

A Critical Review on Pyramid Structure of Earnings Management in Family-owned Firms

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Abstract: This study aimed to identify how accounting results were being managed under family owned companies, with pyramid structures and to determine the effect of pyramid structure on firm's corporate value. The pyramid structure is considered an entity of business which the structure of its ownership is represented by control's top-down chain. A divergence of actual control and ownership of the ultimate owners is achieved through this structure for companies situated at the structures' lower-level. Past studies revealed that the ultimate owners in many East Asian show inconsistencies in control right and cash flow that consequently lead to critical allocation of minority shareholders' interests. The findings showed that distinguishing between control and ownership has adverse effects on the value of the firm and earnings management. The study concludes from the perspectives of two theories namely alternative effect and entrenchment effect. The entrenchment effect states that controlling shareholders may participate in manipulative earnings management with the motive of covering the wealth effects of their expropriation activities. However, an incentive was given to the controlling shareholders by the alignment effect to report high quality earnings as they intend to increase the value of the firm in a long term.

Keywords: family firm, pyramid structure, earnings management, firm performance

1. Introduction

From the common book produced by Jensen and Melking (1976) firms operations can be commonly viewed from the lens of agency conflicts. Shleifer and Vishny (1997); Mashhadani, and Talab, (2013); Talab, Manaf, and Malak, (2018); Talab, (2009) stated that there exist several previous studies on agency conflicts regarding managers and owners of companies with separated ownership like the effect of agency conflict on managerial decision and firm performance using the flow of free cash. Considering a lot of European organizational firms and other firms in developing countries, it is believed that the idea that firms that are widely-held are minority in the business world. Many companies are being controlled essentially by families either through indirect method like pyramid structure or direct control of shares. For example in India, Piramal (1996) stated that about 70% of the firms are family-oriented. In addition, Villalonga and Amit (2007) stated that in United States, a third of both poor and standard companies of about 500 belong to families and they accounted for 18 per cent of the rights to vote and 11 per cent of cash flow rights of these firms.

The agency conflict is reduced by the family-ownership of firms between the owners and the managers. The members of the family are responsible for a great fraction of the chairmen in the firms that are family-controlled and CEOs and most of these firms significantly represent family on their board. The basis of what is called Type 1 agency conflict which is the separation between ownership and management is thus weak. However, these organizations are generally known for type 2 which is an alternative type of agency conflict existing between shareholders that are in control i.e. the minority and family shareholders. There is a vital effect on the family firms by substituting one agency problem's type with other one.

Furthermore, the positive effect of this identity and interest convergence of the managers and owners in control maybe higher than the negative effect of the entrenchment in their management. The families in control

can later optimize their private benefits in detriment of other shareholders. The expropriation of shareholders who are non-family has been proved in particular by the family-owners of firms where significantly the right to vote of the families surpasses the right to cash flow (Bertrand, Mullainathan & Mehta, 2002; Gao & Kling, 2007). The expropriation's level that is generally known as tunneling is especially high in countries with legislative right to protection for the minority shareholders.

Tunneling may appear as asset expropriation or cash flow or equity or incorporation of the mentioned firm aspects. Expropriation of equity has impacts on preparation of balance sheet while expropriation of cash has effects on earning statements. The expropriation form result to earning losses in minority shareholding at the long run from losses of productive asset. Any suggestion regarding expropriation can at the long or short run reduce the external investment in these companies and then decrease the prospect of the expropriation. All these have significant effect on firm's earning management. Notably, Fan and Wong (2002) mentioned that there is proof suggesting that the probability of earning management in the possession of block-holders such as family among the concentrated ownership. In this study, the nature of family firms, ownership structure and its effects on firm's market evaluation through pyramids (tunneling) shall be examined. Earnings management and its various aspects shall also be discussed. The study shall draw conclusion on how earnings are managed in family owned companies by analyzing two competing hypothesis of owner managers' behavior in the firm using the two theories namely entrenchment and alignment hypothesis.

2. Literature Review

2.1 Theory of Agency

One of the renowned theories of economy is the agency theory. From a point of view, relationship in agency is a contracted relationship where one or more principals (or persons) interact with other person known as agent in order to discharge some duties on their behalf by authorizing some peculiar decision makings to the agent (Jensen & Meckling, 1976). According to this assertion, managers can be seen as agents while shareholders are recognized as the principals. Moreover, both the manager and shareholder have their respective targets of own interests. The relationship between the two parties leads to divergence. Furthermore, managers know more information regarding to the company than shareholders due to the separation of this control and ownership. Thus, managers can act out of self-interested motivation instead of shareholder's interest. In other word, managers can apply special information that is not available to shareholder involving in management of earnings. The shareholder's interest can be harmed through this action and mislead the shareholder. To minimize the bone of contention between shareholders and managers, monitoring can be applied in order to solve the problem. Fama and Jensen (1983) stated that the word "monitoring" means the shareholders measure the performance of the managers. Monitoring cost is the cost generated by the shareholders monitoring the actions of the management.

Type 1 Agency Problem: Owner-manager Problem

The problem of agency arises when the firm ownership is separated from the management. This is due to incompatibility of goals between shareholders and managers where managers usually act in their own interests for example achieving profit objective instead of wealth maximization objective. Therefore, this problem should not arise without this separation as in case of an owner-managed company both ownership and control are in the custody of one person.

Type 2 Agency Problem: Majority and Minority Shareholders

The main shareholder may act in several manners in which benefits can be substantially benefited by exploiting his advantage position by owning most of the shares. These actions may negatively affect the minority shareholders thus reducing their wealth although this shows possible advantage of the majority shareholders. The power of high decision given to majority of shares (block-holders) can lead to entrenchment situation thus leading to undertaking actions with the aim of expropriating wealth from the rest of the minority shareholders (Fama & Jensen, 1983). From the features of this agency problem, there is more probability for its presence in the countries where the ownership is traditionally more concentrated in the hands of few founding families or large shareholders (Talab, Abdul Manaf, & Abdul Malak, 2017b; Talab, Abdul Manaf, and Abdul Malak, 2017a; Talab, Flayyih, and Ali, 2017).

2.2 Family Firms

Motive behind Family Firms Existence

For a long time, there have been deliberations by social scientists for the issues behind family-firm's existence especially in emerging nations. It is claimed by the economists that the presence of family-owned firms is as a result of irregularities corporate control marketing or managerial talent marketing. For example,

firms may need to depend on the next generations of the founding families in the non-existence of managerial talent marketing in order to produce managerial personnel. In the same view, the convergence of ownership and management can be the second best response with the aim of amending the type 1 of agency problem if there is no market for takeover in a way that is challenging to reliably pose a threat to the administration of under-performing firms with a takeover prospect.

The family-owned firms is the maximum result in any circumstance where there is high in contract enforcement cost and the social norms or informal agreements and output are supported by the issue of social interaction used in facilitating resourceful outputs and positive transaction (Peng & Heath, 1996; Redding, 1990). This explains the popularity of family-owned businesses in China. The management scholars have examined the effect of reliance of any family member in alleviating Type 1 of agency problem (Yeung, 2006).

As an alternative to the market imperfections argument, many scholars have suggested that a family-owned firm is a product of factors like self-sacrifice and externalities related to high cost of contract enforceability and social capital. A firm does not necessarily need to acquire social capital from a widely spread groups of individuals but it will still prosper in addition to social capital as the private benefit to these people would be much less than the collective social capital of the firm. According to Arregle et al. (2007), if firm is family-owned, the social capital of the family can be earned. Most family-owned firms belong to members of broader business systems in an institution that seriously put social capital into investment (Peng & Delias, 2006). This occurrence can be explained by extending the view of “market imperfection” in the family-owned firms. For instance, the source of investment funds may be the internal accruals of firms if there is imperfection in the capital markets. Existing internal accrual firms in such cases pose to be in nest position to initiate fresh ventures in business leading to business group establishment that apply internal capital market to reduce the challenges connected to capital-market inadequacies (Riyanto & Toolsema, 2008).

Arguably, the group firms used supporting as the *de facto* collateral in ensuring flow of credits into a group with weak members in an environment where the cost of stipulating debt covenant is high (Friedman, Johnson & Mitton, 2003). The study cited the case of a family head known as Lee Kun Hee who is the controller of Samsung Group and cleared the debt of Samsung Motor Inc. to with his personal wealth. Additionally, given factors like costs of contract enforcement and market imperfection in an environment where family businesses are ideal organizational form, the economy of opportunity related to tangible and intangible resources can explain the existence of family-affiliated business groups such as business environment and knowledge of distribution channels which are concentrated disproportionately in the existing firms (Gillen, 2000).

According to Bertrand et al. (2008), when gaining control of a firm may be the maximum strategy for the family when a family-owned firm comes into existence if the legal institution supporting the contract enforcement is weak in a way that maintaining the control is the only existing way or gaining control on cash flow right. Furthermore, there are three benefits to the family growth if the control is preserved. In the first case, the family obtains non-pecuniary utility over the firm from the control; for instance, the capability to transfer the firm over to the successive generation or to stand as sponsorship in an event of favorite sporting. Secondly, a long-founded family owned name may indicate quality, has high accessibility to power or authority in a way that the firm value might reduce if in this case the family can no longer control the firm. Similarly, the value of the family's share if it withholds the power to control may be higher than attempting to sell-off the shares of the firms.

Lastly, family in control gives the ability to maintain balance of misappropriated future flow of cash and current share in detriment on the minority shareholder (Johnson et al., 2000). When a change in control significantly adds to the firm's profitability, a control over the firm is renounced by the family to a professional management and especially when the private benefits are considered as amenity potential – accruing to the family as the low-level of the account control (Burkart, Panunzi & Shleifer, 2003). Furthermore, to form a group of networks where all firms under the control are all affiliated, the family-owned firms have a strong incentive to establish a group provided that the appropriation of the firm's cash flow is connected with group affiliation when the same family controls the group firms (Almeida & Wolfenzon, 2006). This idea is in consistency with the above-mentioned relationship between affiliation with business groups and family control.

The Concept of Family Firms

Many previous studies have defined family businesses in various ways and following are some of the definitions to be considered. According to Barnes and Hershon (1976), family businesses are those businesses that have concentrated ownership structure in at least 20 per cent in the hands of people of the kinship level or have significant voting control or rights. In other word, it is characterized as a business where members of the family have control legally over a property. Family firms can be defined in accordance with the form of organizational management. Handler (1989) stated that organization whose major operating plans and decision succession are under the influence of family groups that contain the main board of the company can be

considered family. Also, it is applicable when two or more family members influence the business direction through the management roles, or right of ownership or exercise of kinship ties.

However, the diversity of the family strategy in businesses makes them distinguish themselves from non-family firms (Gomez-Mejia et al., 2010). From this point of view, planning long-term ahead is one of the strategies of the family businesses without pressure to make short-term results with the aim of marketing continuity, passing the legacy on to generation by generation with the desire to propagate the family business (PWC, 2010). The ownership of the group member of a firm is always organized by the top family in a pyramid structure in a family business group. Thus, the family takes control through chain of ownership relations.

2.3 Pyramid Structure

In United States, ownership structures are simple. When firms are owned by others, they are usually as a subsidiary and firms have normally dispersed shareholders. In contrary, this structure is different from the normality around the world. They might appear interesting from the perspective of U.S., many other firms are organized into the so-called Pyramid around the world. A report stated that about 25% of the firms are members of pyramids in the sample (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1999). To continuously gain control over a large number of companies, the ultimate owners employ indirect ownership in the pyramid. In this case, enough shares are owned by the ultimate owners (assumably 20 per cent) to gain control over firm A. In return, firm B is controlled by enough shares owned by Firm A while B equally owns enough shares to control firm C. Even in the case of the firms which have no direct ownership, the ultimate owner to control all the firms are allowed by the chain of ownership.

Therefore, control is maintained on all the firms in the pyramid by the ultimate owners without an entitlement to too much of cash flows. Claessens et al. (2000b) highlighted that a separation of actual control and ownership in firms situated at the pyramid lower part of the structure is as a direct outcome of pyramidal ownership structure. In contrary, cash flow rights and formal control rights go in line usually in many U.S. firms and stand-alone firms around the world.

(Betrand and Mullainathan Pyramids)

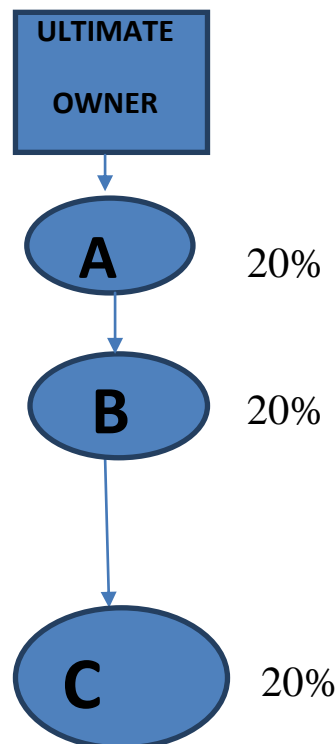


Figure 1: example of pyramid indicating the direction of ownership

Claessens et al. (2000) stated that the cash flow right (CFR) and control rights (CR) are regarded as the actual ownership. Therefore, whenever there is separation, the interests of minority shareholders are negatively affected as such differences allow the ultimate owner to exploit their control right over the resources of the

company without being penalized for such disposition. This minimizes the family incentives to share the free cash flow of the company to the shareholder because it will accept a small portion of the cash flow. Otherwise, there is high incentive for the family to obtain flows of free cash in a way to increase its own private benefits. Franks and Meyer (2001) added that from the practical studies under ownership, the control by family is applied as a proxy for existence of private benefits.

Tunneling

In addition, tunneling may be used with the purpose of retaining control. In this practice for many cases, the family is the controlling entity that applies various ways to transfer a part of the free cash flow from a firm where there are small cash flow rights. Yet, the family has high rights to vote in a company where there is large cash flow of control and rights (Johnson et al., 2000). Generally, the Tanzi family is in control of Paramalat group that siphoned about USD 3 billion into some companies from the group companies that were directly controlled by the family (Enriques & Volpin, 2007). Between 1990 and 2003, this amount accounted for the use of the financial resources of a sixth group and 30 per cent of the debts also belonging to the group. While understanding of debt and hiding of losses on the financial statements are used by the family to make cover-up for fraud done, the allocation of resources was made largely by ways of over-payment for asset acquisition.

Furthermore, tunneling can exist in form of assets, equity, or expropriation of cash flows or the integration of two or more of these attributes of firms. Some cases of cash flow tunneling are sales of firms' resources at a price that is below-market in comparison to other firm at where the family (also block-holder) has complete or significant over-payment or cash flow rights for resources bought from the firms. A long-term productivity of a firm is not necessarily affected by the expropriation of cash but has consequences on the earning management. Typically, asset tunneling means passing of firm's assets into firms completely block-holders or family-controlled. Also, asset-tunneling can have a great effect on long term ability of a firm significantly to produce cash flow.

Also, equity tunneling comprises features that are profitable to the family or block-holder while reducing the shares value that are investors-owned. If the related business venture is successful, the issue of loans to the family would not need to be repaid and a sale of new share to the family at a price which is below-market is an example of equity tunneling. According to Faccio, Lang and Young (2001), investors work towards the possibility of one or more of these forms of tunneling in firms with significant divergence between cash flow right and voting rights and those that are closely connected to the group.

2.4 Separation of Control and Ownership

The challenges arises due to separation of cash flow (ownership) and control rights (control) in the groups of pyramids is the same as the conflicts in agency as mentioned by Jensen and Meckling (1976) in a study where dispersed ownership is mentioned. The authors are of the opinion that firm's managers with dispersed shareholders have authority on the taken actions and had substantial influence due to disorganization and disparity of individualistic shareholders. Individual shareholders may not be able to coordinate themselves in order to share the control and monitoring cost of the managers that were employed to control the corporation due to this disorganization and disparity. Due to this, managers are allowed to make decisions that benefited them alone while the benefits cannot be shared among the remaining individual shareholders. The same divergence of problem interest is permitted by the pyramid structure as in firms with disparity by allowing control and cash-flow rights to separate (Jensen & Meckling, 1976). In a free-standing firm with ownership that is widely dispersed, the managers may venture into inefficient investment as a part of their empire building goals. Such business is carried out for stakeholders by managers without great concern as no individual wealth is connected with the firms. Similar occurrence can happen in pyramidal-related firms with ownership and separated control because the controlling ultimate owners' actual cash flow rights belong only to a small part of the control rights. Thus, if there is failure in the firm due to morally hazardous behavior of the ultimate owner, only a small part of their actual wealth is truncated.

2.5 Earning Management

The Concept of Earning Management

An essential component in the financial reports which is also referred to as net income is called earning. Earnings disclose the firm's performance associated with profit-generating activities and demonstrates the competence of the company's management. The information on earning available in the financial report has impacts on the firms' values. Taking for instance, positive earnings information contributes to the increase in the price of stocks while negative information on earning leads to decrease in the price of stock. In the same way, decrease or increase of price of stock affects the value of firms. Thus, it serves as motivation for management to deliberate on how to make report on the company's earnings information and manage the earnings.

Several definitions are provided by a large number of analysts and researchers in previous articles since earning management is a widely researched topic in the modern society. As cited by Schipper (1989), according to Davidson et al. (1987), earning management is the systematic way of applying some actions within the premises of generally-accepted accounting principles in order to achieve a desired level of reported quality earning. Also, Healy and Wahlen (1999) stated that: "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers."

Moreover, earning management is: "The intentional, deliberate, misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision" (Dechow & Skinner, 2000). Earning management can therefore be seen as intentional action in the financial reporting process by management. In addition, in order to distort the earning information, there are some self-seeking purposes to drive management. The judgments and decisions of the users can be influenced by the intentional behavior and can sometimes harm their benefits.

Since the negativity of earning management is not mutually agreed upon by all researchers, earning management from the past studies is usually considered as a negative effect. Also, Subramanyan (1996) mentioned that the content of information gets increased with discretionary accruals and therefore helps in predicting the firm's earning and future of cash flow. Earnings management is considered positive by Jiraporn et al. (2008). The study employed the theory of agency as the tool of the research and discovered that there is positive association between value of a firm and earning management. The study also posited that investors benefits from earning management as they make provision for information more and more benefits are awarded to the companies.

From the above-mentioned argument raised, there is no consensus agreement on the definitions of earning management in the academic field from the previous studies. In other word, management can be classified into three parts: black, grey and white (Ronen & Yaari, 2008). The black earning management reflects tricks that are employed by the management to reduce and misrepresent transparency of financial reports while the grey earning management is regarded as the chosen accounting treatment that most of either manager's interests or firm's interests represent. On the other hand, white earning management means that managers have the control to show private information connected with future cash flow and flexibly chose accounting treatments. This statements show that the quality of financial reports and transparency can be improved by earning management.

Additionally, the management used information perspective of earning management and presented discretionary management to reflect the private expectations to investors. The study showed that an average earning management is beneficial but not opportunistic to the company. This submission is the same as the definition of white earning management. The managers can discretionarily manipulate the earnings information as a result so that the users will not see the truth of the enterprise out of biased earning information.

Motivations of Earning Management by Managers

A question to be asked after introducing the relevant argument and definition of earning management is that what are the manager's motivations on earning management? The following explanations are given by Healy (1999):

Motivation by Capital Market

Trueman and Titman (1988) stated that in order to maintain the income of the company, the corporate managers are given some incentives. These actions are aimed in keeping the firms relatively stabilized and to avoid decline in the stock market. Unarguably, financial analysts employ information of financial report to determine the future performance of a company and perform prospective analysis. There are sets of rules to some important figures in the forthcoming years such as earnings and sales. If a firm fails to achieve the provided standards by analysts, the price of the stock of the firm will significantly decrease. Thus, by using earning management, managers are allocated high incentives to achieve those earning standards.

Contracting Motivation

There are two types of contracts according to Healy and Wahlen (1999). Management compensation contract is the first one. To assess the performance of a firm, accounting income is considered a crucial figure. Otherwise, to determine the performance of managers, it is also considered a key benchmark. Moreover, the compensation such as stock options, bonus and salaries depends on the evaluation of the managers' performance. Therefore, due to the fact that poor performance will affect the bonus and compensation, managers

have motivations to manipulate earnings. Managers will even lose their jobs more. When the forecast of the analysts is not in line with the earning information, the bonus of CEO will be lower (Matsunaga & Park, 2001). The next one is giving out contract related to hypothesis of debt covenant. The basic concept of this idea is that a company with a lot of debts has incentive to manage earnings. Due to avoidance of breach of debt covenant, this is made achievable.

Regulatory Incentives

From the hypothesis of political cost discussed by Watts and Zimmerman (1986), big firm's managers have motivation to minimize earnings as the information on high earnings attracts the attentions of labour, regulators and government. It was found by Jones (1991) that some companies use earning management to minimize the accounted earnings during the time of import relief surveys actualized by the United States International Trade Commission.

Earning Management Patterns

It is worthwhile to understand the two major pattern of earning management before introducing the methods of earning management. The real activities of earning management are the first one. From the perspective of Roychowdhury (2006), manipulations of real activities is "deviations from the normal operational practices influenced by the desire of the managers to mislead at least some stakeholders into believing specific financial reporting goals that have been achieved in the normal course of operations". In general, real activities in earning management implies that the operational actions are picked by the managements to have impacts on the users of financial reporting.

Similar way for earning management is the discretionary accruals management that is generally applied in previous and current years. In order to minimize the matching and timing problems under Generally Accepted Accounting Principles (GAAP), managers are required to use accruals. However, to beat or just meet the forecasts of the analysts or other self-interested incentive, accruals can be applied to manipulate earnings (Hsu, 2013). These management discretionary behaviours negatively affect the company's true face. User's judgment of the company will be influenced if the management provides biased financial information. There is occurrence of earning management when the managers apply discretion in production process of accounting information. In accordance with accrual-based method, total accruals should be categorized into discretionary and non-discretionary accruals. For a proxy in earning management, discretionary accruals are often adopted. Meanwhile, it is challenging to identify which aspect of the total accruals non-discretionary and which part is discretionary. It is difficult to exactly examine the discretionary behavior by managers because management might use discretionary room at different time.

3. Methods of Earnings Management

Managers may use any of the following earning management methods:

1. Bath Taking: This takes place in the period of reconstruction of organizational stress. The managements might feel they can report a large one in any report of loss in the firm. Hence, it will provide for the expected future costs or write-off assets. Due to accruals reversal this promotes the possibility of future reported profits.
2. Minimization of Income: This is less extreme but looks the same as bath. This method is taken usually during the time of profitability by a politically visible firm. Expenses of research and development expenditure and advertising and rapid write-off of intangible and capital assets are policies that suggest income minimization.
3. Maximization of Income: Managers may participate in the concept of maximization of reported net income for bonus using positive accounting theory provided this does not place them above the gap. Income can also be maximized by companies that are close to violation of debt covenant.
4. Smoothing of Income: a risk-averse manager prefers a less variable bonus stream when other things are being equal from a contracting perspective. In order to receive relatively constant compensation, manager might consequently smooth reported earnings over the time. Effective compensation contracting might explore this impact and allow some smoothening of income as a low-cost way to gain reservation utility of the manager (Al-taei, Flayyih, & Talab, 2017).

Earning Management in Family-owned Pyramid Companies

From the previous studies of Fan and Wong (2002), Francis et al. (2005) and Wang (2006), the use of these control-enhancing mechanism and voting right concentration may be connected in two competitive manners with the quality of accounting earnings. Firstly, it is predicted by the theory of entrenchment theory that shareholders in control have incentive to engage in opportunistic earning management. The Large block-

shareholders enjoy private benefits when they use control-enhancing mechanisms given their significant ownership such as pyramids to sustain control over companies with small fractions of equity ownership (Bebchuk et al., 2000). The study showed that owners of entrenchments have large proportion of right to votes and incentive and power to go after personal interest in detriment of the minority shareholders. The quality of accounting information produced in the case through earnings management by the firms may be reduced to cover the impacts of wealth in the expropriation activities and avoid the losses connected with private benefits and dilution of their control (Fan & Wong, 2002; Wang, 2006).

This implies that the private interests will be pursued by the entrenched owner-manager in detriment of external investors as the managerial increase. Expropriation activities will be high where the legal protection on minority shareholder is weak. Zingales (2004) stated that: government monitors, public opinion pressure, and extra-legal institutions, internal policing through moral norms, labour and level of product market competition contribute majorly in negatively affecting private benefit present for shareholders in control. Also, Athanasakou (2010) stated that firm reputation acts in a manner of deterrent mechanism to the self-serving behaviour of controlling shareholders.

In contrary, alignment theory according to Wang (2006) stated that ownership concentration provides incentive for the controlling block holders to give report on high quality earnings. This action can influence a negative relationship between ownership concentration in family-owned firms and earning management. There are incentives allocated to controlling shareholders to give a close monitor to the managers and keep earnings management within proper bounds to preserve their large ownership stake in the firm. Generally, large shareholders such as the families are actively involved in the management of their firms and have a long-term investment horizon (Villalonga & Amit, 2006). The managers of widely held firms are usually more likely to focus on short-term earnings than the managers of these firms and are consequently less prone to using manipulative earnings management as a device to boost short-term earnings.

However, they are also generally involved in the management of the firm and have a long-term investment horizon considering the alignment effect which aligns their interests with those of minority shareholders (Villalonga & Amit, 2006). This alignment effect as mentioned above makes them unlikely to concentrate on immediate profits and manage earnings in the context of long term benefits of the organization. Particularly in family block holders, the dominant shareholders need to maintain good relationship with investors to maintain a low cost of capital and promote future equity issues (Holderness & Sheehan, 2000). They take care of family values, succession issues, culture and family reputation. Therefore, companies control-enhancing mechanisms or with concentrated ownership cannot participate in opportunistic earning management to avoid establishing a reputation of minority shareholder expropriation with a negative effect on the capital cost.

4. Conclusion

This present study provides evidences in diversity on the relationship between ownership concentration and earnings quality. Ali et al. (2007) and Wang (2006) found that family firms have lower earning management in level than the non-family firms. Ali et al. (2007) in particular mentioned that family controlled firms are characterized by higher ability of earnings to predict future cash flows, a lower level of positive discretionary accruals (implying lesser earnings management) and higher earnings response coefficients. Also, Fan and Wong (2002) showed that the application of control-enhancing mechanisms that allow a separation between voting rights and ownership minimizes the information quality of accounting earnings because the personal interests such as acquisitions and mergers of controlling owners are at stake. Therefore, it is expected to experience the use of earning management practices and opportunistic behavior. Stock financing undermine the voting power of a controlling owner and may pose a threat to the private benefits of control. The owner may apply upward earning management prior to the transaction to increase the stock price, reduce the number of shares and improve the exchange ratio needed to gain control (Erickson & Wang, 1999).

In another vein, the impact of alignment showed that voting rights and ownership concentration produce incentives for the shareholders in control to report high-quality earnings. The direction of the relation between these two variables becomes a practical question, with the existence of two competing theoretical predictions (alignment and entrenchment effects) on the impacts of the ownership structure on earnings management. The effect which is pre-dominant in a given period determines the incentives to manage earnings in family pyramid companies as there is competition between the two theories on which of the incentives is better to manage earnings in a family-owned company.

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