Journal of Contemporary Accounting & Economics xxx (2014) xxx–xxx

Contents lists available at ScienceDirect

Journal of Contemporary Accounting & Economics

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

Institutional incentives and earnings quality: The influence of government ownership in China

Xiang Liu [a,1], Reza Saidi [b], Mohammad Bazaz [a,*]

[a] California State University, San Bernardino, San Bernardino, CA 92407-2397, United States
[b] The Catholic University of America, Washington, DC 20064, United States

ARTICLE INFO

Article history:
Received 30 August 2013
Accepted 29 September 2014
Available online xxxx

Keywords:
Earnings quality
Government ownership
China
State-owned firms

ABSTRACT

We examine the effect of government ownership and its associated institutional incentives on firms' earnings quality using a sample of Chinese firms during the transitional economy between 1998 and 2005 when state-owned and non-state-owned firms were traded in the stock exchanges. We find that, in China, state-owned firms exhibit a lower earnings quality property than non-state-owned firms. Particularly, state-owned firms have more earnings smoothing, more frequently managed earnings toward target, less frequent timely recognition of losses, and less value relevance, relative to non-state-owned firms. We also find that state-owned firms have significantly higher discretionary current accruals than non-state-owned firms. We conclude that the Chinese government, through its controlling ownership of state-owned firms, creates incentives and regulatory backing for self-serving purposes that negatively influence these listed firms' financial reporting.

© 2014 Published by Elsevier Ltd.

1. Introduction

A stream of prior literature documents that different ownership types, family ownership (Wang, 2006; Chen et al., 2010), private equity ownership (Katz, 2009), public share ownership (Givoly et al., 2010) and venture capitalist ownership (Morsfield and Tan, 2006; Wongsunwai, 2013; Liu, 2014), affect financial reporting. In this paper, we explore how reported accounting numbers are shaped by another important ownership type, government ownership. This helps us understand the nature of financial reporting incentives that government ownership creates. There is a dearth of research on the impact of government ownership on financial reporting because government owned publicly traded companies in the United States are virtually non-existent. China, however, has gone from a completely government owned economy to a free market economy, and, during the transition, the government partially privatized the state-owned firms and listed them on the stock market. This provides a powerful setting in which we can identify publicly listed firms that are owned by either government or individuals.

Two broad views of government participation in the financial market exist. The political theories of North (1990) and Olson (1993) define the nature of government as self-serving, i.e., governments acquire control of enterprises in order to provide employment and subsidies to supporters who in return provide political contributions and bribes (La Porta et al., 2002; Shleifer and Vishny, 1994; Bushman and Piotroski, 2006). The government uses these enterprises to achieve its political purposes. On the contrary, the development theories of Gerschenkron (1962) and Shleifer (1998) describe the

* Corresponding author
[1] We thank K.K. Raman, Carol Ann Frost, and seminar participants at the University of North Texas for their helpful comments. We acknowledge the financial support of the California State University, San Bernardino. We appreciate the valuable comments from the editor and anonymous referee.

http://dx.doi.org/10.1016/j.jcae.2014.10.003
1815-5669/© 2014 Published by Elsevier Ltd.

nature of government as benevolent, i.e., state ownership is necessary to mitigate market imperfections, such as monopoly power or externalities, and to develop particular strategic industries The purpose of this study is to examine China, a country with both state-owned and non-state-owned publicly-traded firms in a transitional economy between 1998 and 2005, to determine whether government ownership mitigates or aggravates the earnings management problem. Do firms owned by the state report the same quality accounting information as those not owned by the state?

The same set of accounting standards will yield different accounting outcomes when different preparer incentives are offered. The application of accounting standards involves the use of judgment and discretion by corporate insiders through the use of reported earnings to provide more information about a firm's economic performance or to serve other less benign interests (Burgstahler et al., 2006; Leuz et al., 2003).[2] For this reason, the reporting incentives and the forces shaping them are likely to determine earnings quality. Watts and Zimmerman (1978, 1986) hypothesize that political cost is one of the important incentives that drive managers' accounting choices and reporting practices. Healy and Wahlen (1999) identify political cost as one of the incentives for earnings management. In this study, we focus our investigation on how government ownership shapes a firm's incentives to report earnings that reflect economic performance. We argue that government ownership and control are likely to influence the financial reporting quality of a state-owned firm. Consistent with Lang et al. (2006) and Barth et al. (2008), we consider measures important to the informativeness of accounting data, i.e., earnings smoothing, tendency to manage earnings towards a target, timely loss recognition, and value relevance. We include multiple measures to mitigate the potential biases that may affect some of the measures.

Prior literature documents that a country's institutional factors, such as legal/judicial system, dispersed vs. concentrated ownership, political connections, investor protections, and political economy, may create financial reporting incentives (Ball et al., 2000; Fan and Wong, 2002; Ball et al., 2003; Leuz et al., 2003; Bhattacharya et al., 2003; Bushman et al., 2004; Bushman and Piotroski, 2006; Burgstahler et al., 2006; Leuz and Oberholzer-Gee, 2006; Chaney et al., 2011; Srinidhi et al., 2014; Guedhami et al., 2014). Using two country-level measures,[3] Bushman and Piotroski (2006) compare accounting conservatism in countries with more government interventions with accounting conservatism in countries with less government interventions in the economy. They find that the extent of the government involvement in a country's economy is associated with conservative accounting in countries with weak investor protections (civil law country) and is associated with aggressive accounting in countries with strong investor protections (common law country). Consistent with Watts and Zimmerman's (1978, 1986) political costs hypothesis, Bushman and Piotroski (2006) argue that managers adjust financial reporting in response to the nature of the government involvement. If managers view government involvement as an increased risk of expropriation, they tend to report conservatively to disguise profits. On the other hand, if managers view government involvement as a necessary intervention to eliminate poor performing firms, they will report earnings aggressively, and the firms will tend to look healthier. Using data in 47 countries, Chaney et al. (2011) find that politically connected firms have lower earnings quality. They define politically connected firms as those non-state-owned listed firms either having major shareholders (owning more than 10% of shares) or top directors as Members of Parliament, Ministers, or Heads of States or having tight relationships to a politician or a party. Another study by Guedhami et al. (2014) uses the same database and finds that politically connected firms are more likely to choose high quality (big) auditors. They find that the relation between political connections and auditor choice is stronger for firms operating in countries with relatively poor institutional infrastructure. This implies that tough external monitoring by Big Four auditors becomes more valuable for preventing diversion in such situations. They also find that politically connected firms show less earnings management and lower cost of equity in their sampled countries. Using a sample of listed Chinese private sector firms, Srinidhi et al. (2014) question the generalizability of Guedhami et al. (2014) result and argue that Chinese politically connected firms' preference for small auditors is consistent with the need for safeguarding the benefits of rent-seeking dominating over the benefits of signaling through big-auditor choice. They find that politically connected firms are less likely to engage high-quality auditors, are less timely in recognizing losses, and exhibit higher discretionary accruals than similar non-connected firms in China.

To our knowledge, this paper is the first to examine the impact of state ownership on earnings quality. Government ownership is an important institutional incentive of financial reporting that adds to the abovementioned research stream. Most of these prior studies investigating institutional incentives use country-level evidence. However, each country has state-owned firms and non-state-owned firms. Which type of firm is actually the driving force behind a specific accounting practice is still unknown. This paper contributes to the accounting literature by examining firm-level evidence. We partition state-owned firms and non-state-owned firms and thus reveal the first order impact of state ownership on earnings quality. In China, state-owned listed firms and non-state-owned listed firms are subject to the same accounting standards but to different political interference. This allows us to examine the effects of institutional incentives on different types of firms while holding the accounting standards constant.

[2] For example, Leuz et al. (2003) argue that insiders use earnings management to conceal firm performance from outsiders in order to protect their private control benefits.

[3] Bushman and Piotroski (2006) use two proxies for the extent of government involvement in a nation's economy. One is the risk of government expropriation reported by La Porta et al. (1999b), measuring the risk of outright confiscation of firms' wealth or forced nationalization by the state. The other is the share of country-level output supplied by state-owned enterprises, measuring the extent to which government ownership per se influences reported numbers or the threat of government involvement in non-state-owned firms.

UNCORRECTED PROOF

Please cite this article in press as: Liu, X., et al. Institutional incentives and earnings quality: The influence of government ownership in China. Journal of Contemporary Accounting & Economics (2014), http://dx.doi.org/10.1016/j.jcae.2014.10.003

Download English Version:

https://daneshyari.com/en/article/5092863

Download Persian Version:

https://daneshyari.com/article/5092863

Daneshyari.com