How do insiders and outsiders affect most Japanese CEOs’ profit manipulation?
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ARTICLE INFO

Article history:
Received 05 October 2020
Received in rev. form 16 Oct. 2020
Accepted 19 October 2020

Keywords:
Earnings Management, Insiders, Outsiders

JEL Classification:
M1, M4

ABSTRACT

This study investigates how insiders and outsiders affect the earnings management of CEOs by conducting a comparative analysis of insiders, trust banks, outsiders, and global investors. Interestingly, the holding shares of insiders and outsiders have opposite effects on CEOs’ opportunistic accounting behaviors.

Introduction

Insiders are very close to CEOs of companies. This proximity gives them access to crucial information on CEOs’ management decision-making. Although insider trading is regulated by law, they may have insight on when the company makes capital investments or mergers and acquisitions. Because insiders are in this key position, they have the most potential to reduce information asymmetry with CEOs. They are among the company shareholders in the best position to gain valuable information to maintain shareholding. Insiders can make CEOs feel uncomfortable. For example, if a bank is an insider, it lends to a shareholding company. A CEO may thus succumb to insider pressure and adjust the bottom line on income statements. The investment projects planned by the CEO may be rigorously examined by the bank (as a shareholder or a fund provider).

Outsiders, on the other hand, have far less access to corporate information. For example, if a company does not make an accurate external announcement regarding stock splits or capital increase information, outsiders may suffer disadvantages due to a drop in stock price. Thanks to information technology, the information a CEO neglects to disclose to outsiders may immediately be disseminated to society via social networking services by general public, securities analysts and mass media. This may cause the stock price of the company to fall, and the CEO could be attacked individually. CEOs may thus adjust profits as outsiders would expect. If certain outsiders are activist funds, the CEO may adjust the profits to improve their mindset. For example, CEO may change inventory valuation to generate profits. If the CEO does not make the intended profit, the CEO may be dismissed or a tender offer could be announced by them.

The stock prices of the aviation, hotel, and tourism industries have fallen due to the coronavirus in Japan. In the long run, as these stock prices fall, those of other industries are expected to follow suit. Both of the above shareholders may sell their own stocks before the stock market slump. Alternatively, insiders may make various management efforts to maintain their client firms’ stock prices with CEOs. On the other hand, global investors (the representatives of outsiders) may purchase a wide range of stocks from high-end companies with weak stock prices.
The representatives of insiders of Japanese companies are banks. Among them, trust banks (private banks) act as stable shareholders of companies. The general outside investors purchase the stock of trust banks; therefore, both insiders and outsiders are trust bank shareholders. The latter may be global investors who demand accountability from trust bank management in order to keep client companies’ shareholding stable.

It is worth conducting a comparative analysis of inside stable shareholders, trust banks, and outside global investors to determine how insiders and outsiders affect the earnings management of CEOs. Furthermore, there are two types of earnings management models: accrual-based and real earnings. This study seeks to demonstrate which model is more effective to discover CEOs’ earnings management, as that has not been scientifically proven yet.

**Literature Review**

**Theoretical and Conceptual Background**

Various events affected the Japanese economy from the late 1990s to the early 2000s such as declining value of bank stocks, bank business failures, and the introduction of market valuation for cross-shareholdings. These circumstances greatly impacted cross-holding of shares in Japanese companies and shareholding by financial institutions. As a result, the percentage of conventional insiders within Japanese companies declined. Conversely, the number of shares held by outsiders (such as global investors and individual investors who are minority shareholders) has increased. In this way, the share composition of companies has changed. CEOs of listed companies in particular have changed their businesses in consideration of the interests of outsiders, especially global investors (Kodama, and Takamura, 2014).

**Insiders**

Some banks today may have conventional and stable share-holders, but they do emphasize win-win relations between shareholding companies and banks. Both parties aim to coexist, grow, and achieve mutual prosperity. Many listed companies are financing with syndicated loans. In other words, the lending bank group jointly lends to the company. Among the lending bank groups, one or several banks are stable share-holders support the business behaviours of CEOs in client companies. Banks have two main functions as stable shareholders. The first is to own a stake in the client company and financially support its growth. The second is to dispatch bank personnel to the company. Since a trust bank holds shares of the company, it can select employees to be appointed directors (or other officers who support the financial operation of the company) at an annual shareholder meeting. These directors can monitor the CEO for arbitrary behavior. For example, to seem like a capable executive, a CEO might intentionally raise sales figures (near the end of the fiscal year) through the fictitious sale of a product that the customer is later asked to return. As insiders, directors from banks can also make resolutions on the board to remove a CEO, thus restraining CEO behavior.

In other words, insiders, trust banks, are not generally interested in the latest profits from shareholding companies because they support CEOs and growth strategies of client companies through a stable relationship with those companies. However, some scholars consider these relationships relics of the past, as trust banks continue to purchase more shares in various companies (Yoshimura, 2012). In recent times, trust banks have demonstrated their belief that client firms should grow and profit by returning profits from client firms. Unlike the traditional growth-oriented management, this new type of trust bank (that is also a stable shareholder) wishes to recover the investment rather than focusing on company growth. This shareholder is currently dominant in the listed companies. Because trust banks are also private companies, management indicators (e.g., return on investment) must have good figures to show shareholders of the trust banks themselves.

In other words, if the traditional stable shareholder policy is primarily used, trust banks’ current globalized shareholders would not be impressed by the management. Therefore, it is necessary for trust banks’ management behaviour to enable profits for their own shareholders. This is why the aforementioned employees dispatched to client companies as directors (with decision-making authority) can greatly influence CEOs to manipulate and increase profits from client companies.

**Outsiders**

The share acquisition rate of global investors has risen with globalization. The Tokyo Stock Exchange reports that as of 2018, global investors hold approximately 30% of the shares of listed Japanese companies (The Nikkei, 2019). These global investors are becoming key players as outsiders within Japanese companies. This can be attributed to Japan’s changing accounting standards.

Financial institutions such as banks and securities companies have been able to perform market value accounting for securities transactions since 1997. Since 2000, market value accounting has been used by non-financial institutions, and since 2001, “other securities” such as cross-shareholdings must be evaluated on the balance sheet. As an indirect major change, cross-shareholding was

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1 Antitrust law 5% rule. Financial institutions are prohibited from holding more than 5% of the voting rights of all shareholders of domestic general business companies.
cancelled and stable shareholders (mainly banks) became speculative ones (global shareholders). Japanese corporate management shifted towards shareholder-oriented management due to the increase in the shareholder ratio of global investors.

Insider shareholders have emphasized corporate growth as they support familiar client firms. On the other hand, global investors value high profits over company growth. As a result, CEOs of companies with a large share of global investors have shifted from growth-oriented to profit-oriented management. The global investors have increased their stakes in listed companies in Japan. Iwatsubo and Tonogi (2007) reports that the higher the global investors’ ownership ratio of investees, the higher the investees’ corporate value. This is because global investors have been exerting pressure on both the exercise of voting rights (Voice) and the sale of shares (Exit).

Research and Methodology

Data and Model

Based on the discussion in the literature review, the following model (1) is used for analysis. Earnings management was used as a non-independent variable. For the independent variables, this paper used the shareholding by trust banks and global investors. The more directors come from the trust banks to the board of directors, the more likely it is that the CEO of the company will be forced to act as the trust bank intends. Therefore, this study uses that variable to examine how the ratio of directors dispatched from trust banks at the board of directors affects the profit manipulation of the CEO.

In terms of the sample for this study, the sample companies are listed on the Japanese Stock Exchange. The fiscal year ending in March is common for Japanese companies, so this research applies that. Securities companies, insurance companies, and public service companies are excluded from the sample. The sample period was from 2006 to 2015. The final observation was 2,970 for 302 firms. The financial data required for analysis was obtained from Pronet’s EOL database. The accounting numbers of samples used those on the consolidated financial statements.

Suda and Shuto (2004) wrote that it is appropriate to use the modified CFO Jones model in this statistical analysis. However, it has not yet been determined whether that is optimal to calculate the company’s accrual-based earnings management. Therefore, this study uses both the Jones model and the modified Jones model to investigate which models are appropriate to detect CEOs’ opportunistic accounting behaviours.

In addition, Iwasaki (2009) conducted research on real earnings management. Therefore, this study attempts its analysis in reference to Iwasaki’s real earnings management model.

\[ EM = \alpha + \beta_1 OT_{it} + \beta_2 BT_{it} + \beta_3 GLOBAL_{it} + CV + e \] (1)

In this equation, \( EM \) represents the absolute value of corporate earnings management. The accrual-based earnings management models are the following three:

1. CFO is an accrual-based amount calculated using the modified CFO Jones model.
2. JONES is the accrual-based amount using the Jones model.
3. MODIFIED is the calculation of accrual-based earnings management using the modified Jones model.

There are also three real earnings management models:

1. REAL_CFO is the real earnings management using cash flow.
2. REAL_PRO uses cost of sales.
3. REAL_DEP uses corporate expenses.

The six non-independent variables above constitute \( EM \).

The independent variables are shown as follows: \( OT \) represents the shareholding ratio of the trust banks to the client companies, \( BT \) represents the ratio of trust bank directors to boards of directors, and \( GLOBAL \) shows the shareholding ratio of the global investors to the companies.

The following three variables are used as control variables:

1. The shareholding ratio by CEOs themselves (CEO) – the more shares CEOs have, the easier it is for them to manage their businesses.

\[ ^2 \text{Since the 1990s, its closure, opacity and inefficiency have been pointed out, and it has been regarded as a problem of Japanese style management.} \]

\[ ^3 \text{The breakdown of sample is as follows. 318 in 2015, 293 in 2014, 294 in 2013, 296 in 2012, 295 in 2011, 297 in 2010, 296 in 2009, 313 in 2008, 284 in 2007 and 294 in 2006.} \]
2. CPA is the certified public accountant who is a financial expert within the board of directors. They monitor the client firms’ financial statements. This variable is a dummy variable (1 if the CPA is present, 0 if not).

3. The remuneration ratio within the board of directors dispatched from trust banks (COMP). A high salary may motivate earnings management to maintain stock prices.

See Table 1 for the descriptive statistics and correlations.

Table 1 Descriptive statistics \((N = 2,970)\)

| Variables        | Mean    | Standard Deviation | Median  | Minimum | Maximum |
|------------------|---------|--------------------|---------|---------|---------|
| **EM:**          |         |                    |         |         |         |
| **Accrual-based:** |        |                    |         |         |         |
| CFO              | 0.060   | 0.326              | 0.013   | 0.000   | 7.675   |
| JONES            | 0.062   | 0.359              | 0.017   | 0.000   | 10.240  |
| MODIFIED         | 0.063   | 0.359              | 0.017   | 0.000   | 10.242  |
| **Real:**        |         |                    |         |         |         |
| REAL_CFO         | 0.027   | 0.027              | 0.021   | 0.000   | 0.374   |
| REAL_PRO         | 0.076   | 0.223              | 0.035   | 0.000   | 5.736   |
| REAL_DIS         | 0.052   | 0.078              | 0.032   | 0.000   | 1.713   |
| **Insider variables:** |    |                    |         |         |         |
| OT               | 0.352   | 0.915              | 0.000   | 0.000   | 6.470*  |
| BT               | 0.006   | 0.022              | 0.000   | 0.000   | 0.286   |
| **Outsider variable:** |     |                    |         |         |         |
| GLOBAL           | 4.796   | 6.218              | 2.885   | 0.000   | 53.020  |
| **Control variables:** |   |                    |         |         |         |
| CEO              | 0.043   | 1.325              | 0.000   | 0.000   | 53.367  |
| CPA              | 0.270   | 0.444              | 0.000   | 0.000   | 1.000   |
| COMP             | 0.016   | 0.025              | 0.000   | 0.000   | 0.243   |

*As an exception, the antitrust law stipulates that financial institutions do not have to comply with the 5% shareholding rule in cases such as corporate relief.
Table 2 Results of Multiple Regression (N=2,970)

| Models                  | Accrual-based earnings management | Real earnings management |
|-------------------------|-----------------------------------|--------------------------|
|                         | CFO                               | JONES                    | MODIFIED    | REAL_CFO  | REAL_PRO  | REAL_DIS  |
|                         | Coefficient (t-value)             | Coefficient (t-value)    | Coefficient (t-value) | Coefficient (t-value) | Coefficient (t-value) | Coefficient (t-value) |
| Intercept               | 0.060*** (6.150)                  | 0.060*** (5.590)         | 0.061*** (5.640)   | 0.025*** (31.230)    | 0.068*** (10.250)     | 0.050*** (21.600)     |
| Insider variables:     |                                   |                          |              |           |           |           |
| OT                      | -0.013* (-1.960)                 | -0.013* (-1.760)        | -0.013* (-1.710) | -0.001* (-1.870)    | -0.008* (-1.710)      | -0.008*** (-4.740)    |
| BT                      | 0.270 (0.900)                    | 0.331 (1.000)           | 0.311 (0.930)     | 0.020 (0.810)       | 0.014 (0.070)         | 0.230*** (3.210)      |
| Outsider variable:     |                                   |                          |              |           |           |           |
| GLOBAL                  | 0.001 (1.090)                    | 0.001 (1.290)           | 0.001 (1.300)    | 0.001*** (7.690)    | 0.002*** (3.230)      | 0.001** (2.780)       |
| Control variables:     |                                   |                          |              |           |           |           |
| CEO                     | -0.000 (-0.100)                  | -0.000 (0.000)          | -0.000 (-0.010)   | -0.000 (-0.750)     | 0.006* (1.850)        | 0.001 (0.670)         |
| CPA                     | 0.017 (1.230)                    | 0.017 (1.130)           | 0.017 (1.150)     | -0.002 (-1.620)     | -0.007 (-0.700)       | 0.003 (0.890)         |
| COMP                    | -0.387 (-1.470)                  | -0.407 (-1.400)         | -0.410 (-1.410)   | -0.016 (-0.720)     | 0.073 (0.410)         | -0.038 (-0.600)       |
| Adjusted R-square       | 0.002                            | 0.002                   | 0.002           | 0.021          | 0.004       | 0.012      |
| Model F                 | 1.870*                           | 1.730                   | 1.720           | 11.790***       | 3.140**      | 6.900***   |

Note: p-values are one-tailed; ***, ** and * denote p < 0.01, < 0.05, and < 0.10, respectively.

The F-value was 3.140 to 11.790 for models of real earnings management (it is significant at the 0.05% to 0.01% level). As for accrual-based models, the fitness of the models was not significant except for the modified CFO Jones model, which is in line with Suda’s result. The adjusted coefficient of determination was in the range of 0.002 to 0.021. From these results, the model fits particularly well with the real earnings management. The predicted results of the influence from dependent and independent variables are reasonable in the modified CFO Jones and real earnings management models.

The results of the relationship between dependent and independent variables must be addressed. First, all variables of GLOBAL show positive effects on real earnings management. OT and BT are variables of trust banks. In terms of OT, as initially expected, it became clear that the shareholding ratio by the trust bank had a negative impact on all CEOs’ earnings management. BT, on the other hand, had no relationship with the dependent variable other than REAL_DIS.

Conclusions

To answer the question of the title of this paper, insiders’ and outsiders’ holding shares have opposite effects on CEOs’ opportunistic accounting behaviors. Insiders, the shareholders of trust banks, suppress CEOs’ opportunistic earnings behaviours. After all, the trust banks of insiders seem to function as stable shareholders who monitor management, restrict arbitrary actions from CEOs, and promote the growth potential of the client companies. It turns out that shareholding by insiders does not necessarily have the effect of...
increasing the companies’ profits. In other words, insiders focus on a company's future growth potential. Unlike outsiders, insiders do not seek immediate profit from shareholding companies. The trust bank’s particular holding strategy is to reduce the profits of holding companies as much as possible and not release the profits to the outside. This may support the growth potential of the company as an insider.

In contrast, the holding ratio by outsiders, global investors, is high when CEOs raise real earnings. It seems that the CEOs are increasing actual profits by taking measures for global investors. Outsiders are those who urge CFOs to make direct profits (through real earnings management) rather than indirect profits (from accrual-based earnings management). The modified CFO Jones model is the best fit for the accrual-based model. Moreover, it turns out that the REAL_CFO model detected the most earnings management from CFOs within this research. The holding of corporate stock by outsiders had no effect on the CEO's discretionary accruals. However, outsiders have the effect of raising cash directly by having the CEO do the real earnings management. In accounting, there is a saying that profit is an opinion, cash is a fact, and cash is king. The outsider's holding strategy exemplifies this adage.

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