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Insider trading, accrual abuse, and corporate governance in emerging markets — Evidence from Taiwan☆

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ABSTRACT

This study investigates the endogenous relationship between abnormal insider trading and accrual abuse, and explores whether corporate governance affects this relationship. Our results suggest that insiders take advantage of private information on abnormal accruals to time their trading and manipulate accruals opportunistically to mislead the stock market prior to their planned trading. More important, we find that the abuse of inside information for stock trading becomes more serious when a firm's ultimate controller has a great divergence of control rights (or seat-control rights) from cash flow rights. We also find that higher family ownership and control, increased managerial ownership, or a dual leadership structure not only induces more private information trading prior to financial reports disclosure, but also intensifies accrual abuse for future trading. The results for composite governance indices are also consistent with our expectation. Taken together, our evidence suggests that a poor corporate governance system interacts with abnormal insider trading and abnormal accruals, thereby aggravating insider expropriation on outside investors.

1. Introduction

Corporate insiders typically possess superior information about firm prospects to use information advantage for stock trading. Managers also have accounting discretion under the generally accepted

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accounting principle (GAAP) in preparing financial statements to use accounting choices to mislead the markets. Therefore, insiders have both the motivation and opportunity to take advantage of inside information to trade before the information is publicly released or to manipulate accruals for their planned trading. Several studies have attempted to investigate the relationship between insider trading and accrual abuse. These studies have indicated that managers consistently manipulate discretionary accruals to affect stock prices prior to their planned trading (Zhang, 2003; Sawicki and Shrestha, 2008; Huang, 2010). Beneish and Vargus (2002) also suggested insider trading to be an informative signal on earnings quality and the valuation implications of accruals. In other words, insiders could take advantage of superior accrual information to trade. Even worse, they might also engage in earnings management for future trading.

Therefore, exploring the relationship between insider trading and accrual abuse in an emerging market with weak investor protection is more important than that in developed markets because insiders have more opportunities to expropriate minority shareholder rights in this case. Taiwan denotes an ideal situation to investigate this issue because Taiwanese firms characterize by high-level earnings management (Leuz et al., 2003), large ownership-control separation, prevalent family-control (Yeh and Woidtke, 2005), and widespread pyramidal groups and cross-holdings (La Porta et al., 1999; Claessens et al., 2000; Faccio and Lang, 2002). Although the Taiwan Securities Exchange Act strictly prohibits insiders from abusing undisclosed information for stock trading,[1] abnormal insider transactions still occur from time to time. With accounting discretion and information superiority, insiders could make extremely abnormal returns in stock markets under weak corporate governance.

Whereas prior research has discussed the effect of corporate governance on deterring earnings manipulation (Chen et al., 2007a; Chen, 2012; Hazarika et al., 2012) or reducing abnormal insider trading (Fidrmuc et al., 2006; Betzer and Theissen, 2009), there is little evidence on the endogenous relationship between insider trading and abnormal accruals, and the effect of corporate governance on the mentioned relationship. To fill this gap, this study employs three-stage least squares (3SLS), which combines two-stage least squares (2SLS) with a seemingly unrelated regression (SUR), to investigate the endogenous relationship between insider trading and abnormal accruals. This study specially explores how corporate governance affects the relationship between insider trading and abnormal accruals.

Our empirical results show that discretionary current accruals (*DCA*) and discretionary accruals (*DA*) had a significantly positive (negative) effect on abnormal insider purchases (abnormal insider sales). These findings suggest that insiders might abuse information on high (low) accruals before it is publicly revealed and opportunistically purchase (sell) corporate stocks in advance to make subsequent abnormal returns (prevent losses) from the market. Our results also show that abnormal insider sales (purchases) had a significant and positive (negative) influence on DCA and DA. These findings indicate that insiders might deliberately report earnings upward (downward) to sell (buy) their shareholdings at a superior price after financial reports are publicly revealed.

We found that firms with a large ownership-control wedge, high-family ownership, and family-board members are associated with increased insider purchase and sales related to informed abnormal DCA. Family concentration also induces insiders to exploit accounting discretion to increase (decrease) earnings so that they can sell (buy) their shareholdings at a better (cheaper) price subsequently. We also found that a higher managerial ownership and a dual-leadership structure are associated with increased insider trading due to observing abnormal accruals and more accrual management for their planned trading. These findings suggest that, when managers possess more shareholdings or a CEO is also the board chair, they have a greater opportunity to access financial information and stronger control on managing

[1] Articles 157-1 and 171 of the Securities and Exchange Act in Taiwan indicate that: "Any director, supervisor, managerial officer, or shareholder holding more than 10% of company shares is not allowed to purchase or sell, in the person's own name or in the name of another, upon knowing any information that will have a material effect on securities price of the issuing company after the information is precise, and prior to the public disclosure of such information or within 18 h (12 h before 2010.06.02) after its public disclosure. Persons in violation of the provisions shall be punished with imprisonment for not less than 3 years and not more than 10 years, and in addition thereto, a fine of not less than NT$10 million and not more than NT$200 million may be imposed."