



The Hotel School

Cornell
SC Johnson College of Business

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)
 - Faleye 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
 - Cin & Smith (2002), Cole & Mehran (1998), Jones & Kato (1993) – Employee ownership stimulates productivity improvements, with increased ownership proportions inducing a stronger response
 - These effects grow as ESOPs age (Kumbhakar & Dunbar 1993)
 - Guedri & Hollandts (2008) – U-shaped relationship between ESOP ownership and accounting-based (but not market-based) performance measures
 - 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

$$\frac{Total\ Accruals_{it}}{Assets_{it-1}} = \frac{1}{Assets_{it-1}} + \frac{\Delta Sales_{it}}{Assets_{it-1}} + \frac{PPE_{it}}{Assets_{it-1}} + e_{it}$$

$$\frac{CFO_{it}}{Assets_{it-1}} = \frac{1}{Assets_{it-1}} + \frac{Sales_{it}}{Assets_{it-1}} + \frac{\Delta Sales_{it}}{Assets_{it-1}} + e_{it}$$

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!



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