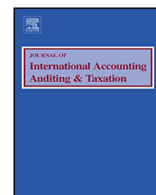
Journal of International Accounting, Auditing and Taxation 22 (2013) 71–85

Contents lists available at SciVerse ScienceDirect

Journal of International Accounting, Auditing and Taxation



# Aggressive reporting, investor protection and stock price informativeness: Evidence from Chinese firms☆

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ARTICLE INFO

*Keywords:*
Aggressive reporting
Investor protection
Stock price informativeness

ABSTRACT

This paper investigates the impact of aggressive reporting on the ability of stock prices to inform in Chinese firms. Using both stock price synchronicity and the probability of informed trading as proxies for stock price informativeness, we find that aggressive reporting damages the ability of stock prices to inform in Chinese firms. Our findings are robust to potential endogeneity and the use of alternative aggressive-reporting measures. Finally, we find that the impact of aggressive reporting in reducing stock price informativeness is stronger in firms located in regions of weaker institutional development and in private sectors firms.

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## 1. Introduction

This paper investigates how the governance or investor protection role of financial reporting affects the ability of stock prices to incorporate and reflect information. Specifically, we examine the unexplored question of whether aggressive reporting reduces stock price informativeness in Chinese firms. Firm reporting practices are said to be aggressive or less conservative if they tend to withhold bad news and accelerate the release of good news, leading to more delayed recognition of bad news as losses, than good news as gains in financial statements (Watts, 2003a, 2003b). Aggressive reporting has governance implications because it protects corporate insiders to the detriment of small investors, and thus exacerbates the agency conflict between small investors and corporate insiders by increasing firm-level opacity and reducing investor protection. With investor protection weakened and firm-level transparency reduced, investors are less willing to gather firm-specific information before they trade. Thus, stock prices are less able to incorporate and reflect information and are less able to inform the true worth of the underlying stocks (Jin & Myers, 2006; Morck, Yeung, & Yu, 2000). The equilibrium result is that investors are less able to rely on stock prices to make informed investment choices and the stock market is less functionally efficiency because scarce capital is not channeled into the best investments (Tobin, 1982).

We are motivated to study the impact of aggressive reporting in Chinese firms for three reasons. First, there are severe agency problems in Chinese firms resulting from the underdevelopment of governance institutions, both internal and external, to protect investors (e.g., Allen, Qian, & Qian, 2005). These problems suggest that reasonable/prudent reporting standards/practices can be ignored with relative impunity in China and aggressive reporting (a manifestation of the

☆ We thank the editors, two anonymous reviewers, and participants in PhD seminars and research workshops at City University of Hong Kong and Xi'an Jiaotong University for comments and suggestions. Hao Zhang acknowledges partial financial support for this research obtained via the Strategic Research Grant (project no. 7002622) from the City University of Hong Kong.

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1061-9518/$ – see front matter © 2013 Published by Elsevier Inc.
http://dx.doi.org/10.1016/j.intaccaudtax.2013.07.004

underlying agency problems) is likely to be serious.[1] While the information implications of aggressive reporting have been explored in previous US-based studies (LaFond & Watts, 2008; Watts, 2003a), the governance or investor protection implications of aggressive reporting are yet to be examined and warrant research attention. Second, and in contrast, investors in US firms (for example) enjoy significantly better investor protection because of much better developed institutions that ensure law/regulatory enforcement and adequate compliance via reporting, auditing, and disclosure standards. Because of the generally higher level of investor protection available from governance institutions in the US, these institutions are more able to compensate for aggressive reporting. In other words, China provides an excellent laboratory in which to study the investor protection effect of aggressive reporting on stock price informativeness. Third, Chinese stocks are found to be among the least informative in the world, whereas US stocks are the most informative. Previous research attributes the lack of stock price informativeness in China to poor governance in general and the lack of investor protection in particular (Morck et al., 2000). However, the specific factors (such as aggressive reporting) contributing to weak investor protection in China have not been examined.

Using the negative of the conservatism measure constructed by Khan and Watts (2009) to proxy for aggressive reporting, we find a negative and significant relation between aggressive reporting and stock price informativeness, measured both by stock price synchronicity and the probability of informed trading. Our results are robust to potential endogeneity and other specifications as well as to the use of additional aggressive-reporting measures, as suggested by Francis, LaFond, Olsson, and Schipper (2004). In addition, we find that the effect of aggressive reporting is stronger in reducing stock price informativeness in regions (or provinces) of relatively weaker institutional development and in private sector firms. These results, taken together, indicate that aggressive firm reporting reduces the ability of firm stocks to incorporate and reflect information.

This paper contributes to the literature in two related ways. First, by exploring the interaction between aggressive financial reporting and stock price informativeness in China, this paper extends our understanding of the important *governance role* (i.e., in addition to the information role) that financial reporting plays in the capital markets of a large emerging economy. Second, our results contribute to the debate on whether conservative reporting is desirable. Specifically, the arguments used in accounting research so far are largely information-based rather than governance-based (LaFond & Watts, 2008; Watts, 2003a). However, our results suggest that conservative (aggressive) reporting affects investor protection and thus the ability of stock prices to incorporate and reflect information. The implication is that the governance role of financial reporting warrants more research attention.

This paper proceeds as follows. Section 2 discusses the development of our hypotheses and empirical predictions. Section 3 describes the sample and measurement of key variables. Section 4 presents the empirical analysis and results. Section 5 sets forth our conclusions and implications.

## 2. Hypothesis development

Watts (2003a, 2003b) argues that the demand for conservative reporting arises mainly from four major sources: contracting, shareholder litigation, taxation, and regulation. Contracting parties demand more conservative reporting because more verifiable accounting numbers resulting from such reporting practices facilitate legal enforcement of contracts (e.g., Zhang, 2008). In addition, small investors demand conservative reporting to reduce the asymmetry of information between themselves and corporate insiders (LaFond & Watts, 2008). Finally, firms adopt a more conservative reporting practice to minimize total tax liabilities and avoid regulatory intervention (Bushman & Piotroski, 2006; Watts, 2003a). Evidence shows that conservative or less aggressive financial reporting tends to occur in firms operating under stronger rule of law regimes, in large part because legal protection of investors often requires availability of verifiable information (Bushman, Chen, Engel, & Smith, 2004). In short, firms operating in environments of strong governance institutions tend to be less aggressive in their reporting practices because conservative reporting mitigates agency conflicts between contracting parties, small investors and corporate insiders, firms and regulatory authorities.

### *2.1. Can small investors in Chinese firms demand conservative reporting?*

Resent research documents severe agency problems in Chinese firms stemming from the serious underdevelopment of governance institutions, both external and internal, to protect small investors (e.g., Allen et al., 2005; Yu & Zhang, 2008). In such an environment, laws to enforce formal contracts and other economic activities are often non-existent and unenforced (Allen et al., 2005; Yu & Zhang, 2008). Plundering of corporate assets (usually in the form of various self-dealing transactions) by corporate insiders to the detriment of small investors is relatively common and restraining regulations can be easily circumvented (Jiang, Lee, & Yue, 2010). Moreover, there is heavy reliance on political connections and other personal relationships to support business activities (Srinidhi, Zhang, & Zhang, 2012). In fact, Allen et al. (2005) argue that Chinese

[1] Basu (2009) surveys relevant research and suggests that Chinese accounting income generally lacks conservatism. The recent financial statement problems the SEC has found with Chinese firms operating in the US also gives a strong basis for investigating the practice of aggressive reporting by Chinese firms. We thank one of the reviewers for pointing this out.

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