Journal of Accounting and Public Policy xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Accounting and Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol

Full length article

On the association between strategic institutional ownership and earnings quality: Does investor protection strength matter?

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ARTICLE INFO

Keywords:
Earnings quality
Strategic institutional ownership
Investor protection
Monitoring

JEL classification:
F30
G15
G18
G32
K22

ABSTRACT

The aim of this study is to examine: (i) whether strategic institutional ownership is associated with better earnings quality at the international level and (ii) whether this relationship varies with the strength of investor protection. Using firm level data from 41 different countries, we document a positive association between strategic institutional ownership and firm earnings quality. More importantly, we find that the documented association is economically more significant in countries with stronger investor protection. Our results are robust to a battery of robustness tests. We interpret our findings as evidence that the monitoring role played by institutional investors is shaped by the degree of investor protection at the country level.

1. Introduction

The aim of this study is to examine: (i) whether strategic institutional ownership is positively associated with earnings quality at the international level and (ii) whether this relationship varies with the strength of investor protection at the country level.

Our motivation stems from two strands of literature. First, several studies show that institutional investors, in particular dedicated ones, are beneficial for U.S. firms. For instance, institutional ownership is positively associated with firm financial strength (Chung et al., 2015), earnings quality (Rajgopal et al., 2002), pay performance sensitivity (Hartzell and Starks, 2003); and dividend payment (Crane et al., 2016). Further, it is negatively associated with real-activities based earnings management (Bushee, 1998; Roychowdhury, 2006; Zang, 2012) and total executive compensation (Hartzell and Starks, 2003). Although there is extensive evidence showing that institutional investors, in particular dedicated ones, play a monitoring role in the U.S. context, empirical research seldom examines whether such roles exist elsewhere, due in part to data availability.

The second relevant strand in the literature concerns studies that argue that country level institutional factors matter to financial reporting quality. For instance, Ball et al. (2000) find that earnings are significantly more timely in common law countries than in code law countries, and Leuz et al. (2003) document a negative association between earnings management and the degree of investor protection at the country level. The channels through which investor protection can impact earnings quality remain an open question, however. Leuz et al. (2003) attribute their findings to differences in firms' incentive to manage earnings. The authors argue that managers of firms located in strong investor protection countries have less ability to acquire private control benefits, which lowers their incentive to manage earnings. Francis and Wang (2008) show that a strong investor protection regime is associated with higher

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http://dx.doi.org/10.1016/j.jaccpubpol.2017.09.002

earnings quality only for firms with high audit quality. They contend that as the investor protection regime becomes stricter, the likelihood that client misreporting is detected and auditors are punished, increases, thus weakening auditor incentives to abide by firm earnings management behavior. More recently, Ben-Nasr et al. (2015) find that while state ownership is associated with lower earnings quality, foreign ownership is associated with higher earnings quality. The positive association between foreign ownership and earnings quality is limited to countries with more stable governments and a lower risk of government expropriation.

In this study, we argue that the investor protection regime's strength is likely to affect the association between earnings quality and institutional ownership. On one hand, earnings quality is already high in strong investor protection countries (Leuz et al., 2003); as such, institutional investors have little roles to play in improving earnings quality. Conversely, there is more demand for high quality financial reporting in weak investor protection countries. According to this argument, institutional investors are likely to have a stronger effect on earnings quality in countries with lower investor protection. On the other hand, the ability and incentive of institutional investors to monitor firm managers is unlikely to be uniform across countries. In countries with strong investor protection, institutional investors are endowed with higher incentives and ability to monitor managers, thus resulting in a stronger association between institutional ownership and earnings quality in such countries. Given the above conflicting arguments, it is an empirical question whether the association between institutional ownership and earnings quality is stronger or weaker in countries with better investor protection. We study this research question by examining the effect of strategic institutional ownership, the percentage of total shares in issue held as long term strategic holdings by investment banks or institutions seeking long term return, on earnings quality in a panel of 41 countries.

Following Chaney et al. (2011), we use the standard deviation of the performance-adjusted current accruals (REDCA_5y) as our main proxy of earnings quality, with higher levels indicating lower earnings quality.[1] The method used to derive discretionary accruals is similar to that used by Ashbaugh et al. (2003). Also, similar to Chaney et al. (2011), we focus on the variability of current discretionary accruals instead of their level, for two reasons: (i) we do not have a particular prediction about the direction of the reporting bias in current accruals and (ii) the variability of unexplained accruals is a better measure of earnings quality than their level, for firms with consistently large unexplained accruals (Francis et al., 2005).

Using this earnings quality measure, we find that institutional ownership is positively associated with earnings quality. In particular, our results indicate that a one standard deviation increase in institutional ownership is associated with a 5.1% increase in earnings quality across all countries.[2] More importantly, we distinguish between weak versus strong investor protection regimes, and examine whether the documented association between earnings quality and institutional ownership is different across jurisdictions. We use several proxies of investor protection, namely: (1) country legal origin (common law versus code law); (2) the anti-self-dealing index developed by Djankov et al. (2008); and (iii) a combined index composed of three indices developed by La Porta et al. (2006): i.e., disclosure level, liability standard, and public enforcement of securities laws. We find that the association between institutional ownership and earnings quality is stronger in countries with higher quality investor protection regimes. In fact, a one standard deviation increase in strategic institutional ownership is associated with a 6.1% increase in earnings quality in high investor protection countries, versus only a 1.4% increase in earnings quality in low investor protection countries, where the investor protection is measured by the legal origin.[3] The Chow-test statistic suggests that these estimates are also statistically different from each other at the one percent level.

We perform a battery of robustness checks. Overall, our results reveal that institutional ownership is associated with higher earnings quality, and this association is stronger in jurisdictions with strong investor protection. These findings suggest that institutional investors have more incentive and/or are more able to perform their monitoring role in countries with strong investor protection.

This study makes several contributions to the literature. First, while there is a large body of research on institutional ownership and earnings quality in the U.S. context (e.g., Rajgopal et al., 2002; Bushee, 2001; Burns et al., 2010; Chung et al., 2015), international studies are scarce, partially due to data availability issues. The evidence from the U.S. remains parochial without the ability to generalize to other markets. We fill this void in the literature by exploring this relationship internationally. Second, we add to the growing literature on the importance of reinforcing country level investor protection. We provide evidence that institutional investors exercise a better monitoring role in countries with strong investor protection regimes. Third, Leuz et al. (2003) show that earnings management is lower in countries with strong investor protection. They attribute their findings to the lower incentive for managers to manipulate earnings in strong investor protection countries due to limited ability to acquire private benefits. While their results suggest that the degree of investor protection shapes managerial incentives to manipulate earnings, our results suggest that the degree of investor protection also shapes the ability of institutional investors to perform their monitoring roles. Our findings corroborate Francis and Wang's (2008) argument that the effect of investor protection on earnings quality is an indirect one.

The rest of the paper is organised as follows: the next section briefly reviews the related literature, and develops the hypotheses. Section 3 describes the data and methodology. Sections 4 and 5 present the results and robustness tests, respectively. Finally, the last Section concludes the study.

[1] In Table 6, we report the results using several other earnings quality measures, and our findings still hold.

[2] The mean of earnings quality is 0.10, and the standard deviation of strategic institutional ownership is 0.13, for the full sample. With the most conservative estimated coefficient of -0.0394 (with country fixed effect), a standard deviation increase in strategic institutional ownership is associated with 5.1% ($0.13 * (-0.0394)/0.10$) increase in earnings quality change.

[3] The standard deviation for strategic institutional ownership is 0.16 and 0.06 for common law and code law markets, respectively. And the mean of earnings quality is 0.12 and 0.08 for common law and code law markets, respectively. With the estimated coefficient of -0.0460 and -0.0184 for these two markets, the impact in common law countries is calculated as $0.16 * (-0.0460)/0.12 = -6.1\%$, and in code law countries: $0.06 * (-0.0184)/0.08 = -1.4\%$.