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Split-share reform and earnings management: Evidence from China

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ABSTRACT

This paper investigates the impact of split-share structure reform on earnings management in China. A unique institutional feature of China was the co-existence of two types of share that endowed all shareholders with equal voting and cash flow rights but different tradability. This split-share structure significantly constrained the tradability of shares that led the Chinese Securities Regulatory Commission to make it mandatory for the conversion of non-tradable shares into tradable shares from 2006 onwards. We investigate whether such a conversion has any effect on information quality through reduced earnings manipulation. We specifically examine the incentives for earnings management during the reform-transition period. A unique feature of the split-share reform has been the requirement for non-tradable share holders to compensate the tradable share holders. We argue that the rational response from the non-tradable share holders would be to pay a lower consideration to tradable share holders by portraying a favorable picture through income-increasing earnings management. We also test for the effect of an increase in tradable shares on earnings management during the reform-transition and post-reform period.

1. Introduction

This paper investigates the effect of split-share structure reform in China on the incentives for earnings management practices by Chinese corporate managers. A distinct feature that separated the Chinese stock market from those of other countries was the creation of a two-tier share structure consisting of non-tradable shares (NTS) and tradable shares (TS).[1,2] The NTS held by state and legal persons effectively gave the government absolute control over the joint stock companies. Such a split-share structure arrangement has been argued to have created severe agency problems between the controlling (NTS holders) and minority shareholders because of the weak managerial incentives faced by NTS controlled firms to act in the best interest of the public shareholders (Wei & Geng, 2008). Considering this split-share structure as an obstacle to the efficient functioning of the Chinese capital market, the Chinese government initiated a split-share structure reform to convert publicly listed firms' NTS to TS. The reform allows the NTS holders to sell and realize gains from stock price appreciation same as TS albeit through a gradual process. Event study analysis focusing on the market reaction of the reform announcement generally concludes that share reform has been successful evidenced by positive excess stock returns and increased trading volumes and liquidity (e.g., Liao, Liu, & Wang, 2010; Lu, Balatbat, & Czernkowski, 2011).

We depart from the financial economists' approach and focus on the quality of accounting information — proxied by the magnitude of earnings management to determine the effect of the split-share reform. Research on earnings management in China is relatively sparse and primarily examines the managerial propensity to manage earnings to meet regulatory thresholds for equity issuance. For example, Chen and Yuan (2004) use data from 1996 to 1998 and report strong evidence that Chinese managers managed earnings to exceed the minimum 10% return-on-equity (ROE) requirement for right issues. We contribute to the earnings management research in China and financial reporting regulation in general, by considering a significant regulatory change with profound implications for the Chinese stock market using a much longer sample period from 2001 to 2009, longer than any other studies on earnings management in China. We have broken down our sample period from 2001 to 2009 into three distinct time periods namely, the pre-reform period (2001–04), the reform-transition period (2005–07), and the post-reform period (2008–09) to examine the differential extent of earnings management by Chinese managers during these three regulatory phases.

We begin our analysis by investigating the association between NTS holdings and earnings management in the pre-reform period. Firth, Fung, and Rui (2007, p.465) argue that "…the controlling shareholders own non-tradable shares and so the market price of the tradable shares is of less interest to them; this may make them less concerned about

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[1] A typical Chinese company was comprised of three predominant groups of shareholders: the state, legal persons/institutions, and individuals. State and legal persons hold NTS, while TS holders include institution and individual shareholders.

[2] The Chinese government released "Circular on Issues relating to the Pilot Reform of Listed Companies Split Share Structure" on April 29, 2005 (CSRC. 2005a), and relevant guidelines and circulars (Chinese Congress, 2004; CSRC, 2005b; CSRC, 2005c) pertinent to this reform. The CSRC selected two batches of firms for a trial reform in May and June 2005. The trial was deemed an incredible success and the full-scale reform then started. Till the end of 2007, 858 listed firms have accomplished the non-tradable reform (Green, Morris and Tang, 2010).

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the quality of public accounting information." The incentives for earnings management for these NTS firms may stem from the "expropriation" argument. Earnings management allows these NTS holders to transfer resources to other wholly-owned businesses. However, instead of examining the effect of NTS holdings on earnings quality, they test for the effect of TS holders on earnings management. They find a negative and marginally significant association between absolute discretionary accruals (DACCR), a proxy for earnings management, and INDIV (a proxy for tradable share holders) using data from 1997 to 2003. Additionally, their results may be biased because of the inclusion of B-shares along with A-shares as components of TS. The financial statements of B-share companies are prepared following International Accounting Standards (IASs) and are all audited by Big 5 auditors in order to improve the credibility of financial statements. Firth et al. (2007) do not specify whether their sample also includes B-shares. We, therefore examine the effect of NTS holdings on earnings management to provide a cleaner test since NTSs pertain to only A segment shares.

We then examine the incentives for earnings management during the reform-transition period. A unique feature of the split-share reform has been the requirement for NTS holders to compensate the TS holders. Under the split-share structure, tradable A-shares are priced with the expectation that non-tradable A-shares can't be traded in the open market. Hence, the former trades at a premium which represents the value of liquidity. After the reform, when non-tradable A-shares become tradable, there is an expectation that the pricing will improve this type of shares at the expense of shareholders of tradable A-shares. To avoid the inequitable transfer of wealth, shareholders of tradable A-shares must be compensated (Lu et al., 2011). We argue that the rational response from the NTS holders would be to pay a lower consideration to TS holders and the former group could engage in upward earnings management to achieve that goal. Such manipulated earnings will portray a profitable picture of the organization to the TS holders. If TS holders can't undo such strategic earnings management practices, then they may be content to accept a lower consideration value with the expectation that firm performance will continue to improve in the future. Increased firm performance, in turn, will boost the stock price to their benefit. Our empirical evidence, however, does not lend credence to such a proposition. We also tested for the effect of an increase in TS on earnings management during the reform-transition and post-reform period and find that there is no significant (negative) association between TS and DACCR during the reform-transition (post-reform) period respectively.

We use DACCR, an extensively used earnings management proxy, to test our hypotheses. Previous earnings management studies in China documented that dominant shareholders expropriate resources from minority shareholders by accrual management techniques (Aharony, Wang and Yuan, 2010; Aharony, Lee, & Wong, 2000); and Chinese listed companies used such techniques to meet or beat earnings thresholds promulgated by the China Securities Regulatory Commission (hereafter CSRC) for regulations related to Initial Public Offering (IPO), right issues and delisting (Yu, Du, & Sun, 2006; Kao, Wu, & Yang, 2009). We find that NTS holding is positively associated with DACCR implying the presence of earnings manipulation in the pre-reform period.

Our paper contributes to the evolving literature on earnings management in China by providing direct evidence regarding the efficacy of the reform in improving the quality of accounting information in the backdrop of Chinese regulatory change and identifying a unique incentive (compensation consideration) for income-increasing earnings management.

2. Background information and literature survey

2.1. Chinese listed companies' two-tier share ownership structure

Under the two-tier share structure regime, NTS and TS, having similar cash flow and voting rights but distinct tradability were common in listed companies in China. During the Chinese privatization process, when a company lists on the stock market for the first time, about 64% of its shares were retained by the founders, typically, the state owned enterprises (SOEs). The other 36% of the shares were offered to the public as TS. The NTS were not tradable on either the Shanghai or the Shenzhen Stock Exchange, but could be transferred off-market to other government agencies, legal entities, and foreign investing firms on a State Asset Management Bureau (SAMB) approved price normally higher than the book value per share.[3] TS were held by minority shareholders and institutional investors like mutual funds, and were traded on stock exchanges. TS include A-shares, B-shares, and H-shares.[4,5,6] Originally, this two-tier share structure was designed to significantly constrain the tradability of NTS held by state and legal persons, which effectively gave the government absolute control over the partially privatized companies in stock markets while at the same time improving SOEs' performance using market mechanisms. However, such non-tradability is argued to have resulted in severe agency problems between the NTS and TS because of the misalignment between risk sharing and the exercise of control by the NTS; the free riding problem associated with TS, and weak managerial incentives (Wei & Geng, 2008).

Two-tier share structure distorts managerial incentives for shareholder value maximization because managers of the state and legal person-controlled firms have greater incentives to act in the best interest of state or legal persons/institutions because of their political appointments. Due to the co-existence of NTS and TS in listed SOEs and the absolute controlling shares held by NTS holders, management and NTS holders tend to collude through related party transactions or insider trading detrimental to the TS holders interest and firm value (Wei & Geng, 2008).

On the other hand, the two-tier share structure creates a second type of agency problem between NTS and TS holders due to a lack of common interest for market discipline and maximizing shareholder wealth. Because NTS holders could not sell their shares on the public markets to realize gains through stock price appreciation as holders of TS could do, NTS holders may have been more interested in expropriating firm resources for their private benefit than increasing the stock price and maximizing firm value. If controlling shareholders intend to the transfer assets and profits out of the firm for their own benefit (called tunnelling), they have incentives to mask

[3] Foreign entities are allowed to buy NTS from November 2002, and qualified foreign institutional investors are allowed to invest in A-shares. NTS includes state-owned shares and legal person shares. State-owned shares are controlled by either government agencies (GA) or SOEs. GA can be central government ministries and commissions, national industrial companies, local government bureaus, local branches of the SAMB and state asset operating companies. Legal person shares are held by non-individual entities with mixed ownership structures like collectively-owned enterprises, township and village enterprises, private enterprises, non-bank financial institutions, joint stock companies, and foreign companies.

[4] Liu and Lu (2007), among many others, explain the difference among these three segments of the shares. All B-shares and H-shares are TS. A-shares were divided into NTS Ashares and TS A-shares. The reform was aimed at converting NTS A-shares into TS. Therefore, throughout this paper, TS and NTS are used to represent TS A-shares and NTS A-shares respectively.

[5] The majority of the listed companies are profitable units spun off from state-owned enterprises (SOEs). The parent-SOEs have incentives to siphon resources from the newly listed companies to subsidize their own business. One feasible way of doing this is tunnelling through related-party transactions. Existing studies have shown that corporate loans are the major form of tunnelling. It is reported that Chinese parent companies frequently do not pay debts to their listed companies, which is a direct reason for the untimely demise of many newly listed companies (Aharony et al., 2010).

[6] Current Chinese Accounting Standards require public listed companies to disclose all material RP transactions in the notes to the financial statements. Related party transactions can happen between listed companies and their parent SOEs, large shareholders, their parent companies' other affiliates or board members and management team. For more discussion on RP transaction issues in China, refer to Aharony et al. (2010).