Ownership Concentration and Earnings Management Literature Review

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Abstract. This paper reviews the main literature of ownership concentration and earnings management research, comments the views development of this area research from the large shareholders equity concentration, the identity of owner shareholder and institutional investors holding ratio according to the conclusion of literature and the logical relationships of the literatures respectively. It also discusses the research development of earnings management theory in equity structure. Expect to provide a reference for the future research of ownership structure and earnings management.

Introduction

Although earnings management has received considerable attention in the accounting literature, the existing literature is not able to clearly show that the relationship between ownership structure and earnings management. The prior literature only documents a wide variety relationship between the complexity of ownership structure and earnings management. For example, the ownership concentration, state ownership, family ownership, private ownership, institutional ownership, insider holding, managers holding and the board of directors holding all effect earnings management differently, etc. Moreover, the results are mixed and can be grouped into positive relation, negative relation and no significant relationship, etc. According to the content this paper involved, we only review three broad categories: category 1, the relationship between big shareholders and earnings management; category 2, the identity of the largest shareholder effected earnings management, include state ownership, family ownership, private ownership, foreign ownership, etc; category 3, institutional ownership effected earnings management.

1. Big Shareholders and Earnings Management: Entrenchment Hypotheses and Convergence of Interest Hypotheses

The relationship between the owner–largest shareholder and earnings management can possibly be explained using two opposing views suggested in the finance literature entrenchment hypotheses and convergence of interest.

1.1 Entrenchment hypothesis

The traditional agency problem is the conflicts of interest between shareholders and management. Shleifer and Vishny (1997) argue that one of the two most effective solutions to such an agency problem is concentrated ownership (the other being legal protection). However, with the improvement of ownership concentration, another form of conflict of interests—action being taken by controlling shareholders for their own benefit, at the expense of minority shareholders. This has been called “tunneling” (Johnson et al., 2000). Big shareholders must use abnormal accruals cover for their tunnel behavior, then enable them maximum expropriate small shareholders’ interests.

Stulz (1988) proposed a theoretical model of the entrenchment effect, which predicts a “roof-shaped” relationship between managerial ownership and firm value. In this model, as managerial ownership increases, the entrenched manager-owner will pursue his private interests at the expense of outside investors, thus lowering firm value. The entrenchment of large shareholders is similar to that of the manager.
La Porta et al. (1998) suggests that concentrated ownership is common in countries with poor legal protection of minority shareholders. In these countries, gaining control over management minimizes conflict of interests between management and shareholders and thus lowers the agency problems. However, control by one shareholder over firm’s activities introduces agency conflicts between largest shareholder and minority shareholders (Gedajlovic and Shapiro, 2002). La Porta et al. (1999a) show that concentrated ownership is common in the world’s 27 wealthiest economies. Claessens et al. (2000) provide further evidence that most of these corporations are controlled by families or states in the nine East Asian economies. In this context, the agency problem is between large and small shareholders, minority shareholders face the risk of being deprived of this right due to expropriation by the controlling shareholders, who usually also gain effective control of the firm’s management (La Porta et al., 1999a).

As argued by Shleifer and Vishny, “Large investors may represent their own interests, which need not coincide with the interests of other investors in the firm” (1997, p. 758). Entrenched controlling owners are less subject to stock market discipline and governance input by minority shareholders, so there is a lot of discretion in pursuing their own interest rather than the company’s (Claessens et al. 2002). The opportunistic activities of entrenched controlling owners will eventually harm the health of the company, but as the same owners also control the preparation of financial statements, which are the primary means of communicating corporate financial information, they will try to hide the company’s real economic situation by increasing reported profit (Leuz et al. 2003), and earnings management is higher in countries where family ownership concentration is higher because of weak investor protection and majority shareholder motivation to expropriate minority. As Morck, Shleifer, and Vishny (1988) claim, entrenchment occurs, causing information asymmetry problem and a moral hazard between the owner and outside investors, result in higher earnings management (entrenchment effect). In the theory of entrenchment: the firm decisions will likely be made to benefit the personal wealth of the owner, and expropriation of minority shareholders by the controlling owner could also occur. As a controlling shareholder, the parent or holding company can inject valuable assets into its listed subsidiary in order to boost earnings. Also, the parent company or other group members may absorb unprofitable units from the listed company prior to listing. In return, the holding company expects future payoffs by siphoning profits or cash back from the listed company (Jian and Wong, 2004). Under a weak governance system, monitoring will be more difficult to perform as the owner’s holdings increase. Outside investors will be motivated to impose more accounting constraints on the firm, but owners who have complete discretionary power could respond by manipulating earnings through discretionary accruals, thus lowering the reliability of earnings and earnings quality. Under this scenario, there will be a positive relationship between the owner’s holdings and earnings management.

This entrenchment effect is also supported by some other empirical evidence. For example, Liu and Lu (2002) examined whether earnings management in China’s publicly traded companies was related to “tunneling” of corporate resources by controlling shareholders for their own benefit. Their empirical evidence shows that total accruals and industry median adjusted accruals are positively correlated with the largest shareholder’s interest in a company, top executives’ interests in the company. Wang (2006) who investigated the relationship between family ownership and earnings quality showed a negative relationship between the two at a high level of ownership concentration. Bolton et al. (2006) found that higher ownership concentration is associated with higher earnings management in another related study. Ali et al. (2007) showed that ownership concentration negatively affects earnings quality. Al-Fayoumi et al. (2010) used Jordanian industrial firms data (during the period 2001-2005) test that insiders’ ownership was significant and positively affect earnings management.

1.2 Convergence of interest hypotheses

Jensen and Meckling (1976) suggested that alignment hypothesis, was based on the classic agency theory, and alignment was a convergence of interest, could occur as the owner’s holdings increase, reducing agency costs, suggested ownership concentration caused alignment effect and
result in lower earnings management. Shleifer and Vishny pointed out that large shareholders “have both a general interest in profit maximization, and enough control over the assets of the firm to have their interest respected”. As a result, the controlling owners’ interests are better aligned with the firm’s interests when ownership concentration is higher (Shleifer and Vishny, 1986). Further more, the alignment effect of increased ownership concentration is significant in countries with a less developed legal and institutional environment. La Porta et al. (1999b) argued that concentrated ownership in developing countries was endogenously formed, suggesting its positive effect. Gomes (2000) suggested that high ownership concentration was a signal of the controlling owner’s commitment to build a reputation for not expropriating minority shareholders. Investors may perceive that the owner–largest shareholder behaves in a way to maximize firm value when the owner’s holding is large, and in this case, convergence of interest between the owner and outside investors occurs.

And the stewardship theory is support alignment hypothesis. In accordance with the stewardship theory, when the owner’s holdings increase, earnings are less likely to be manipulated because controlling families would identify their interests more closely with the firms’ wealth. Jung and Kwon examined the relationship between corporate ownership structure in Korea and the informativeness of earnings, and found that the greater the holdings of owner–largest shareholder, the more informative the earnings were.

In addition, empirical studies find that large holder has no significant impact on earnings management. Chirinko et al. (2004) studied on Dutch companies, and found that ownership concentration had no discernible impact on firm performance, a finding which might reflect large shareholders’ dual role in lowering the costs of managerial agency problems but raising the agency costs of expropriation. Farooq and Jai’s research found that ownership concentration—percentage shareholding of the largest shareholder – had no significant impact on earnings management.

While the alignment effect reduces the degree of upward earnings management, the entrenchment effect suggests that earnings maximization rises with ownership concentration. In fact, large shareholders really exist dual role in two type agency problems. Depiction of an unambiguous relationship between ownership concentration and earnings management is thus an empirical issue.

2. The Largest Shareholder’s Identity Effected Earnings Management—Incentive or Restrain

The identity of the largest shareholder includes state ownership, family ownership, private ownership, foreign ownership, etc.

2.1 State owner and earnings management

Bauwhede et al(2003) used the Belgian company data, research find that public ownership works as an incentive to manage earnings upward and thus has a positive impact on discretionary accruals. And both private and public Belgian companies all engage in income smoothing and manage earnings opportunistically to meet the benchmark target of prior-year earnings. Xu et al. (2012) examined the influence of ownership structure on earnings quality of firms listed on the Chinese Stock Exchanges. They found that privately-owned firms, foreign-owned firms and society-owned firms outperform the state-controlled firms in earnings quality; and foreign-owned firms had the highest earnings quality among all types of ownership groups.

But other research shows that, ownership structure could also play important roles in restraining opportunistic earnings management. Li (2010), Shen and Chen (2009), and Sueyoshi, Goto, and Omi (2010) studies found that large/state shareholding was an important governance mechanism. Wang and Campbell (2012) concluded that state ownership to an extent discourages earnings management in China.

2.2 Family ownership and earnings management

Wide-spread ownership structure is only found in the United States and the United Kingdom. In other developed and developing countries, most companies are still controlled by family ownership. La Porta, Lopez-de-Silanes, and Shleifer (1999), report that 85% of Spanish firms have controlling
shareholders, compared to United States and the United Kingdom, which have only 10% and 20%, respectively.

Thai firms (Wiwattanakantang, 2000), Belgian firms (Crijns & De Clerck (1997), Turkish firms (Sarac, 2002), Egyptian firms (Shahira, 2003), and Indonesian firms (Arifin, 2003), are also controlled by founding families.

Family-controlled firms should be more efficient than publicly-owned firms because monitoring costs are lower in family-owned firms (Fama & Jensen, 1983). Anderson and Reeb (2003) showed that minority shareholders in large U.S. firms benefit from the presence of founding families in the management. Arifin (2003) found that in his sample of publicly listed firms in Indonesia, family controlled firms, have fewer agency problems than publicly-controlled firms or firms without controlling shareholders, because there is less conflict between the principal and agent in family-owned firms.

Arifin (2003) also said that agency problems in family-controlled firms were fewer than in publicly-controlled firms or firms without controlling shareholders.

McConaughny, Matthews, and Fialko (2001), Yammeesri and Lodh (2001), Suehiro (2001), and Anderson and Reeb (2003) found that family-controlled firms were valued higher or perform better than other firms.

If family ownership represents an efficient organizational structure, then in family owned firms opportunistic earnings management will be limited. However, as Claessens. Djankov, Fan, and Lang (1999) found, family-controlled firms, through pyramid ownership structure and their business group, expropriate minority shareholders. Claessens et al. (1999) found that higher cash-flow rights were associated with higher market valuation, but higher control rights were associated with lower market valuation, especially when cash-flow rights were low and control rights were high. This suggests expropriation of minority shareholders by controlling shareholders. They conclude that family control is an important factor behind the negative relation between control rights and market valuation.

Then, in firms with business groups (in Indonesia most publicly listed firms have business groups), opportunistic earnings management may be unavoidable. For firms belonging to business groups, most of the owners’ capital is not invested in a single company, but rather is spread over several companies. If any portion of that capital is invested in public firms, then expropriation of minority shareholders and thus opportunistic earnings management is likely to occur, even if the company is controlled by one family. This happens because public firms are exploited by the owners who use them to collect funds from the public which are in turn transferred to other firms in the business group. Kim and Yi (2005) found evidence that opportunistic earnings management was higher in firms with business groups compared to firms without them. Their results suggest that firms with business groups give their controlling shareholders more incentive to engage in earnings management.

2.3 Foreign owner and earnings management

Extant literature documents superior of foreign institutions relative to local institutions in emerging markets. This strand of literature argues that due to their access to better resources and greater talent, foreign institutions can act as better monitors than their local counterparts in emerging markets. Seasholes (2004), for example, documented that foreign investors, mostly institutions, act like informed investors in emerging markets.

Better monitoring by foreign institutions in emerging markets is, however, not a conclusive matter. A competing strand of literature argues that foreign institutions have information disadvantage relative to their local counterparts. Coval and Moskowitz (2001) documented that local investors firm can visit the firm’s operations, talk to its suppliers and employees, and assess the local market conditions in which the firm operates in better than foreign investors. As a result, local institutions can monitor firms better than foreign institution. This strand of literature would, therefore, predict lower earnings management by firms where local institutions are the largest shareholders.
3. The Impact of Institutional Ownership on the Active Monitoring of Earnings Management, the Choice of Strategic Alliances and the Types of Earnings Management

For the discussion on the impact of institutional ownership on Earnings Management, there are three views in the previous literatures: active monitoring, strategic alliance hypotheses and earnings management selection.

3.1 Active monitoring

Active monitoring theory suggests that institutions may have incentives to actively monitor firm management. Because, institutional investors are large investors, other than natural persons, have greater resources, are more sophisticated than individual investors, and have more relevant expertise to monitor management. As a result, they are able to force effective disclosure of information.

The effects of institutional ownership on earnings management behaviour of managers in various contexts suggest that institutional investors are not necessarily myopic, as well as improving information efficiency in the capital market. Maug (1998) believed that it is this lack of marketability that makes institutional investors long-term investors and thus forces them to closely monitor firms. Some literature considers institutions as an important channel via which minority shareholders are protected against expropriation of controlling shareholders in emerging markets (Oehl, 2000).

In addition, literature also suggests that institutions have strong incentives to monitor management to increase firm value by focusing on long-term profitability instead of short-term earnings found that when institutions collectively owned a high percentage of stocks in firms, managers were prevented from opportunistically manipulating earnings. Long-term institutional investors constrain accruals management among firms that manage earnings to meet/beat earnings benchmarks. Rajgopal et al. (1999) and Koh (2007) argued that institutional investors were long-term oriented and acted as corporate governance mechanism that toned down aggressive earnings management. They argued that as institutional shareholding grew, selling shares became more costly due to large discounts involved while selling large blocks of shares.

Research also provides evidence that the management of distressed firms with higher institutional ownership has less tendency to manage earnings, and the monitoring role of institutional investors suggests that the association between TMT ownership and earnings management is weaker for firms with high institutional ownership than for firms with low institutional ownership. Jung and Kwon (2002) examined the relationship between corporate ownership structure in Korea and the informativeness of earnings, found that the higher the holdings of the institutions, the more informative the earnings were. Institutions and block holders, play a more active monitoring role. These results support the competing view that institutional investors serve a monitoring role, with their presence reducing the incidence of aggressive earnings management.

3.2 Strategic alliance

On the other hand, the strategic alliance hypothesis suggests that institutional investors and owners find it mutually advantageous to cooperate.

Many critics, such as Bhide (1993) and Porter (1992), alleged that the frequent trading and fragmented ownership by institutional investors discourage such investors from becoming actively involved in the corporate governance of their portfolio firms and encourage myopic behaviour by portfolio firm managers. Institutions do not monitor effectively because they either lack expertise or suffer from freerider problems among themselves, or strategically ally with the management (Pound, 1988).

The Business Week Harris Poll reveals that 60% of the 400 CEOs surveyed indicate that institutional investors exert the most pressure on firms to focus on short-term performance. Because the market rewards earnings growth. Institutional investor trading is sensitive to current earnings news, and that managers have incentives to manage earnings aggressively. These arguments indicate that institutional investors’ short-term orientation is likely to associate with aggressive earnings management by portfolio firm managers.
Consistent with these, Bushee (2001) found that transient institutional investors exhibit a strong preference for near-term earnings, which translates into misvaluation of stock prices where the near-term earnings are over weighted. Furthermore, a trading strategy exploiting this weighting scheme generates significant abnormal returns [6]. Institutional investors are found to sell their shares as a result of the underperformance of current earnings. The excessive focus on current earnings by such institutional investors creates incentives for firm managers to manage earnings upwards. Fox (1997), Levitt (1998) and Loomis (1999), among others, have highlighted a culture of unforgiving investors severely penalising firms’ stock value when firms under-performed.

3.3 Institutional investors’ affect on type of earnings management selection

Yuan’s study finds evidence that institutional investors have significant influence on the type of earnings management selection in China [3]. Firms with a high proportion of institutional investors tend toward to select efficient earnings management (AEM) and restrain aggressive earnings management (REM).

Koh examined the association between institutional investor type and firms’ earnings management found that: transient institutional ownership was associated with firms using positive discretionary accruals to meet/beat earnings benchmarks but not in other settings; transient institution-associated aggressive earnings management was restricted to accruals management to avoid losses and earnings declines; and long-term institutional ownership constrained accruals management among firms that manage earnings to achieve earnings targets [5].

References


