Chapter 2
Institutional Investors' Representativeness and Earnings Management:
Evidence From a High Ownership Concentration Context

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ABSTRACT

In contexts characterized by high ownership concentration, institutional investors may lose their monitoring role and might not be effective in constraining earnings management. So, this study investigates whether directors appointed by institutional shareholders are more effective in inhibiting earnings management for companies with a high ownership concentration, rather than the mere presence of institutional investors. Based on a sample of Italian listed companies, findings suggest a negative relationship between minority directors appointed by institutional shareholders and abnormal accruals, while no relationship is found between the latter and the mere presence of institutional investors. Moreover, results also highlight that the difference between strategic and no strategic institutional investors does not count in a context characterized by high ownership concentration. Overall, this study suggests that institutional investors, regardless of their characteristics, are more effective in constraining earnings management when they can count on an agent on the board of directors.

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INTRODUCTION

Accounting earnings are considered as key performance indicators and represent one of the main sources of information for a firm's stakeholders (Graham et al., 2005). However, scholars and practitioners have recognized that preparers often use their private information and discretion in terms of accounting rules to manage the reported earnings in a wide variety of contexts and for many purposes. Therefore, the topic of earnings management has been deeply examined by academic researchers, financial market regulators, operators, and investors.

Although it has been recognized that earnings management is a complex phenomenon with a non-univocal interpretation (Arya et al., 2003; Ronen and Yaari, 2008), a substantial body of literature has stressed the negative impact of earnings management on the quality of earnings and on financial market efficiency (e.g., Dechow et al., 2010; Lang et al., 2012; Bhattacharya et al., 2012), while there is little evidence of the beneficial effects of earnings management activities (e.g., Subramanyam, 1996; Linck et al., 2013; Moscariello et al., 2020).

Based on the negative effects of earnings management mainly supported by the previous literature, a substantial research strand has focused on a variety of external and internal factors that can constrain earnings management activities.

As for the former, several authors argue that country-level institutional factors matter when it comes to financial reporting quality. For instance, Leuz et al. (2003), analyzing earnings management activities across 31 countries, suggest that earnings management is positively associated with ownership concentration and is negatively associated with the quality of minority shareholder rights.

As for the internal factors, many studies highlight that internal corporate governance mechanisms have an impact on corporate accounting behaviour, including earnings management (Dechow et al., 1996). Among other aspects, the impact of institutional ownership on the quality of earnings has been widely discussed in the previous literature, since it is well known that the presence of institutional shareholders can provide an important monitoring mechanism (Rajgopal and Venkatachalam, 1997; Bushee, 1998; Koh, 2003). Specifically, institutional shareholders are considered as sophisticated investors and, therefore, are assumed to be skilled in interpreting financial reports, and easily able to detect the presence of earnings management (Peasnell et al., 2005). In particular, Bushee (1998) found that managers are less likely to cut R&D to reverse earnings decline when institutional ownership is high, implying that institutional shareholders are sophisticated investors who typically serve a monitoring role in reducing pressures resulting from myopic behaviour. Chung et al. (2002) document that the presence of large institutional shareholdings inhibits managers from increasing or decreasing reported profits in terms of their desired level or range. Moreover, Koh (2003) observes a negative association between higher institutional ownership levels and earnings management consistent with the view that long-term oriented institutional investors' monitoring limits managerial accruals discretion.

In addition, the previous literature considers the situation in-depth and suggests that institutional investors can be clustered in the form of short-term oriented or transient institutional investors and long-term oriented or strategic institutional investors (Bushee, 1998; Koh, 2003). On the one hand, the former, usually holding a limited number of shares, tend to have a short-term investment horizon creating incentives for managers to manage earnings upward (Graves and Waddock, 1990; Porter, 1992). On the other hand, the latter, usually holding higher share quotas, are considered as strategic investors due to their long-term investment horizon and are assumed to be able to better act as a complementary effec-

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