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Institutional Investors, Managerial Ownership and Accrual Management

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The study provides an important extension to the research of Warfield Wild and Wild (1995) and Gul Lynn and Tsui (2002) on the relationship between managerial stock ownership and accrual management. Warfield et al. (1995) document that with increase in managerial ownership the magnitude of abnormal accrual adjustments decreases. Gul et al. (2002) document that this inverse relationship is moderated in firms audited by Big-six auditors because high quality audit mitigates agency problem associated with low managerial ownership firms. By considering the effect of another influential governance variable, institutional stock ownership, for firms that are mostly subject to high-quality external audit, the present study provides evidence that substantial presence of institutional investors in a firm's shareholder-mix acts as an effective monitoring mechanism in financial accounting process and moderates the inverse relationship between managerial stock ownership and management's accounting discretion exercised to manage accruals in financial reporting. The original result holds for firms having different sizes and information environment. It is inferred from the result that by collectively owning large percentage of outstanding common stock in a corporation, institutional investors mitigate the adverse effects of agency problem arising out of separation of ownership and control on reported accounting numbers.

INTRODUCTION

This study is based on a prior research of Warfield et al. (1995) on the relationship between managerial stock ownership and level of accrual management. Warfield et al. (1995) document that with increase in managerial ownership, the agency problem arising out of separation of ownership and control diminishes, which is reflected in the inverse statistical relationship between managerial stock ownership and discretionary accounting accruals. By using data for Australian firms, Gul et al. (2002) extend this research and examine whether high-quality external audit has any effect on such relationship based on the premise that Big-six auditors (a proxy for higher quality audit) reduce control risk by mitigating agency costs and improve the quality of financial reports. They find evidence that the association between