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Value relevance, earnings management and corporate governance in China

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A B S T R A C T

This study investigates whether earnings management reduces the level of value relevance and whether good corporate governance restrains earnings management. Using hand-collected data comprising 1012 firm-year observations from all companies listed on the Shanghai SSE 180 and the Shenzhen SSE 100, the results show that the negative impact of value relevance for the companies engaged in earnings management is greater than the companies that have not engaged in earnings management engagement. Furthermore, the companies with good corporate governance practices are more likely to constrain earnings management than those without.

1. Introduction

Since Ball and Brown (1968) began exploring the correlation between accounting earnings and stock returns, later studies (e.g. Ohlson, 1995) expanded to include market earnings to measure value relevance — a new concept of accounting information. A common feature of this research assumes that the value relevance could be empirically evident by the relationship between financial information and market price or return if the accounting figures would be able to reflect the information underlying stock evaluation (Francis and Schipper, 1999; Kothari, 2001). While earlier studies focused on the U.S. market, an increase in value relevance of accounting information has been found in global markets. Examples include Australia, France, the Netherlands and the UK (Alford et al., 1993), Germany (Harris et al., 1994), the UK,

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Australia and Canada (Barth and Clinch, 1996), six Asian economies (Graham and King, 2000) and 14 European countries (Aharony et al., 2010a). Increasingly greater attention on value relevance of accounting information is being devoted in the literature focusing on China due to its fast-growing stock market and unique market segmentation (Aharony et al., 2000; Chen et al., 2001; Haw et al., 1999; Lin and Chen, 2005; Liu and Liu, 2007; Liu et al., 2011; Samia and Zhou, 2004).

This study is motived by empirical evidence that concludes that related-party transactions are widely used to manipulate earnings for financial reporting (Aharony et al., 2010b; Jian and Wong, 2010; Lo et al., 2010a; Wong et al., 2015), and good corporate governance mechanisms could moderate the level of tunneling in China (Gao and Kling, 2008; Jiang et al., 2010; Liu and Tian, 2012; Shan, 2013). For example, Shan (2013) takes China as a case and extends the study of Young et al. (2008) to examine whether corporate governance mechanisms can prevent tunneling from the perspective of the crucial principal–principal conflicts of interests between controlling shareholders and minority shareholders.[1] However these studies ignore the possibility of a "Domino" effect in terms of value relevance, earnings management and corporate governance mechanisms. These relationships remain under-researched in the current literature while growing calls persist to further investigate this area empirically (Chen et al., 2009b; Morris et al., 2011). This study fills the research gap by examining these relationships simultaneously and assessing whether the "Domino" effect among them exists. As a consequence, the two research questions are addressed as follows: (1) Does earnings management reduce stock valuation? (2) Do corporate governance mechanisms restrain earnings management?

Specifically, the contribution of this study is fivefold. First, this study extends Ohlson (1995)'s price model by introducing a measure of earnings management between related-parties that can inflate earnings. Prior studies considered related-party sales to manage earnings. For example, Herrmann et al. (2003) report that Japanese companies use of income from the sale of fixed assets to manage earnings. Chen and Yuan (2004) find that Chinese listed companies use non-operating income to manipulate total earnings. Ge et al. (2010) find that Chinese listed companies use sales of goods and sales of assets to related-parties to manage earnings. However, these measures were mixed with normal and abnormal related-party transactions. In fact, earnings management often engages in abnormal related-party transactions (Gao and Kling, 2008; Lo and Wong, 2011). Therefore, this study examines whether there is an incentive for earnings management through related-party transactions and follows Jian and Wong's (2010) abnormal related-party transactions model to remove any normal components of related-party transactions.[2] The residual term of Jian and Wong's (2010) model is considered as the abnormal related-party transaction which is used as the surrogate of earnings management in this study.

Second, this study adds to the literature by determining the incentive for earnings management on stock price and corporate governance mechanisms using the two-stage least squares (2SLS) simultaneous equation approach. On one hand, Jiang et al. (2010) and Liu and Tian (2012) examine tunneling using inter-corporate loans. Shan (2013) investigates the impact of internal and external governance mechanisms on tunneling using the transactions of the multiple related-parties of the listed company. On the other hand, Ge et al. (2010) provide evidence that the management of Chinese listed companies use related-party sales to inflate

[1] Young et al. (2008) advocate that the principal–principal problem becomes as a major concern in emerging economies that are characterised by high ownership concentration, extensive family ownership and control, and weak legal protection of minority shareholders. Shleifer and Vishny (1997) suggest that the principal–principal conflict of interest between controlling shareholders and minority shareholders often results in asset appropriation or tunneling. Johnson et al. (2000) describe tunneling as the activity to transfer resources out of companies for the benefit of controlling shareholders, and it normally appears in two forms: direct transfer (Type I tunneling) and indirect transfer (Type II tunneling). In Type I tunneling the controlling shareholders simply transfer resources from the company for their own benefit through activities such as theft, fraud, assets sales and contracts, excessive executive compensation, loan guarantees, and expropriation of corporate opportunities. In contrast, Type II tunneling is more difficult to observe than Type I tunneling. The controlling shareholders can increase their share through dilutive share issues, minority freeze-outs, insider trading, creeping acquisitions, or other financial transactions that embezzle the interests of minority shareholders (Johnson et al., 2000). Type II tunneling is less relevant in emerging economies (Gao and Kling, 2008). However, Type I tunneling is more relevant in China as most asset appropriation was made through related party transactions (Cheung et al., 2006; Gao and Kling, 2008; Shan, 2013). Accordingly, the data collection for this study focuses on Type I tunneling (direct transfer of related-party transactions).

[2] Gao and Kling (2008) suggest that the accounting measure for tunneling is difficult to distinguish through normal and abnormal related-party transactions. Thus, this study used Jian and Wong's abnormal related-party transaction model (2010) that suggests the level of related sales and their associated operating profits will be abnormally high when the incentive of earnings management exists.