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# Ownership structure and earnings informativeness Evidence from Korea

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**Abstract**

This paper examines the relationship between corporate ownership structure in Korea and the informativeness of earnings. Korean ownership structure is characterized by the dominance of one primary owner who also participates in firm management. Existing literature offers two alternative perspectives on the behavior of such owner–manager firms, convergence of interests, and management entrenchment hypotheses. We tested the alternative views to see how they are reflected in earnings informativeness. The results show that earnings are more informative as holdings of the owner increase, supporting the convergence of interest explanation for the owner–manager structure. Second, we examine the role of institutional investors and blockholders. On the one hand, institutions/blockholders have incentives to actively monitor management. However, on the other hand, institutions/blockholders may not render effective monitoring because they lack expertise, suffer from freerider problems, or strategically ally with management. These opposing views predict conflicting signs on the relation between the earnings informativeness and holdings of institutions/blockholders. We find that earnings informativeness increases with the holdings of institutions and blockholders. This supports the active monitoring role of institutions/blockholders. Finally, we test the relationship between earnings informativeness for chaebol (Korean business group)-affiliated companies vs. that for nonchaebol-affiliated companies, and find no significant relationship between the owner–largest shareholder's holdings and earnings informativeness. This provides evidence that for chaebol companies, the negative effect of management entrenchment/expropriation of minority shareholders

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offsets the positive effects. This phenomenon is stronger for chaebol-affiliated companies than for nonchaebol affiliates.


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## 1. Introduction

This paper examines the relationship between corporate ownership structure in Korea and the informativeness of earnings. Korean ownership structure is characterized by the dominance of one primary owner. The dominant owner, typically a founder or his immediate family, holds a significant number of shares—enough to be the largest shareholder but usually much less than the majority holdings of a company—and controls the whole company. Using the holdings of family and related companies, this control often extends over many companies in different industries, forming a corporate group called chaebol. These owners usually participate in the management of the firm, directly or indirectly, influencing most of the management decisions. This management style lacks transparency and credibility, and is cited by investors as the main source of economic inefficiency that led to the recent economic crisis in Korea.

We address three issues based on the owner–manager's role and incentives. First, we examine the relationship between holdings of the owner–largest shareholder and earnings informativeness. There are two conflicting views about the informativeness of earnings when an owner–manager dominates the management. One view is that, as Morck, Shleifer, and Vishny (1988) claim, management entrenchment occurs, causing a moral hazard and information-asymmetry problem between the owner and outside investors. Investment decisions are likely made to maximize the (inside) owner's wealth rather than that of outside shareholders. Outsiders could find it difficult to monitor decisions; thus, the firm's management appears less transparent and credible. In such cases, investors and creditors could protect themselves by imposing more contractual constraints on the firm. The owner, in turn, may use earnings management to respond to these accounting constraints. This will reduce the quality of earnings and informativeness.

Another view, as Jensen and Meckling (1976) suggest, is that convergence of interest could occur as the owner's holdings increase, reducing agency costs. Reduction in agency costs would be greater, the higher the holdings of the owner–largest shareholder. In this case, the owner–largest shareholder behaves in a way to maximize firm value and impose fewer contractual constraints on the firm. The owner will be less motivated to manage earnings, resulting in higher earnings quality and informativeness.[1]

[1] Recently, the issue of economic efficiency related to ownership structure in Asia has been a subject of many studies. Fan and Wong (2000) examine how expropriation of minority shareholders by controlling shareholders affects earnings informativeness. Claessens, Djankov, Lang, and Fan (1999) examine the efficiency of investment by diversified firms in nine East Asian countries, and report that misallocation of capital by diversified firms are more pronounced in certain less developed countries. Claessens, Djankov, Lang, and Fan (2000) also examine how expropriation of minority shareholders in East Asia affects market valuation.