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OWNERSHIP STRUCTURE AND REAL EARNINGS MANAGEMENT IN MALAYSIAN CORPORATION

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Abstract. This paper examines the association between ownership structure and real earnings management. The ownership structures tested are managerial ownership, external block-holders ownership and family ownership. Based on the agency theory, we predict that ownership structure is effective in reducing earnings management practices. We use 650 firm-year observations of Malaysian non-financial corporations for years 2012 to 2016. The data is tested using the Feasible Generalized Least Squares (FGLS) Regression Analysis. After controlling for firm size, growth, profitability and leverage, as expected, this study finds that managerial ownership, external block-holders and family ownership are negatively associated with real earnings management. Thus, this study provides strong evidence that ownership structure in Malaysia is an effective monitoring tool to reduce the opportunistic behaviour of managers.

Keywords: managerial ownership, external block-holders, family ownership, real earnings management

1. Introduction

Prior literature provides evidence that managers manage earnings either using accrual-based earnings management or real earnings management for many reasons such as incentive to unduly increase their compensation package, reduce political costs, signal manager's private information in meeting analyst forecast, beat debt covenant, avoid losses, improve credit ratings in terms of its initial public offerings, analyse seasoned equity offerings, manage buyouts, finance stock acquisitions and influence regulatory decisions (Fields, Lyz, & Vincent, 2001; Erickson & Wang, 1999; Guidry, Leone & Rock, 1999; Healy & Wahlen, 1999; Kasznik, 1999; Teoh, Welch & Wong, 1998; Healy & Palepu, 1995; Holthausen, Larcker & Sloan, 1995; Defond & Jiambalvo, 1994).

The difference between the two approaches is that the accruals-based earnings management has no direct impact on the company's cash flow and the real earnings management affects the current year cash flow and accrual in some circumstance. Under the real earnings management approach, Graham et al. (2005) and Roychowdhury (2006) explain that financial executives usually exploit the real activities to earn their desired earnings. The exploitation or control on the earnings will lower the value of the company because the

activities in that particular time will increase the earnings and will lead to negative impact on the cash flows in the future. For example, if the companies set a big discount to give to the customers as to enhance large volume of sales in short term but in the future, the customers as well expect the same thing to happen and this, may lead to small volume of sales without discount given. Additionally, managers manage companies' earnings through hiding the real condition of the financial position and manipulate possible information needed by companies' stakeholders (Loomis, 1999). It happens when there is a separation of ownership between the managers and companies' shareholders that creates agency problem. Jensen and Meckling (1976) explain that the agency problems arise due to the maximization of managers' wealth. As such, the separation of ownership between managers and owners provides an opportunity to mislead the information. Hence, this situation creates the rising of agency cost that will lead to inappropriate decision makings pertaining to earnings management practices (Johari, Saleh, Jaffar & Hasan, 2008; Duncan, 2001).

It is well established in theory and practice that good corporate governance practice can curb managerial tendencies of unethical earnings management practices hence provide a quality financial statement. Mechanism such as board of directors, audit committees as well as ownership structure (i.e. managerial ownership, institutional and external block-holders ownership) can help to reduce earnings management (Dechow, Sloan & Sweeney, 1996; Jiambalvo, 1996; Dempsey, Hunt & Schroeder, 1993). While majority of the past studies focussed more on the board of director characteristics and audit committee characteristics on earnings management, less attention have been given to firm's ownership structure. The nature of firm's ownership structure can either exacerbate or attenuate managers' opportunistic tendencies. For instance, concentration of ownership in the hand of few individual shareholders creates agency problem. However, institutional ownership is widely acknowledged as effective monitoring tools that can be deployed to promote good financial reporting culture (Jensen & Meckling, 1976). Therefore, the nature of firms' ownership structure determines the severity of agency problem. Thus, this study investigates whether ownership structure mitigates earnings manipulation. Specifically, this study focuses on the association between ownership structure and real earnings management.

2. Literature Review and Hypothesis Development

Agency problem arises due to the absence of interest alignment between the shareholder and the manager. When the manager has no stake in the company, they tend to think less of the companies and care less about the performance of the companies (Fama & Jensen, 1983; Fama, 1980; Jensen & Meckling, 1976). According to agency theory, Jensen and Meckling (1976) assert that the higher the percentage of shares owned by managerial, the lower the incentives for managers to engage in accounting misbehaviour. Additionally, agency theory further claims that shareholders perceive that the managements' interests are in line with their interests when the latter acquire shares within the firm. To ratify the effectiveness of managerial ownership in mitigating accounting misbehaviour, Warfield et al. (1995) support the theory by Jensen and Meckling (1976) by hypothesizing that the lower the percentage of shares owned by managerial, the higher will be the incentives for managers to manipulate earnings for their own interest.

Basically, it cannot repudiate that there are studies that posit a higher percentage of shares owned by managerial will enhance them to engage more in earnings management practices. This is because, to this extent, there are studies that report a significantly positive relationship

between managerial ownership and earnings management. The studies are such as Al-Fayoumi et al. (2010), Yang et al. (2008), Cheng and Warfield (2005) and Jung and Kwon (2002). This happens when the higher percentage of managerial ownership creates entrenchment problem. Entrenchment hypothesis explains a situation whereby managers become powerful to extent that earnings are managed aggressively for the purpose of erroneously increasing the firm's share value (Peasnell et al., 2005; Gul et al., 2003; Denis & McConnell, 2003; Fama & Jensen 1983; Weisbach, 1988).

In spite of the entrenchment problem, agency theorist counters the argument by suggesting that managerial ownership lends their effectiveness as monitoring mechanisms in helping companies to mitigate agency problem. This is because managers tend to see the companies as theirs and accordingly make the best investment decision that will enhance the value of the firm (Jensen & Meckling, 1976). Watts and Zimmerman (1986), Warfield et al. (1995) and Patten and Trompeter (2003) noted that managers are entrusted with the resources of the firm with the sole responsibility of maximizing the wealth of the owners. Based on this responsibility, managers are expected to objectively report back to the owners. Therefore, managerial power to control and direct increase with the extent of managerial equity stake which will reduce managerial incentive to manipulate earnings. Teshima & Shuto (2008), Sanchez-Ballesta & Garcia-Meca (2007), Klein (2002) and Warfield et al. (1995) also report that managerial ownership reduce managerial opportunism behaviour.

Moreover, past studies also divulge that managerial ownership supports the agency theory when it is able to be a form of monitoring mechanisms in mitigating earnings management ractices. For instance, several empirical studies such as Alzoubi (2016), Alves (2012), Banderlipe (2009), Ali, Salleh and Hassan (2008), Ebrahim, (2007), Klein (2002), Warfield et al. (1995) and Dhaliwal, Salamon and Smith (1982) provide empirical evidence to support this assertion. Thus, based on the arguments, our first hypothesis is as follows:

H1: There is a negative relationship between managerial ownership and real earnings management.

Farrer and Ramsay (1998) explain that agency theory suggests that monitoring by external block-holders ownership can be an important governance mechanism. In fact, external block-holders can provide active monitoring that is difficult for smaller, more passive or less-informed investors (Almazan, Hartzell & Starks 2005). Additionally, external block-holders have the opportunity, resources, and ability to monitor managers. Therefore, the efficient monitoring hypothesis suggest that external block-holders is associated with a better monitoring of management activities, thus reducing the ability of managers to opportunistically manipulate earnings. The efficient monitoring hypothesis suggests an inverse relationship between external block-holders ownership and firm's earnings management activity. In this vein, several studies document that external block-holder ownership inhibits managers to opportunistically engage in earnings management (Ebrahim 2007; Koh 2003; Chung et al. 2002; Bange & De Bondt 1998; Bushee 1998).

Past studies discover that external block-holders brings a lot of benefit in administering and lend its effectiveness to reduce earning management practices and enhance firms' performance (Bhagat & Black, 2002; Klein, 2002; Yeo et al., 2002; Shleifer & Vishny, 1997). The level of participation might influence them to motivate and direct the companies

in which they have invested (Gabrielsen et al., 2002; Yeo et al., 2002; Shleifer & Vishny, 1997). Overall, most of previous studies conclude that higher percentage of external block-holders ownership acts as an active mechanism of corporate governance in controlling management accounting decisions and results in a higher reporting quality (Wang, 2006; Klein, 2002). Additionally, Yeo et al. (2002) reported that the monitoring mechanism role played by external block-holders diminishes earnings management activities. Based on the discussion, the second hypothesis is developed as follows:

H2: There is a negative relationship between external block-holder ownership and real earnings management.

Fama and Jensen (1983b) explain that family-owned companies are more efficient compared to companies with dispersed ownership. This is because the monitoring cost is lower among family-owned companies. Companies with dispersed ownership tend to face more agency problems which may create higher agency cost stemmed from different incentives and information asymmetries between managers and owners (Miller & Le Breton-Miller, 2006). Most of previous results reveal that family-owned companies supports agency theory and lend its effectiveness as monitoring mechanism in reducing accounting misbehaviours and is able to enhance firm's performance (Alzoubi, 2016; Amran & Che-Ayoib, 2013; Jaggi et al., 2009; Jiraporn and DaDalt, 2009).

The advantages of family-owned companies in shaping good image can be seen from the study conducted by Anderson and Reeb (2003a). The study suggests that family-owned companies are able to monitor and control the operations of the companies with the power they have since most of shares in family-owned companies are held by family members compared to other companies where ownership and control are separated. Hence, the agency problem that is caused by the separation between the owner and manager can be lower than the firm it possesses because the interests of the owners and managers are much more aligned.

Next, family members that run family business hold their investments for a long-term period and usually pass the investments to the next generations. In other words, the objective of family business is dynastic motive or to sustain the reputational they had in long term period (Casson, 1999). With regards to the long-term investment period and reputation, Sanchez et al. (2007) explain that family shareholders tend to maximise firm's wealth in the long-run. Consistent to DeAngelo and DeAngelo (1985), family involvement serves to monitor and discipline managers because of the long-term relationships that exist between family members and the firm. Anderson et al. (2003) further reveals that the controlling family represents a special class of shareholder that potentially has a unique incentive structure, a strong voice in the firm and powerful motives to effectively manage the firm. This is supported by Chen et al. (2008) where companies that are owned by family are concluded to be effective since the family members put extra care regarding companies' reputations and want the companies to sustain for a long time.

With the above advantages of family ownership structure, Alzoubi (2016) finds out that there is a negative relationship between family ownership and accrual-based earnings management. In addition, Bona-Sanchez et al. (2011) report that family-owned companies portray a greater earnings quality compared to non-family owned companies. As such, the result of the study

presents that there is a positive relationship between family ownership and earnings quality. The result further supports the agency theory which recommends that the higher the amount of shares held by family members in a business, the lower the agency costs imposed and thus resulting in the higher quality of earnings. Besides, Jiraporn and DaDalt (2009) and Jaggi et al. (2009) also perceive that family ownership has lower likelihood to manage earnings when family control act as monitoring mechanisms in reducing earnings management. Hence, we develop the third hypothesis as follows:

H3: There is a negative relationship between family ownership and real earnings management.

3. Research Design

	Number of Companies	Firm-Year Observations
All listed companies	904	4520
Finance institution	(33)	(165)
Companies with a fiscal year change (2012-2016)	(97)	(485)
Companies under PN17 (suspended from trading)	(21)	(105)
Missing annual report	(36)	(180)
Initial sample	717	3585
Final Random Sample (Green, 1991)	130	650

3.1 Sample Selection

We select Malaysian public listed firms for the years 2012 – 2016 as a basis for sample selection. In 2016, there were 904 listed companies on Bursa Malaysia Stock Exchange. Table 1 presents the sample selection for the study.

Table 1: Sample

We delete 33 companies comprises of banks and other financial institutions because of the uniqueness in their reporting regulations. We also excludes 97 companies with a fiscal year change, 21 companies under PN17 and 36 companies with missing annual reports. This yields an initial sample of 717 companies. In determining the final sample, this study uses method suggested by Green (1991). This procedure yields a final sample of 130 companies or equivalent to 650 firm-year observations. The financial data are gathered from DataStream database while the data on ownership structure are manually collected from the annual reports of listed companies. Table 2 reports the sample breakdown by industry.

Table 2: Sample Breakdown

Industries	Frequency	%
Consumer products	100	15
Industrial products	185	28
Mining	5	1
Construction	30	5
Trading/Services	165	25
Properties	70	11
Plantation	35	6
Technology	55	8
Infrastructure (IPC)	5	1
Total	650	100

As shown in the table, sample comprises of 100 firm-year observations in consumer product industry, 185 firm-year observations in industrial product industry, 30 firm-year observations in construction industry, 165 firm-year observations in trading/services industry, 70 firm-year observations in properties industry, 55 firm-year observations in technological industry are gathered. Mining and IPC industry have only 5 firm-year observations in each industry.

3.2 Measurement of Real Earnings Management

Roychowdhury (2006) introduces three elements of real earnings manipulation as follows:

(1) Sales manipulation
(2) Reduction of discretionary expenditures
(3) Overproduction

The following regression models are used to estimate normal level of the three elements of real earnings management.

$$CFO_t / A_{t-1} = a_0 + a_1 *(1/A_{t-1}) + b_1 *(S_t/A_{t-1}) + b_2*(\Delta S_t /A_{t-1}) + e_t, \quad (1)$$

$$DISEXP_t /A_{t-} = a_0 + a_1*(1/A_{t-1}) + b_1*(S_{t-1}/A_{t-1}) + e_t, \quad (2)$$

$$PRODt/A_{t-1} = a_0+a_1*(1/A_{t-1}) + b_1* (S_t/A_{t-1}) + b_2*(\Delta S_t /A_{t-1}) + b3*(\Delta S_{t-1}/A_{t-1}) + e_t, \quad (3)$$

Where,
CFO = Cash Flow from Operations,
S = Sales,
A = Total Assets,
ΔS = Sales change,
DISEXP = R&D + Advertising + Selling, General, and Administrative expenses
PROD = Cost of Goods Sold + Changes in inventory.

The abnormal cash flows from operations (ACFO), abnormal discretionary expenses (ADISEXP) and abnormal production costs (APROD) are measured as the residual value of equation (1), (2) and (3), respectively. Following Zang (2012), the real earnings management is calculated as composite measure (REM) using the following formula:

REM = [(ADISEXP * -1) + APROD].

3.3 Regression Model

The following regression model is estimated using the Feasible Generalized Least Squares (FGLS) regression to test the association between ownership structure and real earnings management:

$$REM = \alpha_{it} + \beta_1 MANOWN_{it} + \beta_2 EXBOWN_{it} + \beta_3 FAMOWN_{it} + \beta_4 SIZE_{it} + \beta_5 REVGWTH_{it} + \beta_6 ROA_{it} + \beta_7 LEV_{it} + \mu i \quad (4)$$

Subscript *it* represents panel data notation; *i* = sectional units, *t* = period from 2012 to 2016.

Where,

REM	=	Real earnings management, measured by [(abnormal discretionary expenses * -1) + abnormal production costs]
MANOWN	=	Managerial ownership, measured as the percentage (%) of executive directors' shareholdings, direct and indirect.
EXBOWN	=	External block-holders ownership, measured by the ownership which held at least 5% interest in shares by several classes of ownerships. The classes are; (1) banks, (2) investments companies (e.g. Employee Providence Fund), (3) insurance companies, (4) industrial and commercial companies, (5) individual investors, (6) federal and regional authorities and (7) realty investment companies.
FAMOWN	=	Family ownership, measured by the percentage of family shareholding.
SIZE	=	Size of the companies, measures as the natural logarithm of total assets
REVGWTH	=	Growth, measured by revenue growth; [(Current Period Net Sales – Prior Period Net Sales) / Prior Period Net Sales * 100]
ROA	=	Profitability, measured by return on assets; Net Profit / Total Assets
LEV	=	Leverage, measured as Total Debt / Total Assets
α	=	Constant

4. Empirical Results

4.1 Descriptive Statistics

Table 3: Descriptive statistics of dependent and independent variables

Variables	Mean	Median	Std. Dev.	Min	Max
REM	0.3930	0.3480	0.2910	-0.245	0.9170
MANOWN (%)	37.667	42.705	23.572	0	83.720
EXBOWN (%)	20.995	13.385	22.323	0	78.880
FAMOWN (%)	10.872	7.130	9.144	0	75.300
SIZE	13.788	13.495	1.814	10.275	18.705
REVGWTH	0.047	0.038	0.220	-0.481	0.814
ROA	0.061	0.054	0.073	-0.285	0.379
LEV	0.199	0.164	0.184	0.001	0.995

Note: n=650. REM is real earnings management; MANOWN is managerial ownership; EXBOWN is external block-holders ownership; FAMOWN is family ownership; SIZE represents the natural log of total assets; REVGWTH is revenue growth; ROA is return on assets; LEV is leverage.

Based on Table 3, REM has a mean of 0.393, median value of 0.348 with reported standard deviation of 0.291, minimum value of -0.245 and maximum value of 0.917 while. MANOWN gives the highest mean with an amount of 37.6673 per cent with maximum percentage of ownership of 83.72 per cent. It indicates that approximately about 38 per cent of Malaysian companies' shares are owned by executive directors. Next, mean and standard deviation value of EXBOWN are revealed to be at 20.9948 and 22.3247 percent. The mean and standard deviation result are consistent with Mustapha and Che-Ahmad (2013) which reports its mean value of 15.17 with standard deviation of 19.11 percent. As for FAMOWN, the reported mean value is at 10.8723 percent. The result is strongly consistent with Ishak, Ku-Ismail and Abdullah (2012) which gathered a value of 10.677. The standard deviation gathered is 9.1443 which is consistent with standard deviation gathered by Ishak and Napier (2006) at 16.58 percent.

Table 4: Correlation Matrix

	REM	MANOWN	EXBOWN	FAMOWN	SIZE	GWTH	ROA	LEV
REM	1.000							
MANOWN	0.038	1.000						
EXBOWN	-0.215**	-0.554***	1.000					
FAMOWN	-0.129**	-0.076*	0.022	1.000				
SIZE	-0.223**	-0.357***	0.490***	-0.043	1.000			
GWTH	0.232**	0.054	-0.028	-0.025	-0.041	1.000		
ROA	0.338**	-0.065*	-0.006	-0.051	0.013	0.194*	1.000	
LEV	0.098*	0.052	-0.073*	-0.0701*	0.073*	0.001	-0.092	1.000

Table 4 presents the Pearson correlation matrix for the research variables included in the real earnings management model. Based on the Pearson correlation matrix, REM correlates with all variables except MANOWN according to the estimates statistical significance levels of 1%, 5% and 10% respectively. Accordingly, REM is positively correlated with the GWTH and ROA ($r = 0.232$ and 0.338) at 5% significance level. EXBOWN, FAMOWN, SUKSTA, SUKRAT and SIZE have negative correlation with REM at 5% significance level ($r = -0.129$ to -0.223) while LEV has positively correlated with REM at 10% level ($r = 0.098$). Besides, in examining correlations between other variables, the highest correlation coefficient is between MANOWN and EXBOWN, which is at 0.554. However, this value is less than 0.80 of the benchmark to identify multicollinearity (Pallant, 2007). Hence, there is no evidence of multicollinearity problem among variables in the model.

4.2 Regression Results

Table 5 presents the regression results of this study. The adjusted R^2 value shows that the regression model which consists of MANOWN, EXBOWN, FAMOWN, SIZE, REVGWTH, ROA and LEV could explain 24.20 per cent variations in REM. With regards to significant p-value, Table 5 depicts that six variables are significant on REM at their own p-value. The six variables are MANOWN, EXBOWN, FAMOWN, REVGWTH, ROA, and LEV. MANOWN, EXBOWN, FAMOWN, REVGWTH, ROA and LEV are reported to be significantly associated with REM at 1% ($p < 0.01$). SIZE is not significantly associated with REM.

Table 5: Regression Results: Ownership Structure and Real Earnings Management

REM	Expected Sign	Coef.	Robust Std. Err.	z-value	p-value
_cons		0.6369	0.1121	5.68	0.000***
MANOWN	-	-0.0018	0.0005	-3.45	0.001***
EXBOWN	-	-0.0022	0.0006	-3.79	0.000***
FAMOWN	-	-0.0035	0.0011	-3.25	0.001***
SIZE	+	-0.0125	0.0085	-1.47	0.143
REVGWTH	+	0.2137	0.0462	4.63	0.000***
ROA	+	1.2607	0.1416	8.9	0.000***
LEV	+	0.2192	0.0557	3.93	0.000***
Adj R^2	0.2420				
Wald chi (10)	101.79				
Sig	0.000				

Note: n=650. REM is real earnings management; MANOWN is managerial ownership; EXBOWN is external block-holders ownership; FAMOWN is family ownership; SIZE represents the natural log of total assets; REVGWTH is revenue growth; ROA is return on assets; LEV is leverage. *** p<0.01

Table 5 shows that three variables are found to meet the expected sign or can be best described to support the constructed hypotheses. The variables are managerial ownership, external block-holders and family ownership. MANOWN is negatively associated with REM and significant at 1 per cent level. Therefore, H1 is accepted and it can be concluded that the managerial ownership which comprises of the insider board members (executive directors) and independent non-executive directors can reduce earnings management hence, enhance the financial reporting quality. Thus, the higher the percentage of managerial ownership, the lower the level of REM revealed. Real earnings management decreases by approximately 0.0018 for each per cent increase in managerial ownership.

External block-holder (EXBOWN) also shows the anticipated sign. The coefficient for EXBOWN is -0.0022 (z = -3.79). The sign on EXBOWN is negative and statistically significant at p-value of 0.001. The result is strongly consistent with previous studies like Fleming et al. (2005), Fosberg (2004), Koh (2003), Singh and Davidson (2003), Chung et al. (2002) and Yeo et al. (2002) which report that external block-holders can reduce earnings management since they have the necessary tools to monitor management effectively. Specifically in Malaysia, Mohd-Ali, Hassan and Mohd-Saleh (2007) found and reported that external block-holders ownership has a negative relationship with REM. This further suggests that the external block-holding is one of the effective monitoring mechanisms that can constrain earnings management hence improving the quality of the financial statement.

Regarding the family ownership, Table 5 presents a negative relationship between family ownership (FAMOWN) and REM. Consistent with the hypothesis in this study; there is a negative relationship between FAMOWN and REM. The coefficient for FAMOWN is -0.0035 (z = -3.25). The results indicates that family ownership in Malaysia is efficient in reducing earnings management practices. Overall, ownership structures play important roles in mitigating REM. Besides, the positive relationship between REVGWTH, ROA and LEV, and REM indicates that companies with high sales growth, profitability and leverage engage in earnings management practices in order to meet their short term goals.

Conclusions

This study investigates the association between real earnings management and three ownership structure characteristics including managerial ownership, external block-holder and family ownership. We use 650 firm-year observations using Malaysian data. We measure real earnings management using a composite measure based on abnormal discretionary expenses and abnormal production costs. We document that all the three characteristics of ownership structure are negatively associated with real earnings management. This finding is consistent with the notion that ownership structure is effective in constraining opportunistic behaviour of managers. This study hints the market participants and regulators regarding the possible techniques practiced by managers in managing companies' income.

This study has its limitations. It can only be generated on Malaysian context and based on proxies suggested by Zang (2012) which restricted the measurement to two proxies only; abnormal discretionary expenses and abnormal production cost. This study only focuses on sample companies based on specified industries. Thus, it limits the generalization of the results for all industries. However, manufacturing industry should be highlighted more in order to see the real situation where those three activities such as overproduction, discounted price and reducing expenses are more prominent. Future studies should take into consideration all the limitations.

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