



# Corporate Ownership Structures as an antecedent of Real and Accrual Earnings Management: A Conceptual Study

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The aim of this study is to provide a complete description of the related literature associated to the relationship between ownership structures, namely; family, managerial and foreign ownership; and Real and Accrual Earning Management. As has much research over the past decades preceding this study, this research explores how ownership structure plays an essential function in forming the corporate governance system of a company. The existing literature on ownership structure indicates that there is a lack of research on the three forms of ownership nominated above and their subsequent impact on the two kinds of earnings management in developing countries. Thus, this research focuses on the three specific and less researched ownership structures to fill the identified gap as well as to attempt to add to literature in this field.

**Key words:** *Earnings management (EM), accrual earnings management (AEM), real earnings management (REM), family ownership, managerial ownership, foreign ownership.*



## Introduction

Ownership structure is deemed an essential factor that can effect a firms' performance, the behaviour of managers and the shareholder's wealth (Jensen & Warner, 1988). Also, ownership structure act as a main function in forming the corporate governance of a company (Amran & CheAhmad, 2013; George & Georgios 2017). According to Grossman and Hart (1980), Fama and Jensen (1983), ownership structure is a mechanism of corporate governance in resolving various agency issues because they have power and incentive to discipline management. Also, since they will become managers and at the same time owners, there is an alignment of interest between owners and managers, also known as principal-agent (PA). On the contrary, the ultimate ownership by managers, family control, information asymmetry, and weak protection of minority shareholders may lead to conflict of interest between the minority shareholders and the majority shareholders or controllers, especially in the case that the latter expropriate the wealth of the earlier through tunnelling and propping. This type II conflict is called the principal- principal conflict (PP) ( Young *et al.*, 2008; Sauerwald & Peng, 2013). Since the divergence in purpose may drive t managers to utilize their choice to achieve self-interest objectives and gain effective control of a company (Jiraporn *et al.*, 2008), an understanding of the structure of ownership is fundamental in resolving issues (Lemmon & Lins, 2003).

Prior studies have examined earnings management determinants, and one of the determinants studied was ownership structure (Nia *et al.*, 2017, Chung *et al.*, 2004). Whether ownership structur is a strong motivation to decrease EM or increase it is an unknown. Existing literature has presented two inconsistent views. The first perspective is anchored in the alignment theory, to mitigate the agency problem ensuing from ownership structure, for example, Agrawal and Knoeber (1996) suggest that managerial ownership and concentrated ownership by the institutional and blockholders act as effective monitoring mechanisms. Similarly, Achleitner *et al* (2014) found a negative impact of family ownership on AEM and REM. The second perspective centres on the entrenchment hypothesis. It postulates that ownership structures are associated with increasing EM (Wang, 2006). Razzaque *et al*, (2016) found that family ownership is linked to EM meaning. Consistent to the above, Fan and Wong (2002) who studied the linkage between ownership structure and earnings informativeness among seven countries of Asia found that there is a higher level of information asymmetry in companies whose owners are more concentrated. Based on the unique objective of the current study, this paper is strutured as follows, an examination of the



existing literature in sections 2 highlights the theoretical links between ownership structure and earning management, and section 3 concludes the study.

## **Hypotheses Development**

### ***Family Ownership and Earnings Management***

Corporate governance (CG) is divided into internal and external governance mechanisms, and the ownership structure is considered a vital element of internal CG. In this study, family ownership as the most prevailing form of ownership in both developing and developed countries is chosen as an important determinant of the earning management. Unfortunately, there has not been a consensus on the definition of “family ownership”. However, two factors are always considered in determining whether a company should be categorised as a family firm: The firm must own a majority firm’s shares and family must involved in management. Thus, family ownership can be defined as where family members either have a strong control of the management or possess a significant amount of firm’s shares, and act as officers or directors of the firm (Villalonga & Amit, 2006; Chu, 2011; Amran & CheAhmad, 2013; Mohd-Saleh & Omar, 2014; Gamba, 2017). In the same context, measurement of family ownership as the percentage of shareholdings owned by the family directors over the total outstanding shares is supported by research (Achleitner *et al.*, 2014; Amran & CheAhmad, 2013; Anderson *et al.*, 2003; Basheer, 2014; Chen *et al.*, 2015; Chi *et al.*, 2015; Chu, 2011; Mohd-Saleh & Omar, 2014; Razzaque *et al.*, 2016; Villalonga & Amit, 2006).

Jensen and Meckling (1976) broached an important argument that family ownership helps to reconcile the interest of the managers and owners and hence reduces the agency conflict. Furthermore, Socio-Emotional Wealth Theory argues that family ownership would accept financial performance without achieving the target to conserve its Socio-Emotional Wealth for the next generation. According to the alignment hypothesis, family businesses have a strong economic motivation to align the interests of controlling families with other stockholders and lower monitoring costs, thus associated with decreased EM. The benefit is that families are aligned with the interests of the company, and given the significant shares awarded a family member, this places them to handles earnings in a manner that evades possible harm to the survival of the company ( Salvato & Moores, 2010; Wang, 2006; Hussain, Ali, Thaker, & Ali, 2019).

Ali *et al.* (2007), Wang (2006) and Hashim and Devi (2008) reported that family ownership is linked to higher earnings quality and their findings provide support to the incentive alignment hypothesis (Yasser, Al Mamun, & Rodrigs, 2017). Similarly, findings by Martin *et al.* (2016) suggested that the family firms within the United States are less able to manage

earnings than non-family firms (Prochazka, 2017). Using a Spanish sample, Sánchez *et al.* (2007) provided evidence that family-related firms usually have a lower level of AEM. Achleitner *et al.* (2014) in Germany and Chen *et al.* (2015) in Japan, documented the significant association between various family ownership and the REM and AEM. Masri (2018) in Indonesia, found that family businesses incline to affect REM negatively.

Despite the fact that the family ownership emerged as a solution to the principal-agent conflict it offers threat of principal-principal conflict. On the other hand, family businesses could be affected by more agency problems between the principal controller and minority stockholders (PP), Shleifer and Vishny (1997) posited that conflict of interests between majority and minority stockholders exist and according to the entrenchment hypothesis, family ownership might make private gain from the firm at the expenditure of various other shareholders. Family owners have strong incentives to channel wealth from the publicly traded companies they control to firms they own privately by using related-party transactions and engaging in opportunistic EM (Cheung *et al.*, 2006; Munir *et al.*, 2013; Wang, 2006).

Fan and Wong (2002) highlighted that the ownership concentration in the form of family control is associated with low earnings. They then argued that a firm with ownership concentration coupled with family control is vulnerable to family entrenchment. Similar findings provide evidence that family ownership is linked with various higher AEM (Bataineh *et al.*, 2018; Chi *et al.*, 2015; Chin *et al.*, 2006; Ishak *et al.*, 2011; Kamran & Shah, 2014; Kim & Yi, 2006).

Accordingly, the impact of (PP) agency problems in family companies prefers AEM to REM because REM is associated with lower future performance (Achleitner *et al.*, 2014; Razzaque *et al.*, 2016; Georgantopoulos, Poutos & Eriotis 2018). Therefore, the following hypotheses have been developed:

H1a: There is a significant association between family ownership and AEM.

H1b: There is a significant association between family ownership and REM.

**Table 2.1:** Empirical Studies on Family Ownership and Earnings Management

Author(s)	Sample	Findings	Theories
Fan and Wong (2002)	977 firms from East Asian countries (66 Taiwanese, 282 Hong Kong, 177 Malaysian, 133 Thai, 133 Singaporean, 95 South	1) Associated with low earnings informativeness and earnings quality. 2) Creates agency conflicts between controlling owners and	Agency theory

Author(s)	Sample	Findings	Theories
	Korean and 91 Indonesian) for the period 1991-1995.	outside investors.	
Yang (2010)	3,914 firm-year observations from Taiwan Stock Exchange for the period 2001–2008	The higher the share of insider ownership, the higher the level of AEM. Supporting an entrenchment effect of family ownership.	Agency theory
Chi, Hung, Cheng, and Tien Lieu (2015)	378 firms with a total of 2492 firm-year observation from Taiwan for the period 2006 - 2012.	Family firms are positively related to AEM. Family firms are likely to get involved in AEM activities more than nonfamily firms in high-tech firms.	Agency theory
Kamran and Shah (2014)	372 listed Pakistani firms over the period of 8 years from 2003 to 2010	Companies' directors, their spouses, children, and other family members increase AEM. The dominant family play the role to expropriating external minority shareholders in Pakistan.	Agency theory
Razzaque, Ali and Mather (2016)	691 firms for the period 2006 - 2011 (Bangladesh listed firms).	Family firms engage in REM more when compared to non-family companies between 2006-2011. REM is associated to lower future performance.	Agency theory
Bataineh, Abuaddous and Alabood, (2018)	43 Jordanian industrial firms yield (258) observations for the period 2011-2016.	The AEM appeared is positive and significant relationship with AEM.	Agency Theory and (SEW) Theory
Achleitner, Günther, Kaserer and Siciliano (2014)	402 families and 436 non-families' firms from Germany to period 1998–2008.	Family firms are less likely to participate in REM. Instead, they may engage in AEM practices that assist families in keeping transgenerational control.	Socioemotional wealth theory (SEW)

Author(s)	Sample	Findings	Theories
Chen, Gu, Kubota, and Takehara (2015)	4857 families and 7826 nonfamily's observations from Tokyo Stock Exchange during 2004–2011.	The level of AEM and REM is lower for family firms when compared with non-family firms. Family firms in Japan utilize AEM more often than REM.	Socioemotional wealth theory (SEW)
Ishak <i>et al.</i> , (2011)	236 firms from Main Market of Bursa Malaysia in 2009.	Larger presence of family people on boards is positively related to discretionary accruals.	Agency theory
Hashim and Devi (2008)	204 listed firms on Malaysian Stock Exchange in 2004.	Earning quality increases in the presence of family ownership	Agency theory and Resource dependence theory
Masri (2018)	61 manufacturing Indonesian firms' from 2010 to 2013	Family ownership tends to affect REM negatively.	Stewardship theory

### ***Managerial Ownership and Earnings Management***

Managerial ownership is one of the most important elements of the corporate ownership structure. Managerial ownership is seen as a solution to the agency problem as many prior studies (Ali *et al.*, 2010; Mat Nor & Sulong, 2007; Ramli *et al.*, 2013) have argued that higher level of managerial ownership in a firm reconciles the interest of managers and owners and thus alleviates the agency cost. In line with previous studies, measurement of managerial ownership is as to the part of the total shares by directors to the total shares issued (Ali *et al.*, 2010; Alves, 2012; Alzoubi, 2016; Amran & CheAhmad, 2013; Aygun *et al.*, 2014; Kamran & Shah, 2014; Masmoudi Ayadi & Boujelbène, 2014; Mustapha & CheAhmad, 2011; Ramadan, 2015).

Jensen and Meckling (1976) stated that managerial ownership is a vital means of aligning the interests of shareholders and managers and curbing agency problems. As such, the manager is part of the firm's ownership and in a practical sense, aligns interests with those of the outside shareholders (alignment effects). This decreases opportunistic managerial behaviour and

lowers motivation to manage earnings (Jung & Kwon, 2002; Teshima & Shuto, 2008). Several studies showed an opposite connection between managerial ownership and EM and supported the incentive alignment (Ali *et al.*, 2010; Alves, 2012; Alzoubi, 2016; Hsu & Wen, 2015; Teshima & Shuto, 2008; Warfield *et al.*, 1995).

In contrast, positive accounting theory proposes that managers incline to manipulate earnings to reduce political costs, to relieve debt covenants, and to raise bonuses (Healy, 1985; Watts & Zimmerman, 1990). The management entrenchment school of thought states that an advanced level of managerial ownership provides to managers greater room for opportunistic behavior (Morck *et al.*, 1988; Stulz, 1988; Warfield *et al.*, 1995). Thus, high managerial ownership might be advantageous in the sense of manipulation of earnings (Yang *et al.*, 2008). Accordingly, despite the hypothesized negative relationship, the majority of the managerial ownership studies found that the entrenchment hypothesis is dominant and the association between managerial ownership and EM is positive (e.g. Al-Fayoumi *et al.*, 2010; Aygun *et al.*, 2014; Bao & Lewellyn, 2017; Cheng & Warfield, 2005; Gopalan & Jayaraman, 2012; Huang *et al.*, 2013; Johari *et al.*, 2009; Leuz *et al.*, 2003; Masmoudi Ayadi & Boujelbène, 2014; Mitani, 2010).

Regarding the above discussion, managerial ownership is no longer the solution to the agency conflict due to the agency problem identified as principal–principal (Claessens & Fan, 2002; Fan & Wong, 2002; Zandi and Haseeb, 2019). Even though the hypothesis competes with the agency theory, this study considers ownership structure to vary between emerging markets and developed markets. Therefore, the following hypotheses are posited:

H2a: There is a significant association between managerial ownership and AEM.

H2b: There is a significant association between managerial ownership and REM.

**Table 2.2:** Summary of Empirical Studies in Managerial Ownership and Earnings Management

Author(s)	Sample	Findings	Theories
Aygun, Ic and Sayim (2014)	230 Turkish firms, for period 2009 to 2012.	The association between managerial ownership and earnings management is positively statistically significant.	Agency theory
Al-Fayoumi,	195 Jordanian firms' for the period 2001- 2005.	Managerial ownership and earnings management have a	Agency theory

Author(s)	Sample	Findings	Theories
Abuzayed, Alexander (2010)		significant positive relationship.	
Ramadan (2015)	The 77 firms listed on Jordanian Stock Exchange from 2000 to 2014	Managerial ownership is in negative relationship with earning management	Agency theory
Johari, Saleh, Jaffar and Hassan (2009)	598 Malaysian listed firm-year observations over the period 2002 and 2003.	High managerial ownership (larger than 25%) might influence incentive management leading to EM and also that managerial ownership is linked positively with EM practices.	Agency theory
Ali, Salleh and Hassan (2010)	1,001 Malaysian firm-year observations for 2002 and 2003.	Managerial ownership is associated with the magnitude of accounting accruals negatively.	Agency theory

### ***Foreign Ownership and Earnings Management***

Foreign ownership is the third piece of the ownership puzzle. Foreign investment involves shifting financial capital from one country to another, to meet the shortage of capital and reduce unemployment in those countries (Dahlquist & Robertsson, 2001). Foreign ownership is evaluated by the portion of shares possessed by foreigners to the number of shares issued. (Ali *et al.*, 2010; Alzoubi, 2016; Ben-Nasr *et al.*, 2015; Guo *et al.*, 2015; Mangena & Taurigana, 2007; Mohd-Saleh & Omar, 2014).

Knowledge spillover hypothesis poses that foreign ownership with sophisticated skills and investment experiences may provide access to knowledge and strategic expertise that help to restrain EM. Furthermore, foreign ownership could play a significant part in monitoring skills in corporate governance and align their benefits with those of the owners (Aggarwal *et al.*, 2011; Khanna & Palepu, 1999). Chung *et al.* (2004) showed that foreign ownership provides adequate oversight to prohibit managerial opportunism and improve the valuation of discretionary accruals. Beuselinck *et al.* (2017) and Yasser *et al.* (2016) investigated a direct link between foreign ownership and earnings quality of firms. Poli (2015), Ajay and Madhumathi (2015) and Alzoubi (2016) provided similar evidence that foreign ownership

diminishes using discretionary accruals opportunistically. Guo *et al.* (2015) documented that sophisticated foreign ownership plays an instrumental role in limiting REM. Nia *et al.* (2017) found similar evidence that foreign ownership can constrain upwards REM-related to discretionary expenditure.

On the other hand, information asymmetry hypothesis anticipates that cultural barriers and spatial distance may lead to difficulty for foreign investors trying to obtain local information and thus allows managers to manipulate earnings. Consistent with this view, Sarkar *et al.* (2008) designated no association between foreign ownership and discretionary accruals. Likewise, Ali *et al.* (2010) described that foreign ownership is ineffective in alleviating the practice of EM.

Based on the findings of the studies mentioned above, this study predicts that foreign ownership may play a prominent role in restraining both types of EM and poses the following hypotheses:

H3a: There is a significant association between foreign ownership and AEM.

H3b: There is a significant association between foreign ownership and REM.

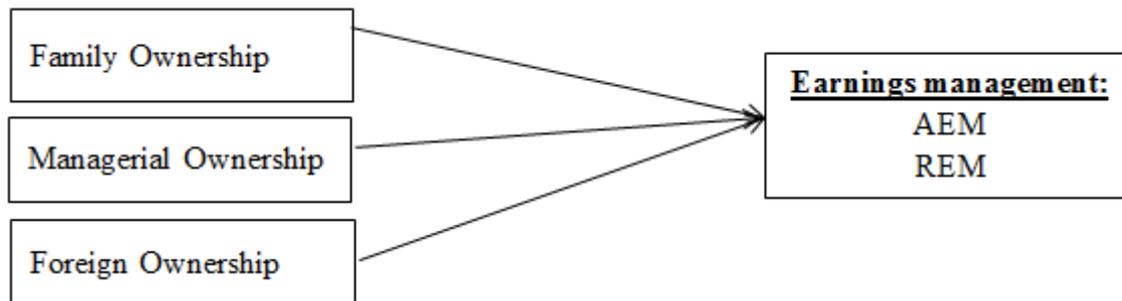
**Table 2.3:** Summary of Empirical Studies in Foreign Ownership and Earnings Management

Author(s)	Sample	Findings	Theories
Beuselinck, Blanco and García Lara (2017)	1,590 firm-year (265 firms) observations, from (372 Greece, 612 Italy, 198 Portugal and 408 Spain) over the period 2002-2007.	More foreign ownership is positively related with earnings quality of firms operating in countries with weak institutional quality.	Agency theory
Poli (2015)	13,724 Italian firms, with 27,448 observations for the period 2012-2013.	Foreign ownership firms operating in countries with strong institutional quality negatively affects the EM in Italian private firms.	Agency theory
Ben-Nasr, Boubakri and Cosset (2015)	350 privatised firms across 45 countries during the period 1985–2007.	In countries with lower risk of expropriation the foreign ownership is in positive relationship with the earning quality.	Information asymmetry theory

Author(s)	Sample	Findings	Theories
Alzoubi (2016)	62 Jordanian firms' for the period 2006 to 2013.	Foreign ownership influences financial reporting quality, and it has the potential to restrict earnings management.	Agency theory
Nia, Sinnadurai, Sanusi, & Hermawan, (2017)	Using 1,180 observations of financially distressed companies in Malaysia, for the period 2001-2011,	foreign ownership can constrain upwards real earnings management	Agency theory

### Conceptual Framework

Figure 4.1. Conceptual framework



### Conclusion

The study aimed to conceptualise the association between corporate ownership structure and types of earnings management (real and accrual). After reviewing the existing literature, the authors of the study have concluded that this study is among the pioneering studies on these issues. The inclusion of real earnings management is one of the contributions of this study to the current body of knowledge on earning management and corporate ownership structures. The role of corporate ownership structure to reduce EM and mitigate the agency problem is consistent with many studies and agency theory (owner-manager); however, some studies have shown the opposite and supported the view that the controlling shareholders of the company (majority) expropriate the rights of outside shareholders (minority), an agency problem identified as principal–principal.



The current study, which is one of only a few pioneer studies seeks only to explain the conceptual relationship between ownership structures and earning management; however, no empirical evidence is given. Therefore, an empirical study is recommended based on a sample of emerging and developing countries. Moreover, it is also recommended that an investigation with regard to the intervention of other elements such as audit committee, leverage etc. in the form of mediation or moderation in the association between ownership structure and EM be conducted.

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