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Organizational structure, agency costs, and accrual quality

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ABSTRACT

Our study investigates whether a firm's organizational structure as measured by the number of investment layers connecting the parent firm and the lowest-tiered subsidiaries is negatively associated with earnings quality when the investment structure has high agency costs as measured by high deviation between voting rights and cash flow rights. We find that in firms with high deviation, information asymmetry as measured by bid-ask spread and share turnover increases with the number of layers, and earnings quality declines as the number of layers increases. The findings are more pronounced in family firms than in other firms, supporting the theory that agency problems between controlling and non-controlling shareholders are more severe in family firms. In additional analyses, we also find that high deviation and long investment chains increase expropriation, which can be covered up by manipulating earnings.

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1. Introduction

Multinational corporations (MNCs) typically conduct business by delegating work and responsibilities to subsidiaries. Prior studies have often addressed accounting quality issues at the consolidated-firm level without taking a close look at how the structure of subsidiaries within the consolidated entity may affect earnings quality. A substantial body of research (see Healy and Palepu, 2001; Dechow et al., 2010) has also been dedicated to examining the relationship between earnings quality and firm characteristics such as CEO ability (Demerjian et al., 2013), CEO reputation (Francis et al., 2008), and CEO age (Huang et al., 2012). However, no study has focused on the relationship between earnings quality and organizational structure.[1] In particular, the "vertical distance" between the parent and the subsidiary has been unexplored. Dyreng et al. (2012) and Schroff et al. (2014) have called for more research to explore the characteristics of subsidiaries within a consolidated entity.

In this study, we first test whether firms with more investment layers in the corporate pyramid are associated with higher information asymmetry when the deviation between voting rights and cash flow rights increases. Prior studies suggest that organizational complexity is associated with greater information asymmetry (e.g., Duru and Reeb, 2002; Bens and Monahan, 2004; Bushman et al., 2004; Demirkan et al., 2011; Gilson et al., 2001). To the extent that more investment layers represent organizational complexity, information asymmetry can increase with the number of investment layers. In addition, the

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[1] Lee et al. (2007) link a dimension of organizational structure, the intensity of interdivisional transaction relatedness and complementarity, to earnings management, which is different from what we investigate in this study.

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corporate pyramid, with the parent at the top and successive layers of subsidiaries below, is commonly used to establish control of the subsidiaries (Hoyle et al., 2011). A longer chain of investment layers gives controlling shareholders more control over the lower-tiered subsidiaries than their equity ownership indicates. For example, a parent that directly owns 70% of the first-layer subsidiary, which in turn owns 60% of the second-layer subsidiary, achieves control of the second-layer subsidiary with an ultimate cash flow stake of only 42%. Securing control through such arrangements is beneficial for the parent firm when the private benefits of control are large (Claessens et al., 2000). When a long span of investment layers induces a significant conflict of interest between controlling and non-controlling shareholders, such a structure increases the probability that insiders will begin empire-building or extracting private benefits (Bebchuk et al., 2000; Johnson et al., 2000). Such separation of cash flow rights from voting rights facilitates expropriation from minority shareholders and creditors (Bebchuk et al., 2000; Bertrand et al., 2002; Johnson et al., 2000; Morck et al., 2004). The entrenchment effect of pyramidal structures potentially affects firms' transparency adversely, as the controlling owners may manipulate earnings or conceal information to cover up outright expropriation (Fan and Wong, 2002). Thus, we expect information asymmetry to increase with the number of layers when the deviation between voting rights and cash flow rights increases.

However, information asymmetry does not necessarily increase. Consolidation procedures can remove any accounting differences between the subsidiaries and the parent because the unrealized gains/losses from intercompany transactions are eliminated (Hoyle et al., 2011). In particular, the processing of accounting transactions at the subsidiary level likely leads to better accounting quality and not less.[2] Hsu and Pourjalali (2015) argue that consolidation imposes reporting constraints on firms by reducing their ability to hide costs and risks associated with the investee and fictitious gains through affiliated transactions.

Second, to the extent that information asymmetry increases in firms with a large number of layers, we expect a negative association between the number of layers in the investment structure and earnings quality when the deviation between voting rights and cash flow rights increases. Hope and Thomas (2008) find that managers are more likely to engage in non-value-maximizing investments when information asymmetry increases. To mask the adverse effect of suboptimal investment decisions related to firm performance, managers have the incentive to engage in aggressive financial reporting (Leuz et al., 2003).

Third, we investigate whether the above association is more pronounced in the presence of family control than in other firms. In East Asian countries, over two-thirds of firms are family controlled (Claessens et al., 2000). East Asian countries are characterized by a relatively weak legal environment, weak investor protection, and an inactive market for corporate control (see La Porta et al., 1999; Claessens et al., 2000). Controlling families in East Asian countries tend to increase their control via pyramidal structures. Family firms are characterized by more severe agency problems that arise between controlling and non-controlling shareholders (Type II agency problems) (Ali et al., 2007). Thus, we test whether the number of layers and the deviation between voting rights and cash flow rights created by layer-pyramiding adversely affect earnings quality more for family firms than for non-family firms.

We analyze a sample of listed non-financial firms in Taiwan for 2000–2011, as all listed companies in Taiwan are required to disclose information on all of their affiliated enterprises according to *Criteria Governing Preparation of Affiliation Reports, Consolidated Business Reports and Consolidated Financial Statements of Affiliation Enterprises* (hereafter CGPAR). Thus we are able to calculate the number of layers based on publicly available information.

In our primary tests, we use relative bid-ask spread and stock turnover as proxies for information asymmetry to investigate whether information asymmetry increases with the number of layers when the deviation between voting rights and cash flow rights increases. Test results are consistent across the measures, suggesting that information asymmetry does increase with the number of investment layers in firms with a higher deviation between voting rights and cash flow rights.

Regarding our second research question, we measure earnings quality as the absolute value of the residual from the regression model employed by Francis et al. (2005), who modify and extend the original Dechow and Dichev (2002) model by adding growth in revenue and property, plant, and equipment from the modified Jones (1991) model, which explain nondiscretionary accruals.[3] Dechow and Dichev (2002) view high accrual quality as a better matching of accruals to cash flows and thus model accruals as a function of realized cash flows in the current as well as previous and succeeding years. We find that firms with more investment layers and higher deviation between voting rights and cash flow rights are negatively associated with accrual quality. We also find that such association is stronger for family firms than for non-family firms.

[2] We are thankful to the reviewer for suggesting the alternative possibility.

[3] We do not measure earnings quality using discretionary accruals but using models estimated by Dechow and Dichev (2002) to measure earnings management for two reasons. First, high discretionary accruals may not necessarily indicate high opportunistic earnings management (Bernard and Skinner, 1996; Guay et al., 1996; Srinidhi and Gul, 2007). Managers can use their discretion over the recognition of accruals either to "signal their private information or to opportunistically manipulate earnings" (Dechow, 1994). Francis et al. (2005) also argue that the modified Jones approach (Dechow et al., 1995) of identifying "abnormal" accruals contains substantial uncertainty and is less direct than the accrual quality measure. In addition, Dechow and Dichev (2002) argue that the accrual quality measure, estimated as the association between current accruals and realized cash flows in the current as well as succeeding and previous years, deteriorates when accruals are driven by opportunism, but not when they are motivated by the need to convey private information. Furthermore, the accrual quality measure is not subject to the criticism regarding the separation of discretionary and nondiscretionary accruals. Thus, we proxy earnings quality with accrual quality. Our main inference does not change when we test its robustness by measuring earnings quality with discretionary accruals in additional analyses.

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