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SAY ON PAY

&

EARNINGS MANAGEMENT

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Abstract

Say on Pay is a form of shareholder activism, which is used by shareholders to express their (dis)satisfaction on executive compensation. This research examines whether the submission of a Say on Pay proposal has an effect on earnings management. Using absolute discretionary accruals as a proxy for earnings management, I find that firms have high absolute discretionary accruals when receiving a Say on Pay proposal, suggesting earnings management. As the practice of earnings management has an influence on the quality of financial reporting, I use three proxies to capture a firms' reporting quality. In the contrast to discretionary accruals, these proxies show that the submission of a SOP proposal does not have an influence on reporting quality. Overall, the findings of this research do not provide conclusive evidence regarding the effect of Say on Pay proposals on earnings management. These findings can be explained by the ineffectiveness of Say on Pay to reduce executive compensation.

Keywords: Say on pay; earnings management; submission shareholder proposal; discretionary accruals; reporting quality; audit fees; SOX 404; meet or beat.

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I INTRODUCTION

1.1 Introduction

Say on Pay (hereafter: SOP) is introduced by Securities and Exchange Commission (SEC) in the United States and is effective since beginning on or after January 21, 2011 (SEC, 2011). This is the result of the involvement of shareholders in the decision-making of firms over the years. SOP is a regulatory response to the rising levels of executive compensation and the lack of transparency in compensation packages in the United States. The main goal of SOP is to moderate the level of compensation related to top executives by providing the owners of the firm the opportunity to express their (dis)satisfaction about executive compensation and to exercise more influence on this matter through the submission of shareholder proposals, also called SOP proposals (SEC, 2011). However, the outcome of the submitted SOP proposals is non-binding in the United States. This means that firms are not required to follow the suggestions of shareholders on executive compensation. Despite this, firms are expected to react to high voting dissent, given that companies are sensitive to the manner in which executive compensation levels are perceived by shareholders and the media (Larcker., 2012). SOP proposals should improve the connection between shareholder demands and executive compensation.

The relation between earnings management and shareholder activism is interesting as the involvement of shareholders with corporate issues is expected to reduce the divergence of interest between shareholders and managers by using shareholder proposals (Conyon & Sadler, 2010). However, shareholder activism could also lead to the undesired outcomes as SOP proposals are designed to regulate the rising levels of executive compensation. Managers could have incentives to engage in earnings management to prevent a drop in executive compensation. Prior studies show that earnings management is associated with managers driven by incentives related to executive compensation. According to Healy (1985), firms engage in earnings management to optimize bonuses (Healy, 1985). In line with the findings of Healy, Guidry et al. (1998) conclude that business managers use discretionary accruals in order to reach the maximum level of short-term bonuses. Hence, a drop in executive compensation caused by SOP proposals could stimulate managers to manage earnings when their firms receive a SOP proposal.

This research examines whether the submission of a Say on Pay proposal has an effect on earnings management. Therefore, this study attempts to answer the following research question:

"Do Say on Pay proposals have an effect on earnings management?"

In order to examine this research question, this study uses the Modified Jones model to estimate discretionary accruals of 276 US-based firms in the period between 2009 and 2017. In addition, this research employs three different proxies for reporting quality to assess the quality of a firms' reporting. Hereby, this study makes a difference between firms that receive a SOP proposal in year t and firms that do not receive this proposal. Furthermore, following Kothari et al. (2005), this study includes a performance-adjustment to the Modified Jones model in order to validate the results of this study.

The findings of this research show different conclusions about whether to accept or reject hypothesis 1. On the one hand, the proxy *absolute discretionary accruals* shows that firms have more propensity to EM in year t+1. Based on this finding, hypothesis 1 is accepted. However, on the other hand, the proxies for reporting quality show that the submission of a SOP proposal in year *t* does not have an impact on *audit fees*, *SOX 404* and *meet or beat*. In other words, a SOP proposal in year *t* does not have an effect on a firms' reporting quality in year t+1. Based on these findings, hypothesis 1 is rejected. As a result, the findings of this study are inconclusive. Therefore, it cannot be concluded that firms engage in EM in year t+1.

This research contributes to the present literature concerning shareholder activism, more specifically the SOP literature. Prior research has mostly focused and provided mixed evidence on the effect of SOP on CEO compensation. On the one hand, research shows that executive compensation has decreased as result of SOP proposals (Balsam & Yin, 2013; Marinilka et al., 2016). On the other hand, studies conclude that SOP proposals do not have an effect on the level and composition of executive compensation (Iliev & Vitanova, 2013). This study, however, examines the reaction of firms to the submission of SOP proposals. The results of this study contribute to a broader view on the undesired outcomes of shareholder activism through SOP in firms. Furthermore, research on earnings management and shareholder activism is still scarce. For instance, Hadani et al. (2010) examine the impact of shareholder activism, measured as shareholder proposals, on earnings management.

The remainder of this paper continues as follows. Section II provides a literature review of the important concepts in this study. This is followed by Section III, which contains the hypothesis development. Section IV specifies the methods, which are used to examine the research question. Furthermore, the results of this study are presented in Section V and finally, the conclusion of this study is shown in Section VI. The limits and suggestions for future research are also included in Section VI.

II LITERATURE REVIEW

This section provides a literature review of the main concepts of this study (also presented in Appendix A). This literature review is used to identify the literature gaps regarding shareholder activism, Say on Pay proposals and earnings management.

2.1 Shareholder activism and its consequences

Corporate decision-making has changed over the years due to the emergence of shareholder activism (Gillan & Starks, 2007). The involvement of shareholders with firm decision-making is a response to agency problems in firms. These problems arise from the divergence of interests between shareholders and managers (Jensen & Meckling, 1976). Managers (agents) have the responsibility to make decisions in order to maximize shareholder value. However, they can differ from this and make decisions in their own interest. This causes dissatisfaction among shareholders who perceive these actions as mismanagement by the firm. In order to address agency problems, shareholders have become more active and involved in the decision-making of firms.

From a broad perspective, shareholder activism is defined as the adoption of numerous actions by shareholders to influence the management in order to make fundamental changes within the firm or to improve firm performance (Gillan & Starks, 2007). Shareholder activism is financially or socially driven and it is implemented to address a wide range of business issues, which are mostly related to corporate governance. Shareholder activists attempt to intervene in the decision-making of the firm in two ways, namely through walk activism and voice. In the case of walk activism, dissatisfied shareholders could respond to the decisions of the management by threatening with a Wall Street Walk, the sale of their shares (Admati & Pfleiderer, 2006), in order to influence the management. In the case of voice, shareholders can express their concerns about corporate governance issues through the submission of shareholder proposals, negotiations with management and vote-no campaigns in order to influence managerial decisions (Gillan & Starks, 2007). For instance, firms associated with an excessive CEO compensation are more likely to be targeted by shareholder proposals (Ertimur et al., 2009).

The rise of shareholder activism has provided shareholders the opportunity to intervene in corporate decision-making and it has resulted in more monitoring. This is consistent with the findings of Chen et al. (2007) which indicate stronger monitoring effects associated with the increase of institutional shareholder activism. They conclude that independent institutional investors with long-term investments are motivated to engage in monitoring activities rather than to sell their stake partly due to high selling costs. Consequently, this results in monitoring the management and taking action when institutional investors identify a problem. The net benefit of monitoring depends on the size of the institutional ownership and length of time invested. Furthermore, institutional shareholders choose to sell their stake when they perceive they are not able to monitor the managers.

Furthermore, Chung et al. (2002) examine the relation between institutional monitoring and opportunistic earnings management. They find that institutional shareholders with large stakes monitor the use of discretionary accruals by managers from being opportunistic. Given that managers have incentives to manage earnings upward, institutional shareholders monitor the use of income-increasing discretionary accruals. Similarly, institutional

investors monitor income-decreasing discretionary accruals when managers have the tendency to manage earnings downwards. Additionally, institutional shareholders are more motivated to monitor the opportunistic behavior of managers when a firm is associated with poor profitability, poor financial health and high agency costs.

In addition, Eritmur et al. (2009) investigate the monitoring role of shareholder activism, in terms of vote-no campaigns and shareholder proposals, in relation to CEO compensation. They find that the occurrence of vote-no campaigns and the submission of shareholder proposals related to compensation have increased significantly, especially, after the accounting scandals in 2002. This finding indicates that shareholders do not agree with the management on executive compensation and that they have more need to get involved in this matter. In order to express dissatisfaction related to remuneration, shareholder activists tend to target firms with excessive levels of executive compensation. Consequently, shareholder proposals and vote-no campaigns related to excessive pay and pay setting process receive higher voting support. Accordingly, these forms of shareholder activism have resulted in a decrease of excessive CEO compensation.

Moreover, Hartzell & Starks (2003) investigate the influence of institutional investors on executive compensation. They find that the presence of institutional ownership is negatively associated with the level of compensation. The researchers also find that firms adopt compensation structures with more pay-for-performance sensitivity in the presence of institutional shareholders. Both these findings suggest more monitoring in the presence of institutional shareholders.

In conclusion, these studies show that shareholder activists influence the managers to act in the best interest of the owners. However, one paper provides evidence that monitoring depends on the shareholder's potential business relationship with the firm in which they have invested. Cornett et al. (2007) show that institutional shareholders, who have or are interested in potential business relationships with the firm, have less tendency to challenge management decisions. Therefore, these shareholders are less suited to monitor the management. However, institutional shareholders are more willingly to question management decisions and to impose controls over managers when these shareholders do not pursuit business relationships. Another paper suggest that intense monitoring will lead to higher compensation due to increased employment and career risk (Hoskisson, 2009).

Prior research shows that the degree to which shareholders attempt to get involved in firm decisions is determined by different factors. One of these determinants is firm performance. The involvement of shareholders with corporate governance decisions depends on the results of the company (John & Klein, 1996). The probability of shareholders influencing firms through corporate proposals increases when these firms report a negative net income in the prior year. In addition, Karpoff et al. (1995) also provide similar findings, which point out, that shareholders are more attracted to initiate shareholder proposals in firms, which show a poor performance. In other words, shareholders tend to target firms when they are dissatisfied with the realized results. Next to firm performance, the size of a firm is also a driver of shareholder activism. Shareholder activists tend to focus on large firms (Karpoff et al., 1995). This can be explained by agency problems. Namely, it is more complicated to monitor large firms, which are more subjected to corporate governance issues, in an effective way (Jensen & Meckling, 1976). Therefore, the probability of small firms receiving a corporate governance proposal is low while this probability is high for large firms (John & Klein, 1996). Putting this differently, larger firms are more likely to be targeted by active shareholders (Smith, 1996).

Besides firm size, the level of institutional ownership is also a determinant of shareholder engagement in the decision-making of companies. Firms, which are associated with a high level of institutional ownership, are more prone to shareholder participation (Smith, 1996). The reasons are that the presence of institutional shareholders tends to be predominated in large firms and that institutional shareholders are more active than other shareholder groups in terms of voting in the case of disagreement with the management.

Finally, managerial ownership also affects the participation of shareholders in a firm. Shareholders tend to be less involved with corporate decisions when managerial ownership increases (Souha & Anis, 2016). This is because it is also in the interest of the managers to have a good firm performance when they own shares of the firm. This means that there is less misalignment of interest between shareholders and managers.

2.2 Say on Pay

In 2002, the United Kingdom was the first country to introduce Say on Pay (here after: SOP). However, the foundation of SOP originates from the so-called shareholder proposal Rule 14A-8 adopted by the Securities and Exchange Commission (SEC) in 1942. This rule provides guidelines and requirements for both proponent and recipient of proposals submitted by the owners of the firm (SEC, 2011). On the one hand, proponents are allowed to submit only one proposal per meeting when he or she holds 1% or owns at least \$2,000 of the market value of equity for at least one year and continues to do so through the annual meeting. Additionally, shareholder proposals are supported by a statement which must contain 500 words or less in length. On the other hand, Rule 14a-8 mandates recipients to include shareholder proposals as part of the firms' annual meetings when these proposals meet the conditions mentioned above. Firms should also give shareholders the opportunity to approve or disapprove on shareholder proposals. It should be noted that the vote outcome is non-binding but advisory.

Under Rule 14a-8, shareholders proposals are allowed to address various topics ranging from social and environmental to other corporate governance matters. However, this rule also gives firms the opportunity to exclude shareholders proposals from the annual meeting for different reasons such as proposals related to personal claims or proposals, which are considered misleading. Most importantly, shareholder proposals that interrupt the manager's right to perform ordinary business can be excluded. This means that shareholder proposals aimed at exercising influence on executive compensation fall under intervening with ordinary business and, therefore, these proposals are excluded from the annual meeting. That is why prior to 1992, firms were able to exclude shareholder proposals concerning executive compensation on their proxy statements. The exclusion of compensation proposals provided dissatisfaction among shareholders due to the accelerated growth of executive compensation. As the level of executive compensation and shareholder concerns continued to grow in the early 1990s, the SEC introduced on October 5, 1992 new rules on executive compensation and required firms to disclose the amount of compensation recognized to the most highly paid executives. On the same date, the SEC expanded the definition of ordinary business, which meant that shareholder proposals on executive compensation were allowed. The underlying idea was to give shareholders the opportunity to express their dissatisfaction about compensation policies presented in the financial statement through shareholder proposals. This gave shareholders the right to get involved in the process of compensation determination and to monitor the management more actively, which resulted in advisory shareholder votes on executive compensation. The foundation for SOP was established.

SOP is introduced by SEC in the United States and is effective since beginning on or after January 21, 2011 (SEC, 2011). It is a regulatory response to the rising levels of executive compensation and the lack of transparency in compensation packages in the United States as it is noted that the excessive growth of executive compensation is remarkably high in large listed US firms compared to large listed firms in other countries (Murphy, 2013). The main goal of SOP is to moderate the level of compensation related to top executives by providing the owners of the firm the opportunity to express their (dis)satisfaction about executive compensation and to exercise more influence on this matter through the submission of shareholder proposals. This should improve the connection between shareholder demands and executive compensation.

As mentioned, SOP enables shareholders to have a 'say' in compensation paid to top executives. Hence, it requires public companies in the United States to conduct a separate shareholders vote on executive remuneration (SEC, 2011). This vote triggers shareholders activism by involving shareholders in corporate decision-making regarding executive compensation (Cuñat et al., 2015). The SOP vote can be either binding or non-binding. Given that a SOP vote is binding, firms are obligated to take the opinions of shareholders in consideration and adjust executive remuneration when SOP proposals are highly supported by the shareholders. On the contrary, a non-binding vote, which is the case in the United States, serves as an advisory vote. This means that firms are not required to change compensation packages based on the outcome of the submitted SOP proposal. In other words, shareholders are only able to express their dissatisfaction regarding the firm's executive compensation. In addition, firms are required to vote on the frequency of these SOP votes and firms are also required to disclose these SOP votes in the annual meeting proxy statement (SEC, 2011).

In conclusion, previously the SEC did not allow compensation proposals, but the increasing levels of executive compensation led to a major change in the guidelines and requirements of shareholder proposals described in Rule 14a-8. The expansion of the shareholder proposals related to ordinary business makes the submission of proposals regarding executive compensation possible and it allows shareholders to advise the management about executive compensation. Hence, Rule 14a-8 forms the foundation for SOP proposals. These proposals have an advisory role and are used by shareholders to express their dissatisfaction associated with executive compensation.

2.3 Earnings management

A definition for earnings management (here after: EM) that is widely accepted does not exist. However, there are a few definitions, which are frequently used. For instance, EM is described as a practice where the management uses its opinion in financial reporting to provide misleading information to stakeholders on purpose (Healy & Wahlen, 1999). Another definition for managing earnings is the attempt of the management to influence the financial statements in such a way to attain a desired financial outcome by using certain accounting policies or transactions (Scott, 2012). Overall, EM is characterized by intentional actions, which are aimed at obtaining certain benefits and these actions, in turn, result in deceiving the users of financial statements by the use of discretionary power of the management (Schipper, 1989).

Managers are subjected to several incentives to engage in EM. EM can be driven by capital market incentives (Healy & Wahlen, 1999). When managers are driven by these incentives, they are motivated to manage earnings in order to meet earnings benchmarks. The reason is that shareholders derive the value of a firm's shares from this information and, therefore, managers are triggered to manipulate earnings and, thus, influence the short-term share price. Accordingly, Gunny (2010) examines EM and firms just meeting earnings benchmarks. This study shows a positive relation between EM and firms just meeting earnings benchmarks, which suggests that firms manage earnings to just meet earning benchmarks. Other results of this study indicate that these firms manipulate earnings by engaging in R&D and selling, general & administrative expenses to reduce expenses. Furthermore, the results show that self-interest is to the only reason for managers to engage in EM. Managers also manage earnings to allow better future performance.

EM can also be stimulated by contracting incentives, where the focus lies on debt covenants and compensation contracts (Healy & Wahlen, 1999). On the one hand, it is argued that managers manipulate earnings to prevent additional costs and other contract conditions as result of the violation of debt covenants. DeFond & Jiambalvo (1994) examine the relation between EM and firms close to debt covenant violation. They conclude that firms have abnormal accruals in the year prior to the violation of debt covenants, indicating manipulation of earnings upward to avoid violations of contractual commitments. On the other hand, contracting incentives can also be derived from compensation contracts. The underlying idea is that managers have incentives to manage earnings when their compensation is based on the performance of the firm. Healy (1985) puts the focus of EM on compensation contracts and reaches to the conclusion that companies engage in earning management to optimize bonuses. Consistent with Healy, Guidry et al. (1998) examine EM and the setting in which bonuses paid to business managers are based on the performance of the business unit. The study concludes that business managers use discretionary accruals to reach the maximum level of short-term bonuses.

Regulatory incentives are also considered drivers of EM (Healy & Wahlen, 1999). Firms deal with the regulation of their industry. The corresponding rules are connected to accounting information. For instance, bank industry regulation requires banks to meet certain capital requirements to classify as having healthy financial conditions. When firms are not able to comply with these conditions, managers may use their managerial discretion to meet requirements. This is in line with the results of Beatty et al. (1995), which show that banks

which are close to the minimum capital requirement engage in EM by using loan loss provisions to manage capital.

The use of managerial discretion in order to present earnings in a favorable has led to different economic consequences. Prior research shows the effect of EM on future financial performance of the company. Tabassum et al. (2013) show that EM has a negative effect on the performance of the firm in the future. This finding suggests that future performance deteriorates as consequence of managing earnings to show good results. This is consistent with the study of Gunny (2010) which shows that companies, which use managerial discretion to manage earnings upwards, are associated with poor performance in consequent years. Chapman and Steenburgh (2010) examine the manipulation of marketing expenses by managers to live up to earning targets. They indicate that managers meet earnings targets at the expense of long run earnings and conclude that EM has a negative effect on the prospective performance of the firm.

EM also affects cost of capital. Dechow et al. (1996) focus on firms which have overstated their earnings and, therefore, are targeted by the SEC. The results show that after making public that these firms have managed their earnings upward, their cost of capital increases significantly. This finding suggest that firms benefit from EM at first resulting in having low cost of capital at first but when the overstatement of earnings is revealed, cost of capital will increase.

In conclusion, misleading financial statements are the result of managers' actions aimed at managing earnings to obtain a favorable outcome, which is called EM. Managers are driven by different incentives to engage in the manipulation of earnings such as capital market incentives. In this case, managers alter earnings in order to meet earnings benchmarks. Contracting incentives motivate managers to use their managerial discretion to avoid debt covenant violation or to meet their bonus based compensation contract. Regulatory incentives also drive managers to alter earnings because they need to meet certain requirements tied to the industry of the company. Finally, the use of EM has a negative effect on the future firm performance and cost of capital.

2.4 Say on Pay and Earnings management

As consequence of the emergence of shareholder activism over the years, shareholders have become more involved in firm decision-making. This manifests itself in the performance of monitoring activities by shareholders. Prior studies show similar results in relation to shareholder activism and monitoring. For instance, the increase of institutional shareholder activism is associated with stronger monitoring effects (Chen et al., 2007). In addition, independent institutional investors with long-term investments are motivated to engage in monitoring activities rather than to sell their stake partly due to high selling costs. Consistent with these findings, Chung et al. (2002) show that institutional shareholders engage more actively in monitoring activities when they have large stakes in the firm. Thereby, they focus monitoring activities on the use of discretionary accruals by managers from being opportunistic. Given that managers have incentives to manage earnings upward, institutional shareholders monitor the use of income-increasing discretionary accruals. Similarly, institutional investors monitor income-decreasing discretionary accruals when managers have the tendency to manage

earnings downwards. The increase of monitoring, caused by shareholder activism, reduces the possibility to engage in EM. However, the ability of shareholders to perform monitoring activities is questionable when there are potential business relationships in between in the firm and shareholder (Cornett et al. 2007).

Because of the rise of shareholder activism, shareholders are able to express their opinion on several corporate issues, which includes executive compensation. Like mentioned before, compensation incentives are considered a reason for managers to manage earnings as executive compensation is based on firm performance (Healy & Wahlen, 1999). This is the case for bonuses, which are based on firm performance. Managers tend to optimize bonuses by engaging in EM (Healy, 1985; Guidry et al., 1998). Given that shareholders disagree with the level of executive compensation, shareholders have the opportunity to express their dissatisfaction and to exercise influence on executive compensation and pay setting process. This way, shareholders attempt to make changes in order to restrict undesired behaviour by managers, which arises from compensation incentives. However, the influence of SOP proposals on executive remuneration could be limited because the outcome of the SOP votes is non-binding, which means that these votes only serve as an advice.

In addition, SOP proposals also serve as a monitoring tool in the case of excessive compensation to counteract EM. The occurrence of vote-no campaigns and the submission of shareholder proposals related to compensation have increased significantly, especially, after the accounting scandals in 2002 (Ertimur et al., 2009). This indicates that shareholders attempt to influence managers to act in the best interest of the owners instead of their own self-interest and to prevent misleading financial information provided by managers. As result, vote-no campaigns and shareholder proposals have resulted in a decrease of excessive executive compensation. Hence, SOP proposals could be used to monitor the actions of the managers regarding executive compensation.

Furthermore, shareholder activism tends to be more conservative when managerial ownership increases (Souha & Anis, 2016) and thus result in less SOP proposals. The reason is that shareholders believe that managerial ownership will give managers the incentives to act in the best interest of the firm because they own shares of the firms. This would prevent EM.

III HYPOTHESIS DEVELOPMENT

This section is based on the literature review discussed in the previous section. The literature review provides a foundation to develop the hypothesis of this study by connecting different literature regarding shareholder activism, SOP proposals and EM. Consequently, this leads to the hypothesis of this research.

3.1 Hypothesis development

As mentioned, SOP arises from shareholder activism. Shareholders have become more active and involved in the decision-making process of firm over the years. The involvement of shareholders is stimulated by the divergence of interests between shareholders and managers (Jensen & Meckling, 1976). As a result, shareholders have obtained new means to influence firm issues. One of these means are the shareholder proposals through which shareholders are able to express their opinion on corporate issues.

According to prior studies (Chung et al., 2002; Chen et al., 2007), the presence of institutional shareholders leads to more monitoring, which suggest that there is less opportunity for managers to engage in EM as they are being monitored by the owners of the firm. This is especially the case when institutional shareholders have large stakes in the firms because it is more costly for them to sell their shares and therefore they are motivated to engage in more monitoring activities (Chen et al. 2007). Thereby, the use of discretionary accruals is monitored from being opportunistic (Chung et al., 2002). In short, the presence of institutional shareholders leads to monitoring activities performed by owners of the firm such as an analysis of the use of discretionary accruals. This limits the possibility of managing earnings, which suggests that firms will not engage in EM when they receive a SOP proposal.

Although the occurrence of EM decreases due to the presence of institutional shareholders, research shows that EM increases when compensation includes options, even in the presence of institutional shareholders (Cornett et al., 2008). This suggests that managers use their managerial discretion to provide misleading financial information on purpose when they are driven by compensation incentives. Increased monitoring enabled by institutional shareholders would not limit them from managing earnings. As the goal of SOP is to regulate the increasing levels of compensation, this could stimulate managers to manage earnings when their firms receive a SOP proposal.

In addition, intense monitoring is related to higher executive compensation (Hoskisson, 2009), which would imply that managers do not have incentives related to compensation to engage in EM to prevent a drop in executive compensation. The reason for higher executive pay is that the intensity of monitoring transfers more risks to managers related to job security. For instance, research shows increasing dismissals of CEOs over the past years (Lucier, Wheeler & Habbel, 2007). Furthermore, the average CEO turnover has decreased over the years. Therefore, managers demand a higher compensation and managers do not have the incentives to manage earnings in order to obtain a higher compensation. Additionally, the dissatisfaction of shareholders concerning high levels of executive compensation through SOP proposals would lead to more monitoring. On its turn, this would, again, lead to higher executive pay.

Managers could be motivated to manage earnings due to the intended goal of SOP. SOP is a tool, which enables shareholders to exercise influence on executive compensation, and it is aimed at regulating the level of executive compensation. Managers could perceive this as a threat to their compensation and, therefore, manage earnings when the firm receives a SOP proposal in order to prevent a drop in compensation. In order to maintain the same level of compensation, managers could manage earnings in such a way to optimize bonuses (Healy, 1999).

Shareholders who are interested in a potential relationship with a firm in which they have invested can be biased when performing monitoring activities (Cornett et al., 2007). This gives managers the opportunity to manage earnings because they know that shareholders have more difficulties to confront managers with certain decisions, as they are interested in a potential relationship. As they know that SOP proposals could possibly lower their compensation, managers could use the difficult position of shareholders to manage earnings when their firm receives a SOP proposal.

These arguments provide the foundation for the hypothesis of this study, which is stated as:

H1: Firms, which receive a Say on Pay proposal, engage in earnings management to prevent a drop in CEO compensation.

IV RESEARCH DESIGN

This section discusses the methodology in order to examine whether firms will engage in EM when the firm is subjected to the submission of a SOP proposal during 2009 – 2017. This research uses an accrual-based model – Modified Jones model – and employs different report quality proxies such as *Audit fees*, *SOX 404* and *Meet or beat* to detect EM. In order to connect the theoretical concepts with the operational measurements, Appendix B provides the Libby boxes of the different approaches, which are used to examine the hypothesis. Furthermore, Appendix C presents Table 1, which shows all variables used in this research and the calculation of these variables. Moreover, the sample selection process is presented in Table 2. At the end of this section, the data and sample selection are discussed.

4.1 Discretionary accruals as a proxy for earnings management

Based on prior literature (Jones, 1991; Dechow et al., 1995; Kothari et al., 2005), the most common technique to detect EM is measuring the level of discretionary accruals. There are several accrual-based models to detect EM. However, this study uses the Modified Jones model to determine whether managers engage in EM. The Modified Jones model is considered the best method to detect EM compared to other accrual-based EM models as this model deals with the measurement error of discretionary accruals (Dechow et al., 1995). By making the assumption that, it is easier to exercise managerial discretion on sales from accounts receivables than cash sales, the Modified Jones model reduces measurement errors when determining the discretionary accruals. Therefore, this model provides the best explanatory value with least systematically errors (Dechow et al., 1995), which results in reducing the probability of rejecting the absence of EM when it is false (Ronen and Yaari, 2008).

Following the Modified Jones model provided by Dechow et al. (1995), I formulate the ordinary least squares (OLS) model, presented in Equation (1). This model estimates the total accruals for each US firm during 2009 – 2017. Based on prior research on EM (Bekiris and Doukakis, 2011), I use Equation (1) to estimate total accruals (TA) and, consequently, to decompose total accruals into discretionary accruals (DA) and non-discretionary accruals (NDA) as follows:

$$\left(\frac{TA_{it-1}}{A_{it-1}}\right) = \beta_0 + \beta_1 \left(\frac{1}{A_{it-1}}\right) + \beta_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{t-1}}\right) + \beta_3 \left(\frac{PPE_{it}}{A_{t-1}}\right) + \varepsilon_{it} \tag{1}$$

where TA_{t-1} is total accruals, A_{it-1} is lagged total assets, ΔREV_{t-1} is the change in revenue in year t, ΔREC_{t-1} is the change in account receivables in year t and PPE_{t-j} represents property, plant and equipment in year t. The error term in Equation (1) represents the discretionary accruals of each US firm. In order to control for heteroscedasticity, these variables are scaled by lagged total assets except for the inverse of lagged assets (Jones, 1991). Furthermore, this study uses the cash-flow-statement-approach to estimate the total accruals, as the balance sheet approach produces more estimation errors when determining the accruals (Hribar & Collins, 2002).

I use the absolute value of discretionary accruals as a proxy for EM in Equation (2). It is preferable to use absolute discretionary accruals instead of signed discretionary accruals to detect EM because managers can either manage

earnings by using income-increasing or income-decreasing accruals (Cunningham et al., 2017). In other words, the absolute value of discretionary accruals is a measure of the magnitude of the discretionary part of total accruals. Following Hadani, Goranova & Khan (2011), I formulate the following OLS regression model to detect EM:

$$ABS_DA_{t+1} = \beta_0 + \beta_1 SOP_{it} + \beta_3 SIZE_{it} + \beta_4 ROA_{it} + \beta_5 GROWTH_{it} + \beta_6 LEV_{it} + \beta_7 L_TACC_{it} + \beta_8 INST_OWN_PCT_{it} + \beta_9 MAN_OWN_PCT_{it}$$
(2)
+ Year fixed effects + Firm fixed effects + ε_{it}

where ABS_DA is the dependent variable of this regression model and stands for the absolute value of discretionary accruals for firm *i* in year t+1. This variable measures the overall propensity to EM. Hence, higher values of the absolute discretionary accruals indicate more propensity of the occurrence of EM. The binary variable *SOP*, which is the independent variable, is equal to 1 if an US firm receives a SOP proposal in year *t* and otherwise 0. Positive values for the coefficient of the variable of main interest, *SOP*, would result in higher absolute values of discretionary accruals, which would imply that firms, which receive a SOP proposal in year *t*, have more propensity to engage in EM. Following Hadani, Goranova & Kahn (2011), this regression model also includes control variables in order to control for confounding effects between the dependent and independent variables. The control variables consist of variables, which control for firm characteristics such as firm size (*SIZE*), firm performance (*ROA*), firm growth (*GROWTH*), firm leverage (*LEV*), lagged total accruals (*L_TACC*) and variables which control for corporate governance such as institutional ownership (*INST_OWN_PCT*) and managerial ownership (*MAN_OWN_PCT*), both measured as a percentage of shares owned by institutional owners and managers respectively. The same control variables are included in Equation (3), (4) and (5) and are described in more detail later. Furthermore, firm and year effects are added in this regression model.

4.2 Several proxies for reporting quality

Following Erkens, Gan & Yurtoglu (2018), I use three different measures of reporting quality in order to examine whether firms engage in EM when they are related to the submission of a SOP proposal. High reporting quality reveals a better impression of a firms' condition and, on the contrary, low reporting quality does not reflect the real condition of the firm (Healy & Wahlen, 1999). The link to EM is that managers have the opportunity to exercise their managerial discretion in the firms' reporting process. On the one hand, this is an advantage because the private information and knowledge of managers is useful to reflect the real condition of the firm (Ball & Brown, 1968). On the other hand, managers can use their managerial discretion to drive earnings in a desired way and, therefore, the real condition of the firm would not be reflected. In the last case, reporting quality would be low and the state of firm would be ambiguous (Healy & Wahlen, 1999) due to the improper use of managerial discretion.

The first measure of reporting quality is *Audit fees*. This proxy captures the demand for monitoring of the financial reporting process, which is influenced by firm-specific (e.g. firm's organizational structure and complexity of

business) and external factors that affect the transparency and riskiness of the financial reporting process (Engel, Hayes & Wang, 2010). High demand for monitoring occurs when investors and other stakeholders perceive that the financial reporting process is not transparent and is at great risk. On its turn, greater demand for monitoring of the financial reporting process affects the scope and complexity of audit activities and thus influences the audit fees payed to auditors. Furthermore, *Audit fees* captures the perception of a firms' reporting quality from the perspective of the auditor. Therefore, I use *Audit fees* to proxy for demand for monitoring of the financial reporting process and the perception of the auditor regarding reporting quality by using the following OLS regression model:

$$LOG_AuditFees_{t+1} = \beta_0 + \beta_1 SOP_{it} + \beta_3 SIZE_{it} + \beta_4 ROA_{it} + \beta_5 GROWTH_{it} + \beta_6 LEV_{it} + \beta_7 L_TACC_{it} + \beta_8 INST_OWN_PCT_{it} + \beta_9 MAN_OWN_PCT_{it} + (3) + Year fixed effects + Firm fixed effects + \varepsilon_{it}$$

where $LOG_AuditFees$ represents the natural logarithm of audit fees of firm *i* in year t+1. Higher values of audit fees indicate that there is greater demand for monitoring of the financial reporting process by investors and stakeholders. This implies that auditors, investors and other stakeholders perceive reporting quality of the firm as low in year t+1. Therefore, more audit activities are required, which results in higher audit fees. Again, *SOP* is the variable of interest of this regression model. As mentioned before, this is a binary variable that is equal to 1 if an US firm receives a SOP proposal in year *t* and otherwise 0. Positive values for the coefficient *SOP*, would result in higher audit fees, which would suggests that reporting quality is low. This OLS regression model is augmented with control variables, firm and year fixed effects.

The second measure of reporting quality is *SOX 404*. This proxy examines reporting quality from a different perspective namely the effectiveness of a firms' internal reporting process by assessing the disclosure of internal control weaknesses under SOX 404. The presence of internal control deficiencies is related to probability that annual or interim financial statements might contain material misstatements (PCAOB, 2004). Therefore, the internal control weaknesses of a firms' internal reporting process is an indicator of reporting quality. Prior research shows an association between effectiveness of internal controls and reporting quality. According to Ashbaugh-Skaiffe, Collins & Kinney (2007), firms that disclose internal control deficiencies, are subjected to organizational changes, have greater accounting risk and are involved in operations that are more complex. Moreover, these firms are characterized by having more prior SEC financial restatements and enforcement actions, indicating consequences for reporting quality. Following Erkens, Gan and Yurtoglu (2018), I use *SOX 404* as a proxy for reporting quality in the binary logit regression model presented in Equation (4):

$$SOX404_{it+1} = \beta_0 + \beta_1 SOP_{it} + \beta_3 SIZE_{it} + \beta_4 ROA_{it} + \beta_5 GROWTH_{it} + \beta_6 LEV_{it} + \beta_7 L_TACC_{it} + \beta_8 INST_OWN_PCT_{it} + \beta_9 MAN_OWN_PCT_{it} + (4) + Year fixed effects + Firm fixed effects + \varepsilon_{it}$$

where *SOX 404* is the dependent variable, which represents the likelihood that the independent auditor of firm *i* identifies material internal control weaknesses in year t+1. A high probability of the identification of material internal control weaknesses by an independent auditor indicates lower reporting quality. *SOP* is, again, the variable of main interest in this regression model. Given that the coefficient *SOP* is positive, this means that there is higher probability of an auditor identifying material internal control weaknesses and thus lower reporting quality. Following Ashbaugh-Skaife, Collins & Kinney (2007), I include control variables to control for firm characteristics and corporate governance. Furthermore, the binary logit regression model also includes year and firm fixed effects.

The last proxy for reporting quality is *MEET*, which captures the meet or beat behavior of a firm. As mentioned before, managers have different incentives to engage in EM such as the capital market incentives (Healy & Wahlen, 1999). Given that managers are driven by these incentives, managers are motivated to meet or beat analysts' forecasts and, thereby, use their managerial discretion to achieve their goal. In order to detect meet or beat behavior, it is common to analyze the discontinuity of earnings distributions around forecasts as this is viewed as evidence for EM (Graham, Harvey and Rajgopal., 2005). Therefore, I use the proxy *MEET* in a logic regression model to detect EM as shown in Equation (5):

$$MEET_{t+1} = \beta_0 + \beta_1 SOP_{it} + \beta_3 SIZE_{it} + \beta_4 ROA_{it} + \beta_5 GROWTH_{it} + \beta_6 LEV_{it} + \beta_7 L_TACC_{it} + \beta_8 INST_OWN_PCT_{it} + \beta_9 MAN_OWN_PCT_{it} +$$
(5)
+Year fixed effects + Firm fixed effects + ε_{it}

where *MEET* is the dependent variable, which captures the probability that firm i meets or beats the analysts' forecasts of the earnings per share by zero to one cent in year t+1. A high probability of meeting or beating analysts' forecasts indicates low reporting quality. The variable of main interest in Equation (5) is *SOP*. A positive value of the coefficient *SOP* would mean a higher probability of meet or beat behavior. Furthermore, Equation (5) is completed with control variables, firm and year fixed effects.

4.3 Control variables

This study uses several control variables to account for confounding effects between the dependent and independent variables. Based on prior research (Hadani et al., 2011), the control variables included in these equations consist of variables to control for company characteristics (size, performance, leverage, growth, lagged total accruals) and control variables concerning corporate governance (level of institutional and managerial ownership). The definition and calculation of these variables are shown in Appendix C, Table 1.

The first control variable is firm size (*SIZE*). Previous research provides evidence that there is a relation between firm size and EM. For instance, Burgstahler and Dichev (1997) show that firms, large and small, manage earnings to prevent small profits decline. In line with these findings, Degeorge et al. (1999) show that large firms tend to engage in EM to prevent negative earnings. Therefore, to control for confounding effects, firm size (*SIZE*) is added to the regression models in Equations (2), (3), (4) and (5). Following several studies (Chung et al., 2002;

Cornett et al., 2008; Hadani et al., 2011), firm size is measured as the natural logarithm of total assets. The transformation of total assets is needed to reduce the impact of outliers in the data.

In addition, different control variables are added in order to control for firm performance such as return on assets (*ROA*), cash flow (*CFO*), firm growth (*GROWTH*) and firm leverage (*LEV*). Prior research shows a positive relation between firm performance and the amount of managed earnings (Abarnell & Lehavy, 2003). This is in line with Kothari et al. (2005) who suggest that firm performance should be accounted for when detecting EM. Therefore, *ROA*, measured as ratio between income before extraordinary items and discontinued operations divided by total assets, is included as a control variable for firm performance. In the same line, *CFO* is added to prevent confounding effects. Following Peasnell et al. (2000), this control variable is measured as cash flow from operations scaled by lagged total assets and controls for an extreme level of firms' performance (Bekiris & Doukakis, 2011). Furthermore, research shows a relation between company growth and EM. Skinner & Sloan (2002) examine the relation between accruals and the growth rates of the companies. They conclude that companies with high grow rates are associated with higher income-increasing accruals. Therefore, it is also important to control for firm growth. This is measured as the change of revenue to prior year. This research also controls for firm leverage (*LEV*). Defond and Jiambalvo (1994) argue that highly leveraged firms have incentives to manipulate discretionary earnings in order to avoid debt covenant violation. Besides, these firms are associated with poor performance.

Additionally, the control variable lagged total accruals (L_TACC) in Equation (1) controls for accounting flexibility. According to Dechow et al. (1995) accruals revert to their mean within a year. This means that the ability of managers to manage current earnings upward decreases when the level of lagged total accruals is high. However, when the level of lagged total accruals is low, managers have more opportunities to manage current earnings upward. Lagged total accruals are measured as prior year total accruals.

Finally, the level of institutional and managerial ownership in terms of the percentage of shares held by institutional owners (*INST_OWN_PCT*) and managers (*MAN_OWN_PCT*) respectively are included in Equation (1). Chung et al. (2002) argue the presence of institutional shareholders affect discretionary accruals. The reason is that these shareholders are motivated to engage in monitoring activities (Chen et al., 2007). Moreover, Balsam (2002) argues that institutional owners are better in detecting EM compared to other owners due to their accessibility to timely and important information. In the case of managerial ownership, Warfield et al. (1995) find an inverse relation between managerial ownership and discretionary accruals, indicating a negative association between these two variables.

4.4 Data

This research examines whether the submission of a SOP proposal has an effect on earnings management during the period 2009 – 2017. I use Wharton Research Data Services (WRDS) and Proxymonitor.org to collect data regarding the independent (SOP), independent (Discretionary accruals, Audit fees, SOX 404 and Meet or beat) and control variables (firm size, ROA, cash flow, firm growth, leverage, lagged total accruals, institutional and managerial ownership percentage) in this study. WRDS consists of several sub databases from which I use

Compustat Fundamental Annual database, ExecuComp, Thomson Reuters, Audit analytics and I/B/E/S. These databases contain financial, corporate governance, disclosure of internal control material weaknesses and analysts' forecast data respectively. Proxymonitor.org provides data related to SOP proposals.

Starting with the independent variable *SOP*, I use the Proxy Monitor database, which covers all shareholder proposals for the 250 largest public firms (by revenues) in the United States. By means of this database, I obtain data on SOP proposals for the period 2009 - 2017. Since this research is focused on the 250 largest firms of the US, I use the corresponding CUSIP of these firms to obtain data on the independent and control variables in the other databases within WRDS.

After that, I collect data in order to measure the dependent variable discretionary accruals. I estimate this variable by using the Modified Jones model, which is described in Equation (1). The necessary data is retrieved from Compustat Fundamental Annual database. I use this data to calculate the variables of the Modified Jones model (including ROA) and consequently, I calculate the residuals of Equation (1), which represent discretionary accruals. Furthermore, I collect additional data to create certain control variables (firm size, ROA, cash flow, firm growth, leverage and lagged total accruals), which are described in Equation (2). The construction of these variables is shown in Table 1.

Next, I use Audit analytics to collect data regarding the reporting quality proxies: Audit fees and SOX 404. First, I gather the corresponding audit fees for US firms during the period 2009 - 2017. Once I have retrieved this data, I transform audit fees into natural logarithm audit fees (L_AUDITFEES) in order to deal with outliers and to normalize the distribution of audit fees. Then, I use Audit analytics to collect data regarding the disclosure of material internal control weaknesses of each US firm in the sample. I use this data to create the dependent variable SOX 404 based on the quantity of material internal control weakness.

In addition, I use I/B/E/S to collect data regarding the dependent variable Meet in Equation (5). This database contains analysts' forecasts, which I use to analyze whether firms meet or bfieat the analysts' forecasted EPS. Observations with missing values for median forecast of analysts are dropped, since this is where MEET is based on. Furthermore, I use Execucomp and Thomson Reuters to collect data regarding the rest of the control variables (managerial and institutional ownership percentage correspondingly). Following the instructions of Thomson Reuters database, I winsorize institutional ownership percentage at the 1% and 99% level in order to account for outliers. This way, it is less probable that the results are driven by extreme values.

4.5 Sample selection

Table 2 (see below) shows the sample selection process of this study. The sample consists of 276 firms that are subjected to SOP proposals and the sample period is between 2009 and 2017. The submission of SOP proposals is applicable to firms that have a minimum share capital of \$75 million. Hence, the firms that are included in the sample are required to meet this requirement. These firms are selected from the Proxy monitor database¹, which covers all shareholder proposals for the largest firms in the United States based on revenue as this is a common

¹ The firms included in this database are based on revenues as reported by Fortune magazine.

measure to select large firms (footnote: this is traceable from Forbes magazine). This gives 277 US firms. The sample construction process is described in Table 2.

Using the CUSIP identifier of the firms listed in Proxy monitor database, I collect data on these firms in Compustat Fundamentals Annual, ExecuComp and Thomson Reuters database in order to build a sample for the dependent variable *DA*. I start with 3,244 observations. Prior research (Goodwin & Wu, 2016) states that firms in the financial industry are subjected to different regulatory and reporting requirements and, therefore, have an accrual process, which differs significantly from other industries. For this reason, I exclude firms with SIC codes: 6000 – 6999 from the sample as these codes represent firms in the financial industry. In addition, I exclude firms that are encoded as Financial Services from the sample. This reduces the sample to 2,296 observations. Following Goodwin & Wu (2016), I continue with making adjustments to the sample such as eliminating observations with missing or negative total assets and observations missing values to estimate total accruals as indicated in Equation (1). Hereafter, I use CUSIP identifier to merge Compustat Fundamentals Annual, ExecuComp and Thomson Reuters database. After making adjustments to the sample following Goodwin & Wu (2016) and merging several databases, the sample reduces to 1,539 observations, which represent the sample in order to estimate discretionary accruals, *DA* sample.

In order to build a sample for the reporting quality proxies, I merge data on audit fees and SOX 404 obtained from Audit analytics with the *DA* sample by using CUSIP identifier. Consequently, I eliminate unmatched observations and observations with missing values for audit fees and SOX 404. This reduces the total observations for the sample related to the reporting quality proxies to 1,521. Following the same steps, I merge data obtained from I/B/E/S with just mentioned sample. Eliminating unmatched observations reduces the sample to 477 observations.

Initial observations in the Compustat Fundamentals Annual database							
Less: Firms in financial industry (SIC: 6000 - 6999)	(948)						
Less: Observations with missing or negative total assets	(23)						
Less: Observations with missing values for Equation (1)	(580)						
Less: Unmatched observations (Execucomp)	(19)						
Less: Unmatched observations (Thomson Reuters)	(135)						
Total observations for discretionary accruals sample	1,539						
Less: Unmatched observations (Audit analytics)	(18)						
Less: Observations with missing values for audit fees and SOX404	(2)						
Total observations for Audit fees and SOX404 sample	1,521						
Less: Unmatched observations (I/B/E/S)	(1,063)						
Total observations for meet or beat sample	476						

Table 2: Sample construction process

Table 2 shows each step of the sample construction process for the discretionary accruals and reporting quality models.

V RESULTS

This section describes the analysis of the tests in order to answer the research question. This section starts with the analysis of the descriptive statistics and continues with the analysis of the correlation matrix. Hereafter, the results of the univariate and multivariate regression models will be discussed. Finally, this section ends with the analysis of a sensitivity test.

5.1 Descriptive statistics

Table 3 (see below) reports the descriptive statistics for all models and the results of univariate tests for each variable of the samples. These statistics are calculated for the full sample and the full sample divided into firms which do not receive a SOP proposal (SOP=0) and firms which receive a SOP proposal (SOP=1). The descriptive statistics consist of the mean, standard deviation (SD), minimum (Min) and maximum (Max), which describe the distribution of the variables. The mean value of the continuous variables (*Discretionary accruals* and *Audit fees*) indicates the average value computed over eight years. On the contrary, the mean values of categorical variables (*SOX 404* and *Meet*) present, which part of the firms, possess a certain characteristic. The outcomes of the t-test indicate whether there is a significant difference between firms that are classified under SOP=0 and firms classified under SOP=1.

Panel A of Table 3 indicates the summary statistics of each variable for the absolute discretionary accruals sample. The full sample, which contains 1,539 observations, shows a mean of absolute discretionary accruals equal to -0.0004 and reports a minimum of -0.273 and a maximum of 0.258. The portion of the full sample, which is labeled as SOP=0, contains 330 observations and presents a mean of -0.008 for absolute discretionary accruals. The other part of the full sample, SOP=1, shows an absolute discretionary accruals mean equal to 0.002. As result of comparing these means, the univariate test in the last column shows a significant difference between SOP=0 and SOP=1 regarding absolute discretionary accruals. Putting this differently, the means of the absolute discretionary accruals differ significantly between SOP=0 and SOP=1 (-0.010, p < 0.01), indicating that SOP=1 has more propensity to EM compared to SOP=0.

Panel B of Table 3 shows the descriptive statistics of the audit fees, measured as the natural logarithm of audit fees, and SOX 404 samples both categorized by full sample, firms which are classified under SOP=0 and firms which are classified under SOP=1. The full sample contains 1,521 observations and the descriptive statistics of this sample report that audit fees with a mean of 15.835 have a minimum of 12.837 and a maximum of 18.378. The division of the full sample into SOP=0, 330 observations, and SOP=1, 1191 observations, shows an audit fee mean of 15.620 and 15.894 respectively. Similar to the absolute discretionary accruals sample, the difference between the means of SOP=0 and SOP=1 are significant according to the result of the univariate test shown in the last column (0.275, p < X). This finding suggests that SOP=1 requires more audit activities, leading to higher audit fees which implies low reporting quality compared to SOP=0.

Panel B also presents the summary statistics of the SOX 404 sample. The full sample (1,521), SOP=0 (330) and SOP=1 (1,191) proportions of the full sample contain the same number of observations as the audit fee

sample. The mean of SOX 404 is equal to 0.018 and is accompanied by a minimum of 0 and a maximum of 1. The mean of SOX 404 for SOP=0 is equal to 0.012. This is similar to the mean of SOX 404 for SOP=1 which is equal to 0.019. Despite the similarity of means, the univariate result does not show a significant difference in SOX 404 between SOP=0 and SOP=1 (-0.007, p < X), implying that there is no difference in the likelihood that an independent auditor identifies material internal control weaknesses between SOP=0 and SOP=1.

Finally, Panel C of Table 3 shows the descriptive statistics of the meet or beat sample. The mean of the full sample is equal to 0.092 based on 476 observations. The subdivision of the full sample into SOP=0 and SOP=1 divides the 476 observations in 71 and 405 respectively. The summary statistics show a mean of 0.085 for SOP=0 and 0.094 for SOP=1. The univariate result shows that the means of meet or beat for SOP=0 and SOP=1 do not differ significantly (-0.009, p < X), meaning that there is no difference in the likelihood of meeting or beating forecasts between SOP=0 and SOP=1.

Table 3: Descriptive statistics and t-test

Panel A: Discretionary accruals

-									
		Full	l sample		SO	SOP=0		P=1	T-test
	Mean	SD	Min	Max	Mean	SD	Mean	SD	Diff.
Discretionary accruals	-0.0004	0.047	-0.273	0.258	-0.008	0.054	0.002	0.044	-0.010***
Say on Pay	0.849	0.358	0	1	-	-	-	-	-
Firm size	10.164	1.031	7.462	13.569	9.843	0.996	10.252	1.023	-0.409***
Return on assets	0.065	0.068	-0.407	0.536	0.065	0.068	0.065	0.068	-0.0004
Cash flow	0.116	0.070	-0.185	0.586	0.122	0.073	0.114	0.069	0.008
Firm growth	0.007	0.009	0	0.105	0.010	0.013	0.007	0.008	0.003**
Leverage	1.461	5.589	0	161.744	1.254	4.571	1.518	5.837	-0.263
Lagged total accruals	-0.052	0.058	-0.460	0.321	-0.064	0.072	-0.049	0.054	-0.015***
Inst. ownership (%)	0.783	0.122	0.427	1	0.783	0.118	0.783	0.123	0.0001
Man. ownership (%)	0.887	3.469	0	52.113	1.872	5.942	0.629	2.375	1.242**
Number of observations	1,539				330		1,209		

Table 3 (continued)

Panel B: Audit fees and SOX 404

		Full	sample		SOF	SOP=0		P=1	T-test
	Mean	SD	Min	Max	Mean	SD	Mean	SD	Diff.
Audit fees	15.835	0.798	12.837	18.378	15.620	0.758	15.894	0.799	0.275***
SOX 404	0.018	0.203	0	4	0.012	0.134	0.019	0.218	-0.007
Say on Pay	0.783	0.412	0	1	-	-	-	-	-
Firm size	10.158	1.031	7.462	13.569	9.843	0.996	10.245	1.024	-0.402***
Return on assets	0.065	0.068	-0.407	0.536	0.065	0.068	0.065	0.068	-0.0002
Cash flow	0.116	0.070	-0.185	0.586	0.122	0.073	0.114	0.069	0.008
Firm growth	0.007	0.010	0	0.105	0.010	0.013	0.007	0.008	0.003**
Leverage	1.472	5.621	0	161.744	1.254	4.571	1.532	5.879	-0.278
Lagged total accruals	-0.053	0.058	-0.460	0.321	-0.064	0.072	-0.049	0.054	-0.014***
Inst. ownership (%)	0.784	0.122	0.002	1	0.783	0.118	0.784	0.123	0.001
Man. ownership (%)	0.895	3.488	0	52.113	1.872	5.942	0.636	2.391	1,236**
Number of observations	1,521				330		1,191		

Panel C: Meet or beat

	Full sample				SO	SOP=0		P =1	T-test
	Mean	SD	Min	Max	Mean	SD	Mean	SD	Diff.
Meet or beat	0.092	0.290	0	1	0.085	0280	0.094	0.292	-0.009
Say on Pay	0.851	0.357	0	1	-	-	-	-	-
Firm size	10.601	0.891	8.189	13.569	10.134	0.726	10.683	0.893	-0.549***
Return on assets	0.064	0.056	-0.156	0.438	0.068	0.058	0.063	0.056	0.005
Cash flow	0.105	0.049	-0.185	0.326	0.115	0.051	0.103	0.049	0.012
Firm growth	0.004	0.004	0	0.029	0.006	0.004	0.004	0.003	0.002***
Leverage	1.553	3.044	0	50.019	1.113	1.241	1.629	3.254	-0.509
Lagged total accruals	-0.041	0.042	-0.349	0.321	-0.045	0.049	-0.040	0.040	-0.004
Inst. ownership (%)	0.718	0.123	0.002	1	0.733	0.114	0.716	0.124	0.017
Man. ownership (%)	0.170	0.266	0.001	3.709	0.214	0.280	0.162	0.263	0.052
Number of observations	476				71		405		

Table 3 shows the descriptive statistics of the discretionary (Panel A) and reporting quality models (Panel B and C). The descriptive statistics are shown for firms that receive (SOP =1) or do not receive a SOP proposal (SOP=0). In addition, the table shows a t-test in the last column. **, *** represent, respectively, the following significance levels: 1 percent, 5 percent and 10 percent.

5.2 Correlation matrix

The correlation matrix shows the correlation between the variables used in the regression models. This is presented in Table 4 (see below). According to Panel A and B of Table 4, *SOP* is positively associated with *discretionary accruals* and *audit fees*. These findings are significant at significance level 0.05. Furthermore, Panel A shows that discretionary accruals are positively associated with *leverage* and *lagged total accruals* negatively associated with *cash flows* and *managerial ownership*. Panel B reports a positive association between *audit fees* and the variables *size*, *lagged total accruals* and *managerial ownership*. In addition, Panel B shows a negative association between *cash flows*, *growth* and *institutional ownership*. In contrast to Panel A and B, the correlation matrix presented in Panel C and D show no association between independent variable *SOX 404* and *MEET*.

Panel A: Correlation matrix between discretionary accruals and variables												
Variables	DA	SOP	SIZE	ROA	CFO	GROWTH	LEV	L_TACC	INST_OW N_PCT	MAN_O WN_PCT		
DA	1.000											
SOP	0.086*	1.000										
SIZE	0.005	0.163*	1.000									
ROA	-0.016	0.003	-0.017	1.000								
CFO	-0.685*	-0.046	0.022	0.688*	1.000							
GROWTH	0.016	-0.150*	-0.682*	0.160*	0.057*	1.000						
LEV	0.055*	0.019	0.045	-0.037	-0.059*	-0.059*	1.000					
L_TACC	0.268*	0.105*	-0.050	0.079*	-0.237*	0.080*	-0.018	1.000				
INST_OWN_PCT	-0.001	-0.006	-0.525*	-0.112*	-0.118*	0.304*	0.013	0.024	1.000			
MAN_OWN_PCT	-0.130*	-0.145*	0.127*	-0.019	0.053*	-0.047	-0.010	-0.094*	-0.067*	1.000		

Table 4: Correlation matrix

* shows significance at the .05 level

Panel B: Correlation matrix between audit fees and variables												
Variables	AUDIT	SOP	SIZE	ROA	CFO	GROWTH	LEV	L_TACC	INST_OW	MAN_OW		
	FEES								N_PCT	N_PCT		
AUDIT FEES	1.000											
SOP	0.142*	1.000										
SIZE	0.659*	0.161*	1.000									
ROA	-0.034	0.001	-0.022	1.000								
CFO	-0.088*	-0.047	0.017	0.689*	1.000							
GROWTH	-0.465*	-0.149*	-0.683*	0.162*	0.056*	1.000						
LEV	0.012	0.020	0.046	-0.036	-0.060*	-0.060*	1.000					
L_TACC	0.086*	0.102*	-0.052*	0.078*	-0.237*	0.083*	-0.017	1.000				
INST_OWN_PCT	-0.355*	-0.004	-0.520*	-0.108*	-0.116*	0.300*	0.012	0.025	1.000			
MAN_OWN_PCT	0.071*	-0.144*	0.129*	-0.018	0.054*	-0.048	-0.011	-0.093*	-0.068*	1.000		

Table 4 (continued)

* shows significance at the .05 level

, , ,												
Panel C: Correlation matrix between SOX404 and variables												
Variables	SOX404	SOP	SIZE	ROA	CFO	GROWTH	LEV	L_TACC	INST_OW N_PCT	MAN_OW N_PCT		
SOX404	1.000											
SOP	0.015	1.000										
SIZE	-0.078*	0.161*	1.000									
ROA	-0.015	0.001	-0.022	1.000								
CFO	-0.059*	-0.047	0.017	0.689*	1.000							
GROWTH	0.014	-0.149*	-0.683*	0.162*	0.056*	1.000						
LEV	0.004	0.020	0.046	-0.036	-0.060*	-0.060*	1.000					
L_TACC	0.023	0.102*	-0.052*	0.078*	-0.237*	0.083*	-0.017	1.000				
INST_OWN_PCT	0.065*	-0.004	-0.520*	-0.108*	-0.116*	0.300*	0.012	0.025	1.000			
MAN_OWN_PCT	-0.017	-0.144*	0.129*	-0.018	0.054*	-0.048	-0.011	-0.093*	-0.068*	1.000		

Table 4 (continued)

* shows significance at the .05 level

Table 4 (continueu)	4 (continued)
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Panel D: Correlation matrix between meet or be
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Variables	MEET	SOP	SIZE	ROA	CFO	GROWTH	LEV	L_TACC	INST_OW N_PCT	MAN_OW N_PCT
MEET	1.000									
SOP	0.011	1.000								
SIZE	0.009	0.220*	1.000							
ROA	0.090*	-0.033	-0.028	1.000						
CFO	0.096*	-0.085	-0.097*	0.718*	1.000					
GROWTH	0.018	-0.223*	-0.777*	0.088	0.106*	1.000				
LEV	0.007	0.060	-0.050	-0.126*	-0.139*	0.030	1.000			
L_TACC	0.006	0.036	0.042	0.114*	-0.068	0.030	-0.009	1.000		
INST_OWN_PCT	0.030	-0.049	-0.479*	-0.097*	-0.013	0.324*	-0.002	-0.106*	1.000	
MAN_OWN_PCT	0.048	-0.092*	-0.372*	-0.162*	-0.172*	0.266*	-0.015	0.042	0.824*	1.000

* shows significance at the .05 level.

Table 4 shows the correlation matrix for all variables in this study. Panel A shows the correlation matrix between discretionary accruals and all other variables. Panel B, C and D show the correlation matrix of the reporting quality variables and all other variables in this study.

5.3 Univariate regression analysis

Table 5 (see below) shows results of the univariate regression models, which test for the effect of the submission of SOP proposals on EM and a firms' reporting quality. Starting with the *absolute discretionary accruals* regression model, the coefficient of the variable of main interest, *SOP*, is positive and significant (0.010, p < 0.01). This indicates that the absolute level of discretionary accruals in year t+1 is larger for firms that receive a SOP proposal in year t compared to firms that do not receive a SOP proposal in the same year. This suggests that firms that receive a SOP proposal in year t have more propensity to manage earnings. These results are in accordance with the summary statistics in Table 3, which report a larger absolute level for firms that receive a SOP proposal.

Besides the estimation of the absolute of discretionary accruals, this research uses three proxies to capture the reporting quality of firms. The second model, presented in Table 5, uses *Audit fees* as a dependent variable. The results show that the coefficient *SOP* is positive and significant (0.275, p < 0.001), indicating that the value of natural logarithm of audit fees is higher in year t+1 for firms that receive a SOP proposal in year t compared to firms not receiving this proposal. This finding implies that more audit activities are required due to the low reporting quality perceived by auditors, investors and other stakeholders. In other words, firms that receive a SOP proposal in year t show lower reporting quality in year t+1 compared to firms that do not receive a SOP proposal in year t. Moreover, this is consistent with the results of the descriptive statistics in Table 3, Panel B, which show a higher value of audit fees for firms that receive a SOP proposal compared to firm that do not receive a SOP proposal.

The third model in Table 5 contains *SOX 404* as a proxy for reporting quality. In contradiction to the findings of the *absolute discretionary accruals* and *audit fees* regression models, the third model concerning the likelihood of an auditor identifying material internal control weaknesses in year t+1 presents different results. The third model of Table 5 shows that the coefficient *SOP* is not significant, implying that the submission of a SOP proposal in year *t* does not affect the likelihood of the identification of material internal control weaknesses by an auditor in year t+1. This finding indicates that the submission of a SOP proposal in year *t* does not affect the reporting quality of a firm in year t+1. Again, these findings are similar to the results of the descriptive statistics, which conclude the likelihood of an independent auditor identifying material internal control weaknesses does not differ for firms that receive or do not receive a SOP proposal in year *t*.

Meet or beat is the dependent variable in the fourth model and captures the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. The results of the *meet or beat* model in Table 5 report that the variable of main interest, *SOP*, is not significant. These results suggest that the submission of a SOP proposal in year *t* does not affect the likelihood of firms meeting or beating the analysts' forecasted earnings per share by zero to one cent. Putting this differently, the submission of a SOP proposal in year *t* does not affect the likelihood of firms meeting or beating the analysts' forecasted earnings per share by zero to one cent. Putting this differently, the submission of a SOP proposal in year *t* does not influence the reporting quality of a firm in year t+1. This finding is consistent with the finding of the third model. Yet, the result of the fourth model complements the summary statistics, which infer there is no difference in the likelihood of meeting or beating forecasts between firms that receive or do not receive a SOP proposal in year *t*.

Overall, the results of the *absolute discretionary accruals* model suggest that firms have more propensity to manage earnings when they receive a SOP proposal in year *t* compared to firms that do not receive a SOP proposal in year *t*. The analysis of three proxies for a firms' reporting quality shows different results. On the one hand, the *audit fees* model implies lower reporting quality in year t+1 for firms that receive a SOP proposal in year *t* compared to firms that do not receive a SOP proposal in that same year. On the other hand, the *SOX 404* model indicates that the submission of a SOP proposal in year *t* does not affect the likelihood of the identification of material internal control weaknesses by an auditor in year t+1. This implies that the submission of a SOP proposal in year *t* does not affect the reporting quality of a firm in year t+1. Similar to the results of the *SOX 404* model, the *meet or beat* model shows that the submission of a SOP proposal in year *t* does not affect the likelihood of firms meeting or beating the analysts' forecasted earnings per share by zero to one cent. This implies that the reporting quality of a firm is not affected in year t+1.

Univariate test for the effect of SOP on discretionary accruals, audit fees, SOX404 and meet or beat				
	(1)	(2)	(3)	(4)
	DA	Audit fees	SOX404	Meet or beat
SOP	0.010^{**}	0.275***	0.007	0.009
	(3.02)	(5.76)	(0.74)	(0.26)
Intercept	-0.008**	15.62***	0.012	0.085^{*}
_	(-2.73)	(374.66)	(1.64)	(2.55)
Ν	1539	1521	1521	476
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
F-value/ χ^2 -value	9.23	33.21	0.55	0.07

Table 5: The effect of submission of a SOP proposal on EM and reporting quality

Table 5 shows the univariate results of the discretionary accruals model in column (1) and the reporting quality models in columns (2), (3) and (4). Based on two tail tests, *, **, *** represent, respectively, the following significance levels: 1 percent, 5 percent and 10 percent. Furthermore, the F-value corresponds to the OLS models in column (1) & (2) and the χ^2 -value corresponds to the logistic models presented in columns (3) and (4).

5.4 Multivariate regression analysis

Table 6 (see below) presents the results of the multivariate regression models. Like the univariate analysis, the multivariate analysis shows the effect of the submission of a *SOP proposal* on the proxies: *absolute value of discretionary accruals, audit fees, SOX 404* and *meet or beat*. However, these models now include control variables. Column (1) in Table 6 shows the absolute value of discretionary accruals model. According to this regression model, the coefficient of *SOP* is positive and significant (0.00143, p < 0.01), indicating that the absolute value of discretionary accruals is higher in year t+1 for firms that receive a SOP proposal in year t in comparison to firms that do not receive a SOP proposal in the same year. This finding implies that firms have more propensity to engage in EM when they receive a SOP proposal in year t. This is similar to the results of the univariate model reported in Table 5. However, the multivariate model shows a lower value for the coefficient

of SOP (0.001) compared to the univariate model (0.010). This indicates that the effect of SOP on the value of absolute discretionary accruals in the univariate analysis is for one part explained by control variables. This means that, unlike the univariate model suggested, the value of absolute discretionary accruals is lower after controlling for firm characteristics and corporate governance factors. Thus, firms that receive a SOP proposal in year *t* have less propensity in EM. Additionally, the results show that large firms, firms with a large return on assets, firms with large cash flows and firms with large total accruals in the previous year have lower values of absolute discretionary accruals except for firms with large growth.

Column (2) in Table 6 shows the *audit fees* model. Unlike the results of the univariate model presented in Table 5, the multivariate model shows different results. This model presents that the value of the coefficient *SOP* is negative. However, this coefficient is not significant. This means that the submission of a SOP proposal in year *t* does not affect *audit fees* in year t+1, which suggests that the reporting quality of a firm is not influenced by this proposed proposal in year t+1 after controlling for other factors that also affect reporting quality, measured as the natural logarithm of audit fees. This finding is inconsistent with the findings of the univariate model presented in Table 5, which suggest that firms that receive a SOP proposal in year *t* show lower reporting quality in year t+1 compared to firms that do not receive a SOP proposal in year *t*. Yet, the multivariate results are more accurate than the univariate results due to the inclusion of control variables in the model.

Column (3) in Table 6 presents the *SOX 404* model regarding the likelihood of an auditor identifying material internal control weaknesses in year t+1. Consistent with the multivariate results of the model *audit fees*, the multivariate model of *SOX 404* shows that the coefficient *SOP* is not significant. This implies that the submission of a SOP proposal in year t does not have an impact on *SOX 404*. In other words, this proposal does not have an effect on a firms' reporting quality in year t+1. Moreover, in line with the univariate results presented in Table 5, the addition of control variables to control for firm characteristics and corporate governance in the multivariate model of *SOX 404* shows that the coefficient *SOP* is not significant.

Column (4) in Table 6 reports the *meet or beat* model, which captures the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. The results of the *meet or beat* model shows that the coefficient of *SOP* is not significant. Like the univariate *meet or beat* model in Table 5, the multivariate model indicates that the submission of a SOP proposal in year *t* does not affect the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. This implies that the submission of a SOP proposal in year *t* does not affect the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. This implies that the submission of a SOP proposal in year *t* does not have an effect on a firms' reporting quality in year t+1.

Overall, the findings of the *absolute discretionary accruals* univariate and multivariate models suggest that the absolute value of discretionary accruals is higher in year t+1 for firms that receive a SOP proposal in year t in comparison to firms that do not receive a SOP proposal in the same year. This implies that firms have more propensity to engage in EM when they receive a SOP proposal in year t. However, after controlling for other factors, firms show less propensity to engage in EM under the multivariate model. Despite the addition of control variables, the findings regarding reporting quality show similar results. The *audit fees*, *SOX 404* and *meet*

or beat models show that the submission of a SOP proposal in year t does not have an effect on reporting quality in year t+1.

Multivariate test f	or the effect of SOP	on discretionary accu	ruals, audit fees, SOX4	404 and meet or beat
	(1)	(2)	(3)	(4)
	Discretionary accruals	Audit fees	SOX404	Meet or beat
Say on Pay	0.001**	-0.039	-0.015	0.041
	(2.71)	(-1.86)	(-0.64)	(0.63)
Firm size	-0.001*	0.476***	-0.026	0.217^{*}
	(-2.17)	(19.40)	(-0.91)	(2.14)
Return on assets	0.751***	-0.335**	0.173	-0.523
	(246.00)	(-2.79)	(1.25)	(-1.24)
Cash flow	-0.984***	-0.120	-0.204	0.874
	(-270.36)	(-0.83)	(-1.23)	(1.57)
Firm growth	0.243***	-2.426**	-3.288**	28.66*
C	(10.81)	(-2.74)	(-3.23)	(2.01)
Leverage	-0.000	-0.002*	-0.001	-0.001
C	(-0.87)	(-2.03)	(-0.87)	(-0.24)
Lagged total accruals	-0.010***	-0.220*	-0.092	-0.396
	(-3.99)	(-2.15)	(-0.78)	(-1.05)
Inst. Ownership (%)	-0.002	-0.049	-0.039	-0.141
• • •	(-0.87)	(-0.47)	(-0.33)	(-0.35)
Man. Ownership (%)	0.000	0.002	-0.001	0.075
	(0.12)	(0.73)	(-0.18)	(0.66)
Intercept	0.062***	11.54***	0.312	-1.768
1	(9.78)	(46.69)	(1.10)	(-1.70)
Ν	1539	1521	1521	476
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
F-value/ χ^2 -value	9.41	157.21	2.20	1.30

Table 6: The effect of submission of a SOP proposal on EM and reporting quality

Table 6 shows the multivariate results of the discretionary accruals model in column (1) and the reporting quality models in columns (2), (3) and (4). Based on two tail tests, *, **, *** represent, respectively, the following significance levels: 1 percent, 5 percent and 10 percent. Furthermore, the F-value corresponds to the OLS models in column (1) & (2) and the χ^2 -value corresponds to the logistic models presented in columns (3) and (4).

5.5 Sensitivity analysis

Based on the Modified Jones model (Jones, 1991; Dechow et al., 1995), this research uses Equation (1), presented in section *Discretionary accruals as a proxy for earnings management*, to estimate the discretionary part of total accruals. However, according to Kothari et al. (2005), the estimation of discretionary accruals is more accurate after controlling for firm performance. Therefore, I include the variable *ROA* to Equation (1) in order to control for the performance of a firm and estimate the discretionary accruals of a firm. This provides the following equation:

$$\left(\frac{TA_{it-1}}{A_{it-1}}\right) = \beta_0 + \beta_1 \left(\frac{1}{A_{it-1}}\right) + \beta_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{t-1}}\right) + \beta_3 \left(\frac{PPE_{it}}{A_{t-1}}\right) + \beta_4 ROA_{it} + \varepsilon_{it}$$
(6)

where, like Equation (1), the error term represents the discretionary accruals of a firm. Again, I use the discretionary accruals to estimate the effect of the submission of a SOP proposal in year t on the value of the absolute discretionary accruals by using the model presented in Equation (2). These results are reported in Table 7 (see below), which shows the estimation of absolute discretionary accruals with the Modified Jones model in columns (1) & (2) and the performance-adjusted model in columns (3) & (4), following Kothari et al. (2005).

The univariate results of Modified Jones model in column (1) show that the coefficient *SOP* is positive and significant (0.010, p < 0.01). This suggests that the absolute level of discretionary accruals is larger in year t+1 for firms that receive a SOP proposal in year t compared to firms that do not receive a SOP proposal in the same year. This result is identical to the findings under the performance-adjusted model (0.010, p < 0.01) presented in column (3). This implies that firms that receive a SOP proposal in year t have more propensity to engage in EM.

After including the control variables into the univariate model of the first column, the multivariate model, in column (2), shows that the coefficient of *SOP* is still positive and significant (0.001, p < 0.01). However, the value of the coefficient *SOP* encounters a slightly decrease. This suggests that the effect of *SOP* on the value of absolute discretionary accruals in the univariate analysis is for one part explained by control variables. So, after controlling for firm characteristics and corporate governance factors, the results show that firms that receive a SOP proposal in year *t* have propensity in EM but this propensity is less. These findings are consistent with the findings in column (4) under the performance-adjusted model. The comparison between the multivariate results under the Modified Jones model (0.001, p < 0.01) and under the performance-adjusted model (0.002, p < 0.01) shows the same results.

	Modified	Jones model	Performance a	adjusted model
	(1)	(2)	(3)	(4)
	Discretionary	Discretionary	Discretionary	Discretionary
	accruals	accruals	accruals	accruals
Say on Pay	0.010^{**}	0.001**	0.010^{**}	0.002^{**}
	(3.04)	(2.71)	(3.07)	(2.74)
Firm size		-0.001*		-0.001*
		(-2.17)		(-2.01)
Return on assets		0 751***		0.765***
Return on assets		(246.00)		(244.81)
		(240.00)		(244.01)
Cash flow		-0.984***		-0.983***
		(-270.36)		(-264.26)
Firm growth		0.243***		0.227***
		(10.81)		(9.88)
Leverage		-0.000		-0.000
C		(-0.87)		(-0.90)
Lagged total		-0.010***		-0.011***
accruals		-0.010		-0.011
ucciuuis		(-3.99)		(-4.08)
Inst. Ownership		-0.002		-0.002
(%)				
		(-0.87)		(-0.85)
Man. Ownership		0.000		0.000
(%)				
		(0.12)		(0.14)
Intercept	-0.008**	0.062^{***}		0.060***
·····	(-2.73)	(9.78)		(9.33)
Ν	1539	1539	1539	1539
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
F-value/ χ^2 -value	9.23*	9.41*	621.74*	768.21*

Table 7: Sensitivity analyses

Table 7 shows the univariate and multivariate results of the discretionary accruals model in column (1) & (3) and the reporting quality models in columns (2) & (4). Discretionary accruals in column (1) and (2) are calculated based on the Modified Jones model. Column (3) and (4) present the discretionary accrual calculated by using the performance-adjustment model of Kothari et al. (2005). Based on two tail tests, *, **, *** represent, respectively, the following significance levels: 1 percent, 5 percent and 10 percent. Furthermore, the F-value corresponds to the OLS models in column (1), (2), (3) and (4). *t* statistics are presented in parentheses.

VI CONCLUSION

6.1 Conclusion

This research examines whether the submission of a Say on Pay proposal has an effect on earnings management concerning US-based firms in the period between 2009 and 2017. In order to investigate this matter, this study uses different proxies to detect EM. This research starts with the measurement of *absolute discretionary accruals* – measured through the Modified Jones model – as a proxy for EM. This proxy indicates the propensity of firms to engage in EM. Both the univariate and multivariate regressions models of absolute discretionary accruals show positive and significant results, suggesting that firms have more propensity to engage in EM in year t+1 when they receive a SOP proposal in year t. However, the multivariate model shows lower absolute discretionary accruates factors, indicating that firms that receive a SOP proposal in year t have a slightly decrease in propensity to engage in EM. Furthermore, the results of the sensitivity analysis, which considers a performance-adjustment to measure absolute discretionary accruals, are consistent with the results mentioned before.

As the practice of EM has an influence on the quality of financial reporting, this study uses different reporting quality proxies to approach EM from a different perspective. The first proxy for reporting quality is *audit fees*. This proxy captures the demand for monitoring of the financial reporting process by stakeholders in terms of audit fees. The univariate and multivariate models of audit fees present different results. On the one hand, the univariate model shows significant results which imply that firms that receive a SOP proposal in year *t* show lower reporting quality in year t+1 compared to firms that do not receive a SOP proposal in year *t*. On the other hand, the results of the multivariate model show that the reporting quality of a firm is not influenced by this proposed proposal in year t+1 after controlling for firm characteristics and corporate governance factors.

Reporting quality is also proxied by *SOX 404*, which measures the likelihood of an independent auditor identifying material control weaknesses. The univariate analysis shows that the submission of a SOP proposal in year *t* does not affect the likelihood of the identification of material internal control weaknesses by an auditor in year t+1. This suggests that the submission of a SOP proposal in year *t* does not affect the reporting quality of a firm in year t+1. Accordingly, the multivariate model shows that the submission of a SOP proposal in year *t* does not have an impact on *SOX 404*. Putting this differently, this proposal does not have an effect on a firms' reporting quality in year t+1. These findings are consistent with the results of the model *audit fees*, which also claim that the submission of a SOP proposal in year *t* does not have an impact of a SOP proposal in year *t* does not have an impact of a SOP proposal in year *t* does not have an effect on a firms' reporting quality in year t+1. These findings are consistent with the results of the model *audit fees*, which also claim that the submission of a SOP proposal in year *t* does not have an impact a firms' reporting quality in year t+1.

The last proxy for reporting quality is *meet or beat*. This dependent variable measures the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. Similar to the univariate results of *meet or beat*, the multivariate results are not significant. This suggests that the submission of a SOP proposal in year *t* does not affect the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. This implies that the submission of a SOP proposal in year *t* does not affect the likelihood of a firm meeting or beating the analysts' forecast of the earnings per share by zero to one cent. This implies that the submission of a SOP proposal in year *t* does not have an effect on a firms' reporting quality in year t+1.

In summary, the results provide different conclusions about whether to accept or reject hypothesis 1. On the one hand, the proxy *absolute discretionary accruals* shows that firms have more propensity to engage in EM when they receive a SOP proposal in year t compared to firms that do not receive a SOP proposal in year t. Based on this finding, hypothesis 1 is accepted. However, on the other hand, the proxies for reporting quality show that the submission of a SOP proposal in year t does not have an impact on *audit fees*, *SOX 404* and *meet or beat*. In other words, a SOP proposal in year t does not have an effect on a firms' reporting quality in year t+1. Based on these findings, hypothesis 1 is rejected. Overall, the findings of this research does not provide evidence that firms engage in earnings management when they receive a SOP proposal.

The main finding of this research can be explained by the effect of SOP on executive compensation. Prior research has focused on the effect of SOP on executive compensation after the introduction of SOP and it provides mixed evidence regarding this matter. According to Marinilka et al. (2013), SOP has its desired effect, indicating a decrease of executive compensation in 2011 and 2012. However, Iliev & Vitanova (2016) provide evidence, which indicates that SOP does not have an effect on the level and composition of executive compensation. In short, it is not sure whether SOP is effective as it is supposed to. Given that the goal of SOP is to regulate executive pay, it is possible that SOP does not affect executive compensation according to prior research. Therefore, managers do not have the incentives to manage earnings due to the submission of a SOP proposal because it is unsure whether these proposals will reduce executive compensation.

This research contributes to the present literature concerning shareholder activism, more specifically the SOP literature. Prior research has mostly focused and provided mixed evidence on the effect of SOP on CEO compensation. On the one hand, research shows that executive compensation has decreased as result of SOP proposals (Balsam & Yin, 2013; Marinilka et al., 2016). On the other hand, studies conclude that SOP proposals do not have an effect on the level and composition of executive compensation (Iliev & Vitanova, 2013). This study, however, examines the reaction of firms to the submission of SOP proposals. The results of this study contribute to a broader view on the undesired outcomes of shareholder activism through SOP in firms. Furthermore, research on the earnings management and shareholder activism is still scarce. For instance, Hadani et al. (2010) examine the impact of shareholder activism, measured as shareholder proposals, on earnings management.

6.2 Limitations and future research

The findings of this study are confronted with a number of limitations, which serve as a point of departure for future research. One of these limitations is that this research only uses an accrual-based model to detect EM, measured as discretionary accruals. Research shows a certain shift in the way that managers manage earnings. It indicates that managers are shifting away from accruals EM and are engaging more in real EM over the years (Graham et al., 2005). Therefore, I suggest an extension of this study by examining whether firms engage in real EM when they are related to the submission of a SOP proposal during 2009 and 2017. Another limitation is that this study uses a two-step approach, which adds *ROA* in the Modified Jones model, to estimate discretionary

accruals. This approach emphasizes a certain limitation of the accrual-based model used in this study, namely measurement errors. On the one hand, these measurement errors could indicate the occurrence of EM when managers do not engage in EM (Type 1 error) and on the other hand, it could signal that there is no EM, while managers are managing earnings (Type 2 error). A solution for this problem is to use a one-step approach as proposed by Chen et al. (2018). Following this approach, the Modified Jones model includes *ROA* and the variable of main interest, as control variables, in its equation in order to estimate the discretionary accruals.

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APPENDIX A: Literature Table

Authors	Research question	Sample	Results
Chung, Firth and Kim (2002)	Do institutional shareholdings in a firm deter earnings management by its managers?	<i>Period</i> : 1988 – 1996 Sample of 12,478 firm-year observations	The findings of this study shows that managers associated with incentives to increase or decrease earnings use income-increasing or decreasing accruals. However, the substantial presence of institutional owners impedes the opportunistically use of discretionary accruals by managers due to monitoring activities regarding discretionary accruals performed by institutional owners.
Hartzell and Starks (2003)	Is the presence of institutional investors associated with certain executive compensation structures?	<i>Period</i> : 1992 – 1997 Sample of 36,352 firm-executive- year observations	The researchers find a strong association between the presence of institutional investors and executive compensation. The level of executive compensation is negatively associated to institutional ownership concentration, indicating the monitoring role of institutional investors. Moreover, the findings shows that firms adopt compensation structures with more pay-for- performance sensitivity in the presence of institutional shareholders.

Authors	Research question	Sample	Results
Admati and Pfleider (2006)	Does the threat of exit alleviate the conflicts of interest between managers and shareholders?	Sample is based on assumptions and mathematical models	The researchers conclude that the threat of shareholders selling shares is an effective way used by the institutional owners to discipline the management. However, this effect depends on the type of agency problem between shareholders and management.
Cornett, Marcus, Saunders and Tehranian (2007)	What is the impact of institutional ownership on corporate operating performance?	<i>Period</i> : 1993 – 2000 Sample of 737 firm-year observations	This study shows that institutional shareholders, who have or are interested in potential business relationships with the firm, have less tendency to challenge management decisions. These shareholders are less suited to monitor the management. However, institutional shareholders are more willingly to question management decisions and to impose controls over managers when these shareholder not pursuit business relationships.
Chen, Harford and Li (2007)	Is the conduction of monitoring activities in a firm related to certain institutional owners?	<i>Period</i> : 1984 – 2001 Sample of 2,150 firm-year observations	The researchers conclude that independent institutional investors with long-term investments are motivated to engage in monitoring activities rather than to sell their stake partly due to high selling costs. This results in monitoring the management and taking action when institutional investors identify a

APPENDIX A (continued)

problem.

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Authors	Research question	Sample	Results
Ertimur, Ferri & Musl u (2009)	What are the determinants and consequences of compensation- related activism?	Period: 1997 – 2007 Sample of 1,332 shareholder activism events related to executive compensation	The results show that the occurence of vote-no campaings and the submission related to compensation have increased significantly, especially, after the accounting scandals in 2002. In line with these findings, this study shows that firms associated with abnormally high executive compensation are more likely to be targeted by shareholder proposals. The consequences of compensation-related activism are: 1) a decrease in excess CEO compensation for firms targeted by shareholders and 2) the moderating effect of shareholder activism on executive compensation.

APPENDIX A (continued)

Panel B: Earnings management

Authors	Research question	Sample	Results
Healy (1985)	What is the effect of bonus schemes on accounting decisions?	<i>Period</i> : 1930 – 1980 Sample of 1,527 firm-year observations	The findings indicate that bonus schemes have an effect on accounting decisions. According to this study, the selection of accounting procedures is subjected to the managers' incentives arising from bonus schemes. In other words, managers engage in earnings management to optimize bonuses.

	APPENDIX	A (continued)	
Authors	Research question	Sample	Results
DeFond and Jiambalvo (1994)	What is the relation between debt covenant violation and manipulation of accruals?	<i>Period</i> : 1985 – 1998 Sample of 4,100 firm-year observations	The researchers conclude that firms have abnormal accruals in the year prior to the violation of debt covenants, indicating manipulation of earnings upward to avoid violations of contractual commitments.
Guidry, Leone and Rock (1998)	What is the effect of bonus schemes on accounting decisions by business-unit managers?	<i>Period</i> : 1993 – 1995 Sample of 103, 135 and 115 independent business units each year respectively	The study focuses on earnings management and the setting in which bonuses paid to business managers are based on the performance of the business unit. It concludes that business managers use discretionary accruals to reach the maximum level of short-term bonuses.
Gunny (2010)	What is the relation between earnings management and future performance?	<i>Period</i> : 1988 – 2002 Sample of 39,432 observations	This study shows a positive relation between earnings management and firms just meeting or beating earnings benchmarks, which suggests that firms manage earnings to just meet or beat earnings benchmarks. Furthermore, earnings management occurs through the reduction of R&D and selling, general & administrative expenses.

Authors	Research question	Sample	Results
Tabassum, Kaleem and Nazir (2013)	What is the impact of earnings management on subsequent financial performance?	<i>Period</i> : 2004 – 2011 Sample of 119 companies	The research show that future performance deteriorates as consequence of managing earnings to show good results.

APPENDIX A (continued)

Appendix A provides a review of the papers discussed in Section II Literature review. The table is divided into studies related to shareholder activism (Panel A) and earnings management (Panel B).



APPENDIX B: Libby boxes



APPENDIX B (continued)

Appendix B shows the Libby boxes for the two main concepts of this research. It also contains the operational measures of both concepts.

APPENDIX C: Variable description

Table	1:	Variable	description

Variable	Definition	Database		
Dependent variables:				
ABS_DA	Absolute discretionary accruals	Compustat		
Audit fee	Natural logarithm of audit fees	Audit analytics		
SOX404	1 if firm has disclosed material internal control weaknesses, otherwise 0	Audit analytics		
MEET	1 if the difference between the actual earnings price per share and the forecasted earnings price per share is within zero and one cent and takes the value 0 otherwise.	I/B/E/S		
Independent variable:				
SOP	1 if firms receives a SOP proposal in year t, 0 otherwise	Proxy Monitor		
Control variables:				
SIZE	Natural logarithm of total assets (item AT)	Compustat		
ROA	Return on assets (item IB / item AT)	Compustat		
CFO	Cash flow from operating activities (scaled by lagged total assets) (item OANCF/ item AT) Change in total assets from prior year ((item CSHO x item	Compustat		
GROWTH	PRCC_F)/ item CEQ)	Compustat		
LEV	Leverage ((item DLC + item DLTT)/item CEQ)	Compustat		
L_TACC	Lagged total accruals ((item IBC - item OANCF)/ item AT)	Compustat		
INST_OWN_PCT	Percentage of institutional ownership owned by institutional investors	Thomson Reuters		
MAN_OWN_PCT	Percentage of managerial ownership held by managers	Thomson Reuters		
Table 1 in Appendix C shows the definition of the variables used in this study. The variables are categorized in dependent, independent and control variables. Table 2				

also shows the calculation of the variables.