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Corporate governance, earnings management, and IFRS: Empirical evidence from Chinese domestically listed companies

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ABSTRACT

This research used 1,329 Chinese publicly listed companies' data from 1998 to 2009 to investigate how IFRS, state ownership, and board of directors (BOD) influence earnings management. We conclude that state-ownership to an extent discourages earnings management in the current environment of China. However, IFRS implementation does not seem to deter earnings management. When state-ownership is not the case, increasing the number of independent BOD seems to be a good practice to discourage earnings management, although non-independent BOD does not make any difference.

1. Introduction

According to the IASB, over 100 countries have adopted the international accounting standards officially known as International Financial Reporting Standards or IFRS.[2] The United States is scheduled to decide sometime in 2011 about whether to incorporate IFRS into the financial reporting system for U.S. issuers[3] With the possibility of global adoption of IFRS imminent, this seems an opportune time to investigate the effects of IFRS on various issues. Several researchers have approached this topic from several different angles, e.g., IFRS's impact on earnings management; the relationship between IFRS and information asymmetry (Leuz, 2003); how IFRS affects the cost of equity capital (Daske, 2006; Lambert, Leuz, & Verrecchia, 2007); whether IFRS improves market liquidity (Daske, Hail, Leuz, & Verdi, 2008); and how IFRS affects Tobin's q, which measures effects beyond the cost of capital and market liquidity (Daske et al., 2008).

This paper investigates the effect of state ownership, IFRS, and independent boards of directors on earnings management in the context of Chinese publicly listed companies. The investment market of China has undergone some major changes over the years, including the establishment of an independent board of directors system in 2001 and the conversion to IFRS in 2007. China mandated IFRS conversion for publicly traded companies starting 1/1/2007.[4] China's approach is a principles-based approach to translate the new rules into its own code, the Chinese Accounting Standards System. The revisions bring Chinese standards closer to the IFRS benchmark of internationally recognized quality, but the new standards will not be word-for-word translations of IFRS, though they will be founded on similar principles. A few differences are highlighted below:

- The application of fair value will be tailored for a country where the government retains significant influence and free markets have not fully developed.
- Related party disclosure requirements will be modified to reflect the context of state-ownership. State enterprises will be exempt from the "related-party" disclosure provisions because of the dominance of government enterprises.
- There will be no ability to reverse impairment charges.

In 2001, the China Securities Regulatory Commission issued, "Directory about establishing an independent board of directors system in listed Companies". According to the directory, by 6/30/2003, at least one-third of the members of the board of directors should be independent. The intension is that the independent board of directors system will become a formal mechanism to monitor the behavior of and improve the corporate governance of Chinese domestically listed companies.

How have the above changes influenced the investment market of China? We look at it from the perspective of earnings management. Can an independent board of directors improve corporate governance, and thus reduce earnings management? Bebchuk and Hamdani (2009) pointed out that good corporate governance practices at a publicly held firm will not necessarily be good practices at a publicly traded firm in

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[2] IASB. 2009. Who we are and what we do. International Accounting Standards Board, IASC Foundation, July 13. Available at: http://www.iasb.org/About+Us/International+Accounting+Standards+Board+-+About+Us.htm.

[3] SEC. 2010. Speech by SEC Commissioner: Remarks at the 14th Annual SEC Regulation Outside the United States Conference. US Securities and Exchange Commission, June 10.

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which there is a controlling shareholder. This is because board independence, a key concept in structuring appropriate corporate governance practices, has a different meaning when a controlling shareholder is present. The research by Bebchuk and Hamdani (2009) inspired us to investigate the relationship between independent boards of directors and state ownership of Chinese domestically listed companies. The significant change of accounting system starting 2007 also demands this research to evaluate IFRS effect on the interaction of independent board of directors, earnings management, and state ownership.

2. Literature review

Corporate governance has been a topic of research for decades. We herein review a few of recent studies regarding corporate governance.

Li and Samsell (2009) suggest that economies vary in terms of their emphasis on formal rules versus informal relationships. In Anglo-American economies, the primary governance mechanism is the equity market (Saberwal & Smith, 2008). In China, the primary governance mechanism is the state and informal networks (Shen & Chen, 2009). Judge (2010) gives a complete review of corporate governance around the world.

Li (2010) examined tunneling by controlling shareholders in Chinese public companies. Tunneling is the transfer of assets out of public companies for the benefit of controlling shareholders. Li (2010) concluded that tunneling is severe and that private controlling ownership significantly increases the severity of it. Li's (2010) research seems to support the conclusion by Shen and Chen (2009) that the primary governance mechanism in China is the state and informal networks. Recent study about ownership and corporate governance also includes Sueyoshi, Goto, and Omi (2010) research about Japanese firms. Their conclusion is that stable shareholding is an important aspect of traditional Japanese corporate governance, although stable shareholding enhances operational performance only when the ratio of shares held by stable shareholders is more than 61.21%.

However, Leuz, Nanda, and Wysocki (2003) finds that earnings management appears to be lower in economies with large stock markets, dispersed ownership, strong investor rights, and strong legal enforcement. This conclusion conflicts with research by Li (2010), Shen and Chen (2009), and Sueyoshi, Goto, and Omi (2010). These studies found that large/state shareholding was an important governance mechanism. Leuz et al. (2003) conclusions are based on data from 31 countries from 1990 to 1999. The countries include Asian countries such as Japan, Philippines, Indonesia, Korea, as well as the United States, United Kingdom, Belgium, etc. The dataset did not include China.

This paper investigates the effect on Chinese publicly traded companies of state ownership on corporate governance and earnings management.

Extensive research has been done on the impact of outside directors as well. Musteen, Datta, and Kemmerer (2010) found that firms with a greater proportion of outside directors and those with larger boards exhibited better reputations than those with smaller boards and a higher proportion of insiders. The study sample involved companies included in the 2000 Fortune List of America's Most Admired Corporations. (This list has been compiled annually since 1983.) Duchin, Matsusaka, and Ozbas (2010) conclude that the effectiveness of outside directors depends on the cost of acquiring information about the firm. When the cost of information acquisition is low, performance increases when outsiders are added to the board. When the information acquisition cost is high, performance worsens when outsiders are added to the board. The data are from American firms over the period 2000–2005.

Shen and Chih (2007) examined the impacts of corporate governance on earnings management. They conclude that firms with good corporate governance tend to conduct less earnings management and large size firms are prone to conduct earnings smoothing. The paper used CLSA (Credit Lyonnais Securities Asia) corporate governance measures. CLSA calculated an index with corporate governance rankings for 495 firms across 25 emerging markets and 18 sectors. The paper examined the relationship between Leuz et al.'s (2003) earnings management proxies and corporate governance.

3. Methodology

3.1. Data collection

We recruited students fluent in Chinese to manually collect data from sina.com.cn. Data were collected from a total of 1329 publicly listed companies, and 11,947 company years. We included all industries in our data collection. We then grouped our observations into China GAAP observations from1998–2006 (8059 observations in total) and IFRS observations from 2007 to 2009 (3888 observations in total).

3.2. Earnings management

Earnings management has been the subject of extensive accounting research. Healy and Wahlen (1999) defined earnings management as the alteration of a firm's financial reports by insiders in order either to mislead some stakeholders or to influence contractual outcomes that are dependent on numbers in the financial reports. Leuz et al. (2003) adopted this definition as do we.

Measuring the degree of earnings management has presented challenges, and researchers have devised various methods. In this study, we will use the methods developed by Leuz et al. (2003), which were based on previous work by Dechow, Sloan, and Sweeney (1995), Healy and Wahlen (1999) and Dechow and Skinner (2000).

Earnings management is generally understood to mean attempts by company insiders to protect their positions and benefits by manipulating the financial information provided to outsiders. This often takes the form of income smoothing or income manipulation.

We use the method defined by Leuz et al.'s (2003) to quantify earnings management. We first introduce accruals and cash flow.

The operational definition of accruals is:

$$\text{Accruals} = (\Delta\text{CA} - \Delta\text{Cash}) - (\Delta\text{CL} - \Delta\text{STD} - \Delta\text{TP}) - \text{Dep} \tag{1}$$

where:

ΔCA	change in total current asset;
ΔCash	change in cash/cash equivalents;
ΔCL	change in total current liabilities;
ΔSTD	change in short-term debt included in current liabilities;
ΔTP	change in income taxes payable;
Dep	depreciation and amortization expense.

We then calculate cash flow from operations:

$$\text{Cash flow from operations} = \text{Operating earnings} - \text{Accruals} \tag{2}$$

$$\text{EM} = |\text{Accruals}|/|\text{Cash flow from operations}| \tag{3}$$

where: EM stands for earnings management.

The larger EM is indicative of large-scale use of discretion to manipulate reported accounting earnings. (Leuz et al. (2003) identifies other measures of earnings management. However, these other measures are not applicable for purposes of this paper.)