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Stock liquidity and managerial short-termism

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A B S T R A C T

We examine whether stock liquidity exacerbates or mitigates managerial short-termism. Utilizing earnings management as a proxy for managerial short-termism, we establish three major findings. First, firms with liquid stocks engage in less accrual-based and real earnings management. Second, the effect of stock liquidity on earnings management is amplified for firms with high levels of managerial pay-for-performance sensitivity. Third, the positive association between the intensity of earnings management and firm cost of capital is evident only for firms with low stock liquidity. Our findings are consistent with the threat of blockholder exit as the main governance channel through which stock liquidity discourages opportunistic earnings management and mitigates managerial short-termism.

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> *"Take care of this quarter's numbers, and the future will take care of itself! This oft-repeated adage captures the essence of the short-termism that the corporate and investment communities practice"*
>
> Alfred Rappoport, *Saving capitalism from short-termism: How to build long-term value and take back our financial future* (2011, p. 1)

1. Introduction

Managerial short-termism, or the "desire to achieve a high stock price by inflating current earnings at the expense of long-term growth" (Stein, 1989), is a major issue of interest to academics, practitioners, and legislators. Jacobs (1991), Porter (1992) document that U.S. managers have been heavily criticized for their obsession with short-term performance and their myopic investment behavior. Indeed, Graham et al. (2005) report that 78% of executives would sacrifice long-term value to meet near-term earnings targets. In a similar vein, the Chartered Financial Analyst (CFA) Institute and the Business Roundtable Institute for Corporate Ethics emphasize that the excessive focus that corporate executives place on short-term earnings destroys long-term value for shareholders (Krehmeyer et al., 2006). In a more recent study, Dichev et al. (2013) report that, in any given period, 20% of firms manage earnings in an attempt to influence stock price and avoid adverse compensation and career concerns. These studies clearly highlight the importance of understanding the determinants of managerial short-termism, which is viewed as a first-order problem by academics and practitioners (Edmans, 2009).

Utilizing an earnings management setting, this paper examines how stock liquidity affects managerial short-termism. Prior research shows that managers resort to earnings management using their discretion in financial reporting and investment decisions to pursue short-run objectives, and that the long-term costs of such activities for shareholders are substantial (Bushee, 1998; Teoh and Wong, 2002; Aboody et al., 2005; Bhojraj and Libby, 2005;

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