CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT IN FAMILY FIRMS

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How to cite: Gürünlü, M. (2019). Corporate governance and earnings management in family firms. *Corporate Governance: Search for the Advanced Practices,* 74-76.
https://doi.org/10.22495/cpr19a24

Received: 04.02.2019
Accepted: 07.02.2019
JEL Classification: G30, G32, G34, G35
DOI: 10.22495/cpr19a24
Keywords: Corporate Governance, Earnings Management, Corporate Finance, Ownership Structure

Abstract

In emerging markets, it is known that the shareholders having control power in the companies affiliated to the group have superiority to the minority shareholders by carrying out activities in accordance with their interests. This is called the entrenchment effect. For example, pyramidal ownership structures can be used as a tunnelling mechanism, where the controlling shareholder's control rights are greater than the rights to cash flow. This leads to high agency costs and low firm performance.

Business groups, on the other hand, can also be used to substitute for missing capital markets in less developed economies. Investments in group companies are affected by cash flows in group companies and there is an internal capital market among the companies affiliated to the group. Such an internal capital market also facilitates reach to the foreign capital markets. Banks feel more guaranteed to give debt to group companies. Because the cross-guarantees provided among the member companies of the group reduce the risk of non-repayment of the debt to the bank. This kind of ownership structure is likely to be the outcome of the financing choice of the enterprise group. A new company added to the pyramidal company chain has the advantage of providing funds from the existing subsidiaries in the chain. Companies within the pyramid ownership structure benefit from insurance provided within the group companies.

The internal capital markets advantage is mostly found in groups with pyramidal structures where it is possible to reach internally accumulated funds from the above-mentioned subsidiaries, particularly hierarchically. As a result, firms in the pyramid business groups are less prone to earnings management, which is encouraged by high levels of borrowing. But, the entrenchment perspective claims that special gains (i.e. tunnelling) arising from the deviation between control and ownership in the pyramid motivate managerial shareholders to make earnings management in order to prevent external control. In case of financial distress, managerial shareholders are motivated more for earnings management in order to protect their private earnings and to avoid defaulting on their debts. Thus, from the perspective of entrenchment, it is estimated that earnings management will be higher for the firms within the pyramidal ownership structure compared to firms that do not have a pyramidal ownership structure. Following this debate, another objective of this study is to find out which perspective can better explain earnings management in companies within the pyramid structure.

Earnings management is practice of considering the impression of stakeholders when deciding on the allocation of accruals of non-cash items in the statement of profit or loss. There are many empirically linked studies of earnings management to accrual decisions that lead to high debts and particularly earnings. The debt hypothesis related to earnings management states that debt level enhances earnings management activities. In this study, it is aimed to find out if existence of internal capital markets in group enterprises reduce this motivation or not. Previous articles show that advantages provided by the internal capital markets are closely related to higher investment levels and firm performance. However, the effect of the internal capital markets on the management of earnings is not considered much. In this study, it is predicted that as the internal capital market funds increase as a result of the increase in profitability in the group enterprises, the firm with a higher debt of the business group will be less exposed to the risk of non-repayment and thus less incentive to manage its earnings.

This study contributes to the researches that show positive aspects of group membership especially in the pyramid ownership structure. In previous studies, it has been shown that the control structure of the controlling pyramid group can be used by the managerial shareholders to access the internal capital markets instead of making use of the specific benefits of the entrenchment effect. Some studies show that group companies and ownership in pyramidal group enterprises can lead to the decrease in cost of capital and increase in the value of firm. In addition to these studies, the aim of this article is to show whether the advantages of the internal capital market lead to decrease in the earnings management or not.

This study using a panel data analysis of non-financial firms in Istanbul Stock Exchange provides evidence that internal capital markets in pyramidal ownership structure help to reduce the earnings management caused by having higher debt. In particular, it has been seen that higher group profitability leads to less earnings management. Overall, the results show that internal capital markets are helping to reduce earnings management incentives in capital structure with debt and that the degree of decline in earnings management depends on whether internal capital markets operate effectively.