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Ownership Structure and Earning Management – A Literature Review

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ABSTRACT

This study aims to provide insight into earnings management in companies with various ownership types. This empirical research focuses on a literature review of the relationship between earnings management and corporate ownership. The results of this study found that differences in corporate ownership can influence decisions related to earnings management.

Keywords: Earning Management, Managerial Ownership, Institutional Ownership, State Ownership, Family Ownership

ABSTRAK

Penelitian ini bertujuan untuk memberikan wawasan tentang manajemen laba di perusahaan dengan berbagai jenis kepemilikan. Penelitian ini merupakan penelitian empiris yang berfokus pada tinjauan pustaka tentang hubungan antara manajemen laba dan kepemilikan perusahaan. Hasil penelitian ini menemukan bahwa perbedaan kepemilikan perusahaan akan dapat memengaruhi keputusan terkait manajemen laba perusahaan.

Kata kunci: Manajemen Laba, Kepemilikan Manajerial, Kepemilikan Institusional, Kepemilikan Negara, Kepemilikan Keluarga

INTRODUCTION

Earning management is a topic that is often discussed in the field of accounting. Many researchers have discussed how earnings management related to various aspects such as CEO compensation (Brink et al., 2020; Li & Kuo, 2017), market liquidity (Ajina & Habib, 2017) and ownership structure (Dong, Wang, Zhang, & Zhou, 2020; Martin, Tochman, & Gomez-mejia, 2016; O'Callaghan, Ashton, & Hodgkinson, 2018). In fact, earnings management is an activity of adjusting earnings to achieve predetermined management objectives. This action is a form of deliberate intervention in the process of presenting the company's financial information (Tran & Dang, 2021). In other words, earning management is an action that deceives and misleads, for stakeholders who are not aware of the choice of accounting policies that aim to increase or decrease profits (Martin et al., 2016).

Ownership structure plays an important role to monitor on management performance. However Dong et al. (2020) claim that it is still difficult to find literature that examines the influence of corporate governance in particular on ownership structure and real earnings management. Apart from that, research related to ownership structure and earnings management are still mixed. So a more comprehensive discussion is needed. The monitoring process carried out by investors is often associated with agency theory. As agents, management representing shareholders, responsible for all company operations. Basically, investors want managers to maximize firm value. However, in practice, asymmetry information cannot be avoided. Therefore, managers often carry out activities aimed at maximizing their own profits. O'Callaghan et al. (2018) argue that companies owned by stable institutions can limit management's opportunistic actions. This is based on the long-term goals of their investment. So management performance must always be monitored. However, Shayan-Nia,

Sinnadurai, Mohd-Sanusi, & Hermawan (2017) did not find a relationship between institutional ownership and earnings manipulation.

Family ownership also has a big impact on how a company is managed. Generally in countries with weak investor protection, family ownership is often involved *agency conflict* with minority shareholders. Therefore, the level of management earnings in these companies tends to be higher (Eugster & Isakov, 2019). Eng, Fang, Tian, Yu, & Zhang (2019) in their research found that family companies in the US have a higher level of real earnings management compared to non-family companies. However, different results were shown by Martin et al. (2016) who argue that family companies tend to maintain the company's reputation, so they will avoid earnings management actions.

Given the differences in research results above and the limited literature related to ownership structure and earnings management, a more in-depth discussion is needed. Thus, this research question is how ownership structure influences earnings management from the perspective of existing literature. The aim of this research is to synthesize research on the influence of ownership structure on earnings management. The contribution of this research will be able to enrich the body of governance literature, especially regarding the influence of ownership structure on earnings management. This review consists of several parts. The next part of this research is a literature review. The third part is related to a comprehensive discussion of the relationship between ownership structure and earnings management. And the fourth section is the conclusion of this research.

Literature Review

Earning Management and Agency Problem

Currently there is still debate regarding the impact of governance mechanisms on earnings management actions carried out by management. Several studies state that management takes these actions based on the incentives or compensation received. Levitt (1998) states that earnings management actions are "*dark area*" which causes accounting to present financial information in accordance with what management want, rather than presenting actual information. So it seems as if the financial reports are the result of engineering by management.

Tran & Dang (2021) state that several actions that can be taken by management when making profit adjustments are such as using accounting estimates, carrying out internal transactions, delaying and speeding up the recording of cost and income transactions or using other methods whose aim is to influence short-term profits. These actions reflect management intervention in accounting actions aimed at fulfilling the presentation of company financial information in accordance with management's wishes.

Brink, Gouldman, Rose, & Rotaru (2020) and Li & Kuo (2017) argue that the more satisfactory the compensation received by managers, the more opportunistic actions management will be able to limit for individual benefit. Martin, Tochman, & Gomez-mejia (2016) interpret earnings management as an act that is deceptive and misleading, for stakeholders who do not know about accounting policy choices aimed at increasing/decreasing profits.

O'Callaghan, Ashton, & Hodgkinson (2018) argue that managers' motivation for carrying out earnings manipulation is to achieve bonus targets and increase the compensation received. The existence of information asymmetry between managers and owners supports this action. Agency theory assumes that by giving authority to managers to regulate the company by shareholders, there will be the possibility of information asymmetry and can lead to *agency problem*. Apart from that, no one can guarantee that managers will act according to the shareholders want. All management actions depend on the prevailing values and norms as well as the legitimacy that exists in the company environment (Bao & Lewellyn, 2017).

In their research, Fogel-Yaari & Ronen (2020) grouped earnings management into three categories, namely white, gray and black. Earnings management in the white category shows that earnings management is carried out in a profitable way and can improve the quality of financial reports. Meanwhile, the gray category means carrying out profit management beyond predetermined limits for economic efficiency purposes. Meanwhile, for the black category, this shows the level of profit manipulation which can reduce the transparency of the financial reports presented. In this case it can be said that management can have a beneficial, detrimental or even neutral impact on company performance.

Therefore, monitoring is needed from various parties to ensure that management acts to maximize company value. As an important principle in governance, report transparency is needed to prove that management has not carried out any deviant actions. Therefore, shareholder evaluation of management performance is needed (Attig et al., 2017).

Earning Management and Ownership Structure

Ownership structure is one of the corporate governance mechanisms which refers to how company owner representatives attempt to influence existing policies in the company. The monitoring power that comes from the ownership structure results in an evaluation of company management, especially top management (Sáenz González & García-Meca, 2014). Many previous studies have discussed the relationship between ownership structure and earnings management. Dong, Wang, Zhang, & Zhou (2020) claim that action *real earning management* will be higher as the influence of the largest shareholder increases. In other words, the more concentrated share ownership is, the easier it will be for management to carry out earnings manipulation.

Additionally, institutional ownership plays an important role in corporate governance. Their existence limits the actions that management will take. In general, institutional ownership has long-term goals. Therefore, the stability of company performance is very necessary. Institutional ownership can reduce management opportunism (Sakaki et al., 2017; San Martin Reyna, 2018) and also when the company is under bank supervision (Ferreira, 2012), the supervisory function carried out by bank-company managers can improve company performance.

Family ownership can be viewed from two sides, if it is related to profit manipulation activities. Sometimes family companies will maintain their reputation to avoid earnings management actions (Martin et al., 2016). However, on the other hand, when there is asymmetry information, the family will try to maximize profits for the family.

Relationship Ownership Structure and Earning Management Managerial Ownership

Agency theory states that there is a separation of power between owners and management who act as agents, so that in the end each party will act in individual interests (Jensen & Meckling, 1976; Sáenz González & García-Meca, 2014). Management will try to take actions that can provide personal benefits and there is a possibility that these actions can harm shareholders, such as by carrying out opportunistic actions and earnings management. Of course, this is different from the wishes of share owners, namely an increase in company value which can increase shareholder wealth.

Much research has been carried out regarding the relationship between managerial ownership and earnings. Dong, Wang, Zhang, & Zhou (2020) in their research related to *ownership structure* and *earnings management* on Chinese companies, with a final sample total of 7,143 observations on companies that *listed* in the Shanghai and Shenzhen Stock Exchanges in 2003 - 2014, found evidence that managerial ownership has a negative relationship with earnings management. The higher the level of managerial ownership, the greater the ability to align management interests with the interests of shareholders. This is because management is a representative of the company owner. Therefore, there is a possibility that agency will be less. Likewise, research conducted by Nguyen et al. (2021) on 489 companies listed on the Vietnam stock exchange. They found a negative relationship between managerial ownership and earnings management. This indicates that management can be trusted and has a high level of responsibility in managing the resources owned by the company.

Sáenz González & García-Meca (2014) conducted research on companies that *listed* in Latin America, also found evidence that managerial ownership has a negative relationship with earnings management. In other words, the benefit of managerial ownership can limit management's opportunistic behavior. O'Callaghan, Ashton, & Hodgkinson (2018) also say that companies that have low levels of managerial ownership are likely to carry out higher earnings management activities.

In contrast, research conducted by Attig et al. (2017) state that managerial ownership has a positive relationship with earnings management. This statement is supported because the research was conducted at the company *blockholder* in the Asian region. Therefore *insider ownership* is the *ultimatemate controller* who ultimately have a greater opportunity to carry out opportunistic actions for personal gain. Kazemian & Sanusi (2015) document that managerial ownership also has a positive relationship with earnings management. This means that management has more opportunities and also

a wider scope, so it has the possibility of doing more earnings management. In addition, Moslemany (2019) and Shayan-Nia, Sinnadurai, Mohd-Sanusi, & Hermawan (2017) found no relationship between managerial ownership and earnings management. This is due to limitations in the research sample and limitations in measuring managerial ownership.

Thus, although research results regarding the relationship between managerial ownership and earnings management are still different, the authors view that managerial ownership will limit earnings management behavior. This is because the owner and management are the same person, furthermore management will not take an actions that could be detrimental to the company, both short and long term. Therefore managerial ownership has a negative relationship with *earning management*.

Institutional Ownership

The important role played by institutional investors in corporate governance is mainly related to *monitoring* regarding actions taken by management. The impact of *monitoring* These are a decrease in the level of managerial discretion and an increase in the efficiency of information distributed in the capital market. Shayan-Nia et al. (2017) group institutional investors into two groups, namely long-term investors and short-term investors. Long-term institutional investors have more incentives to monitor and collect information and evaluate management performance. This is because they invest for a long time, so they have to ensure that their investment does not fail.

Meanwhile, short-term institutional investors prioritize short-term profits. In general, these activities are regulated by the portfolio manager by adjusting the expected profits and risks to be faced. If they feel disappointed because the company's performance is not optimal, they can choose to sell shares instead of monitoring management (Shayan-Nia et al., 2017). However, many studies state that monitoring carried out by institutional investors will reduce management's discretionary actions.

San Martin Reyna (2018) conducted research in Mexico from 2005 to 2016 and found evidence that institutional ownership had an impact on low *earning management* or opportunistic actions carried out by managers. These results are also influenced by company size, where the bigger the company, the greater the level of management earnings. In line with this research, Ajay & Madhumathi (2015) also found a negative relationship between institutional ownership and *earning management*. Elyasiani, Wen, & Zhang (2017) argue that banking institutions are better at monitoring compared to non-bank investors. This is because the bank will try to maintain the credit given to the company without experiencing payment failure. Therefore, banks pay more attention compared to other institutions. Sakaki, Jackson, & Jory (2017) also document that a earnings management is lower if it is held by a more stable institution. *Monitoring* carried out in the form of limiting excess production.

However, different results were shown in several studies which found no relationship between institutional ownership and earnings management (Kazemian & Sanusi, 2015; Sáenz González & García-Meca, 2014; Shayan-Nia et al., 2017). Kazemian & Sanusi (2015) in research in Jordan stated that both companies with a level of institutional ownership or *blockholder* high does not have a significant influence on company earnings management. One of the factors that causes the supervisory function to be ineffective *blockholder* is the absence of qualified expertise. Therefore *blockholder* just playing a role *myopic* at companies in Jordan. Sáenz González & García-Meca (2014) in their research on Malaysian companies stated that there is no relationship between institutional ownership and earnings management due to the different characteristics of institutional investors in Malaysia.

Although research results are still mixed, it is believed that institutional investors, especially those who will invest for the long term, will provide benefits in reducing management's opportunistic actions. Supervision of management performance is an important key so that the objectives of investment in the company can be achieved. Banking institutions are considered more capable of providing stricter supervision compared to other institutions.

State Ownership

In some countries, the government has control over companies of both nature *private* or already *listed*. China is a country known for its many companies controlled by the state. Therefore, when talking about state ownership, there will be a lot of research that is regulated in China. Sometimes government ownership has a good impact on stakeholders, but on the other hand it also has a negative impact. Huyghebaert & Wang (2012) explain that BUMN has the opportunity to transfer value from other BUMNs. *listed* to non-BUMN *listed*. Apart from that, the subsidy system still often occurs between

BUMNs that have greater profits and BUMNs that experience losses. In this way, there is neglect of the rights of minority shareholders. All of these actions are carried out by management which is a reflection of the controlling owner of the company. In other words, the government with its power seeks to carry out opportunistic actions.

One of the weaknesses of government ownership is the lack of it *monitoring* which is conducted. Unlike private companies, which have many stakeholders to carry out supervision, BUMN tends to have little supervision by external parties. This is due to the power of the government itself. Attig et al. (2017) explain that as a result of the lack of monitoring on companies, managers tend to carry out higher earnings management. In line with this, Cheng, Wang, & Wei (2015) saw that when Chinese state-owned companies were going to carry out an initial public offering, managers tended to take earnings management actions by reducing the value of profits. Several factors cause this action to be taken by managers, such as top management not having a relatively large number of shares, so they will not feel any profit when the IPO share price is high, BUMN tends to have more access to the capital market, and the existence of easy loans provided by banks which are dominated by state-owned banks. Because of these factors, managers have little incentive when a company undertakes an IPO, so they make the company's profits smaller.

A different view was expressed by Dong et al. (2020) they found evidence that state-owned companies have a negative relationship with earnings management. This is based on a greater social responsibility to society as well as an obligation to process existing resources effectively and efficiently. Chen, Li, Liang, & Wang (2011) stated that the motivation to carry out earnings management in state companies is still relatively low when compared to non-BUMN companies. Thus, research results related to earnings management and government ownership are still mixed. So in the future it is hoped that this relationship will be further explored.

Family Ownership

In most developing countries, families control more ownership of the trust than others. Claessens, Djankov, & Lang (2000) in research on 9 East Asian countries (Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand) found that 7 of these 9 countries had an average family ownership of more than 50% for the 10% ownership cutoff. Even for Indonesia, Top 1 Family controls around 16.6% of company assets. This indicates the extent of family power over the company.

In corporate governance, family companies can be viewed in 2 theories. First, seen from the agency side of the theory developed by Jensen & Meckling (1976). This theory assumes that there will be a conflict of interest between the majority shareholders, which are generally controlled by the family, and the minority shareholders. The power held by the family has an impact on actions *expropriation* on the rights of minority shareholders. Family companies are also very identified with their pyramid structure, which has several subsidiary companies that are controlled. Therefore the ultimate owner has *control right* which is higher compared to cash flow right (Huyghebaert & Wang, 2012), making it easier to take decisions aimed at enriching the family. The problems that occur in this family are categorized into *agency problem type 2*. In this theory, family ownership will have a positive relationship with management earnings.

Chi, Hung, Cheng, & Tien Lieu (2015) conducted research on companies in Taiwan related to earnings management in family companies, finding evidence that there is a positive relationship between family ownership and *abnormal accrual*. The factor of family entrenchment and the weak legal system in Taiwan encourage a high level of profit management in family companies in Taiwan. Eugster & Isakov (2019) stated that family companies listed on the Swiss Stock Exchange have higher agency problems compared to non-family companies. Eng, Fang, Tian, Yu, & Zhang (2019) conducted research by comparing companies in the US and China. The results show that family companies in the US have a higher level of real earnings management compared to non-family companies both in conditions before and after the 2010 crisis. Meanwhile in China, before the 2010 crisis the level *real earning management* family companies are higher than non-family companies, but after the 2010 crisis the level *real earning management* family companies are lower than non-family companies.

Second, the theory that can explain family companies is socio-emotional wealth. This theory explains how companies held by the family behave. Berrone, Cruz, & Gomez-Mejia (2012) explained that family companies are different from non-family companies in carrying out company operational

activities and in making decisions. Companies founded by families try to maintain their reputation so as to avoid actions that could damage it. In the extreme, if the company is unable to survive in industrial competition, the family will lose its wealth. For this reason, actions such as earnings management are seen as less favorable by family companies (Gomez-Mejia et al., 2011).

Martin, Tochman, & Gomez-mejia (2016) use this theory to look at the behavior of family companies towards earnings management. The results of the research show that family companies think about the consequences of earnings management actions which can have an impact on the company's reputation. So family companies have relatively lower earnings management rates compared to non-family companies. At this point it is considered that family companies reduce practices unethical accounting.

In the end, earnings management in family companies can be viewed from two sides. Sometimes the relationship is positive and sometimes the relationship is negative. In general, countries that have weak investor protection, the family as *controller* it will be easy to commit acts of fraud. So that the oppression of the rights of minority shareholders is higher. However, some companies also consider the company's reputation. Therefore, to maintain the continuity of business activities in the future, company management tries to avoid taking action *unethical accounting* such as earnings management.

CONCLUSION

This study concludes with mixed results on how different types of ownership structures influence unethical accounting practices in companies. Four ownership structures were examined: managerial, institutional, state, and family ownership. Managerial ownership is seen as reducing management discretion. This is because management, as owners, will certainly not take actions that could harm the company, which could result in a decline in the company's value. Monitoring by institutional owners plays a crucial role in corporate governance. They ensure management performance aligns with company objectives. Therefore, when institutional ownership is high, unethical accounting practices such as earnings management are lower. However, existing research has yielded mixed results regarding the impact of institutional ownership. Therefore, further exploration is needed in the future.

Family ownership can be likened to a two-way street. Sometimes a company will be well-managed, thus reducing actions that could damage the company's reputation. This perspective utilizes socio-emotional wealth theory. On the other hand, sometimes in countries with weak investor protection, earnings management practices in family firms are higher. Management engages in earnings management with the goal of enriching the family. The motivation for earnings management in family-owned companies is still considered low. This is because government-owned companies must prioritize resources and public welfare.

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