The Relationship Between Institutional Investment and Earnings Management: Empirical Evidence from Turkey

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ABSTRACT

The emergence of corporate scandals at the end of the 20th and beginning of the 21st century raised doubts regarding the integrity of financial reporting and the soundness of firms’ corporate governance practices. The practice of earnings management is considered to be one of the important causes of these scandals due to its harm to the transparency and quality of financial statements. The discretion exercised by managers in accounting result in agency costs arising from the mismatch between the goals and desires of the principle and the agent causing investors to make suboptimal decisions. The recent surge in institutional investors’ shares and associated degree of activism increased their importance as an external control mechanism of corporate governance. Accordingly, the primary purpose of this study is to evaluate the role of these investors on earnings management and alignment of the interests of owners and managers within the context of agency theory. Consequently, two main hypotheses; namely, active monitoring and managerial myopia induced by institutional investors are tested by panel data analysis utilizing data belonging to the firms listed on Borsa Istanbul during the 7 year period between 2005 and 2011, inclusive. The absolute value of discretionary accruals obtained from the performance adjusted cross-sectional industry based accrual model proposed by Kothari, Leone and Wasley (2005) is used as the proxy of earnings management to evaluate whether the presence of institutional investors mitigate or stimulate managers’ discretionary accounting practices. Additionally, further analysis is conducted to evaluate the existence of monitoring and clientele effects to better interpret the direction of the relationship between the associated variables of interest.

Keywords: Agency Theory, Earnings Management, Emerging Market, Institutional Investment, Panel Data Analysis

1. INTRODUCTION

The practice of earnings management undertaken by corporate managers is considered to be detrimental to the quality of financial reporting and is regarded to be one of the important causes of the recent corporate scandals. Thus, the significance of monitoring mechanisms in assuring the confidence of financial statement users in the reliability of the disclosures and value relevance of accounting numbers has become obvious. As emphasized in the study of Dechow, Sloan and Sweeney (1996), governance structure and associated monitoring mechanisms are important determinants of the degree of opportunistic earnings manipulation firms engage in.

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According to the opportunistic perspective of accounting method choice, the flexibility and information advantage possessed by corporate managers enable them to manipulate accounting earnings with the intention of utility maximization at the expense of other stakeholders (Holthausen & Leftwich, 1983; Holthausen, 1990; Godfrey et al., 2010). Thus, the tendency of managers to engage in impression management with respect to earnings generates a potential for reported accounting numbers to be flawed and not reflective of the true economic conditions of the firms. These opportunistic earnings management practices, which are defined as the choice by a manager of accounting policies so as to achieve some specific objective (Scott, 2011, pp. 423), result in agency costs causing investors to make suboptimal investment decisions. Agency theory, which provides the appropriate conceptual framework for the hypotheses generated in this study, deals with the contradiction that occurs in the mismatch between the goals and desires of the principle and the agent representing the owners and the managers of the firm, respectively.

Corporate governance practices are one of the major factors that mitigate agency costs arising from the separation of ownership and control together with the resulting conflict of interest. The significance of institutional investors’ shares and associated degree of activism are considered to be the major reasons for the significance of institutional investors as an external control mechanism in curtailing the degree of discretion exercised by managers to opportunistically manage accruals. The importance of shareholder action in aligning the interests of owners and managers within the context of agency theory is supported by the concentration of control in the hands of institutional investors. Thus, degree of shareholder activism or passivity is considered to be utterly important for corporate governance practices to reduce agency costs through the medium of institutional ownership. Accordingly, the current study is founded on interrelation among the concepts of earnings management, institutional investors, and corporate governance based on the theoretical framework provided by agency theory.

The primary purpose of this study is to provide empirical evidence regarding the role of institutional investors on earnings management with an emphasis on the two main hypotheses; namely, active monitoring hypothesis and managerial myopia induced by short-term oriented institutional investors. The remainder of the study is organized as follows: The following section provides recent literature review related to the topic. Then, the hypotheses are defined together with their reasoning. The fourth section is dedicated to research design followed by the results of the analyses. Lastly, concluding remarks are provided.

2. LITERATURE REVIEW

Initial research focusing on the association between institutional ownership and earnings manipulation mainly utilizes variables based on R&D expenditures as proxies of managerial discretion (Graves, 1988; Hill & Hansen, 1989; Hansen & Hill, 1991; Baysinger, Kosnik & Turk, 1991; Eng, 1995; Bushee, 1997; Majumdar & Nagarajan, 1997; Bushee, 1998). Cuts or increases in firms’ expenditures regarding these long-term investments can be utilized as tools of earnings management. However, together with the advances in theoretical and empirical literature related to the generation of aggregate accrual models, measures other than R&D related proxies are introduced into econometrical models in this array of empirical studies. Furthermore, the improvements in literature related to accruals management increased the generalizability of the theories since this method of earnings management can be used by all firms and is not as costly as investments in R&D (Koh, 2007). Rajgopal and Venkatachalam (1997) conduct one of the pioneering studies; whereby, they investigate whether the presence of institutional owners mitigate discretionary accounting practices. They utilize modified Jones (1991) Model on a dataset of 7,808 firm year observations covering the period between 1989-1995.
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