Ownership structure and earnings management in emerging markets—
An institutionalized agency perspective

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A B S T R A C T
Previous earnings management research has largely focused on firm-level governance mechanisms in single countries or on macro-level variables in multiple countries. Building on this research, we incorporate firm ownership predictors along with national institutional dimensions to explore why firm decision makers in emerging markets vary in their earnings management behavior. Our theoretical framework integrates agency and institutional theories proposing that firm-level ownership mechanisms do not function in isolation, but are reinforced or attenuated by elements of the institutional governance environment. The multilevel empirical analysis of 1200 firms in 24 emerging markets indicates that controlling ownership is positively related to earnings management. We find that the level of minority shareholder protection in a country weakens this positive relationship. We also find that regulatory quality strengthens the negative relationship between institutional ownership and earnings management activity. It is hoped that awareness of how firm ownership structures interact with national-level institutions in affecting firm-level behavior will help managers and investors develop skills and practices to better cope with business norms in emerging economies. 
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1. Introduction

“We struggle to find companies that satisfy our quality criteria,” said Christopher Wong, senior investment manager at Aberdeen Asset Management in Singapore, who runs its emerging markets fund. “We are uncomfortable with the opaque business structures and the generally poor corporate governance standards.” (Sami-nather, 2015)

In recent years, emerging markets have received much scholarly attention due to their economic growth, restructured markets, and significant involvement in the world economy (Hoskisson, Eden, Lau, & Wright, 2000). Despite these developments, as the opening quote illustrates, the quality and accuracy of financial information reported by many firms in these countries continues to be questioned in practice as well as in scholarly research (e.g., Li, Park, & Bao, 2014; Wang & Yung, 2011). Relatedly, earnings management is a concern for regulatory bodies in emerging markets as well, since it may threaten foreign investments and corporate partnerships in these markets (Chen, Elder, & Hsieh, 2007).

Earnings management is defined as “the practice of distorting the true financial performance of the company” (Klein, 2002, p. 376). It occurs when managers exercise discretion in the ways they structure transactions in financial reports, with the intent to either mislead stakeholders about the true financial performance of the company or to influence transactions that rely on reported accounting values (Healy & Wahlen, 1999). Firms in emerging markets have been found to manage earnings to a much greater degree than those in developed economies (Li, Selover, & Stein, 2011; Li et al., 2014). However, despite extensive empirical research on the antecedents of earnings management in the developed market economies of the U.S. and U.K (e.g., Bedard, Chtourou, & Courteau, 2004; Erickson & Wang, 1999; Klein, 2002; Park & Shin, 2004; Peasnell, Pope, & Young, 2005; Xie, Davidson, & DaDalt, 2003; Teoh, Welch, & Wong, 1998), there is much less understanding and empirical evidence of how and why firms manage earnings in emerging economies (Wang & Yung, 2011).

Variation in earnings management across firms in developed markets is often viewed as a function of firm-level governance quality (e.g. Davidson, Jiraporn, Kim, & Nemec, 2004; Klein, 2002; Peasnell et al., 2005). This research largely underpinned by agency

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theory suggests that because of the separation between managers and shareholders, these actors may have conflicting goals (Ball, 2013). The divergence in goals may manifest as an inclination for managers to use their discretion to make earnings appear near target levels, so as to achieve private control benefits and other self-interested objectives (Jiraporn, Miller, Yoon, & Kim, 2008). Since much of this agency theory-based earnings management research has been conducted in single country settings or within developed markets, less attention has been given to how earnings management activity varies in countries that have dramatically different firm-ownership structures and national institutional environments.

We propose that in emerging markets, where firm-level and country-level factors driving managerial behavior largely depart from the Anglo-American governance system, traditional agency theory (Jensen & Meckling, 1976) will not sufficiently explain the variation in earnings management. Rather, institutionalized agency theory (Aguilera & Jackson, 2003; Seal, 2006) provides a more appropriate framework to explore the interplay between firm-level governance mechanisms and national institutional elements on earnings management.

The integration of agency and institutional theories recognizes that the unique institutional environments in which managers and owners/shareholders are embedded shape the nature and behavior of these economic actors as well as how they evaluate information, use their discretion, and justify their behavior (Aguilera & Jackson, 2003; Filatotchev, Jackson, & Nakajima, 2013; Hoenen & Kostova, 2014; Ning, Kuo, Strange & Wang, 2014). In particular, it permits consideration of the distinctive patterns of shareholder concentration that are often observed across emerging market countries as well as the unique identities of ownership types in these countries (Chen & Yu, 2012; Filatotchev et al., 2013).

We hypothesize that in emerging economies, controlling shareholders will be better able to influence the reporting policies of accounting information, in order to fulfill self-interested purposes, resulting in greater earnings management activity. In contrast, we expect institutional ownership will be negatively related to earnings management as these types of shareholders have incentives and capabilities to promote accurate reporting of earnings and discourage financial misreporting (Chung, Firth, & Kim, 2005; Chung & Zhang, 2011). Yet we know from previous theory and empirical evidence that the effectiveness of corporate governance mechanisms is influenced by their level of legitimacy with respect to prevailing institutions within a given society (Aguilera, Filatotchev, & Jackson, 2008; Filatotchev et al., 2013). Therefore we expect that incentives for a given shareholder to influence earnings management activity will vary with the institutional forces at play in the context within which a firm operates. Specifically, we explore how ownership concentration and the type of owner may affect earnings management activity differently because of variation in institutional characteristics related to minority shareholder protections and regulatory quality across countries.

Consequently, by examining these relationships in a nuanced fashion, we seek to contribute theoretical and empirical insights to the comparative corporate governance literature, and in particular that focused on emerging markets. Although interest in investigating firm behaviors in emerging economies has grown significantly in the past decades, research exploring corporate governance issues of these markets remain limited (Chen, Li, & Shapiro, 2011; Crittenden & Crittenden, 2012). The few comparative international studies on earnings management (e.g. Han, Kang, Salter, & Yoo, 2010; Shen & Chih, 2005) consider the influence of firm-level and country-level governance mechanisms in isolation, not capturing the embedded nature of the situation. Our multi-level analysis with a sample of 1200 firms from 24 emerging economies provides a richer understanding of how the national institutional environment in which firms are embedded in plays a critical role in shaping the relationships between the important firm-level governance mechanisms of ownership by controlling and institutional shareholders with earnings management activity. In doing so we further understanding of why managers are incentivized and/or dissuaded from using their discretion to manage earnings due to constraints from both their firm’s internal and external contexts. As such we are able to explicitly address concerns about the “under-contextualized nature of corporate governance research” (Filatotchev et al., 2013, p. 966) and in particular “facilitate an international contextualization for the traditional, context-free agency theory perspective” (Bowe, Filatotchev, & Marshall, 2010, p. 347).

2. Theory and hypotheses development

For firms operating in emerging markets, there is less of a distinct separation between ownership and management than for firms operating in the developed markets of the U.S. and U.K. (Chen & Yu, 2012; Filatotchev et al., 2013). Even firms from emerging markets that are publicly listed generally have a highly concentrated ownership structure with top managers being (or directly representing) controlling shareholders (Ding, Zhang, & Zhang, 2007). This underscores the need to re-consider the traditional theoretical approaches to earnings management research, which has focused on conflicts between principles (owners) and agents (managers) (García-Meca & Sánchez-Ballesta, 2009).

With an institutionalized agency theory perspective, managers are still viewed as agents with authority delegated from the legal owners of the corporations, but their actions are also influenced by values and norms that are considered legitimate within a given institutional environment (Seal, 2006). Institutionalized agency theory connects the routine nature of managerial accounting practices with external institutional influences (Seal, 2006). As such, it is a more appropriate framework for understanding how firm ownership governance mechanisms shape earnings management activity in emerging markets. Additionally, it provides a meaningful way to understand how these relationships may be influenced by elements of the institutional context.

2.1. Firm-level governance mechanism of controlling ownership

In emerging markets the fundamental agency problem for firms is not conflicts of interest between outside investors and managers, but rather conflicts of interest between controlling shareholders and minority shareholders (Chen et al., 2007; Ding et al., 2007; Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). In other words, in emerging markets, the traditional agency problems of prerequisite consumption and entrenchment are less relevant than the agency problems of expropriation (Dharwadkar, George, & Brandes, 2000; Filatotchev et al., 2013). This may in part explain why internal governance mechanisms used to monitor firm managers in developed capital markets, such as independent boards of directors and separated CEO and chair positions, have been less effective at forestalling opportunistic managerial behavior such as earnings management in emerging markets (García-Meca & Sánchez-Ballesta, 2009). It is also why, scholars have argued that boards of directors in emerging economies are not as actively engaged in monitoring corporate executives compared to their counterparts in developed markets, rather, it is the firm owners who largely fulfill the governance role of monitoring (Denis & McConnell, 2003).

Research has shown that high levels of ownership by management insiders in firms operating in developed economies may result in entrenchment (Lim & McCann, 2013; Morck, Scheifer,
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