Advances in Accounting, incorporating Advances in International Accounting 28 (2012) 193–199

Contents lists available at SciVerse ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

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

Quality of reported earnings by Chinese firms: The influence of ownership structure

Wei Xu [a,*], Kun Wang [b], Asokan Anandarajan [a]

[a] School of Management, New Jersey Institute of Technology, Newark, NJ 07102-1982, USA
[b] School of Economics and Management, Tsinghua University, Beijing 100084, China

ARTICLE INFO

Keywords:
Earnings quality
Chinese firms
Ownership structure

ABSTRACT

This paper examines the influence of ownership structure on earnings quality of firms listed on the Chinese Stock Exchanges. We empirically test four contemporary earnings quality measures, including volatility of earnings, variability of earnings over cash flows, correlations between accruals and cash flows, and level of discretionary accruals, for 1438 firms listed on Shenzhen Stock Exchange and Shanghai Stock Exchange. We find that although state-owned firms are bigger in size and appear more profitable based on reported earnings; privately-owned firms, foreign-owned firms and society-owned firms outperform the state-controlled firms in earnings quality; and foreign-owned firms have the highest earnings quality among all types of ownership groups. We find that there is not much difference in earnings quality between collectively-owned firms and state-owned firms and employee-owned firms exercise least discretion in earnings management. The findings in particular will have direct policy implications for the China Securities Regulatory Committee (CSRC).

1. Introduction

The economy of China has undergone a significant transformation in the last three decades. Industries have been reorganized and corporations and many state owned enterprises have been partially or totally privatized. Chen, Firth, and Rui (2006) investigated the impact of the effectiveness of the privatizations on firms' operating efficiency and performance. They found an overall decline in efficiency and asset utilization in the 5 years after privatization. This finding is in stark contrast to similar studies from other countries where the results show a marked improvement in both profitability and efficiency. Some studies suggested that part of the reason for poor profitability could be due to the state retaining control in some companies. However, Chen, Firth, and Xu (2009) stated that these studies fail to properly identify and distinguish among the different types of owners or ownership structures. Chen et al. (2009) found that operating efficiency was a function of who controls the firm after its listing. In particular, when private investors control the firm, there is a marked improvement in efficiency relative to when the firm is state controlled. Jensen and Meckling (1976) argued that when private investors manage the business there is an incentive for them to increase the "wealth" of the firm. Is this wealth "increase" real or manipulated? This issue has not been examined with respect to Chinese firms. However, this is important because China currently attracts significant amounts of capital from western investors. Hence, any study contributing to knowledge about reported earnings quality by Chinese firms and factors that enhance or reduce reported earnings quality is relevant to investors and regulators.

The objective of this paper is to examine the influence of ownership structure on earnings quality of firms listed on the Chinese Stock Exchanges. Limited research has been done on earnings quality and earnings management by Chinese firms. Chui, Lau, and Ip (2001), in one of the early studies, observed that there were many incentives and potential opportunities for earnings management during the process of corporatization. Subsequent research attempted to examine if earnings management existed and what factors contributed to earnings management (if any) including studies examining the association between earnings management and corporate governance (Liu & Lu, 2007), earnings management and regulatory requirements set by the Chinese government (Yu, Du, & Sun, 2006), local government intervention on earnings management (Chen, Lee, & Li, 2008) and even how different ownership structures influenced choice of auditor (Wang, Wong, & Xia, 2008). Finally, Wang, Wu, and Yang (2009) concluded that reported earnings numbers were not fully trusted by investors due to suspicions of poor quality.

In summary, while papers have provided evidence of earnings management, and studied the impact of types of ownership on operating performance, no paper has examined if the type of ownership is associated with earnings management and/or earnings quality. Our paper, therefore, adds to the extant literature and attempts to fill this vacuum in the literature. Specifically, our paper contributes to the extant literature by examining if and how ownership structure influences potential earnings management behavior and, thereby, quality of reported earnings. By empirically testing four contemporary earnings quality measures for 1438 firms listed on Shenzhen Stock Exchange and Shanghai Stock Exchange during the period of 1999 to 2006, we find that although

* Corresponding author. Tel.: +1 973 596 6420; fax: +1 973 596 3074.
E-mail addresses: xwrachel@adm.njit.edu (W. Xu), wangk@sem.tsinghua.edu.cn (K. Wang), anandarajan@adm.njit.edu (A. Anandarajan).

0882-6110/$ – see front matter
doi:10.1016/j.adiac.2012.03.005

state controlled firms(which account for almost three quarters of the total listed firms in China), are bigger in size and more profitable based on reported earnings, private firms (firms owned predominantly by private investors), foreign firms (firms owned predominantly by foreign investors) and society owned firms outperform the state- controlled firms in earnings quality. Our results also indicate that predominantly foreign owned firms have the highest earnings quality among all types of ownership structure groups and the employee-owned firms exercise most discretion in earnings management and rank last in all earnings quality tests. In addition, although collectively-owned firms are claimed to be more efficiently operated, we do not find that this reflects on their earnings quality (possibly due to the heavy intervention of government). The findings in particular will have direct policy implications for the China Securities Regulatory Committee (CSRC).

2. Background and literature review

2.1. Institutional Background

Commencing in 1978, the Chinese government turned the previously central-command economic system into a market economy. The transition period was characterized by the emergence and rapid development of a private sector. The establishment of the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991 marked an important milestone in Chinese economic reform. The Chinese stock market, despite its short history, is a good example of a developing capital market with highly concentrated ownership. Most of the listed companies are transformed state-owned enterprises (SOEs). The development of privately-owned firms, however, has not been as rapid since the government appears to favor SOEs relative to non-SOEs.

There are five major categories of ownership structures based on their ultimate controllers' identities: (1) state-owned firms; (2) privately-owned firms; (3) foreign-owned firms; (4) collectively-owned firms; and (5) employee-owned firms.[1] The possibility of principal-agent conflict differs between state-owned firms and privately-owned firms. Firms that have predominantly private investors as their controlling shareholders are actively monitored by those shareholders. In contrast, when a firm is state controlled, the “controller” being the State Assets Management Bureau (SAMB), has neither strong incentive nor ability to monitor the listed firms. This is because, first, SAMB's principal objective, which is to implement governmental functions, differs from that of a private shareholder. SAMB is in charge of all state-owned equity within its administrative region and one of its principal functions is to ensure state asset preservation and appreciation. The function of improving performance of the firms it controls is not within its purview. Moreover, SAMB does not receive any cash flow from its shares thus reducing its incentive to actively monitor performance. Cash flows from an SAMB such as dividends or sales revenues of the shares are submitted to the Ministry of Finance or to local state asset management funds for future state asset investment.

Since SAMB remains a government branch, it is prohibited from acting as a listed company. SAMB is also prohibited from direct contact with the firms (other than the basic functions such as selecting the board of directors and attending shareholders' meetings).[2] This accentuates the information asymmetry between the listed company and SAMB. In addition, SAMB officials are selected through political processes. Usually, they are not chosen for their management experience or specific industry knowledge. Their promotions are based more on their commitment to government policies, instead of performance (Groves, Hong, McMillan, & Naughton, 1995). This further reduces SAMB's ability to perform normal shareholder's duties.

Unlike state-owned firms, non-state firms are operated predominantly on market mechanisms (Jin & Qian, 1998). Since 1992, foreign direct investment has increased and played an increasingly important role; China has now become the second largest country in the world to attract direct foreign investment since 1993 (the United States being the largest) according Cao, Qian, and Weingast (1999). Except for foreign-owned firms, collectively-owned firms that transformed from town-village enterprises and private firms also expanded since 1992. Although collectively-owned firms are relatively more effectively operated by community governments as compared to state-owned enterprises, there is frequent government intervention to achieve public objectives (examples of public objectives include but are not limited to increasing employment for the purpose of maintaining social stability). Overall, Jin and Qian (1998) argued private enterprises are more market-oriented compared to collectively-owned firms. We now discuss the relevant literature in this area pertinent to our study.

2.2. Studies examining earnings management behavior and relevant causes

In chronological order initial studies examined if earnings management occurred during the initial public offering process. In related studies the Chinese government required minimum targets of performance prior to rights issues. Researchers examined if targets set by the government instigated earnings management behavior. The government subsequently made efforts to increase levels of corporate governance. Subsequently research examined if tendency to manage earnings was constrained by corporate governance. However, local governments in China could play a role in earnings management. The Chinese central government tends to distribute funding based on the performance of local firms. Subsequent research examined a pertinent issue; namely, does the local government intervene to encourage earnings management behavior? Research pertinent to this study also examined the perceived informativeness of reported accounting numbers given the suspicion that reported numbers are being managed. The findings of these studies are now discussed below.

2.2.1. Earnings management in presence of rights issue legislation

Even though this line of literature is not directly related to our study, we include this to provide a greater understanding of factors contributing to earnings management by Chinese firms. Using a distribution approach, Yu et al. (2006) examined whether Chinese firms manipulated their earnings to meet the regulatory requirements. Their findings indicated that Chinese firms were heavily engaged in earnings management to meet the rights issue thresholds for their sample covering the period 1994–2002. The authors showed that firms changed their behavior in response to changes in regulatory requirements. The authors also found that this behavior is pervasive. Chen and Yuan (2004) show that for the period in their sample (1996 to 1998) listed companies managed their earnings to achieve the minimum required rate of return on equity (ROE) of ten percent that was required by regulators to enable companies to issue additional shares. Even though Chinese regulators scrutinize listed companies, the authors found that many of these firms underperformed after the issue indicating perhaps that they may have engaged in earnings management prior to the issue. This finding is in accordance with positive accounting theory (Watts & Zimmerman, 1986), which predicts that regulations based on accounting numbers create incentives for managers to manipulate their accounting numbers.

2.2.2. Earnings management and corporate governance

Liu and Lu (2007) examined the relation between earnings management and corporate governance by Chinese firms. They observed systematic differences in earnings management across China's listed companies over their sample covering the period 1999–2005. They demonstrated that firms with higher corporate governance levels have lower levels of earnings management.