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Mutual funds' holdings and listed firms' earnings management: Evidence from China☆

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ABSTRACT

This study examines the impact of long-term and short-term mutual funds' ownership on various types of earnings management in China. We find that both long-term and short-term funds' holdings can lead to reduced non-core income. However, long-term mutual funds' holdings have an insignificant impact on accrual items, while short-term funds' holdings encourage an increase in accruals. The positive influence of short-term funds' holdings on accruals is much stronger than their negative impact on non-core income. Finally, we find the impact of mutual funds' holdings on earnings management is much stronger in non-state-controlled listed firms than that in state-controlled ones.

1. Introduction

The study examines whether institutional investors cause listed firms to engage in short-term earnings management. To date, there is no definite answer. Froot et al. (1992), Porter (1992) and

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others argue that institutional investors tend to focus on short-term earnings and thereby encourage short-term managerial behaviour. On the contrary, Chung et al. (2002) suggest that institutional investors are more sophisticated than individual investors and, therefore, are less likely to be fooled by earnings management, which reduces the incentives for managers to use opportunistic discretionary accounting accruals. Recent studies show that institutional investors with different investment strategies (long-term vs. short-term) influence listed firm earnings management in different ways (Bushee, 1998, 2001; Koh, 2007). Koh (2007) finds that long-term institutional investors can constrain accruals management in the US, while short-term ones encourage earnings management. In this paper, we use a unique database of Chinese mutual fund holdings and comprehensive earnings management measures to cast new light on the importance of these two competing viewpoints.

Mutual funds have become major player in the Chinese stock markets in recent years. Firth et al. (2010) state that mutual funds are the largest type of institutional investors in tradable shares,[3] with mutual fund holdings accounting for 76% of all the institutional tradable shareholdings in the Chinese stock markets. Although the absolute holdings of mutual funds in China are not as high as those in the US due to the fact that mutual funds can only hold tradable shares in China, being the largest tradable shareholders, mutual funds do play an important role in the stock markets. Yuan et al. (2008) argue that mutual funds can mitigate free-rider problems by pooling diffused minority (individual) shareholders in China. Furthermore, mutual fund holdings could significantly influence individual investors' trading behaviours in China, as many individual investors follow mutual funds when buying and selling the shares of listed firms[4] (Tan, 2010).

Since mutual funds were introduced to China in 1997, the regulatory bodies have expected them to reduce market volatility and provide sufficient monitoring of listed companies. The role of Chinese mutual funds has, however, been ambiguous. In 2000, an article titled "*The dark side of mutual funds*" (Ping and Li, 2000) was published in a leading Chinese financial magazine "*Caijing*", unveiling many illegal operations of mutual funds. This article suggests that many mutual funds in China are short-term speculators and that illegal operations of mutual funds could significantly harm the stability of stock markets and the interests of individual investors. Moreover, using non-tradable share reform to reveal the role of institutional investors in China, Fu and Tan (2008), Qiu and Yao (2009) and Firth et al. (2010) all find that mutual fund holdings are negatively associated with the compensation rate to tradable shareholders during the reform. Despite being the largest tradable shareholder, mutual funds seem either to work with large non-tradable shareholders, or to be under political pressure from them, during the reform. The above evidence indicates that institutional investors do not provide adequate protection to individual investors in China. On the other hand, Yuan et al. (2008) find that mutual funds have a positive impact on both the operating and stock market performance of listed firms. They argue that mutual funds can provide effective monitoring of listed firms, and in turn, boost the performance of listed firms.

In this paper, we try to answer the following questions: Do mutual fund holdings increase, or decrease, earnings management in China? Do different types of mutual funds (short-term vs. long-term mutual funds) affect different types of earnings management (non-core income, discretionary accruals and positive discretionary accruals) differently? Does this impact differ in state-controlled vs. non-state-controlled firms?

This paper makes the following contributions to the literature: (1) Given previous research finds that Chinese firms use different methods to manipulate earnings, this study uses three earnings management measures (non-core income, discretionary accruals, and positive discretionary accruals) to examine the relationship between mutual funds' holdings and earnings management. Chen and Yuan (2004) argue that state-controlled listed firms often manipulate earnings through non-core items, as they can easily arrange the related-party transactions with their parent companies, or with other

[3] In the Chinese stock markets, there are tradable shares and non-tradable shares. Non-tradable shares are mainly held by the state and legal persons. They cannot be traded freely on the two stock exchanges in China. Tradable shares are held by individual shareholders and institutional shareholders, such as mutual funds, and can be traded on the Shanghai Stock Exchange and the Shenzhen Stock Exchange. Following the non-tradable share reform in 2005, the proportions of tradable shares and non-tradable shares are roughly 50% and 50% (Yang et al., 2014).

[4] This has also been reported in the press. See http://finance.sina.com.cn/money/lczx/20070720/04463803380.shtml.