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Product market power, industry structure, and corporate earnings management

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ABSTRACT

This is the first study to establish a link between product market power of firms and the degree of earnings management. We hypothesize and document a significant and robust association between (a) a firm's product market pricing power and its degree of earnings management, and (b) industry competitiveness and the degree of earnings management in the industry. Our study reveals that firms with inferior product market pricing power engage in greater discretionary earnings accruals, adding a new dimension to our understanding of the transparency and informativeness of firms' financial statements. These findings are mirrored at the industry level where we document that more competitive industries are associated with greater earnings manipulation. The empirical evidence has direct implication on the informativeness and earnings quality of firms based on their product market power and competitiveness.
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1. Introduction

The idea that competitive pressure is an important determinant of managerial decision-making has received empirical support in the literature. A number of studies establish that a firm's product market environment influences its investments, financing, cash distributions, corporate governance, analysts' earnings forecasts, and hedging decisions (see e.g., Akdogu and MacKay, 2012; Datta et al., 2011; Haushalter et al., 2006; Grullon and Michaely, 2007; Fama, 1980). Yet, how product market power impacts the strategic decision to manage a firm's reported earnings is an issue that has largely been overlooked. A central issue in earnings management research is to identify which firms have a propensity to engage in earnings manipulation. Much of the literature on earnings management delves into the degree to which firms are able to "game" the capital markets through earnings manipulation. However, we know very little about firm attributes that drive earnings management. In fact, Healy and Wahlen (1999) state "These studies point to the value of further research to explain how business factors drive accruals."

In this study we argue that a firm's pricing power has the potential to influence the degree of earnings management for a number of reasons. First, pricing power can serve as a cushioning mechanism that affords the firm the ability to pass on any cost shocks to the customers, reducing cash flow fluctuations, and thereby diminishing the need to manipulate earnings. Second, in light of the fact that the market punishes firms when they fail to meet earnings expectations, one can argue that firms under weak pricing power are more likely to manipulate earnings to meet market expectation. Another motivation for earnings manipulation is to strategically limit and obfuscate the information available to rivals in an attempt to maintain a competitive advantage. Therefore, firms facing greater competitive pressures may be motivated to manage earnings to limit information available to their rivals. Till date, the potentially important link between product market pricing power of firms and earnings management remains unexplored. The primary focus of this study is to address whether product market power influences the degree of earnings manipulation by corporate managers.

Specifically, we seek to answer the following questions: Is there a link between product market pricing power and the transparency

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of firm's reported earnings? Put differently, does pricing power that affords firms the ability to pass on cost shocks to customers lead to less earnings manipulation? Or, does lack of pricing pressure on firms that enjoy high product market power exacerbates earnings management? How does corporate governance influence the managerial decision to manage earnings in light of its product market pricing power? How does industry competitiveness influence corporate earnings management?

This study contributes to the finance and accounting literatures by documenting how a firm's relative product market pricing power and industry competitiveness determine earnings management decisions. Based on a comprehensive sample of 43,628 firm-year observations during the period spanning 1987–2009, our study documents that product market power is an important determinant of corporate earnings transparency. Notably, our analysis shows that firms with inferior product market pricing power engage more in discretionary accruals management, which suggests that such firms strategically act to limit transparency in their financial reporting. This validates the notion that the ability of high market power firms to pass on cost shocks to customers reduces the need to use accruals manipulation.

We extend our analysis by also examining the link between different measures of industry structure and earnings management. Using three alternative proxies of industry competition, our results indicate that the greater the competition in an industry, the greater the earnings management indicating that a lack of competitive environment diminishes the need to engage in earnings manipulation. Moreover, all our findings are highly robust to controlling for (a) internal and external disciplinary governance mechanisms, (b) executive compensation, and (c) the firm's information environment, indicating that governance factors cannot be considered substitutes for product market pricing power or competitiveness in an industry.

Our findings contribute to the literature on financial disclosure and the disciplinary effect of competition. Specifically, our results provide empirical evidence in support of Verrecchia's (1983) model that competitive pressure reduces information disclosure. In line with predictions by Shleifer (2004) and Rotemberg and Scharfstein (1990), the positive association between competition and earnings management supports the notion that managerial career concerns arising from operating in an intense competitive environment pressures managers to manage earnings. The results do not support the view that competition serves as a disciplinary mechanism by providing more information transparency.

To the extent that earnings management can distort the financial picture of the firm, our analysis should help investors better understand the association between a firm's product market power and the degree of earnings manipulation, thereby enhancing their ability to gauge the real numbers behind the reported earnings.

The remainder of the paper is structured as follows. Section 2 presents the background literature and formulates the hypotheses. Sample formation, measurement of product market power, industry-level competition measures, and description of the sample are presented in Section 3. Section 4 presents the empirical findings. Section 5 concludes.

2. Background literature and hypotheses development

2.1. Background literature

Financial reporting is a key source of information to capital markets. Opportunistic earnings manipulation subverts the purpose of financial reporting by distorting firm's true economic performance, and thus can act as a hindrance to the full flow of information to market participants leading to higher informational asymmetry. The degree to which firms manipulate earnings has ramifications for the informativeness of their reported financial statements.

A survey of CFOs by Graham et al. (2005) documents that earnings management is pervasive. They report that a vast majority of managers admit to smoothing earnings via manipulation of real or accrual activities to influence the stock price and firm's risk premium. Skinner and Sloan (2002) show that managers manipulate earnings to avoid revealing the true value of their firms because reporting lower than expected earnings is severely penalized by financial markets.

Researchers have addressed various aspects of discretionary earnings management. A prominent focus of this body of work is on capital markets based incentives to manipulate earnings, such as boosting stock prices (Collins and Hribar, 2000), and obtaining lower financing costs (Dechow et al., 1996). Past studies have also documented that managing reported earnings is intended to influence the decisions of external capital providers. In particular, some research reports that managers inflate earnings prior to seasoned equity offerings, initial public offerings, and stock-financed acquisitions (Adams et al., 2009; Teoh et al., 1998; Rangan, 1998; Erickson and Wang, 1999) and to meet regulatory requirements (Yu et al., 2006) while earnings are managed downward prior to management buyouts (Perry and Williams, 1994). In contrast to this strand of research that focuses on managerial discretion in reported earnings around a certain event, the focal point in this study is distinctly different because it addresses whether the firm's product market power is a major driving force behind earnings management.

2.2. Hypotheses development

There are a number of arguments that suggest a potential link between product market power and earnings management. Intra-industry pricing power (which we interchangeably refer to as product market power) emanates from the firm's ability to extract abnormal rents (higher prices) from its customers with little impact on demand, thus conferring a competitive pricing edge to the firm. The preceding argument does not require us to make the assumption of a perfectly inelastic demand curve for it to hold. Uniqueness and superiority of product lines or a strong brand name are the hallmarks of strong pricing power and competitive advantage. While industry-wide elasticity of demand is determined by the aggregate demand curve for the industry, *intra*-industry product differentiation (among firms within the industry) can affect the price elasticity of demand faced by a *specific* firm, regardless of the industry structure in which it operates.

Pricing power confers a number of advantages on the firm. For example, firms with greater pricing power can better maintain their profit margins when they are subject to exogenous productivity shocks because of the uniqueness of their products and/or strong brand name. Greater product differentiation (or lower product substitutability) can lead to more inelastic demand curve for a firm's products, affording it the flexibility to pass on cost shocks to its customers.[1,2] In Gaspar and Massa (2006), product market power

[1] Price competition increases with increased product substitutability (see Salop, 1979).

[2] To see how cost shocks impact firms within a specific industry, consider two firms: Firm A has differentiated its products from the rest of the industry and is able to command higher prices and Firm B has undifferentiated products (i.e. experiences greater product substitutability) and hence a decreased ability to raise prices. Firm A exhibits greater product market power than Firm B by virtue of its ability to extract a greater price from its customers in the face of an idiosyncratic cost shock. In other words, it enjoys less price competition. Thus, the inability of firms with weak pricing power to pass on cost shocks and protect profit margins serves to exert more pressure on them to manage earnings. In contrast, greater product market power enables firms to reduce the uncertainty about their future cash flows without resorting to earnings management.

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