

OWNERSHIP STRUCTURE AND THE QUALITY OF FINANCIAL REPORTING: EVIDENCE FROM NIGERIAN DEPOSIT MONEY BANKS

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Abstract

This paper examines the relationship between Corporate Ownership Structure and Financial Reporting Quality among Deposit Money Banks in Nigeria. Extant literature suggests that ownership structure does not only decrease the incentive to manage earnings but also provide the opportunity and incentive to manipulate earnings. Therefore, this paper analysed whether a firm's ownership structure (measured with three variables: managerial ownership, foreign ownership and institutional ownership) improves the quality of the financial reporting or not. Using a sample of all Deposit Money Banks listed on Nigeria Stock Exchange for nine years between 2005 and 2013, using Ordinary Least Square (OLS) Regression technique, we found that discretionary accruals as a proxy for financial reporting quality is positively related to managerial ownership and relate negatively to institutional and foreign ownership. The study's result suggests that managerial ownership improve the quality of annual earnings by reducing the levels of financial reporting manipulation.

Keywords: *Discretionary Accrual, Deposit Money Banks, Earnings Management, Financial Reporting Quality, Ownership Structure*

INTRODUCTION

One of the most important functions of corporate governance is to ensure the quality of the financial reporting process. The quality of financial reporting is to promote transparency and deliver high quality annual report through comprehensive disclosure (Hassan, 2013). Financial information influences investors' behaviour with respect to portfolio selection which in turn affects security prices, and therefore, the terms on which a firm obtains additional financing. Empirical research has shown the importance of markets that work well for efficient capital allocation (Wurgler, 2000). When the market works well, the pricing of securities will be correct, the allocation of capital in the economy will be efficient, and everyone will be better off. Financial reporting regulation is one of the mechanisms used to promote the operation of securities markets. The ownership structure of a company could be of critical importance to the effectiveness of oversight mechanisms employed to reduce the likelihood of earnings management practice. It has been argued that an effective mechanism to constrain fraudulent financial reporting is the development of an appropriate ownership structure.

This research paper considers three types of ownership which are internal ownership by managers, ownership by institutional investors and ownership by foreigners.

Managerial ownership is a situation where insiders or managers of the firm act as shareholders if they acquire a considerable portion of the entity's shares, and this is deemed to be useful in reducing agency conflicts and aligning the interests of management and shareholders.

The overwhelming majority of empirical studies found a positive association between insiders' ownership and earnings manipulation. This study attempts to examine the relationship between earnings management and managerial ownership using a different measurement of managerial ownership from previous UK evidence by Peasnell, Pope & Young (2005).

Institutional investors take various forms, including pension funds, mutual funds, corporations, private equity firms, fund managers, banks and trusts. It is a global view that institutional investor involvement in corporate governance is a complementary corporate governance mechanism. Ferreira (2007) investigates the role of institutional investors around the world using a comprehensive data set of equity holdings from 27 countries. It was found that firms with higher ownership by foreign and independent institutions (unlike other institutions) have higher firm value, higher operating performance and lower capital expenditures.

Institutional investors were classified into two main groups by recent studies. Firstly, long-term institutional investor, who invests in firms with the intention of holding their ownership stake over a long period. Hence, they have strong incentives to monitor those firms. Secondly, short-term oriented institutional shareholders or myopic, or transient institutional investors as

some studies referred to them. This group of investors is the dominant type and they focus mainly on current earnings rather than long-term earnings in determining stock prices (Bushee, 2001). They engage less in the management monitoring process and, if they are unhappy with the firm's results, they prefer to sell their stakes rather than to monitor or remove inefficient managers (Coffee, 1991).

Foreign and local investors are likely to invest in companies for which timely information is more easily available (Ahearne, Grier & Warnock 2000). Timely financial statements assist foreign ownership to preserve their investment by monitoring the management's performance and making efficient decision as soon as possible.

The study is interested in the effectiveness of these ownership structures to produce qualitative financial reporting. The following hypotheses have therefore been formulated:

H₁: There is no significant relationship between managerial ownership and quality of financial reporting among Deposit Money Banks in Nigeria.

H₂: There is no significant relationship between institutional ownership and quality of financial reporting among Deposit Money Banks in Nigeria.

H₃: There is no significant relationship between level of foreign ownership and quality of financial reporting among Deposit Money Banks in Nigeria.

The outcome of this study, serves as a framework to enable corporation to report qualitative and reliable information within the timeframe that will ensure informed decision. This study contributes to expand knowledge, awareness and understanding of the relevance of time which are necessary for preparation of adequate, reliable and workable report. The study, therefore, informs on where more efforts should be intensified in an attempt to improve the quality of financial reporting in the banking industry.

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Overall, the governance and earnings management literature suggests that ownership structures influence the credibility of financial reporting. Regarding managerial ownership, the overwhelming majority of prior studies suggest that low managerial ownership is a good governance attribute, and this runs counter to the proposition of Agency Theory. However, the review of the results indicates that high institutional ownership is associated with less earnings management in accordance with Agency Theory. The Agency Theory suggests that a higher percentage of management ownership implies higher firm value, since the goals of management and other shareholders are more closely aligned (Jensen and Meckling, 1976). Jensen and Meckling (1976) also use the agency theory to argue that managers with a high ownership are less likely to alter earnings for short-term private gains at the expense of other

shareholders. Shareholders are likely to perceive that managers' interests are aligned with their interests when managers become shareholders by acquiring equity shares. Thus, managers with high level of ownership in the firm are more likely to report reliable earnings that reflect the underlying economic value of the firm (Warfield & Wild, 1995).

Managerial Ownership

Teshima and Shuto (2008) examine the effect of managerial ownership on earnings management using discretionary accruals. They test a large sample of 18,790 Japanese firm-year observations from 1991 to 2000 and used the Kasznik (1999) model to measure discretionary accruals, which control Cash Flow from Operation. They find that this relationship is significantly positive within intermediate regions of ownership, which suggests that the entrenchment effect is dominant in these regions.

However, they also find that the relationship between managerial ownership and discretionary accruals is significantly negative within low and high regions of ownership, suggesting that the alignment effect is dominant in these regions.

The above studies suggest that monitoring seems to be weaker at higher managerial ownership levels. Therefore, a negative association is documented between the managerial ownership variable and quality of financial reporting. Using Australian data, Koh (2003) examines the association between managerial ownership and Australian firms' aggressive earnings management practice. He tests only income-increasing accruals for a sample of 107 firm-year observations from 1993 to 1997. The main findings are a positive association, with a smaller magnitude of income-decreasing accruals for all specifications, consistent with the view that high managerial ownership encourages managerial accruals discretion.

This study measures managerial ownership (MNGOWN) as the percentage of total shares held by executive directors divided by the total number of shares.

Institutional Ownership

The literature shows that short-term and long-term institutional holdings have opposite effects on financial reporting quality while long-term institutional holdings have a significant positive effect on financial reporting quality; short-term institutional holdings have a negative effect. Bushee (2001) shows that the characteristics of institutional investors should be considered when examining the relationship between institutional investors and financial reporting quality. He examines the differential effects of institutional non-blockholders and active institutional blockholders on earnings management behaviour. As measured by discretionary accruals, he proposes that institutional non-blockholders are more interested in short-run performance than

the institutional blockholders and that this interest creates pressure on management to deliver high earnings.

From the previous studies, it can be seen that institutional shareholders with a high ownership stake can play a significant role in monitoring and mitigating management opportunistic behaviour such as earnings management. This seems not to happen when the institutional ownership stake is low.

However, this study will measure institutional ownership (INSTOWN) using the average percentage of shares outstanding owned by institutional investors, as in Liu (2006).

Foreign Ownership

Corporate governance literature on ownership construction argues that foreign investors have a vital role to control and monitor management (Gillan & Starks 1998; Muhamad & Karbhari, 2005). This is because of the contradiction of interest between principal and owners (Jensen & Meckling, 1976). Emphasizing of such important activism, Gillan & Starks (1998) argue that the management of the poor performing firms can be under the pressure by the owners to improve shareholder value. Following this, due to the importance of timely financial information to the investors, foreign ownership also can perform their role actively and monitor management effectively by increasing pressure on them to release timely corporate reports including audited financial statements. External users place heavy reliance on firm's audited financial statements. A good indication of this is when the ownership of a company's shares is more widely held by outside shareholders relative to the shares held by inside shareholders. The study measures foreign ownership (FOROWN) using the Percentage of company shares held by the foreigners.

Bank Size

Watts & Zimmerman (1978) suggest that larger firms may face greater political costs relative to small firms due to higher analyst expectations following and investor scrutiny. Consequently, the political cost (size) hypothesis suggests that large firms are more likely to choose income-decreasing earnings management in order to reduce the probability of adverse impact from political exposure. Consistent with this hypothesis, Banderlipe (2009), Jiang, Lee and Anandarajan (2008) and Peasnell, Pope and Young (2005) find that larger firms are associated with lower absolute discretionary accruals. On the other hand, large firms may have more incentives to increase earnings because this can bring more benefit to their managers (Lobo and Zhou 2006). In addition, large firms face more pressures than small firms to meet or beat the analysts' expectations (Barton and Simko 2002). Chen, Elder and Hsieh (2007), Chung,

Firth and Kim (2002) and Yang, Lai and Tan (2008) find that larger firms are associated with higher absolute discretionary accruals.

METHODOLOGY

The population for this study consists of all the twenty Deposit Money Banks in Nigeria. Fifteen of the twenty Deposit Money Banks that are quoted on the Nigerian Stock Exchange were selected for the study. Financial reports of the banks for the period 2005-2013 were considered. The CBN actually started taking positive steps toward enforcing corporate governance code in the year 2005 which became effective in the year 2006. The year 2005 was chosen; because it was the year 89 banks in Nigeria were reduced to 25 as a result Central Bank of Nigeria banking reform. They were further reduced to 20 through subsequent mergers and acquisitions aimed at making the financial institutions more viable.

The data collected were analysed using both descriptive and inferential statistics. The use of descriptive statistics involves frequency count, percentages; mean, standard deviation, minimum and maximum values. In order to analyse the causal effect of ownership structure on the quality of financial reporting, multiple regression analysis was used.

Model Specification

The implicit economic model to be used in this study is given as: $Y = f(x_i) + \varepsilon$

Where, Y is the dependent variable; $f(x)$ comprises of β_0 (constant) and a set of β_i 's which are the coefficient of the explanatory variables (corporate governance characteristics), and ε is the random effect (assumed to have zero mean and independent across time period).

Explicitly, the regression model is specified as:

$$DAC_{i,t} = \beta_0 + \beta_1 MANGOWN_{jt} + \beta_2 INSTOWN_{jt} + \beta_3 FOROWN_{jt} + \beta_4 SIZE_{jt} + \varepsilon_{jt}$$

Where: $DAC_{i,t}$: Discretionary Accrual used as proxy for financial reporting quality

MANGOWN: The percentage of total shares held by executive directors divided by the total number of shares.

INSTOWN: The average percentage of shares outstanding owned by institutional investors:

FOROWN: The Percentage of bank's shares held by the foreigners.

SIZE: Bank size used as control variable is measured as the log of total assets of each bank.

ε_{jt} : Error term

The measure of earnings quality used is the modified Jones model (Dechow, Sloan and Sweeney, 1995) which is one of the models used to determine quality of earnings (earnings management). Accounting fundamentals are used to separate accruals into nondiscretionary (normal) and discretionary (abnormal) components. The absolute value of the abnormal

component determines the quality of earnings. The larger the absolute value of discretionary accrual, the lower the quality of earnings (Dechow et. al., 1995).

Total Accruals (TA) = Net Profit after Tax (NPAT) – Net Cash Flow from Operations (CFO)

To estimate abnormal accruals ($DAC_{i,t}$) for company i in year t , the following cross-sectional regression is performed

$$TA_{it}/A_{i,t-1} = \beta_{1t}[1/A_{i,t-1}] + \beta_{2t}[\Delta REV_{it}/A_{i,t-1}] + \beta_{3t}[PPE_{it}/A_{i,t-1}] + \varepsilon_{i,t}$$

Where:

$TA_{i,t}$ = Total Accruals in year t for company i ;

$\Delta REV_{i,t}$ = Revenues in year t less Revenues in year $t-1$ for company i scaled by total assets at $t-1$;

$PPE_{i,t}$ = Gross Property, Plant and Equipment in year t for company i scaled by total assets at $t-1$;

$A_{i,t-1}$ = total assets in year $t-1$ for company i ;

$\varepsilon_{i,t}$ = the residual of company i for time t ;

The industry year specific parameter estimates from the above model is used to estimate company specific normal accruals ($NA_{i,t}$) for company i in year t as a percent of lagged total assets; that is,

$$NA_{it}/A_{i,t-1} = \beta_{1t}[1/A_{i,t-1}] + \beta_{2t}[(\Delta REV_{it} - \Delta AR_{it})/A_{i,t-1}] + \beta_{3t}[PPE_{it}/A_{i,t-1}]$$

Where:

$AR_{i,t}$ = company i 's Accounts Receivables in year t .

Abnormal Accruals ($AA_{i,t}$) for company i in year $t = DAC_{i,t} = (TA_{it}/A_{i,t-1}) - (NA_{it}/A_{i,t-1})$

The absolute value of abnormal accruals ($|DAC_{i,t}|$) is the measure of earnings quality with lower values indicating higher earnings quality.

Information on managerial ownership, foreign ownership, institutional ownership, total assets, revenues, gross property, plant and equipment, receivables and net income are collected from the Annual Reports and Corporate Governance Reports of the selected firms.

RESULTS AND DISCUSSION

Table 1 presents the sample descriptive statistics for the variables used in this research.

Table 1: Summary of Descriptive Statistics

	Mean	Median	Min.	Max.
DISCRETIONARY ACCRUALS	.39947166	.24739	.029813	1.76755
MANAGERIAL OWNERSHIP	.00532143	.0036	0.0000	.039
INSTITUTION OWNERSHIP	.14552143	.1103	0.0000	.3429
FOREIGN OWNERSHIP	.14493571	.023	0.00	1.00
SIZE	18.585874	18.8749	14.0611	19.9431

Table 1 shows that the mean (median) *DAC* is 0.3995(0.2474) with a minimum of 0.03 and a maximum of 1.77, the mean (median) managerial ownership is 0.53% (0.36%), with a minimum of 0.0% and a maximum of 3.9%. The institutional ownership variable shows that, on average, listed Deposit Money Banks display a large degree of ownership concentration. Table 1 also shows that about 14% of companies have foreign ownership as shareholders.

The difference between the mean and the median reveals a considerable skewed nature, suggesting the existence of large percentages of shares held by foreigners in some firms and little or none in others (as can be confirmed by the minimum and maximum of the variable). The mean of Bank Size is 18.59 with a minimum of 14.061 and a maximum of 19.94.

Table 2: Correlations

		Discretionary Accrual	Managerial Ownership	Institutional Ownership	Foreign Ownership	Bank Size
Pearson Correlation	Discretionary Accrual	1.000	.241	-.153	-.015	.503
	Managerial Ownership	.241	1.000	.076	-.602	.423
	Institutional Ownership	-.153	.076	1.000	-.385	-.325
	Foreign Ownership	-.015	-.602	-.385	1.000	-.005
	Bank Size	.503	.423	-.325	-.005	1.000
Sig.(1- tailed)	Discretionary Accrual	.	.129	.238	.472	.006
	Managerial Ownership	.129	.	.362	.001	.020
	Institutional Ownership	.238	.362	.	.032	.061
	Foreign Ownership	.472	.001	.032	.	.491
	Bank Size	.006	.020	.061	.491	.

The analysis of Table 2 shows that there are significant correlations between the variables. Managerial ownership is positively related with *DACC*, suggesting that financial reporting quality is significantly higher for firms with greater managerial ownership. A negative correlation between managerial ownership and foreign ownership indicates that managers' equity interest in the firm is declining as foreign ownership increases. *Size* is positively correlated with *DACC*, suggesting that larger firms have higher quality reporting activity. *Managerial* is positively

correlated with *Size*, suggesting that managers' equity interest in the firm is increasing as firm size increases.

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.504 ^a	.254	.097	.3139328	.254	1.616	4	19	.211	1.819

A. Predictors: (Constant), Bank Size, Foreign Ownership, Institutional Ownership, Managerial Ownership

B. Dependent Variable: Discretionary Accrual

Coefficients^a

	Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-3.039	1.417		-2.144	.045
	MANAGERIAL OWNERSHIP	.112	.739	.044	.151	.881
	INSTITUTIONAL OWNERSHIP	.092	2.522	.008	.036	.971
	FOREIGN OWNERSHIP	.016	.260	.017	.061	.952
	BANK SIZE	.221	.111	.487	1.998	.060

A. Dependent Variable: Discretionary Accrual

Hence this equation:

$$DAC_{jt} = \beta_0 + 0.044MANGOWN_{jt} + 0.008INSTOWN_{jt} + 0.017FOROWN_{jt} + 0.487SIZE_{jt} + \epsilon_{jt}$$

Having examined the output from this regression analysis, using simple regression, the study looks to the p-value of the F-test to see if the overall model is significant. The R-squared is 0.254, meaning that approximately 25% of the variability of discretionary accrual is accounted for by the variables in the model. In this case, the adjusted R-squared indicates that about 9.7% of the variability of discretionary accrual is accounted for by the model; even after taking into account the number of predictor variables in the model. The coefficients for each of the variables indicates the amount of change one could expect in discretionary accrual given a one-unit change in the value of that variable, given that all other variables in the model are held constant. From the analysis, considering the variable MANGOWN, it is expected that a

decrease of 0.112 in the discretionary accrual score for every one unit increase in MANGOWN, assuming that all other variables in the model are held constant.

SUMMARY AND CONCLUSIONS

Previous studies have indicated that ownership structure has an impact on corporate accounting behaviour (Banderlipe, 2009; Chung, Firth & Kim, 2002; Dechow, Sloan & Sweeney, 1996; Klein, 2002; Kim & Yoon, 2008; Mitani, 2010; Warfield & Wild, 1995). Therefore, the aim of this paper is to examine the effect of ownership structure on a firm's earnings management activity within the Nigerian capital market. For this reason, we selected a sample of 15 Deposit Money Banks listed by the Nigeria Stock Exchange between 2005 and 2013. The empirical findings show that the financial reporting quality of these listed firms is influenced by these firms' ownership structure. Specifically, our findings show that managerial ownership improves financial reporting quality of these listed firms. This result is consistent with the alignment of interest hypothesis that suggests that managers who own a significant portion of the equity in a firm have less incentive to manipulate reported accounting information. However, there is negative correlation between financial reporting qualities and foreign ownership as well as institutional ownership.

Every study has its own limitations; this study is not an exemption. The possible limitations of this study include the proxy used for reporting quality in this study which has its own defect and therefore cannot guarantee a perfect result and the study was restricted to banking sector of the economy. However, these limitations have not affected the result of our findings.

In sum, our findings highlight the importance of ownership structure, mainly managerial ownership, institutional ownership and foreign ownership, in improving the financial reporting quality of listed firms in Nigeria. Therefore, the findings reveal that managerial ownership affects the informational quality of earnings positively and consequently enhances the quality and value relevance of published financial data.

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