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Earnings quality in privatized firms: The role of state and foreign owners ☆

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A B S T R A C T

We use a unique dataset of 350 privatized firms from 45 countries to investigate the relationship between shareholder identity and earnings quality. We find robust evidence that state ownership is associated with lower earnings quality while foreign ownership is associated with higher earnings quality. Furthermore, we report evidence suggesting that the impact of foreign ownership on earnings quality varies with the country's institutional environment. Specifically, we find that foreign ownership is associated with higher earnings quality in countries with higher government stability and lower risk of government expropriation.

1. Introduction

In this paper, we examine the role of state and foreign owners in determining earnings quality. Specifically, we attempt to answer the following questions: Does government ownership affect

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earnings quality? Does foreign ownership affect earnings quality? Does the role of foreign owners vary with the country-level corporate governance?

We conduct our research in the specific context of privatization because major regime shifts, such as privatization, provide a natural laboratory in which we can isolate the determinants of accounting transparency (Bushman and Smith (2003)). Specifically, the drastic change in the ownership structure of former state-owned enterprises, which is accompanied by severe information asymmetry problems (Denis and McConnell, 2003; Dyck, 2001), provides us with a unique opportunity to investigate how the quality of accounting information is related to the new ownership structure given the following considerations. First, Shleifer and Vishny (1994, page 998) argue that: "In principle, there is no magic line that separates firms from politicians once they are privatized." Indeed, prior empirical research (e.g., Bortolotti and Faccio, 2009; Boubakri et al., 2005) shows that the presence of the government as a particular shareholder characterizes the post-privatization ownership structure, even several years after divestiture. Unlike typical shareholders, governments tend to achieve social goals and short-term political objectives rather than maximizing profits (Shleifer and Vishny, 1993, 1994). This action, in turn, increases the policy risk borne by shareholders. We term the impact of the government's direct influence on the earnings quality of newly privatized firms (NPFs) as the "political interference hypothesis." According to this hypothesis, the "grabbing hands" of governments may lead managers/bureaucrats in state-owned firms to manipulate earnings in order to hide "tunneling," or the expropriation of corporate resources for political purposes.

Second, several studies (e.g., Boubakri et al., 2005) show that a part of the relinquished state ownership is absorbed by foreign shareholders, which leads to more restructuring of privatized firms (Djankov and Murrell, 2002). Given that, we examine whether foreign ownership is associated with better quality of accounting information after privatization. Lastly, we examine how the role of foreign owners varies with the country-level corporate governance in determining earnings quality.

The examination of these issues is timely and important for several reasons. First, despite the prevalence of state-owned firms around the world and the increased government participation in bailed out firms during and as a result of the latest financial crisis, little is currently known about the link between the quality of disclosed information and state participation (Bushman and Smith, 2003).[1] Second, two of the objectives often put forward to justify privatization are the expansion of popular capitalism and boosting the development of local capital markets, both of which typically rely on transparent information. We examine whether these objectives do indeed translates into better earnings quality in NPFs. Third, both academics and regulators recognize the importance of transparency, as well as the quality of the disclosed financial information, in reducing asymmetrical information among investors, increasing market liquidity (Verrecchia, 2001), lowering the cost of equity of firms, and improving the efficiency of investment decisions (Biddle and Hilary, 2006). Efficient investments lead to better resource allocation, hence better functioning of financial markets, and, ultimately, economic growth (Wurgler, 2000; Durnev et al., 2009).[2] These are all justifications for our interest in examining the impact of post-privatization shareholder identity/ownership on earnings quality.

Using a multinational sample of 350 privatized firms from 45 countries and three different proxies of earnings quality (i.e., discretionary abnormal accruals, earnings response coefficients, and earnings persistence), we find strong evidence that state ownership is associated with lower earnings quality, even after controlling for standard determinants of earnings quality. Specifically, we find that state ownership is associated with: (i) greater abnormal accruals — that is, more earnings management,

[1] State-owned companies today account for a large capitalization of domestic stock markets in the developing world. In developed countries as well, the state is still an important owner of large companies, such as EDF in France (85% state-owned) and Deutsche Telekom in Germany (32% state-owned). Defining a state-owned firm as one in which the state owns more than 10% of the shares (United Nations Conference on Trade and Development, we can assert that the state is now the most powerful shareholder in the world.

[2] Bushman and Smith (2003, p. 56) define corporate transparency as "the widespread availability of relevant, reliable information about the periodic performance, financial position, investment opportunities, governance, value, and risk of publicly traded firms." Durnev et al. (2009, p. 1533) define transparency in a broader sense, as "a set of market mechanisms that facilitate information acquisition and processing by investors". The latter also argue that transparency "could lower cost of capital, increase liquidity, improve value estimates in corporate control contests (Healy and Palepu, 2001); reduce contracting costs associated with managerial compensation (Core, 2001); signal managerial talent (Trueman, 1986); and decrease litigation costs".