A brief survey of the impact of block holders on earnings

Loretta N. Baryeh
Albright College

ABSTRACT

This study surveyed and attempted to reconcile the differences between prior studies on block holders (large shareholders) and their effect on firm value through earnings management. The study was motivated by the lack of consensus as to whether block holders have a positive or negative influence on firm value. Block holders will have a lot to lose (gain) when firms collapse (prosper) through earnings management. Shareholders also have a part to play in earnings management. Shareholders reward firms that are quality or have potential while they tend to discount non-quality firms. Investors tended to vote with their feet. The larger shareholders however were more sophisticated and had the ability to discount firms and vice versa depending on the information. This study finds that there is more room for further research on block holders and earning management to support or refute the conflicting findings.

Keywords: Block Holders, Earnings Management, firm value

INTRODUCTION

According to a former Securities and Exchange Commission; Chair, Arthur Levitt, good accounting practices, enhance access to capital and reduces its cost; moreover "quality information" is the anchor of capital markets; (Salem et al. 2012). In the absence of these, there would be no liquidity and market inefficiency will be rampant. Furthermore according to Easley and O'Hara (2004) information asymmetry is created by the markets but investors' can decreases investment mishaps. The 21st century was bombarded with scandals in the accounting field. In the United States for instance there was Enron, HealthSouth, Lehman Brothers, Tyco, and WorldCom. The main issues leading to these scandals was earnings management (EM) sometimes referred to as earnings manipulation? According to Loomis (1999) EM has concerned both practitioners and controllers as such a concentration in its study in the accounting and finance literature. EM masks true financial performance and creates some inaccuracies which somehow misleads shareholders Loomis (1999).

The analysis above shows that the study of earnings management is still valid. If earnings manipulation can be stopped, further accounting scandals can be curtailed. Shareholders also have a part to play in earnings management. Shareholders reward firms that are quality or have potential while they tend to discount non-quality firms. The larger shareholder (block holder) has more ability to discount firms and vice versa. According to Holderness (2003) there is no general consensus as to whether block holders have a positive or negative influence on firm value. Holderness further states that block holders have not been found to have a pronounced impact on the value of the firm. The main aim of this study is to survey and attempt to reconcile the differences between prior studies on block holders and their effect on firm value through earnings management. This is due to the fact that block holders will have a lot to lose (gain) when firms collapse (prosper) through earnings management.

WHO ARE BLOCK HOLDERS?

Block holders are shareholders who tend to have a big proportion of the company's shares as compared to other shareholders. For instance a person holding about 10 000 shares or shares worth about $200 000 can be considered a block holder. Since block holders have large proportions of shares they tend to have a large proportion of voting rights too. They are therefore able to influence the decisions of their respective firms. Some researchers have measured investor sophistication by block size. According to Edmans (2008) a block holder gathers information about the value of the firm. For instance "weak earnings result from low firm quality or desirable long-term investment." If weak earnings is a result of low firm quality then the block holders depresses the stock price by selling, as such making profit. Block holders will not sell if weak earnings is a results of "desirable investment." This encourages market efficiency. Block holders tend to be very sophisticated investors who are motivated to earn profit despite liquidity. Block holders do not sell immediately there are losses; they tend to ask questions first due to their sophistication and size. For instance, Warren Buffet acquires large amounts of shares in growth firms and thus shields these companies from price fluctuations so they can concentrate on long term value. Stock market behavior of block holders, therefore have social benefits.

WHAT IS EARNINGS MANAGEMENT?

Earnings management (EM) is the use of accounting methods to depict financials that emphasize a better position than the firm is actually at. It involves either the manipulation of earnings directly or indirectly through accounting methods. Sometimes companies use this to meet investor expectations or smooth earnings when they are volatile. Prior studies have shown that companies indulge in upward earnings management as such reporting high earnings; (Teoh, Welch, & Wong, 1998; Marquardt & Wiedman, 2004). These researches showed that earnings management was pernicious. It was used to present a better position of the firm's earnings than the firm was truly at. Other studies have shown that earnings management has no effect; (neutral) Ronen & Yaari, (2008) while others show that earnings management could be beneficial.

MOTIVATION FOR THE STUDY

The motivation behind this study was to survey and attempt to reconcile the differences between prior studies on block holders and their effect on firm value through earnings manipulation. There was no general consensus on the effect of block holders on earnings manipulation. While some studies advocate a positive effect, others advocate a negative effect. Some studies also find no effect. The various studies must therefore be analyzed and further studies must be conducted to reconcile the differences in the studies. For instance, according to Dou (2013) there is the need for further studies to comprehend the mechanisms by which shareholders influence financial reporting. Earnings manipulations have led to many an accounting scandal. This study therefore asks the following research questions,
i) Do block holders have private information so their trades can be used as a signal about the firms quality to the market ?
ii) Do firms which have been structured to have more block holders have less earnings manipulation?

Outside Block Holders

There are two opposing views as to how outside block holders influence EM. Outside block holders have been found to reduce earnings management through better monitoring. On the other hand it is argued that outside block holders may increase earnings management because they prefer more returns from their investment and this will encourage more earnings manipulation by management. Klein (2002) found an inverse relation between earnings manipulation and a large outside shareholder on a firm's board's audit committee. Zhong (2007) found that outside shareholders are not able to monitor earnings management done within GAAP. Moreover, neither the representation of a Block holder or the proportion of votes controlled by Block holders was significantly related to discretionary accruals (a proxy for EM).

Inside Block Holders

While some studies found a positive effect of block holders on earnings management others found a negative relationship while others found both a positive and negative relationship depending on the concentration of the block holders. Researchers who have found a positive relationship postulate that shareholders exert capital market pressure as such managers manipulate to meet earnings benchmarks. Others who advocate the negative relationship are of the view that block holders serve as monitors as such tend to increase financial reporting quality by reducing earnings management.

Ding (2007) found both positive and negative effect on block holders and earnings management. According to Ding (2007), Chinese firms' ownership characteristics against earnings management follows "inverted U shape" Initially large shareholders try to reap future benefits by maximizing accounting earnings. However the earnings management plateaus about the 55 to 60 % of ownership level. After that they show a negative effect of earnings management on ownership.García-Meca, Emma, and Juan (2009) found a "non linear" relation among institutional investors and accruals that are caused by income increases. Relation was positive (negative) at lower (higher) institutional ownership and vice versa. Institutional owners can therefore complement corporate governance.

According to Al- Fayoumi et al. (2010) block holders as well as institutions were not found to significantly monitor earnings management. They studied earnings management represented by "discretionary accruals" and ownership represented by "institutions and block holders" for Jordanian firms. Furthermore other research found a positive effect of block holders on earnings management implying that block holders did not monitor earnings management. Moreover block holders decrease financial reporting quality" by exerting significant capital market pressures on managers to meet short-term earnings benchmarks." Managers therefore manage earnings to meet or beat expectations to avoid negative reactions from the market.

Other studies have found a negative effect of block holders on earnings management. Edmand (2008) studies how block holders can exert governance. Block holders benefit from closely observing firms because they can trade on private information, sell their stocks when there is negative information and vice versa. This causes prices to show real value instead of current earnings consequently investment decisions are for the long run growth as against short run earnings. Dou et al. (2013) found that "including individual block holder effects yields statistically significant and economically meaningful increases in model explanatory power." Furthermore evidence of the economic significance of the "block holder fixed effect" was also provided by this study. They found that the association between block holder effect and financial reporting quality was caused by the influence of block holders on firms accounting practices. The behavior of block holders followed the same pattern over time. According to traditional theories governance is highest when there is a large block holder because he undertakes "value enhancing intervention." In reality there are several small block holders. According to Edmand and Manso several small block holders generates a free –rider problem which impedes intervention, but leads to "a second governance mechanism: disciplining the manager through trading" When there are many block holders they tend to trade competitively and this reduces information asymmetry and "strengthens the threat of disciplinary trading, inducing higher managerial effort."

CONCLUSION

Questions asked by this study "Do block holders have private information so their trades can be used as a signal about the firms quality to the market? Do firms which have been structured to have more block holders have less earnings manipulation?" have no general consensus in the accounting literature. The inconclusive findings in the literature about the influence of block holders on earnings manipulation and the value of the firm means that there is room for more research to study the phenomena. Empirical research investigating the effect of discretionary accruals on block holders for firms in the United States must be done, since some of the prior studies focused on foreign sample firms. Also different measurements of earnings management apart from accruals must be used to investigate the impact of block holders on earnings management.

REFERENCES

Al-Fayoumi, N., Abuzayed, B., & Alexander, D. (2010). Ownership Structure and Earnings Management in Emerging Markets: The Case of Jordan. *International Research Journal of Finance and Economics, 38*.

Ding, Y., Zhang, H., & Zhang, J. (2007). Private vs state ownership and earnings management: evidence from Chinese listed companies. *Corporate Governance: An International Review*, *15*(2), 223-238.

Dou Y. H., Ole –Kristian, Thomas W. B. and Zou Y.(2013). Blockholder Heterogeneity and financial Reproting QAuality (june). Available at SSRN: http://ssrn.com/abstract=2283839

Edmans, A. (2008). Blockholder Trading, Market Efficiency, and Managerial Myopia. *Journal of Finance*, Forthcoming.

Easley, D., & O'hara, M. (2004). Information and the cost of capital. *Journal of Finance, 59*(4),1553-1583.

García-Meca, E., & Sánchez-Ballesta, J. P. (2009). Corporate Governance and Earnings Management: A Meta-Analysis. *Corporate Governance: An International Review*, *17*(5), 594-610.

Holderness C G. (2003) A Survey of Blockholders and Corporte Control FRBNY Economic Policy Review April

Jung, K., & Kwon, S. Y. (2002). Ownership structure and earnings informativeness: Evidence from Korea. *The International Journal of Accounting, 37*(3), 301-325.

Klein, A. (2002). Audit committee, board of director characteristics, and earnings management. *Journal of accounting and economics*, *33*(3), 375-400.

Loomis, C. J. (1999). Lies, damned lies, and managed earnings. *Fortune*, *140*(3), 74-92.

Marquardt, C. A. and Wiedman, C. I. (2004). The effect of earnings management on the value relevance of accounting information. *Journal of Business Finance and Accounting*, 31, 3/4 (April/May): 297

Shivakumar, L. (2000). Do firms mislead investors by overstating earnings before seasoned equity offerings? *Journal of Accounting & Economics*, 29 (3).

Salem A, Ebraheem S. , Salamat M. H.(2012) Proposing conceptual framework for reducing earnings management. Using a conceptual framework A Jordanian company's perspective. *Journal of Finance , Accounting & Management*.

Teoh, S. H., Welch I. and T. J. Wong, 1998, "Earnings management and the underperformance of seasoned equity offerings", *Journal of Financial Economics* 50 (1): 63-99.

Xie, B., Davidson, W. N., & DaDalt, P. J. (2003). Earnings management and corporate governance: the role of the board and the audit committee. *Journal of corporate finance*, *9*(3), 295-316.

Zhong, K., Gribbin, D. W., & Zheng, X. (2007). The effect of monitoring by outside blockholders on earnings management. *Quarterly Journal of Business and Economics*, 37-60.