J. Account. Public Policy 28 (2009) 92–117

Contents lists available at ScienceDirect

J. Account. Public Policy

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

Earnings quality effect of state antitakeover statutes

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ARTICLE INFO

JEL Classification:
M41
G34
G38
K22

Keywords:
Antitakeover protection
State antitakeover statutes
Earnings quality

ABSTRACT

Existing theories suggest two opposite effects that antitakeover protection may have on earnings management: the exacerbating effect and the mitigating effect. We use the introduction of state antitakeover laws during the mid- to late-1980s as a natural experiment to test the relationship between antitakeover protection and earnings quality. The results show that firms incorporated in states that passed the laws have lower magnitudes of abnormal accruals and higher levels of earnings informativeness in the post-passage periods, suggesting that antitakeover protection mitigates earnings management and enhances earnings quality. Further evidence shows that reductions in earnings management are concentrated in firms with low firm-level antitakeover protection and in firms with serious agency problems, and that the earnings management effect of state antitakeover laws is likely to be of short-term duration.

1. Introduction

Recent waves of corporate fraud and scandals have raised concerns about the practices of antitakeover protection. For example, Manne (2002) calls for the revocation of state antitakeover statutes that protect incompetent managers and interfere with the market for corporate control. He asserts that "with such a reversal of policy…there would be less pressure on accountants to cook the books". Partly in response to public pressure, security market regulators have also increased efforts to reduce

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doi:10.1016/j.jaccpubpol.2009.01.007

antitakeover protection.[2] The Business Roundtable and other business associations, however, have strongly resisted reducing such protection. They argue that these reforms would cause widespread distraction and disruption, including pressing managers to ‘‘cook the books” to ensure the company ‘‘did not end up as a rival’s lunch” (Lipton and Rosenblum, 2003; Porter, 2004). With at least two sides arguing for opposite effects, the earnings quality effect of antitakeover protection remains a contentious empirical issue.

Prior literature suggests that antitakeover protection may have two opposite effects on earnings management: the exacerbating effect and the mitigating effect. Manne (1965) argues that antitakeover protection entrenches managers and lessens managers’ motivation to maximize shareholder value. As a result, entrenched managers would likely engage in expropriation of shareholder funds (Shleifer and Vishny, 1997), which in turn motivates earnings management to disguise such behaviors and avoid legal penalties or other undesirable consequences. These arguments imply that antitakeover protection exacerbates earnings management. In contrast, Dechow and Skinner (2000) argue that capital market pressures likely motivate managers to manage earnings. Berger and Hann (2002) and Fu and Liu (2007) further suggest that less-protected managers may obfuscate financial performance to ease takeover threats. Antitakeover protection reduces takeover pressures on managers and thus mitigates earnings management intended to ease takeover pressure. These arguments suggest that antitakeover protection mitigates earnings management.

Following Bertrand and Mullainathan (1999, 2003), we use the enactments of state antitakeover statutes during the mid- to late-1980s as an exogenous treatment for enhancing antitakeover protection. Using this approach minimizes the *endogeneity* problems that studies using firm-level measures of antitakeover protection often experience. We adopt two measures of earnings management: a direct measure based on abnormal accruals, and an indirect, market-based measure of earnings informativeness. Our sample is focused on *Forbes* 500 firms, which allows us to control for various firm-level governance features that may also affect earnings management.

Using a differences-in-differences methodology, we document evidence consistent with antitakeover statutes mitigating earnings management. Specifically, after the enactment of the laws, firms incorporated in the enacting states generally have lower magnitudes of abnormal accruals and higher levels of earnings informativeness than before. We also demonstrate that the results are robust to using various model specifications and controlling for potential confounding factors. In addition, we find that the earnings quality effect of antitakeover statutes is concentrated among firms with lower firm-level antitakeover protection and firms with more severe agency problems. Finally, we find evidence suggesting that the earnings quality effect is likely to be of short-term duration.

This study contributes to the accounting literature on the association between corporate governance and financial reporting quality. Previous accounting studies focus mostly on internal governance mechanisms and find that earnings quality is associated with board composition (e.g., Beasley, 1996; Klein, 2002), ownership structure (e.g., Warfield et al., 1995; Rajgopal et al., 2002; Francis et al., 2005), and audit quality (e.g., Teoh and Wong, 1993; Becker et al., 1998). The takeover market is an important external mechanism that disciplines misbehaving managers; its effect on earnings quality, however, has so far received scant attention in accounting studies. Our results suggest that future studies on corporate governance and earnings quality need to incorporate external governance mechanisms into their analyses.

This paper also has important policy implications. Our evidence suggests that state antitakeover statutes may mitigate managers’ incentives to manage earnings and thus enhance earnings quality. However,

[2] The Securities and Exchange Commission (SEC), for example, proposed in October 2003 a rule entitled ‘‘Security Holder Director Nominations”, requiring public companies, under certain circumstances, to include in their proxy materials information about candidates for director who were nominated by shareholders. The SEC believes that the proposed disclosure rule can increase shareholders’ access to the nomination process of the board and thus reduce protection of incumbent board members. Due to great controversy, the proxy-access proposal has been deemed ‘‘dead” since its issuance. However, in August 2005, the 2nd US Circuit Court of Appeals in New York issued a ruling that effectively prohibits the SEC from blocking shareholder groups from forcing companies to run many of their proxy initiatives. Immediately following this court decision, the SEC announced that it would renew its focus on the proxy-access issue by the end of 2006 (see Hansard, 2006). In addition, in August 2003, the SEC proposed another rule entitled ‘‘Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors” and adopted it in November 2003.