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Drivers Behind the Monitoring Effectiveness of Global Institutional Investors: Evidence from Earnings Management

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Abstract

This paper studies the drivers behind the monitoring effectiveness of institutional investors in curbing earnings management in an international setting. We identify three distinct drivers and propose two competing hypotheses: the hometown advantage hypothesis predicts that because of proximity to monitoring information, domestic institutions have a comparative advantage over foreign institutions in deterring earnings management, whereas the global investor hypothesis predicts that foreign institutions have a comparative advantage because of their proclivity toward activism and ability to deploy superior monitoring technologies. Consistent with the hometown advantage hypothesis, in aggregate, domestic, but not foreign, institutional ownership is associated with less earnings management; the monitoring effectiveness of foreign institutions improves as they gain proximity to monitoring information. Consistent with the global investor hypothesis, the monitoring effectiveness of foreign institutions improves in environments of greater agency conflicts or weaker governance controls or when the gap in monitoring technology between foreign and domestic institutions widens.

JEL classification: G15; G2; G32; G34; M41
Keywords: Institutional investors; Earnings management; Corporate governance; Geographic distance

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