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## Article

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Contemporary Economics

## Provided in Cooperation with:

University of Finance and Management, Warsaw

*Suggested Citation:* Andoh, Francis Kwaw; Osoro, Nehemiah E.; Luvanda, Eliab (2019) : The moderating effect of audit quality on the relation between shareholder activism and earnings management: Evidence from France, Contemporary Economics, ISSN 2300-8814, University of Finance and Management in Warsaw, Faculty of Management and Finance, Warsaw, Vol. 13, Iss. 1, pp. 63-78,  
<https://doi.org/10.5709/ce.1897-9254.299>

This Version is available at:

<https://hdl.handle.net/10419/297469>

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Primary submission: 04.04.2017 | Final acceptance: 05.02.2018

# The moderating effect of audit quality on the relation between shareholder activism and earnings management: Evidence from France

Souha Bouaziz Siala<sup>1</sup>, Anis Jarboui<sup>2</sup>

## ABSTRACT

The present paper aims to provide empirical evidence regarding the impact of shareholder activism on earnings management. Specifically, it is focused on investigating the moderating role of an external governance mechanism such as external audit quality. Based on a sample of French companies listed on the French stock market index (SBF 120 index) from 2008 to 2012, we apply several multiple regressions using a standard methodology devised by Aiken and West (1991). We find that external audit quality plays a moderating role between shareholder activism and earnings management in such a way that it greatly helps to attenuate the relationship in the presence of high-quality external audits.

## KEY WORDS:

shareholder activism, discretionary accruals, earnings management, audit quality index

**JEL Classification:** M41, M420, M480

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## 1. Introduction

The spectacular down falls of large companies such as Enron and WorldCom in the US and France Telecom and Vivendi Universal in France, along with the financial scandals that struck the Credit Lyonnais and Air France in the 1990s, have all contributed to stimulating public interest in corporate governance-related issues. In this context, we have observed the recent emergence of the notion of shareholder activism worldwide. In broader terms, the issues of “shareholder activism” can be defined as the use and exploitation of an ownership position in

actively influencing company policy and the relevant practices (Judge, Gaur, & Muller-Kahle, 2010; Prevost, Wongchoti, & Marshall, 2016; Sjöström, 2008).

Shareholders at all levels, including institutional, individual and minority shareholders, are now noticed for their strategic efforts to control corporations through shareholder activism (Fahmi & Omar, 2005; Gantchev, 2013; Othman & Borges, 2015; Sikavica & Tuschke, 2012; Yeoh, 2010). Hence, the presence of an activist shareholder can be of crucial importance to the proper functioning of corporate governance. Actually, the exercise of voting rights is for activist shareholders the most direct means of controlling the actions of managers. The aim of activist shareholders who exercise control is maximizing their wealth, which is measured by reported accounting numbers. For that

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reason, activist shareholders should be concerned with accounting and financial reporting.

In fact, the previous literature has been largely focused on the impact of shareholder activism on executive remuneration and firm performance (Daily, Johnson, Ellstrand, & Dalton, 1996; Faccio & Lasfer, 2000; Gantchev, Gredil, & Jotikasthira, 2015; Gillan & Starks, 2000; Karpoff, Malatesta, & Walkling, 1996; Khanna & Palepu, 2000; Kochhar & David, 1996; Mínguez-Vera, A., & Martín-Ugedo, 2007; Sahut & Gharbi, 2011; Tsai & Gu, 2007; Woidtke, 2002) and has rarely addressed accounting issues. The lack of studies addressing the effect of shareholder activism on financial information, particularly on earnings management, has been noticeable. Indeed, little evidence is available regarding the correlation between shareholder activism and earnings management. This topic is an important question to examine because the perceived positive effects of shareholder activism and other corporate governance mechanisms are often based on reported accounting measures that are subject to management discretion and manipulation.

In fact, managerial latitude may affect the authenticity of the information they diffuse, as illustrated by the notion of “creative accounting” (Gillet, 1998). Nevertheless, the importance of withholding reliable data about annual accounts provides solid ground for explaining the development of mechanisms whereby the financial statements released by management can be evaluated. Among these mechanisms is the external audit. This mechanism is widely recognized as a major source of external control (O’Sullivan & Diacon, 1994; Yeoh & Jubb, 2001), and the audit continues to play a critical key role in governance insofar as it greatly helps in controlling managerial actions and resolving agency conflicts (Jensen & Meckling, 1976).

The interaction between the corporate governance component of shareholder activism and earnings management as measured by discretionary accruals requires a great deal of investigation. Thus, it seems relevant to study the possible interaction between shareholder activism and earnings management. In this context, the present study is aimed at analyzing the impact of shareholder activism on earnings management and explaining the moderating effect of external audit quality on this relationship.

Hence, the basic problem resulting from the above discussion is the following: *To what extent does exter-*

*nal audit quality exert a moderating effect on the relationship between earnings management, as measured by discretionary accruals, and shareholder activism in the context of French listed companies? In other words, how might shareholder proposals affect earnings management in the presence of high-quality external auditors?*

Thus, the objective of this study consists primarily of studying the impact of shareholder activism on earnings management practices. In fact, an attempt has been made to provide a modest contribution to the literature based on a sample of French firms listed on the SBF 120 while testing the impact of shareholder proposals on discretionary accruals. The present work is structured into three sections, the first of which is a literature review. The second section is devoted to highlighting our research methodology; and an analysis of the results is the subject of the next section. Finally, some concluding remarks and prospective research perspectives are proposed.

## 2. Literature review and hypotheses development

### 2.1. Shareholder activism and earnings management

When there is separation of ownership and control, a variety of mechanisms act to monitor or motivate managers (Xue & Hong, 2016). Many researchers have underlined the association between corporate governance and earnings management (Cornett, Marcus, & Tehranian, 2008; González & García-Meca, 2014; Jaggi, Leung, & Gul, 2009; Lin, Liu, & Noronha 2016). A specific governance mechanism, that is, shareholders activism, is associated with earnings management behavior. Shareholder activism affects earnings management in both directions. Shareholder proposals may discourage earnings management through either an alignment effect or a disciplinary effect. In fact, a negative relation is explained by the objective of resolving conflicts of interest between shareholders and managers and better aligning interests. This alignment allows managers to focus more on activities that create long-term value and worry less about managing current earnings to achieve short-term performance benchmarks. However, in an alternative view, shareholder activism is positively related to earnings management. Hadani, Goranova, and Khan (2011) suggest that shareholder activism

could increase the public scrutiny faced by a firm, and managers may feel more compelled to signal managerial quality by alternative or symbolic means, such as engaging in earnings management. Certain activist shareholders may stimulate more managerial discretion in financial reporting and, thus, more earnings management. Additionally, shareholder proposals may have unintended consequences and create incentives to manage earnings. If shareholders focus on short-term performance, monitoring efforts may pressure managers to smooth earnings or avoid negative earnings surprises (Bowen, Rajgopal, & Venkatachalam, 2008). Using a sample of US firms that are targeted by pay-for-performance proposals (Sun, Wang, Wang, & Zhang, 2013) find that such firms have more discretionary accruals in their reported earnings and larger increases in the level of discretionary accruals around the proposal year. These results also indicate that short-term effects may dominate the alignment and/or disciplinary effects of shareholder monitoring. Based on the above discussion, the following hypothesis is formulated:

**H1: Shareholder activism has an impact on earnings management.**

## 2.2. The role of audit quality

Theoretically, audit quality is the joint probability that the external auditor detects an anomaly in financial statements and then reveals it to external users (DeAngelo, 1981).

Due to recent corporate accounting scandals, the role of auditing in ensuring the quality of reported earnings and constraining client earnings management has come under considerable scrutiny (Astami, Rusmin, Hartadi, & Evans, 2017; Cameran, Francis, Marra, & Pettinicchio, 2015; Chee, Phua, & Yau, 2016; Chen, Chen, Lobo, & Wang, 2011; Chi, Lisic, & Pevzner, 2011; Houqe, Ahmed, & Zijl, 2017; Jordan, Clark, & Hames, 2010; Khalil & Ozkan, 2016; Rusmin, 2010).

Given that firms have sufficient incentives and opportunities to manage earnings, a quality external audit acts as a monitoring governance mechanism in part because it reduces managerial opportunistic discretion in financial statements. In fact, audit quality is perceived to be effective in detecting aggressive earnings management. A high-quality audit firm requires high financial reporting quality in order to pro-

tect its brand name and reputation from the risk that may arise from misleading financial reports by clients (DeAngelo, 1981; Francis & Wang, 2008). Indeed, large audit firms earn considerably higher fees and use part of the audit fee premium to enhance their technological capabilities and hire skilled professionals to design and employ effective tools for detecting misreporting (Craswell, Francis, & Taylor, 1995; Choi, Kim, Liu, & Simunic, 2008). From this perspective, the ability of external audit quality to curb earnings management may constrain the relationship between shareholder activism and earnings management. In other words, while shareholder activism could increase the pressure that executives face to manage financial impressions in the face of higher public scrutiny, high external audit quality could constrain their ability to manage earnings. Therefore, higher audit quality also plays a moderating role in the relationship between shareholder activism and earnings management such that the relationship is weaker in the presence of higher external audit quality. Based on the above discussion, the following hypothesis is formulated:

**H3: Audit external quality weakens the relationship between shareholder activism and earnings management**

## 3. Data collection and research methodology

### 3.1. Sample composition and data collection:

Our initial sample consists of all companies listed on the SBF 120 index over the period of 2008-2012. The data were hand-collected from annual and special reports obtained from the *Infinancial* Database and *DataStream* Database (Thomson Reuters). We eliminated financial and insurance companies, firms from the Netherlands (due to specific regulations), and companies with missing data or outliers. Thus, the final sample consists of 77 firms and a total of 385 firm-year observations.

### 3.2. Research methodology

We use the models listed below to examine the impact of shareholder activism on earnings management and the moderating role of external audit quality in this relationship. These models are estimated by the feasible generalized least squares (FGLS) method, as there is

a problem with heteroskedasticity. The models specifications are shown below:

#### Model 1

$$AD_{it} = \alpha_0 + \alpha_1 IQUA_{it} + \alpha_2 ROE_{it} + \alpha_3 LEV_{it} + \alpha_4 INST_{it} + \alpha_5 CHANGDIREC_{it} + \alpha_6 MANG_{it} + \alpha_7 INDEXTGOV_{it} + \alpha_8 SIZE_{it} + \alpha_9 GROWTH_{it}$$

#### Model 2

$$AD_{it} = \alpha_0 + \alpha_1 PROP_{it} + \alpha_2 ROE_{it} + \alpha_3 LEV_{it} + \alpha_4 INST_{it} + \alpha_5 CHANGDIREC_{it} + \alpha_6 MANG_{it} + \alpha_7 INDEXTGOV_{it} + \alpha_8 SIZE_{it} + \alpha_9 GROWTH_{it}$$

#### Model 3

$$AD_{it} = \alpha_0 + \alpha_1 PROP_{it} + \alpha_2 IQUA_{it} + \alpha_3 ROE_{it} + \alpha_4 LEV_{it} + \alpha_5 INST_{it} + \alpha_6 CHANGDIREC_{it} + \alpha_7 MANG_{it} + \alpha_8 INDEXTGOV_{it} + \alpha_9 SIZE_{it} + \alpha_{10} GROWTH_{it} + \alpha_{11} PROP * IQUA_{it}$$

Where:

AD: discretionary accruals estimated by Raman and Shahrur model (2008)

PROP: number of shareholder proposals

IQUA: external audit quality index consisting of eight items and weighted by item number (8): size of audit firm, existence of co-commission, audit opinion, audit lag, auditor specialization, audit fees, auditor rotation and affiliation of co-commission with the Big 4.

ROE: net income divided by total assets

INST: percentage of shares retained by institutional investors

MANG: dummy variable equal to one if there exists managerial ownership within the firm and zero otherwise

INDEXTGOV: governance index consisting of 10 items, where each item respected assigns one point to the firm

CHANGDIREC: dummy variable equal to one if there is CEO succession and zero otherwise

LEV: total debts divided by total assets

SIZE: natural logarithm of total assets

GROWTH: the ratio of book value to market value per share.

### 3.3. Definition and measure of variables

#### 3.3.1. Dependent Variable: Earnings Management (AD)

Drawing on prior research, this study uses discretionary accruals as a proxy for unobservable earnings

management behavior. The discretionary accruals approach suggested by Raman and Shahrur (2008) is used to measure the discretionary accrual component. This model is recent. We measure discretionary accruals (AD) in two stages. First, we estimate non discretionary accruals (AND) as a function of changes in cash revenues and levels of property, plant and equipment, lagged returns on assets and book-to-market value using the following ordinary least squares (OLS) industry-year model:

$$TA_{it}/AT_{it-1} = \alpha_0 (1/AT_{it-1}) + \alpha_1 ((\Delta REV_{it} - \Delta REC_{it})/AT_{it-1}) + \alpha_2 (PPE_{it}/AT_{it-1}) + \alpha_3 ROA_{it-1} + \alpha_4 BM_{it} + \epsilon_{it}$$

where

$TA_{it}$ : total accruals of firm i in year t measured as

$TA_{it} = \text{Total net income} - \text{Cash flow from operations}$

$AT_{it-1}$ : total assets at the beginning of the period for firm i;

$\Delta REV_{it}$ : change in sales between year t and year t-1 for firm i;

$\Delta REC_{it}$ : change in receivables between year t and t-1 for firm i;

$PPE_{it}$ : gross value of fixed assets in year t for firm i;

$ROA_{it}$ : return on assets ratio net income before extraordinary items scaled by lagged total assets;

$BM_{it}$ : book-to-market ratio, the ratio of total assets to total assets minus the book value of equity plus the market value of equity.

In our estimation of accruals, we follow Hribar and Collins's (2002) approach. Non discretionary accruals ( $AND_{it}$ ) are obtained using the following earnings management model:

$$AND_{it}/A_{it-1} = \hat{\alpha}_0 (1/A_{it-1}) + \hat{\alpha}_1 [(\Delta CA_{it} - \Delta CCR_{it})/A_{it-1}] + \hat{\alpha}_2 (PPE_{it}/A_{it-1}) + \hat{\alpha}_3 (ROA_{it-1}) + \hat{\alpha}_4 BM_{it}$$

The discretionary accruals ( $AD_{it}$ ) of firm i in year t are obtained as the difference between total accruals ( $TA_{it}$ ) and nondiscretionary accruals ( $AND_{it}$ ):

$$AD_{it} = TA_{it}/A_{it-1} - [\hat{\alpha}_0 (1/A_{it-1}) + \hat{\alpha}_1 [(\Delta CA_{it} - \Delta CCR_{it})/A_{it-1}] + \hat{\alpha}_2 (PPE_{it}/A_{it-1}) + \hat{\alpha}_3 (ROA_{it-1}) + \hat{\alpha}_4 BM_{it}]$$

### 3.3.2. Independent variables

#### *Activism Shareholder (PROP)*

To measure shareholder activism, we used the number of shareholder proposals. This measure has been used by several researchers (Bizjak & Marquette, 1998; Daily et al., 1996; David, Bloom, & Hillman, 2007; Ertimur, Ferri, & Muslu, 2010; Hadani et al., 2011; Thomas & Cotter, 2007; Smith, 1996; Strickland, Wiles, & Zenner, 1996; Woods, 1996). These proposals are sponsored by activist shareholders whether institutional, minority or individual.

The following are the most common shareholder proposals:

- Contesting anti-takeover measures
- Contesting dividend amounts
- Challenges of political leaders
- Challenges of executive compensation
- Contesting a financial transaction
- Challenges of accounting earnings
- General assembly interventions
- Complaints filed with the AMF
- Legal complaints
- Requests for an extraordinary general assembly

*External audit quality index (IQUA):* The external audit quality index consists of eight items and weighted by the item number (8):

1. Size of the audit firm,
2. Existence of a co-commission,
3. Audit opinion,
4. Audit lag,
5. Auditor specialization,
6. Audit fees,
7. Auditor rotation,
8. Affiliation of the co-commission with the Big 4.

### 3.3.3. Control variables

✓ *Governance Index (INDEXGOV):* One point is assigned for each item in the 10-item index. It is possible to include bad practices in different categories. There ten criteria are used by Wirtz (2008), Biswas, Bhuiyan, and Ullah (2008) and Huynh (2010):

1. Creation or extension of double voting rights;
2. Creation of specialized committees;
3. Absence of regulated agreements;
4. Absence of authorization for capital increase during an offer period;

5. Absence of authorization for a capital increase without preferential subscription rights;
6. Existence of a standards reference document;
7. Mandate for directors  $\leq 4$  years;
8. Independent board of directors;
9. Separation board/supervisory board;
10. Size of the board of directors.

✓ *Institutional ownership (INST):* We measure institutional ownership as the percentage of shares retained by institutional investors.

✓ *Managerial ownership (MANG):* We measure managerial ownership as a dichotomous variable taking the value 1 if managerial ownership exists within the company and 0 otherwise.

✓ *ROE:* We measure performance as net income divided by total assets.

✓ *CHANGDIREC:* We measure CEO succession as a dummy variable equal to one if there is a new CEO and zero otherwise.

✓ *GROWTH:* We measure growth opportunity as the ratio of the book value to the market value per share.

✓ *Leverage (LEV):* We measure the leverage ratio as the ratio of total debts to total assets.

✓ *Firm size (SIZE):* We measure firm size as the natural logarithm of total assets.

## 4. Empirical results

### 4.1. Descriptive statistics

In this section, descriptive statistics, namely, mean, standard deviation, minimum, maximum, etc., will be presented for each variable.

#### ■ Discretionary Accruals

Table 1 reports summary descriptive statistics for discretionary accruals. Total accruals (TA) are negative, representing 0.06 of total assets. The value of discretionary accruals is, on average, 0.0001, with a maximum and minimum value of 0.159 and -0.294, respectively. We note that the earnings management level appears to vary slightly in our sample.

#### ■ Independent variables

Table 2 reports descriptive statistics for the independent variables and other variables used in the study. According to this table, shareholder activism (PROP) is approximately 66% in our sample. As indicated in

**Table 1.** Descriptive statistics of TA, AND, AD as standardized by anterior period t total assets

Variables	N	Mean	Standard deviation	Minimum	Maximum
TA	385	-0.060	0.057	-0.410	0.082
AND	385	-0.060	0.028	-0.269	0.025
AD	385	0.0001	0.049	-0.294	0.159

Note: **TA**: total accruals. **AND**: nondiscretionary accruals. **AD**: discretionary accruals.

**Table 2.** Descriptive statistics for independent and control variables

Part A: Continuous variables						
Variables	N	Mean	Median	Std.dev	Minimum	Maximum
PROP	385	0.662	0	1.070	0	6
IQUA	385	0.611	0.625	0.157	0	0.875
INST	385	0.356	0.301	0.296	0	0.977
INDEXGOV	385	0.484	0.5	0.134	0	0.8
ROE	385	0.123	0.107	0.771	-2.806	14.296
LEV	385	0.176	0.17	0.168	-0.348	0.631
SIZE	385	15.789	15.664	1.333	12.930	18.962
GROWTH	385	1.598	1.369	1.619	-15.092	13.445

  

Part B: Binary variables						
Variables	N	0		1		
		Frequency	%	Frequency	%	
MANG	385	59	0.153	326	0.847	
CHANGDIREC	385	355	0.922	30	0.079	

Note: **AD**: Discretionary accruals estimated by the Raman and Shahrur model (2008). **PROP**: Number of shareholder proposals. **IQUA**: External audit quality index consisting of eight items and weighted by item number (8). **ROE**: Net income divided by total assets. **INST**: Percentage of shares retained by institutional investors. **MANG**: Dummy variable equal to one if there exists managerial ownership within the firm and zero otherwise. **INDEXGOV**: Governance index that includes 10 items; for each item respected, one point is assigned to the firm. **CHANGDIREC**: Dummy variable equal to one if there is a CEO succession and zero otherwise. **LEV**: Total debts divided by total assets. **SIZE**: Natural logarithm of total assets. **GROWTH**: The ratio of book value to market value per share.

Table 2, external audit quality index has a mean value equal to 0.611. This result indicates that the mean value of the external audit quality index is approximately 61%, with a minimum of 0 and a maximum of 7 (0.875 \* 8). This average rate is quite close to the maximum value of the quality index, indicating that companies listed on the SBF 120 index are particularly likely to hire a high-quality auditor.

Concerning control variables, the descriptive statistics displayed in Table 2 indicate that French companies are characterized by the presence of institutional investors (INST). In fact, institutional investors hold, on average, 36% of firms' capital, ranging from zero to 98%. As a result, these investors have great power within companies, which allows them to exert pressure on managers. Concerning the governance index variable (INDEXGOV), few firms in our sample appear to have poor governance, with an average index value of 5 out of 10 (0.5). Thus, most companies in our sample meet governance criteria. The mean ROE of sampled firms is approximately 12.3%. Regarding leverage, the average debt ratio (LEV) is 17.6%. Moreover, firm size (SIZE), as measured by the natural logarithm of total assets, reaches an average threshold of 15.789, a standard deviation of 1.333, a minimum of 12.930 and a maximum of 18.962. Furthermore, Table 2 reports that CEOs tend to hold a high proportion of shares (MANG) in most companies in our sample (85% of cases). Concerning the growth variable, we note that our companies have high growth opportunities, with an average value of 1.6, since their market values are lower than their book values. Finally, our sample is characterized by few changes in CEOs at 8% of our sample.

#### 4.2. Univariate Analysis

An examination of Table 3 indicates that the relationship between shareholder proposals and discretionary accruals is significant at the 10% level and positive; hence, shareholder activism has a positive impact on discretionary accruals. Thus, shareholders appear to exert pressure on managers to manage earnings, supporting hypothesis 1.

As for the relationship between discretionary accruals and the external audit quality index, it is positive but not statistically significant, indicating that high-quality auditors have no effect on earnings management.

The correlation between discretionary accruals and the presence of institutional investors is positive and statistically significant at the 1% level, which indicates that the more shares investors hold, the more leaders are enticed to manage earnings. Managerial ownership (MANG) has a crucial role to play in discretionary accruals; the univariate correlation between the presence of managers and earnings management is negative and statistically significant. However, CEO succession has no remarkable impact on earnings management. In fact, the correlation between the CHANGDIREC variable and accruals is not statistically significant.

Notably, a strong, positive correlation prevails between accruals and the leverage ratio, which is statistically significant at the 1% level, whereas the correlation between ROE and accruals is non-significant.

The relationship between the growth variable and earnings management is statistically significant at the 1% level, although it has a negative sign. In contrast, the correlation between firm size and accruals is positive and statistically significant.

In summary, although the descriptive and univariate analyses are not categorical, they have revealed certain patterns. Indeed, shareholder activism appears to have a positive effect on earnings management.

#### 4.3. Multivariate analysis

##### 4.3.1. The Pearson matrix and multicollinearity

Tabachnick, Fidell, and Osterlind (2001) suggest that multicollinearity may be a problem when the correlation values between independent variables are 0.90 or higher. The correlations in Table 3 indicate no severe multicollinearity among the independent variables. The variance inflation factors (VIFs) presented in Table 3 are all less than two, also indicating that multicollinearity is not a severe problem (Johnston, 1984).

##### 4.3.2. Regression analysis

The results of the univariate analysis reveal a strong association between shareholder activism and earnings management. The univariate analysis, however, does not control for the effects of other variables that may be related to abnormal accruals and/or other variables. These factors may, in turn, confound the earnings management–shareholder activism relationship. Accordingly, the rest of the empirical results are derived from



**Table 3.** Pearson correlation matrix of dependent and independent variables, VIF and Tolerance tests:

N= 385	Vif	Tolerance	Univariate correlation with AD	prop	iqua	inst	indexgov	mang	changdir	lev	roe	growth	size
PROP	1.10	0.905	0.099*** 0.051	1									
IQUA	1.58	0.630	0.056 0.266	-0.152** 0.003	1								
INST	1.18	0.844	0.138* 0.006	0.0856* 0.093	0.112** 0.026	1							
INDEXGOV	1.30	0.770	0.053 0.297	0.101** 0.046	0.126** 0.013	0.297* 0.000	1						
MANG	1.17	0.853	-0.163* 0.001	-0.053 0.295	-0.004 0.933	0.184* 0.000	0.045 0.371	1					
CHANGDIR	1.06	0.942	0.041 0.415	0.155** 0.002	0.026 0.604	-0.015 0.759	0.034 0.495	0.016 0.753	1				
LEV	1.17	0.852	0.190* 0.000	-0.028 0.574	0.031 0.534	0.117** 0.021	-0.003 0.949	-0.060 0.239	0.009 0.857	1			
ROE	1.34	0.745	0.041 0.414	-0.036 0.480	-0.014 0.781	-0.035 0.488	0.080 0.113	0.024 0.629	0.140* 0.005	0.029 0.564	1		
GROWTH	1.54	0.648	-0.291* 0.000	0.030 0.547	-0.082 0.105	-0.048 0.339	-0.217* 0.000	0.113** 0.025	-0.132* 0.009	-0.282* 0.000	-0.471* 0.000	1	
SIZE	1.73	0.579	0.172* 0.001	-0.026 0.601	0.564* 0.000	0.106** 0.036	0.101** 0.045	-0.223* 0.000	0.047 0.355	0.204* 0.000	-0.020 0.690	-0.156** 0.002	1

Note: **AD**: Discretionary accruals estimated by the Raman & Shahrur model (2008). **PROP**: Number of shareholder proposals. **IQUA**: External audit quality index consisting of eight items and weighted by item number (8). **ROE**: Net income divided by total assets. **INST**: Percentage of shares retained by institutional investors. **MANG**: Dummy variable equal to one if there exists managerial ownership within the firm and zero otherwise. **INDEXGOV**: Governance index that includes 10 items; for each item respected, one point is assigned to the firm. **CHANGDIREC**: Dummy variable equal to one if there is a CEO succession and zero otherwise. **LEV**: Total debts divided by total assets. **SIZE**: Natural logarithm of total assets. **GROWTH**: The ratio of book value to market value per share.

\*, \*\*, and \*\*\*, denote significantly different from zero at the 0.01, 0.05 and 0.10 level, respectively.

multivariate analyses. Table 4 presents the results of linear regression analyses of the relationship between shareholder activism and earnings management.

The results show that shareholder proposals are significantly (at the 0.05 level) and positively associated with discretionary accruals, thus confirming hypothesis 1. This result is consistent with (Fortin et al., 2011;

Guthrie & Sokolowsky, 2010; Guthrie & Sokolowsky, 2012; Hadani et al., 2011; Sun et al., 2013) who report a positive relationship between shareholder activism and earnings management. The presence of activist shareholders is a plausibly convincing factor encouraging managers to resort to earnings management as a low-cost way to help improve short-term performance.

Table 4. Major effect regression

$$AD_{it} = \alpha_0 + \alpha_1 prop_{it} + \alpha_2 roe_{it} + \alpha_3 lev_{it} + \alpha_4 inst_{it} + \alpha_5 changdirec_{it} + \alpha_6 mang_{it} + \alpha_7 indexgov_{it} + \alpha_8 size_{it} + \alpha_9 growth_{it}$$

independent variables	dependent variable: AD Raman and Shahrur (2008)	
	coefficient	significance threshold
PROP	0.004**	0.044
INST	0.022*	0.008
INDEXGOV	-0.002	0.275
MANG	-0.017**	0.013
CHANGDIR	0.001	0.980
LEV	0.022	0.143
ROE	-0.005	0.140
GROWTH	-0.009*	0.000
SIZE	0.006	0.127
Wald chi2	70.18	
Prob > chi2	0.000*	
number of observations	385	

Note: **AD**: Discretionary accruals estimated by the Raman & Shahrur model (2008). **PROP**: Number of shareholder proposals. **IQUA**: External audit quality index consisting of eight items and weighted by item number (8). **ROE**: Net income divided by total assets. **INST**: Percentage of shares retained by institutional investors. **MANG**: Dummy variable equal to one if there exists managerial ownership within the firm and zero otherwise. **INDEXGOV**: Governance index that includes 10 items; for each item respected, one point is assigned to the firm. **CHANGDIREC**: Dummy variable equal to one if there is a CEO succession and zero otherwise. **LEV**: Total debts divided by total assets. **SIZE**: Natural logarithm of total assets. **GROWTH**: The ratio of book value to market value per share.

\*, \*\*, and \*\*\*, denote significantly different from zero at the 0.01, 0.05 and 0.10 level, respectively.

Across the reported FGLS models, several control variables are significant: the presence of institutional investors (INST) has a significant effect on discretionary accruals, with a significantly positive coefficient of 0.0229 that is significant at the 1% level. This finding is consistent with those of (Ajinkya, Bhojraj, & Sengupta, 2005; Bowen et al., 2008; Bradshaw, Bushee, & Miller, 2004; Del Guercio, Seery, & Woidtke, 2008; Ferri & Sandino, 2009; McConnell & Servaes, 1990; Shleifer & Vishny, 1986; Renneboog & Szilagyi, 2010). Indeed, with a high percentage of company shares at their disposal, institutional investors enjoy the power, resources and capacity to monitor. This result confirms the hypothesized effect of shareholder activism on

earnings management. Additionally, the managerial ownership variable (MANG) has a negative impact on discretionary accruals, which is significant at the 10% level. Such a result corroborates the findings of Jensen and Meckling (1976) that high managerial ownership helps minimize interest conflicts between managers and shareholders. In turn, Warfield, Wild, and Wild (1995) discovered that the relevance and reliability of earnings are a positive function of managerial ownership. Hence, the leader's shareholding acts as a governance mechanism (Fama, 1980; Chung & Pruitt, 1996) whereby the earnings management tendency can be reduced. This idea has been empirically confirmed in several investigations, mainly those conducted by

Table 5. Regressions summary

independent variables	Model 1		Model 2		Model 3		Model 4: high-level audit		Model 5: low-level audit	
	coefficient	significance level	coefficient	significance level	coefficient	significance level	coefficient	significance level	coefficient	significance level
INST	0.024*	0.005	0.023*	0.008	0.023*	0.007	0.017**	0.045	0.055*	0.005
INDEXGOV	-0.001	0.381	-0.002	0.283	-0.002	0.295	-0.002	0.254	-0.001	0.718
MANG	-0.018*	0.010	-0.017**	0.015	-0.017**	0.013	-0.018*	0.009	-0.024	0.127
CHANGDIR	0.003	0.713	0.001	0.976	0.001	0.950	-0.002	0.794	0.001	0.955
LEV	0.020	0.173	0.021	0.152	0.223	0.140	0.038*	0.010	-0.007	0.862
ROE	-0.005	0.123	-0.005	0.139	-0.005	0.134	0.001	0.728	-0.125*	0.001
GROWTH	-0.008*	0.000	-0.009*	0.000	-0.009*	0.000	-0.004**	0.030	-0.012*	0.003
SIZE	0.007	0.142	0.007	0.169	0.006	0.222	0.009***	0.053	-0.009	0.525
IQUA	-0.010	0.576	-0.004	0.832	0.006	0.783				
PROP			0.004***	0.052	0.009	0.147	0.003	0.101	0.009*	0.088
PROP*IQUA					-0.008	0.428				
Wald chi2	65.820		70.230		70.970		33.130		45.480	
Prob > chi2	0.000*		0.000*		0.000*		0.000*		0.000*	
Number of observations	385		385		385		272		113	

Note: **AD**: Discretionary accruals estimated by the Raman & Shahrur model (2008). **PROP**: Number of shareholder proposals. **IQUA**: External audit quality index consisting of eight items and weighted by item number (8). **ROE**: Net income divided by total assets. **INST**: Percentage of shares retained by institutional investors. **MANG**: Dummy variable equal to one if there exists managerial ownership within the firm and zero otherwise. **INDEXGOV**: Governance index that includes 10 items; for each item respected, one point is assigned to the firm. **CHANGDIREC**: Dummy variable equal to one if there is a CEO succession and zero otherwise. **LEV**: Total debts divided by total assets. **SIZE**: Natural logarithm of total assets. **GROWTH**: The ratio of book value to market value per share.

\*, \*\*, and \*\*\*, denote significantly different from zero at the 0.01, 0.05 and 0.10 levels, respectively.

Warfield et al. (1995) and Peasnell, Pope, and Young (2005). The GROWTH variable appears to have a negative and significant effect at the 1% level, confirming the results published by Caton, Goh, and Donaldson (2001) and Chung, Firth, and Kim (2005) that growth could well affect the tendency to engage in earnings management practices. In other words, rapidly growing firms are more likely to be associated with earnings management (Matsumoto, 2002).

Table 5 reports the regression results for the test of H2, a moderating role of external audit quality on the

relationship between shareholder activism and earnings management.

With respect to Models 1, 2 and 3, the FGLS regression results indicate that the IQUA variable is negative but non-significant. *Thus, hypothesis 2 is not confirmed.* Therefore, high-level auditors appear to have no significant influence on earnings management. Therefore, the presence of external auditors, whatever their level might be, does not participate significantly in altering discretionary accruals. This finding reveals that the practice of earnings manage-

ment is not tightly linked to the external audit quality index, despite auditors' high qualifications with respect to French companies. Indeed, neither Piot (2001) nor Vander Bauwhede, Willekens, and Gaeremynck (2003) validated the effect external audit quality on earnings management.

The interaction shown in Model 4, PROP IQUA is non-significant. This result might be explained by the fact that 70% of companies in the sample have high-level external auditors, which does not yield the anticipated results. Notably, model 4 highlights that the audit quality index has no impact on accruals.

For the purpose of testing our exploratory interaction hypothesis, the standard methodology devised by Aiken and West (1991) will be applied for interaction conditions to be established, as the interaction in Model 3, PROP\*IQUA is non-significant. In this respect, we also consider applying a sample division, as recommended by previous research. Specifically, the data are separately reanalyzed with respect to having a high-level external auditor. Auditors are considered high level when the index value is greater than the median (0.625) (Model 4) and low level (Model 5) otherwise. Model 4 indicates that the interaction coefficient between discretionary accruals and shareholder proposals is positive, though non-significant. The results show that for a subsample of companies with high-quality external auditors, shareholder proposals have no impact on discretionary accruals. In model 5, however, the interaction coefficient between shareholder proposals and accruals is positive and significant. This finding demonstrates that for a subsample of companies with low-level external auditors, shareholder proposals have a significant impact on discretionary accruals. Hence, such results indicate that external auditor quality plays a moderating role in the relationship between shareholder activism and earnings management. Based upon these analyses, we find the high external audit quality weakens the relationship between shareholder activism and earnings management. This finding suggests that shareholder activism and external audit quality are substitute governance mechanisms. This refers to the direct functional replacement of the first mechanism (shareholder activism) by the second (external audit quality), and vice versa. In this way, shareholder activism and external audit quality act as substitutes for one another to pro-

vide a high level of monitoring and incentives to control agency issues.

## 5. Conclusion

Very few studies have addressed the subject of the relationship between shareholder activism and earnings management. Thus, the present work examines this type of relationship in the French context over the period ranging from 2008 to 2012 using firms listed on the SBF 120 index. The empirical results indicate the existence of a significantly positive relationship between shareholder activism and earnings management. Indeed, the presence of activist shareholders plausibly encourages managers to resort to earnings management as a low-cost method of improving short-term performance. Thus, activist shareholders encourage managers to engage in earnings management practices in a bid to inflate profits. In addition, the results reveal that high-level auditors appear to have no significant impact on the practice earnings management. As a matter of fact, the mere presence of an external auditor, regardless of quality level, does not significantly alter discretionary accruals undertakings. This finding highlights that the practice of earnings management is not closely linked to the external audit quality index, despite the remarkably high quality of auditors with respect to French companies. Notably, external audit quality, as an external governance mechanism, appears to play a moderating role likely enhancing and activating the relationship between shareholder activism and accruals using a standard methodology devised by Aiken and West (1991).

Our results make several contributions to the literature. To the best of our knowledge, we are the first to document the moderating role of external audit quality on the relationship between shareholder activism and earnings management. Second, we extend prior work on shareholder activism and its impacts on accounting choices, particularly that of Hadani et al. (2011); Fortin, Subramaniam, Wang, and Zhang, (2011); Gurthrie and Sokolowsky (2012) and Sun et al. (2013). We show that the presence of activist shareholders plausibly encourages managers to resort to earnings management as a low-cost method of improving short-term performance. Additionally, this study makes a major contribution to research on shareholder activism by demonstrating the effects of

activist shareholders on accounting choices. Our research is valuable for researchers, shareholders and regulators. For researchers, this is an innovative area for future research. For shareholders, this research shows the moderating role of audit quality, which is likely to further enhance and activate the relationship between shareholder activism and accruals. This study also helps regulators improve accounting rules and reinforce corporate governance.

While our research makes several noteworthy contributions, our study does have limitations. First, the sample size is quite small (77 firms). Second, the focus of the study is on shareholder proposals as a measure of shareholder activism, though they could be either formal or informal, as documented by Brandes, Goranova, and Hall (2008). Thus, such proposals might well be undertaken behind the scenes, just as negotiations, mutually exclusive and private, could be (Prevost & Rao, 2000). It is worth highlighting that a more recent study has revealed that executives are more liable to implement the proposals submitted by silent shareholders (David et al., 2007).

It is also worth mentioning that future research could focus, on the one hand, on the impact of other variables likely to impact the relationship between shareholder activism and earnings management, measuring discretionary accruals such as regulation. On the other hand, a second application likely to improve this study's validity would be an international comparison (mainly among the French, German and US contexts) of the impact of shareholder activism on earnings management, as measured through discretionary accruals, in a bid to clarify this research area.

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