China Journal of Accounting Research 9 (2016) 137–152

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China Journal of Accounting Research

journal homepage: www.elsevier.com/locate/cjar

Re-examination of the effect of ownership structure on financial reporting: Evidence from share pledges in China

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ARTICLE INFO

Article history:
Received 19 September 2014
Accepted 21 November 2015
Available online 4 January 2016

Keywords:
Ownership concentration
Share pledges
Earnings smoothing
Split share reform

ABSTRACT

In this paper, we present evidence that firms with concentrated ownership manage earnings when their large shareholders have an incentive to do so. The large shareholders of Chinese public firms often pledge their shares for loans. Before the split share reform in 2006, loan terms were based on the book value of the firm. Since then, the share price has become critical for share pledged loans. We postulate that the reform triggered large shareholders' incentive to influence financial reports. Using a sample of non-state-owned enterprises, we test the effect of share pledges on earnings smoothing and how this effect changes after the reform. Our results suggest that share pledging firms smooth their earnings more than other firms, but these results are only found after the split share reform. Accordingly, our results provide more direct evidence on the effect of ownership concentration on financial reporting.

1. Introduction

Concentrated ownership creates opportunities for controlling shareholders to expropriate wealth from other shareholders. Most research shows that concentrated ownership is associated with lower earnings quality (Fan and Wong, 2002; Francis et al., 2005a,b). However, Wang (2006) argues that controlling shareholders may provide higher quality reporting because they are long-term investors and care about the reputation, wealth and long-term performance of their firms. These two different effects associated with controlling

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http://dx.doi.org/10.1016/j.cjar.2015.11.001
1755-3091/

shareholders are summarized as the entrenchment effect and the alignment effect (Fan and Wong, 2002; Wang, 2006). Given the competing views and evidence in the literature, we conclude that the effect of ownership structure on financial reporting behavior is complicated and needs further investigation.

A unique Chinese setting provides an opportunity for us to re-examine this issue. Generally, Chinese public firms have one dominant shareholder whose ownership is much higher than the next largest shareholder. The large shareholders also tend to hold important positions in the management team. In recent years, large shareholders have often used their shares as collateral to obtain short-term loans. Prior to the split share reform in 2006, the pledged shares were mostly non-tradable. Although large shareholders retained their status after the split share reform, their incentives to influence financial reporting have changed. This setting allows us to compare the effects of controlling shareholders' incentives on their firms' discretionary financial reporting decisions.

The findings of numerous studies indicate that managers tend to manage earnings around major financing events, such as IPOs, seasoned equity offerings and seasoned bond offerings (see Leuz et al., 2003; Park and Shin, 2004; Guthrie and Sokolowsky, 2010; Caton et al., 2011). Consistent with the literature, we predict that for share pledge purposes, controlling shareholders tend to manage their firms' accounting performance to increase the value of their collateral.

Before the loans are made, controlling shareholders have incentives to manage earnings to increase their borrowing capacity (e.g., higher loan amounts, lower interest rates, and lower contracting costs) (Ahn and Choi, 2009). As required by law, pledge loan contracts should include a maintenance requirement. After a share pledged loan is made, if the share price drops, the value of the collateral will also decrease, and shareholders (borrowers) will have to make up for the decrease. This scenario is similar to a margin call when buying on margin. To avoid such costly consequences, shareholders will do whatever they can to uphold the share price. Chan et al. (2013) find that pledging firms make repurchases when prices drop. Because financial reporting influences the share price, we expect that shareholders will also manage their earnings to avoid dramatic price drops. Dye (1988) suggests that managers may smooth earnings to increase their firms' share price. Given that most shareholders pledge repeatedly, we predict that share pledged loans increase the degree of earnings smoothing.

However, if the share price is not the primary factor in deciding the loan terms, the shareholder will have no incentive to smooth earnings. In China, listed companies had dual class share ownership until the split share reform in 2006. The shares pledged by large shareholders, which were non-tradable, were evaluated by the book value of the firm. At this time, shareholders were indifferent to the share price. However, the split share reform in 2006 eliminated the discrepancies in the share transfer system. Since then, the value of pledged shares is based on their market price. Therefore, we predict that earnings smoothing is more likely in share pledging firms than other firms *after* the split share reform.

In our setting, we posit the same analytical relationship as Tucker and Zarowin (2006), who measure earnings smoothing by the negative correlation between the change in the discretionary-accruals proxy and the change in pre-discretionary income. Our hypothesis concerns the comparative smoothing of the share pledging firms and other firms. Using non-state-owned enterprises (SOEs) listed on the Chinese capital market as our sample, we test the moderation effect of share pledges on the above correlation. Consistent with our hypothesis, we find that share pledging firms smooth earnings more than other firms. This phenomenon is only observed after the split share reform.

Since the split share reform, shareholders have had the option of selling their shares or making a pledged loan. This raises the question of why some shareholders do not sell their shares. First, shareholders may not want to take the risk of losing their control rights. Because it is difficult to obtain approval for an IPO in China, listed companies are themselves valuable resources for capital raising (Liu and Lu, 2007). Second, shareholders may consider the share price to be undervalued, either because they have private information or they are irrationally optimistic about company prospects (Chan et al., 2013). Although we cannot determine the exact reason for each pledge announcement, we find that shareholdings are positively correlated with earnings smoothing. The more shares held by large shareholders, the less they fear losing their control rights, and the more likely the shares are undervalued in the case of a pledge. Therefore, the earnings smoothing that we find in pledged firms is also consistent with the argument of Ronen and Sadan (1981) that the firms are