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How Efficient Ownership Structure Monitors Income Manipulation? Evidence of Real Earnings Management among Malaysian Firms

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Abstract

This study investigates income manipulation through real earnings management, by listed companies in Malaysia, prior to being officially designated as “financially distressed”, by this country’s stock exchange listed rules. The hypotheses relate to whether the degree of upwards real earnings management, conducted during the four-year period prior to financial distress, can be explained by ownership structure (measured with three variables: managerial ownership, institutional ownership and foreign ownership). Using a sample of 1,180 firm-year observations of financially distressed companies, over the investigation period 2001-2011, the findings suggest that the degree of real earnings management is not associated with ownership by management or institutional investors. Conversely, the evidence indicates that foreign shareholders are able to constrain upwards real earnings management related to discretionary expenditure but not the operating cycle. This study contributes to the importance of diversity of ownership structures in monitoring income manipulation among firms.

Keywords: managerial ownership; institutional ownership; foreign ownership; real earnings management; and financial distress

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Abstract

Key words: managerial ownership, institutional ownership, foreign ownership, real earnings management, and financial distress

1. Introduction

This paper investigates income manipulation through real activities management by listed Malaysian companies, prior to being officially designated by the stock exchange as being “financially distressed”. Roychowdhury (2006 p.337) defines real activities manipulation as “departures from normal operational practices, motivated by managers’ desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations”. The paper is grounded in the assumption that these companies do engage in real activities manipulation. The study examines whether the extent to which they do so may be explained by ownership structure characteristics, unique to the Malaysian institutional setting.

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