are more likely to survive as a result of more stable employment (and concomitant cultural benefits from such stability)
    • “Golden Handcuffs” not “Golden Path”

• Each of these studies suggest less discretion exists for managing earnings in the presence of ESOPs
Research Questions

• What impact does employee ownership have on earnings management?

• If earnings management is increased by employee ownership, is it for informative or opportunistic purposes?

• What impact does earnings management have on future performance in firms with employee ownership?
Data

• Form 5500 Data
  – Presence of ESOP
  – Extent of ESOP Leverage
  – Percentage of equity held by ESOP

• Compustat/CRSP Merged Database
  – Financial Statement Data
  – Stock Market Data

• IBES
  – Earnings Forecast Data
Variable Definitions

• Earnings Management Proxies
  – Accruals-based
    • Discretionary Accruals
  – Real Earnings Management
    • Abnormal Cash Flows from Operations
    • Abnormal Production Costs
    • Abnormal Discretionary Expenses
  – Two Stage Estimation

\[
\frac{\text{Total Accruals}_{it}}{\text{Assets}_{it-1}} = \frac{1}{\text{Assets}_{it-1}} + \frac{\Delta \text{Sales}_{it}}{\text{Assets}_{it-1}} + \frac{\text{PPE}_{it}}{\text{Assets}_{it-1}} + e_{it}
\]

\[
\frac{\text{CFO}_{it}}{\text{Assets}_{it-1}} = \frac{1}{\text{Assets}_{it-1}} + \frac{\text{Sales}_{it}}{\text{Assets}_{it-1}} + \frac{\Delta \text{Sales}_{it}}{\text{Assets}_{it-1}} + e_{it}
\]
Empirical Design

Total EM
= ESOP + HabBeat + Shares + Analyst + Bonus + Options + ROA
+ MktCap + BkMkt + Leverage

• ESOP
  – Presence (Binary Variable)
  – 5% Threshold (Binary Variable)
  – % of ESOP Ownership (Continuous)

• HabBeat – Frequency of meeting of beating analyst forecasts

• Shares - # of shares outstanding (ln)

• Analysts - # of analysts covering the firm (ln)

• Bonus and Option – Proportion of Bonus (Option) to total compensation
Empirical Design

$$\Delta ROA = EM + SalesGrowth + CAPEXGrowth$$
Robustness Tests

• Controls for Endogeneity
  – Heckman Selection Model
  – 2SLS Instrumental Variable Approach (Following Bova et al. 2014)
    • CashETR (5 Year) to account for tax incentives
    • Local Unemployment Rate to account for employee retention incentives

• ESOP Thresholds
  – 10%/15%/20%
Good luck!