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Institutional ownership, product market competition, and earnings management: Some evidence from international data

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ABSTRACT

We examine the impact of institutional ownership and product market competition on earnings management (both accrual-based and real) using data from non-financial firms in 41 countries around the world for the period 1995–2016. Overall all, we document an asymmetry in the role institutional ownership and product market competition play in curbing accrual vis-à-vis real earnings management. After controlling for firm-level determinants of earnings management documented by prior research, industry and country indicator variables, we find robust evidence (no evidence) that accrual (real) earnings management increases (is associated) with percentage of institutional ownership. While institutional ownership appears to have no effect on real earnings management, it significantly accentuates accrual earnings management. We also find that product market competition is positively associated with accrual earnings management, though statistically significantly only when the Herfindahl-Hirschman Index (HHI) proxy is used. Lastly, product market competition is significantly negatively associated with real earnings management, using two of the three proxies of product market competition. Only when we use the inverse of number of firms in an industry (NUMB) do we find a positive association between product market competition and real earnings management. Product market competition appears to accentuate accrual but attenuate real earnings management.

1. Introduction

Whether institutional ownership and product market competition do influence and how much influence they have on firm decisions, corporate governance and earnings management has been a subject of intense debate and a focus of many prior studies. Prior earnings management studies which investigate the role of institutional ownership and product market competition, unlike research in other areas such as capital structure, dividend payout, executive compensation, etc., have been single-country focused. However, both the degree of institutional ownership and product market competition as well as their relative effectiveness in monitoring and disciplining managers likely differ across countries (Çelik & Isaksson, 2013; Haw, Ho, Li, & Zhang, 2015).

Consistent with this, prior single-country studies find mixed results. While some single-country studies report a negative association between institutional ownership and earnings management (see for example, Chung, Firth, and Kim (2002) for the U.S; Park and Shin (2004) for Canada; or Ajay and Madhumathi (2015) for India), others document either a non-linear association (see for example, Koh (2003) for Australia) or no association (see Shayan-Nia, Sinnadurai, Mohd-Sanusi, and Hermawan (2017) for India) between the two variables. Similarly, prior single-country studies on the impact of product market competition on earnings management report varied results. Whereas some studies (see Datta, Iskandar-Datta, and Singh (2013) for the U.S.; Yamaguchi (2016) for Japan) find a positive association between product market competition and earnings management, others document either a negative association (see Young (2015) and Laksmana and Yang (2014) for the U.S.) or no association (see Wang, Li, and Chen (2015) for China) between the two variables. These divergent empirical results suggest that further insights could be gleaned from a multi-country study that examines the association between institutional ownership and product market competition, on one hand, and earnings management, on the other. Thus, the primary objective of this paper is to extend prior research by investigating the roles of institutional ownership and product market competition in accentuating or attenuating earnings management to a cross-country setting.

The sample includes 139,906 firm-year observations pertaining to non-financial, publicly listed firms drawn from 41 countries. Our

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multivariate earnings management models (both accrual-based and real) include, as explanatory variables, the variables of interest (institutional ownership and product market competition), multiple firm-level control variables that prior research documents to be associated with earnings management, and industry and country indicator variables. We estimate the empirical models using the three-stage least squares (3SLS) estimation procedure, which is effective in handling problems associated with the presence of missing or unknown control variables, numerous indicator variables and endogeneity.

Because firms may use different techniques of earnings management to mask economic performance and it is difficult to *ex ante* determine which techniques they actually use (Leuz, Nanda, & Wysocki, 2003), we first measure both accrual and real earnings management using three alternative individual proxies each. Next, we rank firms by each accrual and real earnings management proxy such that higher rank-scores represent higher levels of earnings management. Because the ranks are related to the number of firms in a country, there is a concern that the row rank measure can introduce potential bias related to the size of a country.[1] To mitigate this potential bias related to the size of countries, we scale the rank-scores in each country by the number of firms per country per year. Finally, we develop an overall measure of accrual (A_EM) and real earnings management (R_EM), using an average of the scaled rank-scores for each of the three accrual and real earnings management proxies. We use these overall measures of accrual and real earnings management in all our empirical analyses. The models are generally well specified and the control variables have signs and significances closely comparable to what prior single-country studies document. Overall, we document an asymmetry in the effectiveness of institutional ownership and product market competition in curbing accrual vis-à-vis real earnings management. Our main findings are summarized below.

First, we find significant positive (no) association between accrual (real) earnings management and institutional ownership. Though we find no evidence suggesting institutional ownership has an impact on real earnings management, we document a robust evidence that it accentuates accrual earnings management. The positive association between accrual earnings management and institutional ownership corroborates the prediction that institutional investors tend to focus on short-term profit goals, and hence, pressure managers to engage in earnings management (Graves & Waddock, 1990; Lang & McNichols, 1997; Porter, 1992).

Second, we find significant positive association between accrual earnings management and industry competition, when using the market concentration (HHI) proxy. Managers of companies in highly competitive industries, threatened by heightened career concerns and facing a constant pressure to match or beat the earnings performance of their industry peers appear to engage in higher levels of accrual earnings management (DeFond & Park, 1999; Hermalin & Weisbach, 2012). Alternatively, firms in industries with higher competition are opting for more earnings management to avoid the revelation of strategic information to competitors (Datta et al., 2013; Gertner, Gibbons, & Scharfstein, 1988; Verrecchia, 1983).

Third, we find a negative significant association between real earnings management and product market competition, using two of the three proxies: market concentration (HHI) and market power (INDUSTRY LI). The only exception is the result from the model that uses NUMB as the proxy for product market competition; in this model, real earnings management is positively associated with product market competition. Overall, these results suggest, despite the lower demand for earnings management, firms in less competitive industries appear to engage in higher levels of real earnings management perhaps due to the weak discipling environment in such industries. Alternatively, industrial competition is an effective discipling mechanism in curbing real earnings management by firms. The exception, the positive association between product market competition and real earnings management when using NUMB, is perhaps due to NUMB capturing a different facet of industrial competition than the other two proxies. It also further underscores the importance of checking the robustness of empirical findings, using alternative proxies.

The study has several contributions. First, to our knowledge, this is the first cross-country study investigating the influence of institutional ownership and product market competition on firm level earnings management; all prior studies that examine the influence of these variables on earnings management are exclusively single-country focused. Second, in addition to using data from a broad cross section of 41 countries and extending earnings management studies to a cross-country setting, the study uses multiple alternative proxies for earnings management (both accrual-based and real) with a view to triangulate and assess the robustness of results. Furthermore, the study uses the three-stage least squares (3SLS) estimation procedure which effectively addresses econometric issues related to missing or unknown control variables, endogeneity and the presence of numerous indicator variables in a model. Overall, the study extends, in a meaningful way, prior research that examines the impact of institutional investors and product market competition in limiting managers' myopic behavior to engage in earnings management. The rest of the paper is organized as follows. Section 2 presents a review of the background literature and development of hypotheses. Section 3 outlines the empirical framework including issues of sample selection, variable identification and definition, model specification, and econometric procedures. Section 4 presents the results and discussions and Section 5 concludes.

2. Background literature and hypotheses development

Separation of ownership and control is the hallmark of the Berle and Means' image of the modern corporation (Berle & Means, 1932) and a number of agency problems stem from such separation (Jensen & Meckling, 1976). The divorce of control from ownership, among other things, may lead to situations where management will have incentives to manage earnings (Cheng & Reitenga, 2009; Davis, 2002). The principal-agent problem is more pronounced when ownership is atomistic and/or diffused as such ownership structure does not provide sufficient incentives for shareholders to closely monitor myopic managerial tendencies to engage in earnings management (Jensen & Meckling, 1976; Koh, 2003; Ramsay & Blair, 1993; Shleifer & Vishny, 1986). Furthermore, information asymmetry theory contends that managers do possess private information, external stakeholders do not, about the firm and its earnings stream, which offers them additional opportunities and incentives to engage in earnings management activities (Beatty & Harris, 1998; Dye, 1988; Richardson, 2000; Schipper, 1989; Trueman & Titman, 1988; Yet & Imm, 2010).

The primary objective of the study is to empirically investigate whether institutional ownership and product market competition attenuate (accentuate) earnings management (both accrual and real) by managers. In what follows, we provide a brief summary of the background literature and present the two primary hypotheses of the study.

2.1. Institutional ownership and earnings management

The ability of executives to myopically engage in earnings management activities is strongly influenced by the effectiveness of monitoring exercised by institutional investors. Institutional investors have the opportunities, resources, and ability to monitor, discipline, and influence managers of firms (Chung et al., 2002). The presence of institutional investors with large share ownership, having the opportunity to benefit from economies of scale in information gathering, can have a direct bearing on the agency costs resulting from separation of ownership and control (Koh, 2003). There are two opposing views, namely hands-off passivity and active monitoring, regarding the manner in

[1] We are grateful to an anonymous reviewer for this insight.

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