BLOCK-OWNERSHIP AND EARNINGS MANAGEMENT IN MALAYSIAN LISTED FIRMS

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Abstract

This study examines the association between level of *block ownership* and earnings management activities in Malaysian listed companies. Agency theory suggests separation of ownership and control gives rise to manager's incentives to select and apply accounting techniques opportunistically at the expense of the shareholders. The existence of block ownership may reduce the agency cost to shareholders since block-holders are in a better position and capacity to monitor the management. Our results indicate that there is no significant relationship between the level of block-ownership and the magnitude of discretionary accounting accruals. This indicates that block-ownership is not an effective mechanism in mitigating aggressive earnings management by firms. However, further analysis indicates that institutional and holding block-ownerships are negatively related to the discretionary accruals. This suggests that institutional block and controlling block ownerships have more incentives and possess more sophisticated mechanisms to entail better control toward managerial opportunistic behaviours.

Keywords: ownership structure, earnings management, Malaysia

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1. Introduction

Separation between ownership (shareholders as principal) and control (the management as agent) in firms creates agency conflicts (Jensen and Meckling, 1976). However, with effective corporate governance mechanisms such as the quality of external audit (Becker et al. 1998; Bartov et al. 2002), managerial ownership (Warfield et al. 1995) and audit committee (Klein 2002) may significantly reduce the agency costs. Another aspect of ownership structure that has significant influence over agency costs is block-ownership (Paesnall et al. 2000; Yeo et al. 2002; Jung & Kwan 2002; Singh & Davidson 2003).

The role of block-ownership has become a subject for empirical analysis. The issue has become important particularly in Asian Countries where higher block-ownership has been reported as compared to Western countries (Yeo et al. 2002; Ball et al. 2004). Higher block-ownership is expected to have a positive effect on agency costs. A study by Suto (2003), for example, provides evidence that ownership concentration in Malaysia does mitigate conflict between managers and owners.

The present study attempts to provide empirical results on the role of institutional, parent (holding) and individual block-ownerships, which exist in Malaysian companies, in mitigating agency conflicts. It is expected that the role of block-ownership in reducing the earnings management activities differs among each group, depending on certain factors such as the level of ownerships, level of sophistication, and level of expertise. So far, there is no study that has investigated the types of block ownership and its different monitoring effect on agent. Results from this study are expected to contribute to the existing knowledge on the role of block-ownership in reducing agency costs.

2. Literature Review and Hypothesis Development

2.1 Earnings management as a proxy of agency cost.

Generally, earnings management has been defined in many ways. Schipper (1989), defines this practice as "purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain". The question is why managers manage the earnings? Based on this definition, it appears that earnings are manipulated to the extent where the accounting figure can help managers to meet some of

their personal interest (Watts & Zimmerman, 1986; Eccles, 2001; Patten & Trompeter, 2003). The interests among others are bonus incentive and avoidance of debt covenant violations (Healy 1985; Sweeney 1994; DeFond & Jiambalvo 1994; Holthausen et al. 1995; Gildry et al. 1999; Eccles 2001).

The concerns are that this practice was becoming more widespread and the methods have become more sophisticated in recent years (Levitt, 1998). Due to this, earnings management activity has become a topic of interest in accounting profession and being debated since last few decades. Managers may manage earnings to hide the true financial position of business organisations and relevant information that investors ought to know (Loomis, 1999).

Since earnings management creates the ambience of providing errant information to shareholders, this gives rise to agency costs. The shareholders might use the masked information and consequently resulting to inappropriate decision-making and do not maximise their wealth.

2.2 Block-ownership as an external-monitoring mechanism

External block-holders are said have the incentives to monitor and influence management to protect their significant investments (Friend & Lang, 1988; Mehran, 1992). External block-ownership reduces the proliferation of managerial opportunism and this mitigates conflicts between management and owners (Shleifer & Vishny, 1986; DeFond & Jiambalvo 1994; Peasnell et al. 2000; Yeo et al. 2002; Jung et al. 2002; Jiambalvo et al. 2002; Singh & Davidson 2003). Prior studies, such as Yeo et al. (2002), Jung & Kwon (2002) and Holderness (2003), provide evidence that block-ownership does influence firms' value. If block-ownerships serve as an active monitoring mechanism over the actions of managers, managers may not be able to adjust any accounting figures to their own interests. As the economic stake of block-ownership increases (their level of share ownership rises), it is expected that the incentives of block-ownership to protect their investments and consequently monitor management will also increasing. Prior studies indicate that most of Asian ownerships' structure falls into large highly concentrated category (La Porta et al. 1996; Cleassens et al. 2000; Ball et al. 2003; Yeo et al. 2002; Mak and Li 2003). Yeo et al. (2002) and Jung and Kwon (2002) examine the ownership structures in Singapore and Korea, respectively. Both studies provide evidence that the existence of large and highly concentrated ownership structure in both countries significantly reduces agency conflicts. A similar study by Suto (2003) indicates that ownership size and concentration among Malaysian companies mitigates conflict between managers and owners. We hypothesised that:

H₁: The level of block-ownership is negatively related to the magnitude of discretionary accruals in Malaysian listed companies.

Following Renneboog (2000), we divide block-ownership structure into three main groups to represent the structure of ownership among Malaysian firms. They are institutional block-ownership, individual-block ownership and parent (holding) company's block-ownership. This is done to test the effect of each block ownership category on financial misrepresentation i.e. earnings management.

Institutional block– ownership. Institutional investors, are always referred as sophisticated investors, have the advantages to acquire information compared to individual investors (Jiambalvo et al. 2002). Substantial shareholding in a firm gives the institutional investors resources and reasons for having incentives to monitor and influence the decisions made by managers (Chung et al. 2001).

Large institutional investors can and will monitor for several reasons. According to Coffee (1991), large institutional owners will rely on monitoring senior management to protect their ownership stakes (David & Kochhar 1996; Thomsen & Pederson 2000). Large institutional owners can use various formal and informal mechanisms such as their voting power, shareholder activism, election of board members, and their ability to influence management. Combining the agency theory arguments with concentration facets of institutional ownership, we expect that the greater the ownerships' level of institutional holders, the greater their ability to rein in managers' manipulation activities, for example, in order to meet the option and compensation's incentives. These institutional block-ownerships will advocate greater behaviour-based compensation and reduce outcomes-based compensation as a percentage of total compensation (Eisenhardt, 1989). Therefore, this study provides a joint test on the role of institutional ownership and concentration on earnings management practices in Malaysian environment. In Malaysia, institutional ownership is the largest group that owns between 5% to 71.92% interest in companies. Greater level of institutional ownership may lead to greater incentives and powers to reduce the aggressive behaviour of earnings management in Malaysian companies.

Individual block – ownership. Prior research contends that large, individual owners can also being an effective monitoring agent to reduce agency costs. This is because of their higher stakes and relatively lower coordination costs as compared to more dispersed, individual owners (Hill & Snell 1989). The existence of individual block-ownership in Malaysia is also expected to have significant relationship to reduce earnings management. However, they might not have the sophistication in monitoring their investment.

Parent (holding) company block-ownership. In Malaysia, most listed companies own other companies. With shareholding of more than 50%, it is expected that holding companies will perform some

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controls that may alleviate managerial opportunistic behaviours, in order to protect the value of the company as a one big group. They have enough power, enough resources and even enough reasons to detect and reduce earnings management activities. Parent companies have more access to private information and strategy through directors appointed on the board. Therefore, any attempt to manage earnings must have been detected earlier.

However, some directors have their own incentives that may be detriment to the interest of the parent company's shareholders. For example, managers have the incentives to decrease earnings in order to portray a bad trend that may adversely affect the share price in a management buyout, at the expense of other shareholders i.e. the parent company's shareholders. To the extent that this specific event does not happen, we are quite confident that the incentives of the directors are aligned to those of the parent company they are representing.

They may also manage earnings upward to increase their bonus when the compensation scheme is tied to earnings. However, this practice may be in line with the interest of the company they are representing because it may increase the firm value in the capital market. Nevertheless, this practice implies earnings are managed whether or not there is a parent company. This would reduce the power of test.

3. Methodology and Sample Selection
3.1 Sample selection

The data for this study were collected from annual reports of companies listed on Kuala Lumpur Stock Exchange for the year 2002 and 2003. We exclude financial institutional from our sample since they are subject to other specific requirements. We also eliminate newly listed companies, PN4 firms and companies with unavailable data from our sample. Table 1 provides summary of our sample selection.

Table 1. Sample selection

Selection	No of case
Listed companies available in year 2002 and 2003	1,484
Deduct: New listed companies	109
Financial industries, PN4 status companies and industry with portfolio less than 10 companies.	295
Companies with unavailable data	79
Sample size	1,001

3.2 Dependent variables

The magnitude of discretionary accruals. We use discretionary accruals as a proxy for earnings management. Following Jones (1991) we use the cross-sectional variation of the Jones model as a proxy for discretionary accruals. Equation 1 represents the Jones (1991) Model for total accruals.

$$\frac{TACC_{i,t}}{A_{j,t-1}} = \alpha_1\left(\frac{1}{A_{i,t-1}}\right) + \alpha_2\left(\frac{\Delta REV_{i,t}}{A_{i,t-1}}\right) + \alpha_3\left(\frac{PPE_{i,t}}{A_{it-1}}\right) + \varepsilon_{it}$$

(1)

Where *TACC* is the total accruals measured as income before extraordinary items less cash flows from operations, *A* is the total assets, ΔREV is the change in operating revenue, *PPE* is the gross property, plant and equipment, *t* and *t*−1 are time subscripts, *i* is the firm subscript, and *j* is the industry subscript.

Following Peasnell et al. (2000), we modified the above equation and used the working capital accruals in this study. Depreciation is excluded because it was argued that the opportunity to manipulate the account is very limited due to disclosures about any changes made in the notes (Paesnell et al., 2000; Young, 1999). Since depreciation is excluded in this study, we replaced *TACC* with *WACC*, which refers to the working capital accruals.

$$\frac{WACC_{i,t}}{A_{j,t-1}} = \alpha_1 \frac{1}{A_{i,t-1}} + \alpha_2 \frac{\Delta REV_{i,t}}{A_{i,t-1}} + \varepsilon_{i,t}$$

(2)

Where, *WACC* is the working capital accruals measured as income before extraordinary items less cash flows from operations minus depreciation, and all other variables are as previously defined. Discretionary working capital accruals (*WDAC*) are the residuals of the regression of the equation in each industry-year portfolio. To test the association between institutional ownership and income increasing discretionary accruals, we used the absolute value of *WDAC* as the dependent variable.

3.3 Independent variables

We divided our explanatory variables into two; ownership variables and control variables. First, we obtained end-of-year institutional ownership data from 2002 and 2003 companies' Financial Statements. Then, we collected managerial ownership and other controls variables data from the same source.

Block-ownership. Renneboog (2002) listed eight classes of block-ownerships that possess a minimum of 5% shareholding in firms. These eight classes of block-ownership have been further classified into three main group i.e. individual block-ownership, institutional block-ownership and parent (holding) company block-ownership. To test the hypothesis, we introduced *BLOCKOWN* to measure block ownership. *BLOCKOWN* is represented by the total of ownership's portion for both institutional and individual block-holders, with a minimum level of 5% ownerships (Anderson et al. 2003; Renneboog 2002).

To test the effect of different classes of block-ownership, we replace *BLOCKOWN* with the three

groups of block-ownerships. These are *BLOCK_INS* to represent institutional block-ownership, *BLOCK_IND* (individual block-ownership) and *BLOCK_HLD* (parent/holding company block-ownership). *BLOCK_INS* and *BLOCK_IND* variables are measured as the total percentage of ownership of each investor class that possesses 5% or more shares in a firm. We used a dummy variable (*BLOCK_HLD*) represented by 1 for parent/holding companies ownership and 0 otherwise. The ownership data for these three main block-ownership classes are extracted from the list of *'30 substantial shareholdings'*, which is disclosed in notes to the financial statement.

Managerial ownership. We introduced *MGROWN* to account for the potential reduction in the shareholder–manager conflict due to managerial ownership. This is because as separation between ownership and control widens, managers have the incentives to capitalize on the latitude in reporting regulation to affect accounting numbers (Warfield et al 1995; Yeo et al. 2002). Previous studies reported that managerial ownership is inversely related to the magnitude of discretionary accruals. We measured *MGROWN* as the ratio of directors' shareholdings to the total ordinary shares outstanding.

3.4 Control variables

Firm size (SIZE). The inclusion of firm size is motivated by the size hypothesis (Watts & Zimmerman 1986; Watts & Zimmerman 1990), which predicts managers of large firms are more likely to exploit accounting discretion to reduce political attention. Therefore, we expect a negative relationship between *SIZE* and discretionary accruals. We divided the sample firms based on the median of total assets. We assigned (1) for large firms, which are above the median and (0) otherwise.

Leverage. Managers are more likely to exercise their accounting discretion granted by GAAP when they are closer to default on debt covenants (Park & Shin 2003). A leverage ratio is used to proxy for a firm's proximity to debt covenant violation. Consistent with the debt covenant hypothesis, we expect that as firms approach their accounting-based debt covenants, managers of these firms are more likely to adopt aggressive earnings management techniques to prevent violation of these debt covenants (Watts & Zimmerman 1986; DeFond & Jiambalvo 1994; Park & Shin 2003; Dechow et al. 1995; Warfield et al. 1995; Paesnell et al. 2000). We measured leverage (*LEV*) as the ratio of total liabilities to total tangible assets.

Audit Quality. Previous studies indicate that clients of low quality audit firms (proxied by non-Big 4 auditors) report higher discretionary accruals than high quality audit firms (Becker 1998). In addition to that, lower audit quality is also found to be associated with a greater level of 'accounting flexibility'. Therefore, we expect auditor quality to be negatively

associated with discretionary accruals. Hence, a dummy variable, *AUD*, is used to control for the effect of auditor quality on discretionary accruals. Following previous studies we measure low (high) quality of audit firms as non-Big 4 (Big-4) audit firms. A score (1) is allocated for high quality audit firms i.e. large auditing firms, and (0) otherwise. The following models are used to test the hypothesis:

$$WDAC_i = \alpha_0 + \alpha_1 BLOCKOWN_i + \alpha_2 MGROWN_i + \alpha_3 SIZE + \alpha_4 LEV_i + \alpha_5 AUD_i + \epsilon_i \quad (3)$$

Where;

WDAC	: Discretionary working capital accruals
BLOCKOWN	: Block-ownerships
MGROWN	: Managerial ownership
SIZE	: Firm size
LEV	: Leverage
AUD	: Audit quality

5. Results

5.1 Descriptive statistics

Table 2 presents the descriptive statistics of our variables. Table 2 indicates that our data are not normally distributed. However, the mean values of *LEV* and *WDAC* are close to their median. Table 2 also indicates that both block–holders and managerial ownership are not distributed close to normal with the highest frequency recorded in 0% ownership level. Both *MGROWN* and *BLOCKOWN* are reported with the maximum values of 75% and 81.32% respectively. These had caused the mean values of block–holders and managerial ownerships are more than their median and the standard deviation is very high. Therefore, given this background, we are very concern about the result of our regressions utilizing these variables. However, we examined the stability of the results using non-parametric regressions.

Table 2. Descriptive statistics

	Mean	Median	Standard Deviation
LEV	0.241	0.170	0.252
MGROWN	9.898	3.260	13.822
BLOCKOWN	8.506	0.200	12.737
WDAC	0.233	0.197	0.178

5.2 Multiple regression results

Table 3 presents results for the association between block-ownership (*BLOCKOWN*) and earnings management proxy (*WDAC*). Table 3 indicates that *BLOCKOWN* is not significantly related to *WDAC*. This indicates that the involvement of block-ownerships as a part of ownership construct in Malaysian companies does not reduce the opportunistic behaviours of the managers.

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Table 3. Block-ownership and earnings management proxy[a]

$$WDAC_i = \alpha_0 + \alpha_1\ BLOCKOWN_i + \alpha_2\ MGROWN_i + \alpha_3\ SIZE + \alpha_4\ LEV_i + \alpha_5 AUD_i + \epsilon_i$$

Expected sign	α_0	α_1 (-)	α_2 (-)	α_3 (?)	α_4 (?)	α_5 (-)	F	Adj. R^2
Coefficient	0.263	-0.001	-0.002					0.028
t-statistics	30.053	-1.256	-5.217				9.451	
p-value	0.000	0.105	0.000				0.000	
Coefficient	0.252	-0.000	-0.002	-0.014	0.131	-0.018		0.073
t-statistics	17.429	-0.758	-5.293	-1.135	5.845	-1.499	9.460	
p-value	0.000	0.224	0.000	0.257	0.000	0.067	0.000	

[a]all variables are as previously defined

However, managerial ownership (*MGROWN*) is negative and significantly related with *WDAC* at p < 0.000. This result is consistent with Warfield et al. (1995), where the higher the level of managerial ownership, the lower the magnitude of *WDAC*. This suggests that the managerial ownership is associated with reduced the earnings management. The reason being a high level of managerial ownerships will align and place both managers' and owners' incentive. As a result it reduces the managers' incentives (as manager) to manage the earnings (Warfield et al. 1995). Therefore, conflict of interest between managers and owners may reduce when the managers become owners of the firms.

Table 3 also indicates that *LEV* is significantly related to *WDAC* at p < 0.05. This is consistent with prior research where firms nearly to violate the debt's arrangements have a propensity to manage their accounting figure in order to protect themselves from any actions by the debtors. To examine which groups contribute to the association, we replace *BLOCKOWN* with individual (*BLOCK_IND*), institutional (*BLOCK_INS*) and parent/holding company (*BLOCK_HLD*) block-ownership to our model. The new model is as in equation (4).

$WDAC_i = \alpha_0 + \alpha_1\ BLOCK\_INS_i + \alpha_2\ BLOCK\_IND_i + \alpha_3\ BLOCK\_HLD_i + \alpha_4\ MGROWN_i + \alpha_5\ SIZE + \alpha_6\ LEV_i + \alpha_7 AUD_i + \epsilon_i$　(4)

Where:

BLOCK_INS	: Institutional block-ownership
BLOCK_IND	: Individual block-ownership
BLOCK_HLD	: Parent/holding block-ownership

Other variables are as previously defined.

Table 4 presents the result of the effect of block-ownership types on earnings management. Table 4 indicates that *BLOCK_INS* and *BLOCK_HLD* are negatively and significantly related to *WDAC* at p < 0.000 and p < 0.05 respectively. However, *BLOCK_IND* is not significantly related to *WDAC*. This indicates that the insignificant relationship between variable *BLOCKOWN* with *WDAC*, as presented in Table 2, might be contributed by the insignificance of *BLOCK_IND*. However, *BLOCK_INS* plays an important role in reducing earnings management activities as it is negatively related to *WDAC*. This indicates that the higher the level of ownership by institutional block-holders, the more they have control over managers' activities. This is consistent with prior research since large institutional owners can use various formal and informal mechanisms such as their voting power, shareholder activism, election of board members, and their ability to influence the management. Specifically our findings are similar to Chung et al. (2002), Yeo et al. (2002) and Koh (2003), which report institutional block-holders reduce earnings management.

Table 4. Institutional, individual and parent/holding company block-ownerships and earnings management.

$WDAC_i = \alpha_0 + \alpha_1\ BLOCK\_INS_i + \alpha_2\ BLOCK\_IND_i + \alpha_3\ BLOCK\_HLD_i + \alpha_4\ MGROWN_i + \alpha_5\ SIZE_i + \alpha_6 LEV_i + \alpha_7 AUD_i + \epsilon_i$

Expected sign	α_0	α_1 (-)	α_2 (-)	α_3 (-)	α_4 (?)	α_5 (?)	α_6 (+)	α_7 (-)
Coefficient	0.279	-0.003	0.000	-0.001	-0.059			
t-statistics	28.880	-6.251	0.469	-2.220	-3.687			
p-value	0.000	0.000	0.320	0.013	0.000			
Coefficient	0.263	-0.003	0.001	-0.001	-0.048	-0.011	0.127	-0.017
t-statistics	17.627	-6.068	0.654	-1.690	-2.950	-0.849	5.698	-1.483
p-value	0.000	0.000	0.257	0.046	0.003	0.396	0.000	0.069

	Without Control Variables	With Control Variables
Sample size	1,001	1,001
F- statistics	7.291	8.618
Probability > F	0.000	0.000
Adjusted R^2	0.044	0.081

[a]all variables are as previously defined

Table 4 also indicates that *BLOCK_IND* is not significantly related to *WDAC*. Our result is consistent with other studies, such as Cubbin and Leech (1983), which suggest large institutional owners have more power and expertise, individually and collectively, compared to other large individual stockholders. This is true since the range of institutional block-ownerships for our data is between 5%-71.92% as compared to individual block-ownership (5%-49.05%). Hence, this result implies that the institutional block-holders possess more power and reasons to protect their ownerships in a firm. However, this conclusion is drawn within the limitation of the measurement used. This is because we are unable to trace precisely who are the individual holders, due to the limitation of such information in Malaysian companies.

Table 4 indicates that *BLOCK_HLD* is negatively and significantly related with *WDAC* at $p < 0.05$. This indicates that the existence of holding company helps to improve control over managers' behaviours. This is not surprising since with a holding of slightly above 50%, holding companies will have enough power to influence and control managers' activities. Moreover, the performance of subsidiaries will also have an influence on the performance of the firms as a group, thus holding companies would have enough reasons to monitor and control any opportunistic behaviour by the managers.

As reported in Table 3, we also documented *MGROWN* as negatively and significantly related to *WDAC* at $p < 0.00$. Table 4 also indicates that, except for *LEV*, none of the control variables are significantly related with *WDAC* (*LEV* is significantly related to *WDAC* at $p < 0.000$).

An additional test was performed using rank transformed regressions. This non-parametric test was conducted to test the stability of the result when there is no normality assumption is made about the distribution of the data. The rank regressions also limit the influence of outliers that may have affected the results. The results of the non-parametric test appear to be qualitatively similar to the one presented in Table 4. In other words, it does not change our earlier conclusion that block institutional ownership and block holding investment would reduce earnings management. Separate regressions for each year also yield similar result, indicating there is no specific yearly effect on the result.

5. Conclusion, limitation and future research

Most prior research studies have argued that the existence of monitoring action by block-ownership is in line with the greater incentives and the resources they had. They have the incentives to protect their greater stake in companies (David & Kochhar, 1996; Thomsen & Pederson, 2000). They also have such mechanisms, sophisticated network of information flows, and even the ability to inhibit freely opportunism activities by managers (Jiambalvo et al., 2002; Eisenhardt, 1989; Chung et al., 2001). It is also has been asserted that, by having greater stakes in firm together with experienced professionals to monitor investments, the more effective the investor can influence compensation arrangements (Bathala, 1996). The present study, however, found that only institutional and holding block investors possess the ability to mitigate the agency cost that emerged from managers' opportunistic behaviour in Malaysian companies. This indicates that both institutional and holding block-holders are two external control mechanisms that help to mitigate the agency cost which arises from earnings management activities.

We provide three reasons to support our results. First, consistent with prior research, institutional block-ownerships possess greater ability, power and expertise to influence the management's decision. Therefore, they could implement a better control towards management activities as compared to individual block-holders. Second, according to our data, the range between minimum and maximum value of ownerships may contribute to the clear distinct in the incentives. Institutional block-holders, with the maximum value of near to 72%, may have more 'reasons' to protect their ownerships in firm compared to individual block-holders (maximum value only 49%). Third, we admit that there could be some measurement errors of individual block-ownership. According to prior research, ownership structure in Asian countries including Malaysia is relatively more concentrated in family as compared to Western countries (Yeo et al. 2002; La Porta et al. 1999). However, it is difficult to trace whether the individual owner is a family member or independent-external holders. Investigation into this issue requires careful definition of family influence and sample selection. To this extent, we admit that this inaccuracy in variable definition may lead to less definitive conclusion in terms of the role of individual owners, since there may exist some individual owners who belongs to the same family. This may become a potential area for future research.

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