Earnings Management in Business Groups: Tax Incentives or Expropriation Concealment?

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Abstract

This study provides evidence that Belgian firms affiliated to a business group (holding) manage their earnings more than stand-alone firms. Earnings management is especially more prevalent in fully owned group firms compared to group firms with minority shareholders. This evidence is consistent with the hypothesis that controlling shareholders face fewer constraints to manage earnings if opportunistic earnings management cannot adversely affect the value of minority shareholders and is inconsistent with the claim that group firms would engage in earnings management to hide controlling shareholders’ self-serving transactions. On the incentive part, we find that group firms strategically manage earnings in response to tax incentives. More specifically, we show that signed discretionary accruals of group firms depend significantly more on the marginal tax rate status of the firm as compared to independent firms. Finally, we document that earnings management is particularly facilitated through intra-group transactions.

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1. Introduction

In this study, we examine the effect of business group affiliations on earnings management decisions. While prior literature typically explains earnings management in business groups as a way to disguise value expropriation at the expense of minority shareholders (e.g., Gordon & Henry, 2005; Kim & Yi, 2006), we evaluate the importance of an alternative motivation, namely taxation. We define business groups as the network of parent and subsidiary firms structured in holding groups. In a typical holding, the parent firm is explicitly organized for the purpose of owning a controlling interest in other firms which then *de jure* become the holding firm’s subsidiaries. Holdings have been dominant in many economies worldwide and have been disputed for their opaque ownership structures as well as applauded for their economic purposes (Bertrand, Mehta, & Mullainathan, 2002; Claessens, Fan, & Lang, 2006).

Holding group membership may yield a number of benefits for the parent as well as for affiliated firms. First, parent companies do not need to obtain 100% share ownership for taking control, thereby reducing the minimum investment needed to obtain control over a subsidiary compared to a typical M&A transaction. Also, parent companies can expand their debt capacity since shares of stock in subsidiaries are recorded as parent-level assets and treated as collateral in loan agreements. Relying on the extended debt capacity of the parent, holding subsidiaries can rely on internal capital markets to finance their activities, which make them potentially less dependent on external financiers than stand-alone firms (Claessens et al., 2006; Gramlich, Limpaphayom, & Ghon Rhee, 2004). From a management perspective, decentralized management and cross-pollination between professional group staff services are seen as additional advantages of business groups (Banerjee, Leleux, & Vermaelen, 1997).

Holdings provide another set of features, however, that are particularly interesting from a group perspective. First, holdings are typically structured through a myriad of complicated networks, which provide group members with substantial discretionary tools and flexibility to manage earnings through related-party transactions. As a consequence, holdings may have more tools as well as more opportunities to manage earnings compared to stand-alone firms (Jian & Wong, 2010). Furthermore, holdings are potentially appealing from a tax-minimizing perspective in that losses of one subsidiary can be used to offset profits from another subsidiary, thereby reducing the overall taxes paid.

Despite the unique earnings management potential in business groups, only scarce international evidence exists on this matter. An exception is the study of Kim and Yi (2006), which documents that Korean firms affiliated with a *Chaebol* group engage more in opportunistic earnings management than non-affiliated firms. Kim and Yi argue that

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1. Although holding is the common name for a business group in Continental Europe, they are also referred to as Gruppo (in Italian) and Konzerns (in German). This different typology is purely linguistic and the aforementioned business groups all refer to organizational forms that “actively monitor and control a network of industrial and financial firm entities” (Banerjee et al., 1997).

2. Note that fiscal consolidation or group taxation as being applied in certain large economies like the U.K. or the U.S. would automatically result into offsetting of losses and profits across the business group. In the current paper, we argue that even without the existence of group taxation — as was the case in Belgium over the period of study — business groups are able to reduce their group tax bill. We elaborate on the specifics of the corporate taxation in Belgium in Section 2.2. and explain the motivations for expecting higher earnings management in business groups in Sections 3.1 to 3.2.
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