Available online at www.sciencedirect.com
ScienceDirect
Journal of Financial Economics 87 (2008) 357–373
JOURNAL OF Financial ECONOMICS
www.elsevier.com/locate/jfec

Corporate governance and pay-for-performance: The impact of earnings management ☆

Marcia Millon Cornett[a], Alan J. Marcus[b], Hassan Tehranian[b,*]

[a]*Southern Illinois University, Carbondale, IL, 62901, USA*
[b]*Boston College, Chestnut Hill, MA 02467, USA*

Received 12 May 2006; received in revised form 30 January 2007; accepted 2 March 2007

Abstract

We ask whether the apparent impact of governance structure and incentive-based compensation on firm performance stands up when measured performance is adjusted for the effects of earnings management. Institutional ownership of shares, institutional investor representation on the board of directors, and the presence of independent outside directors on the board all reduce the use of discretionary accruals. These factors largely offset the impact of option compensation, which strongly encourages earnings management. Adjusting for the impact of earnings management substantially increases the measured importance of governance variables and dramatically decreases the impact of incentive-based compensation on corporate performance.

JEL classification: G30; G34; M41; M52

Keywords: Corporate governance; Earnings management; Financial performance; Stock options

1. Introduction

Both accountants and financial economists have devoted considerable attention to the impact of governance structures and compensation schemes on corporate behavior. The accounting literature documents that these factors have a substantial impact on earnings management, while the finance literature shows that they likewise affect financial performance. However, these two strands of literature, when considered together, raise another issue for study: if earnings management is affected by governance and compensation arrangements, then the apparent impact of these arrangements on reported financial performance may be at least in part merely cosmetic. In this paper we examine how governance structure and incentive-based compensation influence firm performance when measured performance is adjusted for the impact of earnings management.

☆The authors are grateful to Yin Duan, Alex Fayman, Karthik Krishsnan, and Umut Gokcen for research assistance. We thank Mike Barry, Jim Booth, Susan Shu, Richard Evans, Wayne Ferson, Amy Hutton, Edith Hotchkiss, Darren Kisgen, Jeff Pontiff, Pete Wilson, and seminar participants at Boston College, Southern Illinois University, and the University of New Orleans for helpful comments.
*Corresponding author. Tel.: +617 552 3944; fax: +617 552 0431.
E-mail address: hassan.tehranian@bc.edu (H. Tehranian).

0304-405X/$ - see front matter
doi:10.1016/j.jfineco.2007.03.003

Our main result is that adjusting for the impact of earnings management substantially increases the measured importance of governance variables and substantially decreases the importance of incentive-based compensation for corporate performance. We focus on the role of discretionary accruals in earnings management. As in previous studies, we find that such management is sensitive to corporate governance structure. We extend this literature by showing that institutional investment in the firm also may be effective in reducing earnings management. Our more novel results address the impact of earnings management on the determinants of corporate performance. While we find a strong relation between incentive-based compensation and conventionally reported measures of firm performance, profitability measures that are adjusted for the impact of discretionary accruals show a far weaker relation with such compensation. In contrast, the estimated impact of corporate governance variables on firm performance is far greater when discretionary accruals are removed from measured profitability. We conclude that governance may be more important and the impact of incentive-based compensation less important to true performance than indicated by past studies.

The paper is organized as follows. Section 2 briefly reviews the literature on earnings management as it relates to our study. Section 3 discusses internal corporate governance mechanisms shown to be important in other contexts that might have an impact on both accounting choice and financial performance. Section 4 presents an overview of our data and methodology. Section 5 presents empirical results and Section 6 concludes the paper.

2. Earnings management

Accountants and financial economists have recognized for years that firms use the latitude in accounting rules to manage their reported earnings in a wide variety of contexts. Healy and Wahlen (1999) conclude in their review article on this topic that the evidence is consistent with earnings management "to window dress financial statements prior to public securities offerings, to increase corporate managers' compensation and job security, to avoid violating lending contracts, or to reduce regulatory costs or to increase regulatory benefits." Since that study, evidence of earnings management has only mounted. For example, Cohen, Dey, and Lys (2005) find that earnings management increased steadily from 1997 until 2002, and options and stock-based compensation emerged as a particularly strong predictor of aggressive accounting behavior (see also Gao and Shrieves, 2002; Cheng and Warfield, 2005; Bergstresser and Philippon, 2006). However, several studies find that earnings management can be limited by well-designed corporate governance arrangements (Klein, 2002; Warfield, Wild, and Wild, 1995; Dechow, Sloan, Sweeney, 1996; Beasley, 1996).

2.1. *Opportunistic earnings management*

Early work on strategic accruals management focused on the manipulation of bonus income (Healy, 1985; Healy, Kang, and Palepu, 1987; Guidry, Leone, and Rock, 1999; Gaver, Gaver, and Austin, 1995; Holthausen, Larcker, and Sloan, 1995). More recent work addresses the use of earnings management to affect stock prices, and in turn, managers' wealth. For example, Sloan (1996) finds that a firm can increase its stock price at least temporarily by inflating current earnings using aggressive accruals assumptions. Teoh, Welch, and Wong (1998a, b) find that firms with more aggressive accrual policies prior to IPOs and SEOs tend to realize poorer post-issuance stock price performance than firms with less aggressive accounting policies, which suggests that earnings management inflates stock prices prior to the offering. Similarly, Beneish and Vargus (2002) find that periods of abnormally high accruals (which temporarily inflate earnings) are associated with increases in insider sales of shares, and that after the "event period" stock returns tend to be poor.

Option and restricted stock compensation is a particularly direct route by which management can potentially increase its wealth by inflating stock prices in periods surrounding stock sales or option exercises. Indeed, considerable evidence links such compensation to a higher degree of earnings management. Bergstresser, Desai, and Rauh (2006) find that firms make more aggressive assumptions about returns on defined benefit pension plans during periods in which executives are exercising options. Burns and Kedia (2006) show that firms whose CEOs have large options positions are more likely to file earnings restatements. Gao and Shrieves (2002), Bergstresser and Philippon (2006), Cohen, Dey, and Lys (2005), and Cheng and