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Corporate General Counsel and Financial Reporting Quality

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We examine the role of general counsel (GC) in firms' financial reporting quality. GCs have a broad oversight role within the firm, including keeping the firm in compliance with laws and regulations and dealing with potential violations with respect to financial reporting. Several high-profile U.S. Securities and Exchange Commission (SEC) investigations have resulted in lawsuits or indictments against GCs for perpetrating financial fraud and caused many to ask: where were the gatekeepers? As such, we examine the conditions under which GCs may stray from their primary role as gatekeepers. Mainly, we empirically investigate claims that compensation can impair the independence or compromise the professional judgment of a GC. We measure the level of compensation using the GC's presence or absence in the top five officers of the firm by compensation. Results are consistent with GCs straying from their role as gatekeepers, to some extent, when highly compensated in a manner similar to the CEO and CFO. In particular, firms with highly compensated GCs have lower financial reporting quality and more aggressive accounting practices, including management of the litigation reserve. However, the results also show that highly compensated GCs play an important gatekeeping role in keeping the firm in compliance with generally accepted accounting principles. Thus, highly compensated GCs appear to tolerate moderately aggressive behavior but constrain it such that it would not result in violation of securities laws and jeopardize their standing within the firm.

Keywords: corporate counsel; financial reporting; accounting quality; earnings management; incentives
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In truth, the world of the corporate lawyer probably more closely borders on that of the accountant than that of the litigator/advocate. For example, in practice, corporate lawyers are likely to be far more familiar with 'generally accepted accounting principles' than with the Federal Rules of Civil Procedure (which is the bible for litigators).

(Coffee 2006, p. 193)

1. Introduction

In recent years, a debate has ensued regarding the role of general counsel (GC) in financial reporting failures. GCs are facing criticism as the sheer complexity of transactions has connected the fields of law and accounting, placing them within the financial reporting environment.[1] Although GCs may not be involved in routine accounting activities, they are often consulted for major accounting decisions (e.g., to estimate future legal contingencies) and play an important oversight role. The U.S. Securities and Exchange Commission (SEC) has been prosecuting record numbers of GCs for failing to prevent accounting fraud, and the U.S. Congress has initiated rules governing corporate GCs' behavior with respect to financial reporting, compensation, and duties to the corporation.[2] One plausible explanation for GCs' failure to discharge their gatekeeping role is that the compensation and incentives that they receive alter their role within the firm. In particular, some argue that highly paid GCs tend to view executives as clients

[1] Some corporations, primarily very small ones, do not have in-house attorneys and instead rely entirely on outside lawyers or law firms as their legal counsel.

[2] Stephen Cutler, then director of the SEC's enforcement division, expressed similar views in a speech given on September 20, 2004 (Cutler 2004): "Consistent with Sarbanes–Oxley's focus on the important role of lawyers as gatekeepers, we have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate. We have named lawyers as respondents or defendants in more than 30 of our enforcement actions in the past two years."

and fail to fulfill their duties to the corporation and its shareholders.[3] We test this hypothesis by examining whether and to what extent highly paid GCs fail to discharge their gatekeeping responsibilities and allow executives to report more aggressively, thereby reducing financial reporting quality.

The GC is often called the "gatekeeper" because he or she regularly exerts a cautious, conservative influence on the firm. For example, Jagolinzer et al. (2011) find that when the GC's approval is required for insider trades, executives are constrained from using their private information to extract rents from shareholders via insider trading. This conservative influence pervades firms' accounting and disclosure practices. Krishnan et al. (2011) document that the presence of directors with legal backgrounds on the audit committee is associated with higher financial reporting quality. Furthermore, Bamber et al. (2010) and Kwak et al. (2012) find that GCs exert an economically significant influence on their firms' voluntary disclosure choices—in terms of the likelihood of issuing forecasts as well as issuing less optimistic and more accurate forecasts.

The gatekeeper view is consistent with corporate attorneys facing an asymmetric loss function: they are blamed when the firm fails but are not credited when risky decisions succeed. In the area of disclosure and reporting, this has led some to refer to corporate attorneys as gatekeepers responsible for monitoring the accuracy of corporate disclosures and representing the shareholders and public (Coffee 2003). Moreover, regulators are increasingly focusing on the role of the GC in facilitating accounting frauds. For example, the SEC has actively pursued lawyers at companies where fraud was discovered (Johnson 2004, MacLean 2007). The asymmetric loss function coupled with heightened regulatory oversight on lawyers compels the GC to persuade management to be less aggressive and provide higher quality financial statements.

The GC's primary gatekeeper role, however, may break down if the corporation compensates the GC such that it impairs independence or compromises professional judgment. Higher levels of compensation that are incentive based, similar to those offered for CEOs and CFOs, are becoming widespread when GCs take on broader roles as members of the senior management team involved in a firm's strategic decision making and shaping its corporate culture. This, in turn, aligns the interests of GCs with those of the CEO and the CFO, potentially diminishing their monitoring role. Therefore, we posit that such highly paid GCs are more likely to facilitate rather than inhibit aggressive financial reporting practices. That said, regulatory changes (e.g., the Sarbanes–Oxley Act of 2002) following the Enron financial reporting scandal hold corporate lawyers more accountable for their actions and may act as a deterrent to such behavior. Thus, it remains an empirical question whether compensation can encourage GCs in the upper echelons of management to stray from the gatekeeping role and engage in aggressive financial reporting practices.

Our primary measure of the GC's stature and compensation level within the firm is based on whether the GC's total compensation is among the top five best-compensated officers of the firm. Our sample includes 2,133 firms in ExecuComp for which we could obtain the necessary data and match with financial information from Compustat. Across the 13,103 firm-years in our sample, the GC is one of the top five best-compensated officers approximately 37% of the time. For financial reporting quality, we use various proxies of reporting quality commonly used in prior literature.

After controlling for the standard determinants of reporting quality, we find that our results are consistent with highly compensated GCs exerting an influence that reduces financial reporting quality, proxied by the variance of residuals from Dechow and Dichev (2002) model and the absolute value of discretionary accruals from Jones (1991) model. In addition, we find that firms with highly compensated GCs have more income-increasing accruals than other firms, suggesting that managers of firms with GCs in the top management are more likely to manage accruals upward. Additional analysis reveals that equity incentives of the GC tend to mirror those of the CEO and the CFO. Thus, equity incentives represent a likely channel that encourages GCs to support aggressive financial reporting choices.

Our results are robust to a changes specification where we only include firms that experienced a change in GC compensation; i.e., the GC either became one of the five highest-paid officers or was no longer one of the five highest-paid officers of the firm. Second, we also conduct an instrumental-variables analysis to address potential concerns about endogeneity and self-selection. Finally, we control for CEO and CFO incentives to address potential correlated omitted variables problem. Again, our inferences are robust.

[3] Consider the case of former Tyco GC Mark Belnick. In addition to his $19 million salary, Belnick received millions more in additional payments, interest-free loans (which went unpaid), and other benefits. Many of these payments were approved solely by CEO Dennis Kozlowski without disclosure to the board or investors. Belnick reportedly became aware of suspicious accounting treatment at Tyco as well as Kozlowski's lavish spending on his girlfriend. However, the loans and compensation offered to him may have encouraged Belnick to overlook these issues and view Kozlowski as his client, forgoing his duties to the corporation and the investing public (Jennings 2003, Kim 2005).

Although our results are strongly consistent with highly compensated GCs tolerating aggressive financial reporting, we find that they are still effective gatekeepers in that they do not allow management to cross the line into activities that would constitute fraud or lead to restatements. In other words, while the highly compensated GCs appear to facilitate aggressive reporting choices, it does not compromise their overall governance and monitoring role. Thus, highly incentivized GCs facilitate aggressive financial reporting but at the same time keep the financial reporting within the boundaries of generally accepted accounting principles (GAAP) and SEC regulations.

Next, we examine two channels through which GCs can directly affect financial reporting. First, firms are required under U.S. GAAP to estimate future litigation contingencies, and GCs are instrumental in this process. We find that our primary results are much stronger among the subset of observations for which there is a contemporaneous change in the litigation contingency. Further, consistent with GCs in the upper echelons succumbing to capital market pressures, we find that firms with highly compensated GCs are more likely to meet or beat analysts' estimates particularly through a change in the litigation contingency reserve. Second, we find that our results are driven by the subset of GCs with expertise in accounting, auditing, or finance. Overall, these tests indicate that GCs with relevant expertise affect financial reporting quality, and they do so (in part) through the estimated litigation contingency reserve.

Our study makes several contributions to the literature. First, this paper adds timely evidence to our limited understanding of the role played by individual executives, in particular, the general counsel. As mentioned earlier, corporate counsel play an increasingly large role in firms, yet researchers have just begun to explore the manner and the extent to which they participate in the financial reporting process. Second, our paper adds to the growing body of evidence that individual managers leave their unique fingerprint on the firm's operations. Specifically, we extend the evidence of Bamber et al. (2010) and Kwak et al. (2012) by showing that the influence of general counsel extends beyond voluntary disclosures. This is an important distinction because voluntary disclosures (e.g., management forecasts) are ex post verifiable, providing plaintiffs a starting point for arguing that managers issued misleading statements. Hence, as Kwak et al. (2012) demonstrate, GCs' primary concern with respect to earnings forecasts is to avoid litigation. On the other hand, GCs' role in earnings management is more nuanced. Absent a complete breakdown in the financial reporting process that results in a subsequent accounting restatement, it is difficult for plaintiffs to prove that firms managed earnings. Moreover, GCs face capital market incentives to tolerate earnings management. As our third contribution, our evidence suggests that reporting choices are not the exclusive province of the CEO and the CFO. Rather, the GC also plays an influential role in the firm's tendency to manage earnings and its overall financial reporting quality.

2. Hypotheses Development

Considerable research in accounting examines the role of various monitors in determining accounting choices and curtailing aggressive financial reporting. Several research papers examine monitoring mechanisms external to the firm such as auditors (Becker et al. 1998), short sellers (Fang et al. 2013), regulators (Kedia and Rajgopal 2011), litigants (Hall and Stammerjohan 1997, Hopkins 2014), and investors (Chung et al. 2002). Other research finds that mechanisms internal to the firm such as experts in the audit committee (Krishnan and Visvanathan 2010, Krishnan et al. 2011), incentive compensation arrangements (Bergstresser and Philippon 2006, Jiang et al. 2010), and internal control systems (Doyle et al. 2007) also play an important role in crafting how the firm accounts for economic transactions.

Whether individual managers play a role in corporate decisions is more controversial. The neoclassical view of the firm allows no role for individuals who as top managers are a homogenous input into the production process and serve as perfect substitutes for one another. The strategic management literature also concludes that managers are interchangeable and, hence, have no idiosyncratic influence on the firm (e.g., Lieberson and O'Connor 1972). However, Hambrick and Mason's (1984) upper echelons theory suggests that managerial leadership is an important force in an organization's evolution and that managers have a unique role in corporate decision making. Bertrand and Schoar (2003) use fixed-effects analyses to document manager-specific effects on corporate decisions. Bamber et al. (2010) and Ge et al. (2011) document that top managers have unique decision-making styles in that they exert economically significant influence on corporate financial disclosures. Dyreng et al. (2010) show that individual managers use different tax-avoidance strategies. Jiang et al. (2010) extend this literature further by documenting that CFOs have relatively more influence than CEOs on financial reporting outcomes. We view our paper as adding a new dimension to this literature—the role of general counsels in the financial reporting process.

General counsels have, over time, gained considerable influence within the firm (Duggin 2006). Yet, their role in financial reporting choices has not been

explored. The GC serves many roles within the firm, some of which are related to financial reporting and disclosures (Duggin 2006, DeMott 2005). For example, they play a "gatekeeping" role in monitoring compliance within the organization and representing shareholder interests by upholding professional standards of conduct (Jagolinzer et al. 2011). Also, they facilitate transactions such as mergers, acquisitions, and patenting of intellectual property, and they defend the firm against litigation. Furthermore, they directly affect financial reporting processes by estimating litigation reserves.

Recent SEC investigations also reveal the importance of general counsel in accounting issues. Following the Sarbanes–Oxley Act of 2002, the fiduciary and professional responsibilities of general counsel are increasingly codified and explicit.[4] The SEC has charged many general counsels in high-profile lawsuits against top officers of the firm for perpetrating accounting fraud (DeMott 2005, SEC 2002a). For example, the SEC filed accounting fraud charges against several former senior executives of the Rite Aid Corporation relating to improper reversal of payables, among other things. The SEC noted that when the general counsel learned about the improper accounting reversal, he directed the payable to be reinstated (SEC 2002b). In this case, the GC appears to have played a gatekeeping role, although he was circumvented by other managers.

Prior evidence demonstrates that GCs influence both the incidence and accuracy of voluntary disclosures, particularly management earnings forecasts (Kwak et al. 2012). However, little is known about whether highly compensated GCs affect their firms' financial reporting quality.[5] The distinction is important because forecasts are ex post verifiable, which provides plaintiffs with a starting point to argue that managers issued misleading statements. Empirically, although management forecasts are infrequent compared to earnings announcements, they trigger more litigation (Donelson and Hopkins 2014). Hence, as Kwak et al. (2012) demonstrate, GCs' primary concern with respect to earnings forecasts is to avoid litigation by issuing more conservative forecasts. The risk of litigation is less pronounced for earnings management than for optimistic forecasts, particularly because earnings management is difficult to prove in a court of law. Absent egregious earnings manipulation resulting in a financial restatement, it is difficult for plaintiffs to establish that earnings have been manipulated. Nevertheless, the monitoring role suggests that general counsels improve financial disclosures, on average.

Although we expect that most GCs serve as gatekeepers, those in the upper echelons of management face incentives to support aggressive financial reporting choices. For example, when GCs are some of the most highly paid executives in the firm, GCs may stray from the gatekeeping role, especially if they are incentivized similarly to the CEO and the CFO (Green 2011). Highly compensated and incentivized GCs may be more likely to act as any other member of the executive team. They are also likely to be involved in strategic discussions and subjected to analysis and opinions consistent with management's (optimistic) assessments. Consequently, they may be less likely to question management's aggressive assumptions. This is particularly likely when the GC's compensation is structured similarly to that of the CEO and the CFO and, hence, susceptible to the same incentives to manage earnings (Nagar et al. 2003).[6] Moreover, since firms with highly compensated GCs provide more management forecasts (Kwak et al. 2012), it is plausible that managers engage in aggressive reporting to minimize expected litigation costs associated with missing market expectations (Kasznik 1999). Thus, we posit that GCs in the upper echelons of management have similar incentives to other members of the top management in tolerating earnings management, leading to lower financial reporting quality. Accordingly, we hypothesize the following (stated in null form).

Hypothesis 1 (H1). *Ceteris paribus, firms with highly compensated general counsel* (*i.e., general counsel that is one of the top five compensated officers of the firm*) *do not engage in more earnings management than firms without highly compensated general counsel.*

Although GCs may, in some circumstances, tolerate earnings management, they may only be willing to go so far as permitted within GAAP. As noted earlier, it is difficult for plaintiffs to easily establish the presence of earnings management, except in extreme accounting violations that result in a financial restatement. Accounting irregularities that result in restatements are closely associated with litigation. Palmrose and Scholz (2004) document that 50% of the restatements in core accounts lead to shareholder litigation. Thus,

[4] For example, Section 307 requires "an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof…" (Pub. L. No. 107-204, 116 Stat. 745).

[5] Choudhary et al. (2013) show that outside counsel (i.e., law firms hired by corporations) affect the readability and timeliness of SEC filings.

[6] However, evidence that incentive-based compensation leads to accounting fraud is mixed. See Armstrong et al. (2010, 2013), Burns and Kedia (2006), Efendi et al. (2007), Erickson et al. (2006), Feng et al. (2011), and Schrand and Zechman (2012).

as in the case of management forecasts, the heightened risk of litigation for a restatement might dominate capital market incentives and discourage behavior that would lead to a restatement. Further, highly compensated GCs face even more criticism in the case of a restatement since some may interpret their compensation as evidence of complicity in the accounting violation.[7] On the other hand, highly compensated GCs and managers likely face difficulties in managing earnings without violating GAAP. Discerning the precise limits of GAAP is often possible only after careful ex post investigation of the facts and circumstances. Hence, although highly compensated GCs may not intend to violate GAAP and expose their firm to litigation, they may still do so as a result of heightened incentives. Thus, we hypothesize the following (stated in null form).

Hypothesis 2 (H2). *Ceteris paribus, highly compensated general counsel (i.e., general counsel that is one of the top five compensated officers of the firm) do not affect the likelihood of GAAP violations.*

3. Research Design

To examine whether highly compensated GCs influence their firms' financial reporting quality (H1), we consider two commonly used measures of accruals quality—the standard deviation of Dechow and Dichev (2002) residuals and the absolute value of abnormal accruals (see Francis et al. 2005, and Bergstresser and Philippon 2006). In addition, to capture the propensity to manage earnings, we use the extent of income-increasing accruals.

We use the following general model to empirically examine the influence of GCs who reside in top management:

$$\begin{aligned} &\textit{Reporting Characteristic} \\ &= \beta_0 + \beta_1 \textit{HiPaidGC} + \beta_2 \textit{Size} + \beta_3 \textit{LitRisk} + \beta_4 \textit{Lev} \\ &\quad + \beta_5 \textit{MTB} + \beta_6 \textit{StdSaleGrwth} + \beta_7 \textit{StdSale} + \beta_8 \textit{StdCF} \\ &\quad + \beta_9 \textit{OldFirm} + \beta_{10} \textit{GScore} + \beta_{11} \textit{GovDum} + \varepsilon. \end{aligned} \tag{1}$$

Reporting Characteristic represents financial reporting quality. *HiPaidGC* is an indicator variable for highly compensated GC and takes a value of 1 if the firm's general counsel is one of the top five highly paid officers of the firm and 0 otherwise. We control for other determinants of financial reporting quality.[8] We follow Jiang et al. (2010) and Bergstresser and Philippon (2006) and control for firm characteristics such as firm size (*Size*), firm leverage (*Lev*), age of the firm (*OldFirm*), growth opportunities "proxied" by market-to-book ratio (*MTB*), and volatility in operations measured by volatility of sales growth (*StdSaleGrwth*). The variable definitions are in the appendix. Hribar and Nichols (2007) suggest that financial reporting quality measures are particularly sensitive to firm-specific volatility in outcome variables such as sales and performance. Accordingly, we control for standard deviation of sales (*StdSale*) and standard deviation of operating cash flows (*StdCF*). In addition to these variables, we also consider litigation risk and governance structures that can play a role in improving financial reporting quality. Specifically, we include a measure of litigation risk (*LitRisk*) following Kim and Skinner (2012) and a governance measure (*GScore*) based on the work of Gompers et al. (2003).[9] In addition, we include industry- and year-fixed effects.[10]

The coefficient of interest is β_1 in Equation (1), the coefficient on highly compensated general counsel (*HiPaidGC*). Because *AQ*, *AbsDAcc*, and $DAcc > 0$ are inverse measures of financial reporting quality, a positive coefficient on *HiPaidGC* indicates that highly compensated GCs are associated with lower quality, consistent with the highly paid general counsel exhibiting a reduced monitoring role.

To ensure that β_1 is not merely capturing the incentive effects of CEO and CFO, we also control for CEO and CFO incentives in the empirical specification.[11] Specifically, we determine the equity incentive ratio ($Incent_{CEO}$ *and* $Incent_{CFO}$) for the CEO and CFO. This ratio is computed as $Onepct/(Onepct + Cashpay)$, where *Onepct* is the combined effect of (i) a 1% increase in the firm's stock price on the value of shares held by the executive and (ii) a 1% increase in the firm's stock

[7] In the case of Tyco's GC, Mark Belnick, the fact that he received additional payments, interest-free loans, and other benefits in addition to his high salary gave some the impression that he must be involved in the accounting scandal. In other words, relative to low-paid GCs, highly paid GCs are more likely to be seen as culpable of GAAP violations because they are part of the executive team.

[8] In untabulated tests we also control for the age, tenure, and gender of the CEO and CFO and find similar results to those presented in the tables.

[9] Note that *GScore* is missing for many observations. To mitigate sample attrition from missing values we use an approach (otherwise known as zero-order regression) in which we treat missing observations as having a *GScore* of 0 and include an indicator variable, *GovDum*, that takes on the value of 1 if *GScore* is missing and 0 otherwise (see Greene 1993, pp. 275–276).

[10] We include industry-fixed effects (as opposed to firm-fixed effects) because the variable of interest (*HiPaidGC*) is relatively stable over time within firm. We do, however, implement robustness tests over a sample of firms that experience a change in *HiPaidGC* over the sample period. See §5.

[11] We follow Core and Guay (2002) to compute the incentive effect of all options, i.e., newly granted options, unexercised exercisable options, and unexercisable options.

price on the value of options held by the executive. Using data from ExecuComp, we follow Jiang et al. (2010) and obtain various components of compensation such as cash pay, total pay, and share-based compensation. Cash pay is the sum of salary and bonus. Total pay is the sum of cash pay, stock option grants, restricted stock grants, long-term incentive plan payouts, and other compensation. Share-based compensation consists of the value of stock holdings and stock option holdings.

Our first measure of financial reporting quality is based on an approach proposed by Dechow and Dichev (2002) and modified by Francis et al. (2005). The basic approach is that accruals map into current, past, and future operating cash flows and that measurement error dampens such mapping. Based on this premise, we can take the standard deviation of this measurement error (*AQ*) as a representation of deteriorating accruals quality such that higher *AQ* implies poorer quality. Dechow and Dichev (2002) model the measurement error in earnings using the following expression:

$$WA_{it} = \varphi_0 + \varphi_1 CFO_{it-1} + \varphi_2 CFO_{it} + \varphi_3 CFO_{it+1} + \varphi_4 \Delta REV_{it} + \varphi_5 PPE_{it} + \nu_{it}, \quad (2)$$

where *WA* is working capital accruals, *CFO* represents the cash flows from operations, ΔREV is the change in total revenue, and *PPE* is gross property, plant, and equipment. *AQ* is then the standard deviation of residuals, calculated over years $t-4$ through t, i.e., $AQ_{it} = \sigma(\nu_{it-4,t})$. All variables are scaled by average total assets and "Winsorized" at the 1% level to reduce the influence of outliers.

Our second measure of financial reporting quality, *AbsDAcc*, is the absolute value of abnormal accruals derived from the modified Jones (1991) model. This measure relies on the principle that a firm's accruals reflect fundamentals (such as changes in revenues and property, plant, and equipment) as well as managerial manipulation. Therefore, the level of accruals that are unexplained by fundamentals is viewed as abnormal, and excessive abnormal accruals dampen the quality of accruals in particular, and reporting more generally. To determine the extent of abnormal accruals, we estimate the following regression by industry i in year t.[12]

$$TA_{it} = \lambda_0 + \lambda_1(\Delta REV_{it} - \Delta AR_{it}) + \lambda_2 PPE_{it} + \kappa_{it}. \quad (3)$$

Total accruals (*TA*) are income before extraordinary items reported in the cash flow statement less net cash flows from operations, ΔAR is change in accounts receivable, and the remaining variables are as defined previously. All variables are scaled by average total assets and Winsorized at the 1% level to reduce the influence of outliers. The absolute value of the residual, κ_{it}, is our second proxy of financial reporting quality. Consistent with the measurement of both *AQ* and *AbsDAcc*, higher *AQ* and *AbsDAcc* imply poorer quality.

As a final measure of reporting quality, we use the signed error term κ_{it} in Equation (3) that represents deviations from expected accruals based on fundamental operating activities of the firm. We examine positive errors (labeled as $DAcc > 0$) because with this measure we are interested in the extent to which managers use income-increasing discretionary accruals to achieve financial reporting objectives.[13]

To test (H2), we use the same specification as Equation (1) but use two proxies to capture GAAP violations. Our first proxy for GAAP violations is an indicator variable that is set to one if the firm subsequently restates its earnings. Because not all GAAP violations are discovered, we use an alternate proxy to capture GAAP violations. Specifically, we follow Dechow et al. (2011) and use the likelihood of a financial misstatement by computing a "fraud score" (*Fscore*) based on a linear function of accruals, change in receivables, change in inventory, percentage of soft assets, change in cash sales, change in return on assets, and issuance of debt or equity during the period.

4. Sample and Descriptive Statistics

Our data set includes firm-years listed in both Compustat and ExecuComp during the years 2001–2011. To identify a firm's general counsel, we follow an approach similar to that of Kwak et al. (2012) and search the officer's title, counting an officer as general counsel if the title contains the word "counsel," "law," "legal," or other variant. Any firm with such an officer among the top five highest-paid officers is identified as having a highly compensated general counsel.

Table 1 presents the descriptive statistics of the variables used in the empirical specifications (see the appendix for detailed variable definitions). Panel A reveals that having a GC among the top five officers ($HiPaidGC = 1$) is not the norm. Only 37% of the firms in our sample have the GC among the top five compensated officers. This is generally consistent with the level (43%) reported by Kwak et al. (2012). The mean and median of the financial reporting proxies are broadly consistent with those reported in prior research (e.g., Rajgopal and Venkatachalam 2011).

[12] We require at least 20 firm-years at the two-digit standard industrial classification(SIC) level to estimate the regression.

[13] We also performance match these discretionary accruals following Kothari et al. (2005). Untabulated results are very similar to those presented in the tables.

Table 1 Descriptive Statistics and Correlations

Panel A: Descriptive statistics ($N = 13,103$)[a]

Variable	Mean	Median	Stddev	1st quartile	3rd quartile
HiPaidGC	0.369	0.000	0.483	0.000	1.000
AQ	0.056	0.040	0.054	0.024	0.067
AbsDAcc	0.053	0.033	0.063	0.015	0.065
DAcc > 0	0.045	0.032	0.044	0.013	0.062
Restate	0.024	0.000	0.154	0.000	0.000
Size	7.495	7.386	1.597	6.426	8.498
LitRisk	0.021	0.015	0.019	0.010	0.025
Lev	0.537	0.533	0.236	0.371	0.691
MTB	2.764	2.103	2.951	1.382	3.370
StdSaleGrwth	0.130	0.086	0.148	0.032	0.174
StdSale	0.116	0.081	0.117	0.040	0.150
StdCF	0.042	0.030	0.040	0.017	0.053
OldFirm	0.625	1.000	0.484	0.000	1.000
$Cashpay_{CEO}$	1.215	1.107	0.591	0.862	1.396
$Cashpay_{CFO}$	0.540	0.377	0.303	0.422	0.638
$Cashpay_{GC}$	0.444	0.270	0.267	0.363	0.531
$Totalpay_{CEO}$	4.931	5.499	1.562	3.157	5.904
$Totalpay_{CFO}$	1.720	1.753	0.657	1.167	2.055
$Totalpay_{GC}$	1.232	1.057	0.517	0.897	1.560
$Stockhld_{CEO}$	34.220	129.500	1.462	4.848	14.667
$Optionhld_{CEO}$	9.039	18.783	0.063	2.117	8.971
$Stockhld_{CFO}$	2.336	4.803	0.192	0.782	2.321
$Optionhld_{CFO}$	1.898	3.729	0.003	0.423	2.004
$Stockhld_{GC}$	1.302	1.957	0.105	0.523	1.545
$Optionhld_{GC}$	1.173	1.991	0.000	0.271	1.341
$Incent_{CEO}$	0.182	0.202	0.045	0.112	0.236
$Incent_{CFO}$	0.084	0.096	0.018	0.052	0.113
$Incent_{GC}$	0.066	0.072	0.013	0.041	0.094

Panel B: Incentive pay correlations ($N = 5,035$)

Variable	$Incent_{GC}$	$Cashpay_{GC}$	$Totalpay_{GC}$	$Stockhld_{GC}$	$Optionhld_{GC}$
$Incent_{CFO}$	0.72*				
$Incent_{CEO}$	0.58*				
$Cashpay_{CFO}$		0.78*			
$Cashpay_{CEO}$		0.74*			
$Totalpay_{CFO}$			0.78*		
$Totalpay_{CEO}$			0.75*		
$Stockhld_{CFO}$				0.62*	
$Stockhld_{CEO}$				0.45*	
$Optionhld_{CFO}$					0.73*
$Optionhld_{CEO}$					0.72*

In terms of compensation, the GC's total pay is approximately one-quarter of the CEO's pay and slightly lower than the CFO's pay. Although GCs' cash compensation is comparable to that of CFOs, GCs earn approximately 40%–50% lower stock-based compensation relative to CFOs. Nevertheless, GCs earn a sizable amount of stock-based compensation both in terms of stock and options. On average, the GCs' equity incentive ratio is approximately 6.6%, whereas that of CFOs is 8.4% and that of CEOs is 18.2%. Thus, although GCs' equity incentives are lower than those of CEOs, they are comparable to those of CFOs. Like other executives, GCs have highly compensated equity incentives.

Panel B of Table 1 reports the correlations among the compensation structures and equity incentives of GCs, CEOs, and CFOs. Not only are the various components of a GC's compensation highly correlated with those of the CEO and CFO, the equity incentives are highly correlated, as well. This suggests that (i) GCs appear to be compensated in a similar fashion to other top executives in the firm and (ii) the role of equity incentives documented for CFOs (Jiang et al. 2010) is likely to extend to GCs as well.

Panel C of Table 1 reveals interesting clues about the relation between highly compensated general counsel and financial reporting quality. First, *HiPaidGC* is positively correlated with both *AQ* and

Table 1 (Continued)

Panel C: Pearson (Spearman) correlation matrix ($N = 13{,}103$)

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
(1)	*HiPaidGC*	—	0.02*	0.03*	0.05*	−0.03*	−0.04*	0.01*	0.14*	−0.01	−0.00	0.03*	0.03*	0.03	0.02*
(2)	*AQ*	0.03*	—	0.24*	0.23*	0.02*	−0.07*	−0.21*	−0.02*	0.07*	0.02*	0.18*	0.18*	0.42*	−0.18*
(3)	*AbsDAcc*	0.03*	0.27*	—	1*	0.01	−0.02*	−0.21*	0.02*	0.09*	−0.00	0.09*	0.12*	0.27*	−0.08*
(4)	*DAcc* > 0	0.05*	0.21*	1*	—	−0.00	0.00	−0.15*	0.02*	0.03	0.00	0.11*	0.12*	0.28*	−0.02
(5)	*Restate*	−0.03*	0.02*	0.01	−0.00	—	0.02*	0.02*	−0.00	0.07*	−0.00	−0.02*	−0.00	−0.01	−0.03*
(6)	*Fscore*	−0.04*	−0.10*	−0.07*	−0.04	0.02*	—	0.05*	0.09*	0.00	−0.00	0.02	0.01*	−0.08*	−0.04*
(7)	*Size*	0.02*	−0.25*	−0.19*	−0.15*	0.02*	0.07*	—	0.09*	0.29*	0.00	−0.10*	−0.13*	−0.25*	0.18*
(8)	*Lev*	0.14*	−0.21*	−0.08*	−0.03*	−0.00	0.10*	0.17*	—	0.01	0.00	0.00	0.02*	0.07*	0.13*
(9)	*LitRisk*	−0.01*	0.03*	0.06*	−0.00	0.07*	−0.00	0.50*	0.01	—	−0.00	−0.02	−0.00	0.00	−0.03*
(10)	*MTB*	−0.05*	0.10*	−0.00	−0.00	0.01	−0.00	0.36	−0.11	0.19	—	0.00	0.00	0.03*	0.00
(11)	*StdSaleGrwth*	0.02*	0.27*	0.12*	0.09*	−0.04*	0.00	−0.12*	−0.09	−0.01	0.06	—	0.69*	0.20*	−0.08*
(12)	*StdSale*	0.02*	0.33*	0.18*	0.15*	−0.01	−0.04*	−0.19*	−0.11*	−0.01	0.04	0.69*	—	0.22*	−0.07*
(13)	*StdCF*	0.01	0.48*	0.31*	0.29*	−0.01	−0.14*	−0.29*	−0.19*	−0.01	0.04*	0.38*	0.45*	—	−0.09*
(14)	*OldFirm*	0.02*	−0.19*	−0.09*	−0.02	−0.03*	−0.02*	0.18*	0.17*	−0.03*	−0.05	−0.12*	−0.10*	−0.12*	—

Notes. This table provides descriptive statistics for the samples used in the paper. Panel A details the main sample including 13,103 firm-years with data from both ExecuComp and Compustat. Panel B provides descriptive details on the compensation structure of GCs, CEOs, and CFOs, for firms where general counsel is a top five officer of the firm. In addition, we provide descriptive statistics on the equity incentives. Panel B reports correlations for the main sample. Panel C reports correlations between the compensation and equity incentives of general counsel and those of CEOs and CFOs. Pearson correlations are above the diagonal and Spearman correlations are below the diagonal. All variables are defined in the appendix.

[a]The number of observations for the incentive pay variables is 5,035 and *DAcc* > 0 is 5,697.

*Indicates two-tailed statistical significance at the 5% level.

AbsDAcc, suggesting that firms with general counsel in the top management experience worse accruals quality (i.e., higher *AQ* and *AbsDAcc*). Second, *HiPaidGC* is also positively correlated with *DAcc* > 0, indicating that firms with general counsel in the top management have greater propensity to manage earnings upward, perhaps to achieve earnings targets. However, firms with highly compensated GCs experience fewer restatements and lower *Fscore*s. Although these results are broadly suggestive that highly compensated GCs are associated with financial reporting quality, note that *HiPaidGC* is also correlated with fundamental characteristics such as size (*Size*), leverage (*Lev*), and growth opportunities (*MTB*). Thus, it is premature to draw conclusions from univariate correlations.

5. Empirical Findings

5.1. Main Results.

Table 2 presents the empirical findings for the relation between highly paid GCs and our measures of financial reporting quality. Model (1) reports the results of estimating Equation (1) using *AQ* as the reporting quality proxy. The coefficient on *HiPaidGC* is positive ($\beta_1 = 0.412$, $p < 0.01$), suggesting that firms with a general counsel in top management have lower accruals quality.[14] In model (2) we find similar results in that *HiPaidGC* is positively associated with higher absolute abnormal accruals. These results are consistent with highly compensated GCs facilitating, or at least tolerating, aggressive reporting practices in their firms. Thus, greater compensation for GCs mitigates their gatekeeping role, at least with respect to these aspects of financial reporting. In economic terms, these results imply that the presence of a GC in the top management is associated with an approximately 10% increase in *AQ* and a 13% increase in *AbsDAcc*, measured at the median of the distribution of these variables.[15] The economic magnitudes are comparable (in the opposite direction) to the economic effects of having an accounting expert on the board of directors on a firm's financial reporting quality (see Krishnan and Visvanathan 2010).

Results presented in model (3) of Table 2 test the influence of highly compensated GCs on their firms' income-increasing earnings management. The results generally are comparable to those reported in the univariate correlations in Table 1. In particular, we find that highly compensated GCs are associated with higher levels of income-increasing discretionary accruals ($\beta_1 = 0.375$, $p < 0.01$).[16] As with previous

[14] Standard errors are clustered at the firm and year levels.

[15] Per Table 1, the median of *AQ* is 0.04. The coefficient on the *GC* indicator in Table 2 is 0.412. Since the indicator is scaled by 100, this is a 10% increase [(0.412/100)/0.04]. For *AbsDAcc*, the median is 0.033. The coefficient on the *GC* indicator in Table 2 is 0.417, representing a 13% increase [(0.417/100)/0.033].

[16] In untabulated analyses, we also find that highly compensated GCs are associated with more income-decreasing discretionary accruals.

Table 2 Relation Between General Counsel and Proxies of Financial Reporting Quality and Earnings Management

	Full sample			Switching sample		
	(1)	(2)	(3)	(4)	(5)	(6)
Variable	*AQ*	*AbsDAcc*	*DAcc* > 0	*AQ*	*AbsDAcc*	*DAcc* > 0
HiPaidGC	0.412***	0.417***	0.375***	0.239*	0.299***	0.331***
	(3.49)	(3.75)	(3.96)	(1.89)	(2.85)	(2.60)
Size	−0.005***	−0.007***	−0.002***	−0.006***	−0.008***	−0.003***
	(−6.65)	(−7.07)	(−4.19)	(−6.00)	(−6.09)	(−3.50)
LitRisk	0.373***	0.428***	0.096**	0.407***	0.404***	0.111**
	(3.86)	(8.89)	(2.30)	(4.21)	(11.56)	(2.51)
Lev	0.003	0.017***	0.006	−0.001	0.012***	0.003
	(0.61)	(5.79)	(1.50)	(−0.24)	(4.65)	(0.90)
MTB	0.001***	0.000	0.000	0.001**	0.000	0.000
	(3.97)	(0.59)	(0.75)	(2.53)	(0.74)	(1.20)
StdSaleGrwth	0.036***	−0.005	0.013	0.033***	−0.010	0.004
	(3.58)	(−0.58)	(1.59)	(2.62)	(−0.93)	(0.29)
StdSale	0.015*	0.043***	0.007	0.010	0.049***	0.013
	(1.77)	(5.14)	(0.79)	(1.00)	(4.71)	(1.07)
StdCF	0.458***	0.359***	0.287***	0.405***	0.334***	0.279***
	(11.74)	(21.56)	(9.70)	(8.95)	(14.47)	(7.11)
OldFirm	−0.010***	−0.002*	0.003*	−0.015***	−0.005***	−0.000
	(−4.75)	(−1.67)	(1.80)	(−5.12)	(−2.68)	(−0.18)
GScore	−0.000	−0.001***	−0.000	−0.001*	−0.001*	−0.000
	(−1.24)	(−2.64)	(−1.44)	(−1.72)	(−1.83)	(−1.36)
GovDum	0.000	−0.004	0.001	0.002	−0.003	−0.002
	(0.03)	(−1.48)	(0.34)	(0.44)	(−0.85)	(−0.45)
Constant	0.074***	0.064***	0.036***	0.093***	0.077***	0.042***
	(10.49)	(7.70)	(7.39)	(9.86)	(7.01)	(5.13)
Observations	13,103	13,103	5,697	7,542	7,542	3,450
R^2	0.31	0.17	0.16	0.31	0.18	0.18
Cluster	Firm, Year	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year
Fixed effects	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year

Notes. This table reports ordinary least squares (OLS) estimation of the relation between general counsel who are in the top management and proxies of earnings management and reporting quality over the period 2001–2011. Models (1)–(3) are estimated over the full sample, while we restrict the analysis to firms in which the general counsel moves in or out of the top management during the sample period in models (4)–(6). All variables are defined in the appendix. *t*-Statistics are presented in parentheses.

***, **, and * indicate two-tailed statistical significance at the 1%, 5%, and 10% levels, respectively.

findings, this result is consistent with highly compensated GCs facilitating more aggressive reporting practices in their firms. In economic terms, this implies that the presence of a GC in the top management is associated with a 12% increase in *DAcc*, measured at the median over firms with positive *DAcc*.

Models (4)–(6) of Table 2 conduct similar analyses in models akin to changes specifications. In particular, we only retain observations where the firm adds or drops the GC to or from top management and reestimate Equation (1). In this way, the firm acts as its own control, and the coefficient on *HiPaidGC* captures the change in reporting practices associated with the GC moving into the top management. Results reported are generally consistent with those in models (1)–(3). The coefficient on *HiPaidGC* in the *AQ* regression, although positive, is weakly significant (*t*-statistic = 1.89). The coefficient on *HiPaidGC* in the *AbsDAcc* regression is positive and statistically significant ($\beta_1 = 0.299$, $p < 0.01$). In the final regression, results in model (6) suggest that firms where GC moves into the top management tend to be more aggressive when it comes to using income-increasing accruals ($\beta_1 = 0.331$, $p < 0.01$).[17]

A statistical relation between highly paid GCs and earnings quality could be attributable to a higher demand for GC talent among firms with a weak mapping between underlying performance and earnings. Accordingly, we implement an instrumental-variables approach (Larcker and Rusticus 2010) and use the

[17] We also note that the coefficients on control variables are broadly similar to prior literature in that size, sales growth, firm age, and the governance score are negatively related to financial reporting quality, whereas leverage and the standard deviations of sales and cash flows are positively related to financial reporting quality (Jiang et al. 2010, Bergstresser and Philippon 2006).

distance between the firm's headquarters and the nearest law school as our instrument for highly compensated general counsel. This instrument has both properties of a valid instrument: exogeneity (it is unlikely that distance to a law school affects financial reporting except through the attorney channel) and a strong correlation with the variable of interest.[18] Untabulated results from a two-stage estimation using this instrument further corroborate our inferences from Table 2.

Finally, we reestimate the analyses in Table 2 including a lagged value of the dependent variable as an explanatory variable. Untabulated results are broadly consistent with those reported in Table 2. With the exception of the *AQ* specification, the coefficients on *HiPaidGC* are very similar to those reported in Table 2. For the *AQ* model, the coefficient on *HiPaidGC* is positive but statistically insignificant.

5.1.1. Is the Association Between Highly Paid GCs and Reporting Quality Merely Picking Up CFO and CEO Incentives? Extant research (Bergstresser and Philippon 2006, Jiang et al. 2010) finds that CEO equity incentives, as well as CFO equity incentives, are associated with accruals manipulation. Therefore, to the extent that the GC's compensation structure is similar to that of the CEO and CFO, the GC's incentives are aligned in a manner that creates a strong focus on stock prices. This is important to our study because it is likely that highly paid GCs have more incentive compensation than other GCs. If GC incentive compensation is highly correlated with the incentive compensation of other executives, our measure could simply be picking up the incentive compensation of those other executives. However, unlike the CFO and the CEO, who are always in the top five compensated officers of the firm, not all GCs are highly compensated.

Panel A of Table 3 tabulates results from OLS regressions of reporting outcomes on the highly paid GC indicator while controlling for CEO and CFO incentives. Results are very similar to those presented in the prior table and indicate a strong relation between highly compensated GCs and earnings management.[19] This suggests that our findings are not simply a manifestation of CEO and CFO equity incentives.[20]

Given the strong correlation between the GC's and CEO's incentives, we conduct an additional robustness test to ensure that our measures of the GC's incentives are not serving as proxies for the CEO's or CFO's incentives. First, we create a ratio of the GC's equity incentives to the CEO's and CFO's equity incentives and estimate Equation (1). Panel B of Table 3 demonstrates that the ratio is positive and statistically significant at the p-value < 0.01 level in three of the six models.

Overall, these results suggest that the effect of a highly compensated GC on financial reporting quality is incremental to the effect of the CEO and CFO incentives. Further, it is possible that our indicator variable for highly paid GC is serving as a proxy for the level of the GC's incentive compensation. Although we are not able to test this because it would require compensation data for GCs who are not among the top five officers of the firm, the fundamental conclusion behind our research remains unchanged. When GCs receive incentives similar to those of the other top executives, they behave in a similar manner, leading to deterioration in financial reporting quality.

5.1.2. Is the Presence of General Counsel in the Top Management Associated with Violations of GAAP or SEC Regulations? The findings, thus far, suggest that highly compensated GCs are associated with lower financial reporting quality. Although this evidence suggests that GCs tolerate aggressive accounting choices, it is not necessary that GCs acquiesce to "crossing the line" and violating GAAP or SEC regulations. Conversely, it is possible that highly compensated GCs help management to avoid crossing the line, consistent with their primary role as gatekeepers. As described earlier, we examine two measures of violating GAAP or SEC regulations: (i) the actual incidence of financial restatements and (ii) the estimated probability of a financial fraud.

If higher income-increasing accruals are the result of egregious violations of regulatory compliance, we should observe a higher incidence of restatements and a higher likelihood of a financial fraud. In contrast, highly compensated GCs may "contrive ways

[18] Since financial reporting choices follow industry norms and industries cluster geographically, if the distance to a law school is systematically correlated with industry clusters, the instrument could be endogenous to financial reporting quality. To ensure that this is not the case, we include industry-fixed effects in both first- and second-stage regressions. Results are similar to those presented in Table 2.

[19] We also control for other characteristics of the CEO and CFO including age, tenure, and gender and find results very similar to those in Table 3.

[20] Jiang et al. (2010) find that CFO, but not CEO, equity incentives, are negatively related to the absolute value of discretionary accruals (*AbsDAcc*) after the passage of the Sarbanes–Oxley Act and positively related before the passage. We find no relation between the equity incentives of the CFO and *AbsDAcc* in Table 3. However, if we restrict our sample to the period after Sarbanes–Oxley examined by Jiang et al. (2010), we also find a negative relation between the level of CFO incentive compensation and *AbsDAcc*. Since our sample naturally extends beyond that in Jiang et al. (2010), the lack of statistical significance for the CFO incentive compensation in Table 3 is consistent with a positive relation between CFO incentive pay and *AbsDAcc* in the latter portion of our sample.

Table 3 Tests Controlling for Executive Incentive Compensation

	Full sample			Switching sample		
	(1)	(2)	(3)	(4)	(5)	(6)
Variable	*AQ*	*AbsDAcc*	*DAcc* > 0	*AQ*	*AbsDAcc*	*DAcc* > 0
	Panel A: Estimations controlling for CEO and CFO incentive compensation					
HiPaidGC	0.393***	0.416***	0.380***	0.228*	0.298***	0.330***
	(3.30)	(3.84)	(4.04)	(1.81)	(2.90)	(2.65)
$Incent_{CEO}$	−0.007**	−0.001	0.001	−0.009**	−0.001	−0.001
	(−2.55)	(−0.25)	(0.25)	(−2.52)	(−0.31)	(−0.22)
$Incent_{CFO}$	0.002	0.010	0.011*	0.008	0.007	0.003
	(0.29)	(1.64)	(1.73)	(0.93)	(0.55)	(0.30)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Observations	13,103	13,103	5,697	7,542	7,542	3,450
R^2	0.31	0.17	0.16	0.31	0.18	0.18
Cluster	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year
Fixed Effects	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year
	Panel B: Estimations examining the relation between financial reporting quality and the ratio of GC incentive pay to the incentive pay of CEOs and CFOs					
GC incentive pay/ CEO incentive pay	−0.022	0.115***	0.113	0.418***	0.296***	−0.064
	(−1.11)	(6.81)	(1.26)	(3.81)	(2.75)	(−0.52)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Observations	12,863	12,863	5,596	10,284	10,284	4,496
R^2	0.30	0.17	0.16	0.31	0.17	0.17
Cluster	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year
Fixed effects	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year

Notes. This table reports OLS estimation of the relation between general counsel who are in the top management and proxies of earnings management and reporting quality over the period 2001–2011 while controlling for the levels of incentive pay of the CEO and CFO. Panel A explicitly controls for the incentive pay of the CEO and CFO, and Panel B examines the relation between reporting quality and the ratio of GC incentive pay to the incentive pay of the CEO and CFO. Models (1)–(3) of both panels are estimated over the full sample, whereas we restrict the analysis to firms in which the general counsel moves in or out of the top management during the sample period in models (4)–(6). All variables are defined in the appendix. *t*-Statistics are presented in parentheses.

***, **, and * indicate two-tailed statistical significance at the 1%, 5%, and 10% levels, respectively.

in which business conduct that defeats the purpose of the law can be performed legally" (Parker et al. 2009, p. 211). That is, higher income-increasing accruals do not represent reporting misconduct in terms of a gross violation of GAAP, but rather represent clever use of discretion allowed under GAAP to achieve financial reporting objectives. It is possible that highly compensated GCs are sophisticated advisors in the wake of potential SEC investigations who can justify that the actions of the management are within the legal boundaries. In such instances, we should not observe a higher incidence of restatements. Thus, observing a connection between highly compensated GCs and aggressive reporting does not necessarily imply a connection between highly compensated GCs and a greater incidence of restatements and fraud.[21]

To test this hypothesis, we use the Audit Analytics restatements database to identify firms that restated their financials during the period 2001–2011. From the initial list, we are careful to retain only restatements that are classified as intentional, i.e., restatements that were the result of fraudulent misrepresentation, a class action lawsuit, or an SEC investigation (Hennes et al. 2008). We create an indicator variable, *Restate*, that takes the value of 1 if the firm-year observation was subsequently restated and estimate Equation (1) with *Restate* as the dependent variable. With regards to the second variable, we follow Dechow et al. (2011) and compute a "fraud score" (*Fscore*).

Results of the probit estimation of the likelihood of restatements are presented in Table 4. The coefficient on the *HiPaidGC* variable in model (1) is negative (coefficient = −12.406) and statistically significant at the 10% level, two-tailed (*t*-statistic = −1.73). This indicates that the presence of a highly compensated GC actually mitigates the likelihood of restatement, consistent with the GC's role as gatekeeper. Moreover, results in model (2) show that highly compensated GCs are associated with a reduced fraud score (*t*-statistic = −2.42). Thus, although highly compensated GCs are associated with lower accounting quality, they appear to keep the firm within the bounds of GAAP and SEC regulations.[22]

[21] As Dechow et al. (2010) point out, although accounting restatements represent an external indicator of earnings quality, they may capture different attributes of earnings.

[22] We note that litigation risk is positively related to restatements but negatively related to *Fscore*. This is attributable to the construction of the litigation risk variable, which is the implied litigation

Table 4 Relation Between General Counsel and Intentional Misstatements

	(1)	(2)
Variable	*Restate*	*Fscore*
HiPaidGC	−12.406*	−5.186**
	(−1.73)	(−2.42)
$Incent_{CEO}$	0.064	−0.141***
	(0.39)	(−3.52)
$Incent_{CFO}$	0.514	0.411***
	(1.36)	(4.69)
Size	0.016	0.046***
	(0.62)	(6.53)
LitRisk	6.920***	−2.237***
	(3.99)	(−4.82)
Lev	0.264	0.231***
	(1.43)	(4.58)
MTB	−0.022**	−0.015***
	(−2.06)	(−5.20)
StdSaleGrwth	−0.372	0.258*
	(−1.20)	(1.80)
StdSale	0.639*	0.495***
	(1.74)	(2.66)
StdCF	−2.808***	−2.013***
	(−3.42)	(−5.18)
OldFirm	−0.260***	−0.034
	(−2.74)	(−1.48)
GScore	−0.042**	0.006
	(−2.29)	(1.15)
GovDum	−0.315	0.099*
	(−1.56)	(1.76)
Constant	−2.898***	0.903***
	(−10.30)	(12.88)
Observations	13,103	13,071
R^2		0.21
Pseudo R^2	0.17	
Cluster	Firm, year	Firm, year
Fixed effects	Ind, year	Ind, year

Notes. Results of probit estimation of the relation between general counsel who are in the top management and the likelihood of a financial restatement, and an OLS estimation of the relation between general counsel who are in the top management and the fraud score. All variables are defined in the appendix. *t*-Statistics are presented in parentheses.

***, **, and * indicate two-tailed statistical significance at the 1%, 5%, and 10% levels, respectively.

These results, combined with the evidence in prior tables, are consistent with highly compensated GCs tolerating earnings management to a certain extent, but still maintaining their roles as gatekeepers by keeping it from violating GAAP and resulting in a restatement. It is possible that highly compensated GCs are able to avoid restatements and misstatements in cases that fall into the grey area by tactful deliberations during SEC investigations. Both interpretations are, however, consistent with highly compensated GCs carrying out their duties to protect the firm from extreme outcomes.

5.1.3. Does the General Counsel's Board Membership Mitigate the Negative Influence of Highly Paid GCs on Financial Reporting Quality? Krishnan et al. (2011) hypothesize and find that firms with legal experts on the audit committee are more likely to have better financial reporting quality because directors with legal expertise are sensitive to litigation risk arising from misreporting. That is, directors with legal expertise are more likely to act as monitors to guard against potential litigation. Extending this argument to GCs, we posit that highly compensated GCs who are also members of the board are likely to act as monitors, thereby mitigating the incentive effects that drive financial reporting behavior. To test this hypothesis, we augment the specification in Table 3 by including an indicator variable (*GConBoard*) that takes the value of 1 if the GC is also a board member and 0 otherwise. We predict the coefficient on *GConBoard* to be negative, consistent with the notion that the GC's board membership mitigates the incentive effects of financial reporting quality.

Results, presented in Table 5, are consistent with the predictions. The coefficient on *GConBoard* is consistently negative across all the specifications. Specifically, the coefficient on *GConBoard* in the *AQ* regression is −1.526 and statistically significant (*t*-statistic = −4.07). However, the coefficients on *GConBoard* in the *AbsDAcc* and $DAcc > 0$ specifications only approach statistical significance. The coefficients on the *HiPaidGC* variable continue to be positive and statistically significant across all three accounting quality specifications. Taken together, the evidence suggests that, although highly paid GCs are associated with lower reporting quality, this association may be

Table 5 Relation Between General Counsel and Proxies of Financial Reporting Quality When General Counsel Serves as a Member of the Board

	(1)	(2)	(3)
Variable	*AQ*	*AbsDAcc*	$DAcc > 0$
HiPaidGC	0.450***	0.440***	0.404***
	(3.59)	(3.66)	(3.76)
GConBoard	−1.526***	−0.625	−0.626
	(−4.07)	(−1.54)	(−1.01)
Controls	Yes	Yes	Yes
Observations	13,103	13,103	5,697
R^2	0.31	0.17	0.16
Cluster	Firm, year	Firm, year	Firm, year
Fixed effects	Ind, year	Ind, year	Ind, year

Notes. This table reports OLS estimation of the relation between general counsel who serve on the board of directors and proxies of earnings management and reporting quality over the period 2001–2011. All variables are defined in theappendix. *t*-Statistics are presented in parentheses.

***Indicates two-tailed statistical significance at the 1% level.

propensity estimated over a long window. Since restatements often trigger litigation (Palmrose and Scholz 2004), this variable will be positively associated with restatements, by construction.

Table 6 Relation Between a General Counsel and Proxies for Financial Reporting Quality When General Counsel Has an Accounting or Finance Background

	(1)	(2)	(3)
Variable	*AQ*	*AbsDAcc*	*DAcc* > 0
GCFinancialExpert	0.556**	0.615***	0.364**
	(2.36)	(3.38)	(2.01)
Controls	Yes	Yes	Yes
Observations	4,844	4,844	2,157
Observations (where *GCFinancialExpert* = 1)	1,660	1,660	697
R^2	0.32	0.19	0.17
Cluster	Firm, year	Firm, year	Firm, year
Fixed effects	Ind, year	Ind, year	Ind, year

Notes. This table reports tests of the GC's influence on financial reporting quality when the GC has an accounting or finance background. In this table we restrict our analysis to firms that report general counsel as one of the top five paid executives. The variable of interest is an indicator variable *GCFinancialExpert* that takes the value of 1 when the general counsel is an expert and 0 otherwise. Dependent variables are listed as the column heading and include accruals quality, the absolute value of discretionary accruals, and discretionary accruals where the firm reports only positive values. All variables are defined in the appendix.

*** and ** indicate two-tailed statistical significance at the 1% and 5% levels, respectively.

mitigated if the general counsel is a board member. In other words, when GCs are likely to face greater amounts of litigation risk due to their fiduciary responsibilities arising from board membership, the incentive effects get mitigated.

5.2. GCs with Financial Reporting Expertise.

Next, we explore whether the extent to which GCs can influence financial reporting is a function of their experience or expertise in the area of accounting and finance. We obtain biographies on GCs from Capital IQ and identify GCs with a background in accounting, auditing, or finance, and we examine if the relation between highly paid GCs and earnings management is stronger in this subsample.[23] Specifically, we restrict our analysis to the sample of firms with highly paid GCs and use an indicator variable (*GCFinancialExpert*) that takes the value of 1 if the highly paid GC has financial expertise and 0 otherwise. Table 6 tabulates our findings. We find that approximately one-third of GCs have financial expertise (1,660 observations of 4,844 highly paid GC firm-years). Across all three reporting quality measures (models (1)–(3)), we find the coefficient on *GCFinancialExpert* is positive and statistically significant at the 5% level. Thus, we find that GCs with financial expertise have poorer reporting quality and are more likely to engage in earnings management.

[23] In untabulated *t*-tests, we find that firms that hire GCs with financial expertise are larger, younger, more volatile and levered, and more likely to change the litigation reserve and have a higher risk of litigation.

5.2.1. How Does the GC Affect Financial Reporting?

Our evidence thus far provides only a statistical association between highly paid GCs and reporting quality. Anecdotal evidence, however, suggests that GCs play a direct role in the financial reporting process. For example, Neal Batson, the court-appointed examiner for Enron, found evidence that Enron's GC and several other in-house attorneys committed malpractice for their roles in the Enron accounting scandal. In particular, they helped to establish and attest to the legality of the special purpose entities that kept liabilities off Enron's balance sheet (Batson 2003). Although data are not available for many of the specific GC decisions that influence financial reporting, in this section we examine one way in which GCs can directly influence financial reporting.

One of the areas in which GCs play a central role in the accounting process is in establishing a reserve for pending or threatened litigation. Under Accounting Standards Codification (ASC) 450, at the end of each quarter, firms are required to estimate future contingent liabilities that are probable and in which the loss can be reasonably estimated. Then, the firm must establish a liability for the future contingency, which also reduces earnings. As part of this process, GCs (in coordination with any external counsel) assess the likelihood and costs of future litigation. Hence, the GC's opinion helps to form the basis for this accounting decision. As such, a direct way in which the GC can influence financial reporting quality is through the assessment of future litigation.

To examine whether GCs manage the litigation contingency estimate, we conduct two tests. First, we replicate the prior tests and partition the sample according to whether the firm changed the litigation contingency contemporaneously. Table 7 documents the results of these tests. In general, changes to the litigation reserve are not common: they occur in only 2,860 observations in the full sample. However, despite the smaller sample size, the relation between *HiPaidGC* and both the absolute value (models (3) and (4)), as well as signed positive discretionary accruals (models (5) and (6)), is stronger and statistically greater over the sample of observations where the litigation reserve changed. The accruals quality measure, on the other hand, appears driven by the sample of observations with no change in the litigation reserve.[24] Overall, we conclude that the relation between *HiPaidGC* and earnings management is

[24] However, untabulated follow-up tests suggest that the accruals quality variable is poorly constructed for this test. This variable examines the mapping of cash flows of the prior, current, and subsequent year into accruals. Although these horizons are sufficient to capture accruals and reversals in a general setting, it is problematic in this particular setting since litigation can take years to resolve. Hence, if a highly paid GC underestimates the litigation reserve,

Table 7 The General Counsel's Effect on Financial Reporting Quality via the Litigation Reserve

	AQ		*AbsDAcc*		*DAcc* > 0	
	(1) Change in litigation reserve	(2) No change in litigation reserve	(3) Change in litigation reserve	(4) No change in litigation reserve	(5) Change in litigation reserve	(6) No change in litigation reserve
HiPaidGC	0.125	0.456***	1.015***	0.232*	1.025***	0.168
	(0.64)	(3.46)	(4.67)	(1.91)	(3.43)	(1.16)
	Change – No Change		Change – No Change		Change – No Change	
	−0.331		0.783***		0.857**	
	(−0.93)		(3.05)		(2.26)	
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,860	10,243	2,860	10,243	1,276	4,421
R^2	0.32	0.31	0.16	0.18	0.19	0.16
Cluster	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year	Firm, year
Fixed effects	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year	Ind, year

Notes. This table reports tests of whether the relation between GC pay and financial reporting quality is stronger in firm-year observations with a contemporaneous change in the litigation reserve. The variable of interest is an indicator variable if the firm reports the general counsel as one of the top five executives. The samples for the "Change" models (1, 3, and 5) include only firm-year observations with a contemporaneous change in the litigation reserve, whereas the "No Change" models (2, 4, and 6) include all other observations. Dependent variables are listed as the column heading and include accruals quality, the absolute value of discretionary accruals, and discretionary accruals where the firm reports only positive values. All variables are defined in the appendix.

***, **, and * indicate two-tailed statistical significance at the 1%, 5%, and 10% levels, respectively.

strongest among firm-year observations that included a contemporaneous change in the litigation reserve.

Next, we examine whether firms with highly compensated GCs use the litigation reserve to meet specific earnings thresholds. The essence of this test is to determine whether a firm reached a specific threshold through a change in the litigation reserve (i.e., would the firm have missed the threshold without the change in the reserve?). This way we can establish one of the channels through which general counsel can influence financial reporting. To test this we compare the propensity with which firms meet or beat earnings benchmarks with the change in litigation reserve for firms with and without highly paid GCs and report our findings in Table 8. Panel A indicates that firm-year observations with a highly paid GC were more likely to meet the mean analyst forecast (63.8% versus 60.1%). Further, these observations were more likely to meet the forecast because of the change in the litigation reserve (2.5% versus 2.1%). We find similar results when we use prior quarter earnings instead of analyst forecasts as the benchmark (see panel B). That is, firms with highly paid GCs are more likely to meet or beat the target (53.1% versus 53%) although the difference is not statistically significant. However, the firm-year observations with a highly paid GC are statistically more likely to have met the target through the change in the litigation reserve (0.5% versus 0.3%). Hence, firms with highly paid GCs are more likely to meet or beat these targets through changes in the litigation reserve. Our conclusion is that altering the level of litigation reserve is one mechanism through which GCs can have a direct effect on corporate financial reporting.

Table 8 The Likelihood of Meeting or Beating Earnings Targets with the Litigation Reserve

HiPaidGC	Total obs.	% of obs. that meet target with reported earnings (%)	% of obs. that meet target only because of the change in litigation contingency (%)
	Panel A: Analyst forecasts as the benchmark		
1	26,152	63.8	2.5
0	46,264	60.1	2.1
	Difference	3.7	0.4
	t-statistic	9.92	3.45
	Panel B: Prior quarter earnings as the benchmark		
1	26,152	53.1	0.5
0	46,264	53.0	0.3
	Difference	0.1	0.2
	t-statistic	0.41	3.06

Notes. This table reports tests of whether firms meet or beat their earnings targets through a change in the litigation reserve. *HiPaidGC* is an indicator variable if the firm reports the general counsel as one of the top five executives. The sample is partitioned according to whether the firm reports a general counsel as one of the top five executives, and conducts *t*-tests of differences according to whether the firm met or beat an earnings target through actual earnings (third column). The last column examines whether the firm met or beat an earnings target only through a change in the litigation reserve (i.e., the firm would not meet or beat the threshold if the change in litigation reserve were removed from earnings). Panel A examines the mean analyst forecast as a benchmark and panel B examines the prior quarter's earnings as a benchmark.

6. Conclusions

This paper examines the role that GCs play in determining their firms' financial reporting quality. We

the *AQ* variable will only pick up a divergence of cash flows and accruals if the case is resolved in the following year, an unlikely event. We analyzed 6,691 lawsuits filed between 1988 and 2011 and found that the mean lag between lawsuit filing and resolution was 2.7 years.

find that highly compensated GCs are associated with poorer financial reporting quality. At first blush, the results suggest that highly compensated GCs are not acting as gatekeepers who constrain the aggressive wishes of other senior management, at least with respect to reporting quality. Rather, highly compensated GCs appear to tolerate aggressive financial reporting behavior by the firm. However, we also find evidence that highly paid GCs still maintain their roles as gatekeepers, in that they are associated with a lower fraud score and a reduced incidence of restatements, despite the higher levels of earnings management. That is, although highly compensated GCs appear to tolerate some amount of earnings management, they also tend to discourage firms from crossing the line that results in GAAP violations and fraudulent financial reporting.

To obtain some insight into why GCs appear to tolerate aggressive accounting behavior, we examine the compensation packages of GCs and compare them to those of CEOs and the CFOs. We find that GCs appear to have compensation incentives similar to those of CEOs and CFOs, as reflected in the proportion of stock-based compensation and equity incentives. Although equity incentives appear to drive GCs to allow lower financial reporting quality, this is somewhat mitigated when the GCs are also board members and exacerbated when GCs have financial expertise.

Our findings are robust to a number of research design choices such as modeling endogeneity through an instrumental-variables approach and implementing a changes model. In addition, we find evidence that GCs have an influence on the litigation reserve, a direct channel through which they affect reporting quality, using it to achieve earnings targets. We find that the effect of GCs on financial reporting quality is concentrated in the subset of GCs who have financial expertise.

We contribute to an emerging literature on the role of the general counsel in the firm. Although there have been important advances in research on the role of the GC in disclosure strategies (e.g., Bamber et al. 2010, Kwak et al. 2012, Choudhary et al. 2013), on the whole, empirical evidence on the role of the GC is still in its infancy, with many unanswered questions. For example, recent work by Choudhary et al. (2013) suggests an advisory role for the primary legal attorney for firms, be it in-house counsel or outside legal counsel. It would be useful to explore the relative role of outside legal counsel versus inside counsel in corporate decision making. In addition, several studies suggest that CEOs and CFOs have individual styles that they take with them as they move across firms. Although we do not have sufficient data on GC movement across firms to ask a similar question, it would be interesting for future research to consider whether GCs also have individual styles. We look forward to research on this and other related questions.

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Appendix. Variable Definitions

Variable	Variable definition
HiPaidGC	Indicator variable that takes a value of 1 if the general counsel is reported in ExecuComp as one of the top five compensated officers of the firm and 0 otherwise
GConBoard	Indicator variable that takes a value of 1 if the general counsel is reported in ExecuComp as one of the top five compensated officers of the firm and is a member of the board of directors and 0 otherwise
AQ	Accruals quality estimated as the standard deviation of the residuals of a modified Dechow and Dichev (2002) model lagged one period following Equation (2)
GCFinancialExpert	Indicator variable that takes a value of 1 if the general counsel is in the top five compensated officers of the firm and also has expertise in finance as determined by searching the biography in Capital IQ for "finance" or "financial" and 0 otherwise
AbsDAcc	Absolute value of discretionary accruals from a modified Jones (1991) model following Equation (3)
DAcc	The level of discretionary accruals from a modified Jones (1991) model following Equation (3)
Restate	Indicator variable that takes a value of 1 if the observation was subsequently restated as a result of an intentional violation of GAAP and 0 otherwise. Similar to Hennes et al. (2008), we identify such restatements where (1) fraud or irregularity is explicitly mentioned in the restatement announcement, (2) there is a corresponding SEC investigation, or (3) there is a subsequent class action lawsuit.
Fscore	The likelihood of a firm misstating its financial statements, following Dechow et al. (2011)
Size	Log of market value of equity (CSHO * PRCC_F)
GScore	Governance measure following Gompers et al. (2003) from Andrew Metrick's website (http://faculty.som.yale.edu/andrewmetrick/data.html)
GovDum	Indicator variable that takes a value of 1 if *GScore* is missing and 0 otherwise

Appendix. (Continued)

Variable	Variable definition
Lev	Total long term debt (DLTTQ) divided by total assets (ATQ)
LitRisk	The risk of class action, securities litigation estimated, following Kim and Skinner (2012)
MTB	Market value of equity (CSHO ∗ PRCC_F) scaled by total book value (TBV) averaged over the prior five years
StdSaleGrwth	Standard deviation of sales growth (SALE) scaled by total assets (AT) over the current and previous four years
StdSale	Standard deviation of sales (SALE) over the current and previous four years
StdCF	Standard deviation of cash flows from operations (OANCF) scaled by total assets (AT) over the current and previous four years
OldFirm	Indicator variable that takes a value of 1 if the firm is listed on Compustat for more than 20 years and 0 otherwise
Cashpay	Sum of salary and bonus (TOTAL_CURR) from ExecuComp
Totalpay	Cash pay plus stop option grants, restricted stock grants, long-term incentive plan payouts, and other compensation (TDC1) from ExecuComp
Stockhld	Value of stock ownership (SHROWN_EXCL_OPTS ∗ PRCCF) from ExecuComp and Compustat scaled by the consumer price index (CPI) from Compustat
Optionhld	Value of stock options owned (includes new and old stock options OPT_UNEX_EXER_EST_VAL + OPT_UNEX_UNEXER_EST_VAL) from ExecuComp scaled by the consumer price index (CPI) from Compustat
Incent	Equity incentive ratio calculated as *Onepct*/(*Onepct* + *Cashpay*). *Onepct* is the effect of a 1% increase in a firm's stock price on the value of the firm's shares and options held by the executive. For shares we compute the effect of a 1% increase as 1% ∗ firm's stock price ∗ number of shares held. For options, we adopt the Core and Guay (2002) approach and calculate for new and unexercised options.

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