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Does mutual fund ownership affect financial reporting quality for Chinese privately-owned enterprises? ☆

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ABSTRACT

This paper examines the role of mutual funds in enhancing financial reporting quality in China. Mutual funds are more sophisticated and influential than individual investors. Therefore, they are expected to be more effective at preventing executives from expropriating investors and manipulating earnings as a cover-up, which in turn would reduce the incidence of modified audit opinions (MAOs). Our results, based on the Chinese listed firms from 2003 to 2008, confirm this prediction. More importantly, the effects of mutual fund ownership in reducing the incidence of MAOs are greater among privately owned enterprises (POEs), and especially those with higher growth. This is because POEs rely more heavily on the capital market for financing than do state-owned enterprises (SOEs), and because growth opportunities need to be funded by additional external capital. This finding implies that mutual funds form an important part of the external governance mechanism in emerging countries, but this effect is moderated by state control and ownership.

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1. Introduction

We study the effect of institutional investors on financial reporting quality in an emerging country by examining the relationship between mutual fund ownership and the issuance of modified auditor opinion (MAO) among Chinese firms. There has been a steady rise in the mutual fund industry across the world since the 1990s. Over the period from 1992 to 1998, for instance, the total assets of US mutual funds grew from 1.6 to 5.5 trillion USD (Klapper, Sulla, & Vitas, 2004). In China, the mutual fund industry has also experienced high growth since it began in the early 2000s. Over the period from 2005 to 2007, for example, the total net value of Chinese mutual funds increased from 58.6 to 236.3 billion USD (Yuan, Xiao, & Zou, 2008). The two main benefits mutual funds offer individual investors are the diversification of investment risks and the expertise to monitor the firms they invest in. The latter function essentially qualifies institutional investors such as mutual funds to serve as an external governance mechanism. The governance role of institutional ownership has been widely examined and confirmed in Western developed economies (e.g. Shleifer & Vishny, 1986; Smith, 1996). However, little is known about either its role in enhancing

financial reporting quality, or its contribution in emerging countries such as China, where investor protection and legal enforcement are weak. Our study fills these gaps.

Auditing, which serves as an external monitoring mechanism to constrain a manager's opportunistic behavior that results from the separation of ownership and control, can reduce information asymmetry between managers and external investors (Kinney & Martin, 1994). Auditors communicate with users of financial statements through their opinion expressed in the auditor's report; a clean opinion indicates that the financial reports are prepared in accordance with accounting standards and do not contain fundamental uncertainties that will need to be clarified later. When firms carry out earnings management, the likelihood of receiving a MAO is higher (e.g. Caramanis & Lennox, 2008; Chen, Douglas, Hou, & Lee, 2013; Datar, Feltham, & Hughes, 1991). Auditors issue MAOs in order to raise the alarm regarding any questionable accounting disclosures they detect (e.g. DeAngelo, 1981; Krishnan, Krishnan, & Stephens, 1996). In this study, we assume the issuance of a MAO by the auditor of a firm to be an ex post manifestation of low financial reporting quality.¹

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¹ MAOs are interpreted as a signal of low financial reporting quality from the viewpoint of financial statement users such as the investors. For example, using data on Chinese listed firms, Chen et al. (2000) show negative abnormal stock returns over a three-day window centered on the announcement of a MAO, which suggests that firms receiving MAOs experience increased costs of capital.

The rationale for the influence of mutual fund ownership on the likelihood of firms receiving MAOs is as follows. As large shareholders, mutual funds are more capable of persuading managers against decisions that could reduce firm value or expropriate investor wealth, and disciplining them when they do take such decisions (e.g. Hartzell & Starks, 2003; Kaplan & Minton, 1994). Better monitoring and governance reduces the opportunity for managers to pursue self-serving behavior. This in turn reduces the need for them to manipulate earnings to window dress their performance and conceal their misconduct (e.g. Armstrong, Balakrishnan, & Cohen, 2012; Klein, 2002). Therefore, to the extent that institutional investors act as an external governance mechanism and reduce the information asymmetry between managers and investors, we expect an inverse relationship between mutual fund ownership and the likelihood of a firm receiving a MAO.

In the context of China, one possible hindrance to external governance mechanisms through institutional investors such as mutual funds is the state ownership and control of firms in China. State-owned enterprises (SOEs) are expected to carry out the social or political objectives of the government, and focus less on shareholder wealth maximization objectives. In return, such firms receive greater financial assistance from the state through favorable loans from state banks as well as subsidies (e.g. Allen, Qian, & Qian, 2005; Chen, Chen, Lobo, & Wang, 2010). This financial assistance renders SOEs less dependent on the capital market for financing, which in turn reduces their accountability to investors. Meanwhile, privately owned enterprises (POEs), which in China tend to be entrepreneurial firms, are more reliant on the capital market for funding. As a result, such firms are expected to be more responsive to the demands of outside investors. Existing empirical evidence suggests that managerial remuneration is more sensitive to stock return performance (Firth, Fung, & Rui, 2006; Hou, Lee, Stathopoulos, & Tong, *in press*), and the cost of equity is more sensitive to audit quality (Chen, Chen, Lobo, & Wang, 2011), among privately controlled listed firms than their state-controlled counterparts in China. Therefore, state ownership is expected to moderate the governance effect of institutional investors. In other words, we expect the inverse relationship between mutual fund ownership and MAO to be more pronounced among POEs.

To test our assertions, we empirically analyze a sample of Chinese listed firms, with 8231 firm-year observations over the period from 2003 to 2008. We obtain data on MAOs issued to Chinese listed firms from the China Securities Market & Accounting Research (GTA/CSMAR) database. To measure the influence of fund ownership, we apply both open- and closed-end funds. In both cases, we observe consistently and significantly negative relationships between MAO issuance and mutual fund ownership. This is in line with greater financial reporting quality among firms for which institutional investors are more influential as an external governance mechanism. Furthermore, we observe that this effect is more pronounced among POEs than SOEs, and especially among those with higher growth opportunities. This is consistent with institutional investors having more influence over the transparency of firms that are more dependent on the capital market for funding. Our findings are robust to the control of firm characteristics, governance, industry and regional effects, as well as the potential endogeneity between fund ownership and financial reporting quality.

Our study contributes to the corporate governance literature in two ways. First, institutional investors can help promote financial reporting quality in transitional economies such as China. In an institutional environment with weaker legal enforcement and shareholder protection, the external governance role played by institutional ownership is especially important. Second, state control of listed firms moderates the benefits of external governance mechanisms such as that provided by institutional investors. Therefore, despite some studies suggesting that Chinese SOEs are adapting well to the new market-based economy (e.g. Lin & Germain, 2003; Ralston, Terpstra-Tong, Terpstra, Wang, & Egri, 2006), our findings suggest that state ownership impedes the benefits provided by institutional investors. Our study has two policy

implications. First, institutional investors such as mutual funds should be further encouraged to improve corporate governance and transparency in emerging economies. The expertise and experience of foreign institutional investors may be especially useful. Second, a further reduction of the state influence over listed firms in China could be considered so as to strengthen the capital market's function in disciplining firms and allocating financial resources effectively.

This study is organized as follows. Section 2 reviews the literature and develops the testable hypotheses. Section 3 explains our methodologies and sample. Section 4 presents and analyzes our empirical findings. Section 5 concludes.

2. Literature review and hypotheses

2.1. Effect of large shareholders on corporate governance

Due to the separation of ownership and control, managers have the opportunity and the incentive to expropriate wealth at the expense of the shareholders. On the one hand, dispersed ownership exacerbates agency problems because shareholders are not effective or influential enough to dissuade managers from engaging in self-serving behaviors (e.g. Jensen & Meckling, 1976). On the other hand, concentrated ownership induces two opposing effects on corporate governance, namely the entrenchment effect and the incentive alignment effect.

The entrenchment effect of large shareholders is conceptually similar to that of managers with a high degree of ownership. Existing literature suggests that such managers have a greater incentive to pursue their own interests because shareholders have relatively lower power to influence and monitor them (e.g. McConnell & Servaes, 1990; Morck, Schleifer, & Vishny, 1988; Stulz, 1988). In the same way, large shareholders who gain effective control of a firm's management also have greater incentives to pursue their own interests at the expense of minority investors (e.g. Shleifer & Vishny, 1997). Empirical studies document that firms' market values decline when the control rights of large shareholders exceed their cash-flow rights (Claessens, Djankov, Fan, & Lang, 2002), and that controlling shareholders engage in "tunneling" to transfer both assets and profits out of the firm for their own benefit (Johnson, La Porta, Lopez de-Silanes, & Shleifer, 2000).

The incentive alignment effect of large shareholders arises when they share with minority shareholders the objective to maximize the market value of the firm. Existing literature (e.g. Maug, 1998; Noe, 2002; Shleifer & Vishny, 1986) suggests that large shareholders have more resources and expertise than individual investors when it comes to monitoring managers. Gomes (2000) also suggests that ownership concentration signals reputation-building by the controlling shareholders. In this context, large shareholders would lose more from their firm's decline in market value than they could gain by diverting their firm's cash flow to themselves. Empirical studies document that institutional ownership is positively related to various measures of firm performance (Del Guercio & Hawkins, 1999; McConnell & Servaes, 1990), that managerial remuneration tends to be tighter among firms with larger shareholders (Bertrand & Mullainathan, 2001; Hartzell & Starks, 2003), and that such firms are associated with greater managerial accountability (Kang & Shivdasani, 1995; Kaplan & Minton, 1994).

Existing empirical studies suggest that large shareholders such as mutual funds tend to be associated with the incentive alignment effect (e.g. Admati, Pfleiderer, & Zechner, 1994). For instance, the studies of Cornett, Marcus, Saunders, and Tehranian (2007), Yuan et al. (2008) and Ding, Kuo, Hou, and Lee (2013) document the positive effects of mutual fund ownership on firm performance and stock informativeness, while Morgan, Poulsen, Wolf, and Yang (2009) observe that mutual funds vote more affirmatively for wealth-increasing proposals. On the other hand, empirical studies show that large shareholders that represent the state tend to exert an entrenchment effect. For instance, Chinese SOEs are observed to have lower share price informativeness (Gul, Kim, & Qiu, 2010), CEO turnover-to-performance sensitivity

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