

CORPORATE OWNERSHIP STRUCTURE AND MANAGEMENT EARNINGS FORECAST

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Abstract

The purpose of this paper is to examine how the structure of corporate ownership impacts the accuracy of management earning forecasts in Japan. An evaluation of the financial reporting reform from 2000 is also presented. As a result, corporate ownership structure variables, such as managerial ownership, financial institution ownership, foreign investment ownership and corporation ownership, are negatively associated with the accuracy of management earnings forecast. We find that corporate ownership structure makes the manager announce more accurate management earnings forecasts. In addition, the reform of financial reporting system in 2000 has an influence on the quality of financial disclosures.

Keywords: ownership structure, earnings management, financial reporting

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I. Introduction

Japan is one of the most active countries in term of the financial disclosure of the next period management earnings. Stock exchanges in Japan request the listed firms to publicize management's earnings forecasts in form of point forecasts for upcoming year at the earnings announcement. In addition, the compliance has been so high that almost all listed firms in Japan voluntarily make a prediction of next period earnings. This unique environment in Japan allows us to analyze the quality of financial information in various ways by using sound sample of point forecasts. In this paper, we focus on the relationship between the forecast accuracy and corporate ownership structure¹.

To issue accurate forecasts of the next period earning are very critical for both the manager and shareholders. The management earnings forecast is expected to ease asymmetric information between manager and shareholder. If the management earnings forecast is less accurate, the impact on the stock market when the actual earnings are reported is likely to be larger. For instance, a poor financial disclosure often misleads shareholders and has some adverse effects on their wealth. Therefore, managers have an incentive to announce more accurate earnings forecast to ease the asymmetric information.

Recent several literatures have shown that the effective governance mechanisms are positively associated with the quality of financial disclosure practices. Karamanou and Vafeas (2005) and Ajinkya, Bhojraj and Sengupta (2005) examined that share holdings as expressed by board of directors, Institutional investors and other ownership were associated with the quality of financial disclosure information in U.S.A. This paper regards the corporate ownership structure as critical factors of the

¹ Ota (2006) showed the bias between predicted and actual value of management earnings forecasts of firm in Japan depends on macro shock, such as GDP growth rate, industry factors, financial factors and so on. However, this analysis has not been carried out from a standpoint of the corporate ownership

forecast accuracy, and characterizes this accuracy of earning forecast using some types of ownership structure.

The purpose of this paper is to examine if accuracy of management forecast is affected by several types of corporate ownership in Japan. Also, this paper focuses on the reform of financial reporting system conducted in 2000. As a result, corporate ownership structures variables, such as managerial ownership, financial institution ownership, foreign investment ownership and corporation ownership, are negatively associated with the accuracy of management earnings forecast. This implies that corporate ownership structure makes the manager announce more accurate management earnings forecasts. In addition, the reform of the financial reporting system in 2000 had an influence on the quality of financial disclosure information.

This paper is organized as follows. An econometrics model is presented in section 2. Section 3 describes the data used. Estimated results are presented in section 4. A brief conclusion is presented in section 5.

2. Estimation Model

The estimation model is as follows:

$$RPE_i = \beta_0 + \beta_1 MO_i + \beta_2 FIO_i + \beta_3 CO_i + \beta_4 FI_i + \beta_5 \ln(NO A_i) + \beta_6 \ln(SIZE_i) + \beta_7 SDRES_i + \beta_8 D_{change} + u_i$$

where u_i is assumed to be a random error term of the firm i . In order to evaluate the reform of the financial reporting system conducted in 2000, this paper is used the dummy variable D_{change} , which is a 0-1 variable taking the value with 2000-2004, and zero otherwise. Historically Japanese investors have relied primarily on unconsolidated "parent-only" earnings. But from the fiscal year ending March, 2000, this system changed from the approach above to that of consolidated financial statement. This reform has forced Japanese parent companies to issue more accurate consolidated financial information in consideration of the entire business group. Shareholders are also likely to focus on information from future earnings of the business group as a whole. Therefore, after this reform, the leader of the business group might have responsibility to ensure more transparency by reporting more accurate consolidated forecast. The other variables used in this estimation model are defined and discussed below.

2.1 Absolute Prediction Error (APE)

This paper modifies the relative prediction error used

by McDonald 1973 by converting into the absolute value of it. The absolute prediction error (APE) is defined as the difference between actual earnings and issued management forecasts scaled by actual earnings. APE is calculated for each firm-year observation as:

$$|APE_i| = \left| \frac{e_i - Ee_i}{e_i} \right|$$

, where e_i denotes the actual earnings for firm i and Ee_i denotes the management forecast for firm i .

2.2 Ownership Structure Variables

Managerial ownership (MO), financial institution ownership (FIO), corporation ownership (CO) and foreign investment ownership (FI) are used as proxies of ownership structure variables.

Managerial ownership (MO) is used as a proxy of a direct incentive scheme of manager. Jensen and Meckling (1976) showed that higher ownership of manager serves to align interests of managers and shareholders. On the other hand, managerial ownership frees the managers from some external disciplines. This is called the entrenchment effect of manager (e.g. Morck et al. (1988)). This paper examines which factors, incentive alignment effect and entrenchment effect, are more effective against the APE. Financial institution ownership (FIO) plays a role in monitoring management because they usually have better information about the firm and can prevent management from behaving opportunistically. Also, their stock investment in the firm is usually higher, providing them with a strong incentive to monitor management (e.g. Linchtenberg and Pusher (1994)). Also, corporation ownership (CO) is used as a proxy of an indirect incentive scheme (e.g. Linchtenberg and Pusher (1994)).

Foreign investment ownership (FI) is increasing in Japan stock market. The foreign investment is expected to have strong monitoring power against the manager in Japan.

2.3 Other Control Variables

In this paper, firm size (SIZE), number of analyst (NOA) and the standard deviation of market model residuals (SDRES) are considered as other control variables (e.g. Baginski and Hassell 1997; Karamanou and Vafeas 2005).

The above papers found that forecast behavior was associated with firm size and number of analysts. Firm size (SIZE) is the log of the beginning of the period market value of equity, used as a proxy variable of firm size. We defined number of analyst

(NOA) as the log of the number of I/B/E/S analysts forecasting the next period's earning after the ending of previous period.

The standard deviation of market model residuals (SDRES) is employed as the proxy variable which captures uncertainty in the earnings prospect of firm. It is estimated using standard market model estimation techniques over 250-day period before the ending of previous period.

3. Data

This sample is selected the 1998 to 2004 time period using the following criteria.

1. The firms are listed on the first and second section of the Tokyo Stock Exchange (TSE) in Japan. So, the TSE accounts for more than 90% of total market capitalization of Japanese equity.
2. Only firms whose fiscal years end in March are selected. So, the ownership structure information is available at the company fiscal year end. Also, most Japanese firms have their fiscal years end in March and are dispersed across all industries. Therefore, March fiscal year end firms can be considered to be good representatives of firms listed on the TSE.
3. Banks, securities firms, and insurance firms are excluded.

Data on market value is obtained from the Nikkei Daily Stock Return database. Data on ownership of board member, financial institutions, other corporation and foreign investment were obtained from the Nikkei Financial-Quest databases. Ratio of these variables is respectively computed by dividing the each variable by total number of stock. Data on number of analyst is obtained from I/B/E/S Daily Detail Earnings Estimate History database.

Finally, number of firms which satisfy above condition is 8704. In addition, this paper adopts the absolute APE (less than 2) in consideration of the industrial shock and macro shock and so on. Therefore, number of observation used in this paper is 7209.

4. Estimation Result

The pooled ordinary least square estimation (OLS) and pooled OLS with White heteroskedasticity-consistent standard errors as estimation techniques are implemented. All estimated coefficients of estimation equation are statistically significant. These results are reported in Table1.

Corporate ownership structure variable, such

managerial ownership (MO), financial institution ownership (FIO), corporation ownership (CO) and foreign investment ownership (FI), have significantly negative coefficients. Also, the reform of financial reporting system in 2000 has an influence on the accuracy of forecasts issued. This implies that this reform encourages the manager to announce more accurate financial information.

Managerial ownership (MO) captures alternative two effects; the incentive alignment effect and the entrenchment effect. Estimation result shows that the incentive alignment effect is relatively effective against the APE. Also, it is found that a magnitude of coefficient of managerial ownership (MO) is the greatest among the other variables.

Financial institution ownership (FIO) plays a role in monitoring management because they usually have better information about the firm, and can prevent management from behaving opportunistically in Japan. Estimation results show that the monitoring of manager by the financial institutions works effectively. Also, corporation ownership (CO) is negatively associated with the APE

Foreign investment ownership (FI) is increasing in Japan stock market. The foreign investment is expected to have strong monitoring power against the manager in Japan. Our finding implies that foreign investment might give the manager strong incentive to enhance the accuracy of management earning forecast.

In view of the control variables, firm size (SIZE), number of analyst (NOA) and the standard deviation of market model residuals (SDRES) are statistically significant.

5. Conclusion

The purpose of this paper is to examine how the structure of corporate ownership has an impact on the accuracy of management earning forecast in Japan. Next, the evaluation of the reform of financial reporting system in 2000 is conducted. As a result, corporate ownership structures variables is negatively associated with the accuracy of management earnings forecast of firm. This implies that corporate ownership structure makes the manager announce more accurate management earnings forecast. In addition, the reform of financial reporting system in 2000 has an influence on the quality of financial disclosure practices announced by firm. This reform might give the manager strong incentive to enhance the accuracy of management earning forecast.

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