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The Real and Accrual-based Earnings Management Behaviors: Evidence from the Split Share Structure Reform in China

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Abstract

This paper investigates the earnings management activities in Chinese listed firms and the impact of the split share structure reform (SSSREF). We demonstrate that Chinese listed firms exhibited a long-term positive relationship between real and accrual-based earnings management activities over the 2002–2011 period. This reflects the environment of weak investor protection and lack of effective corporate governance in China. Our results also indicate that the SSSREF in China has not fundamentally improved firms' quality of financial information. This may be because ownership concentration remains high. However, it is of interest that the reform has created an incentive alignment effect exogenously. We find that firms' use of discretionary accruals was constrained, and they have consequently shifted to less detectable and under-scrutinized real earnings activities after the reform. This shift is similar to that seen with the direct regulatory changes in accounting reporting rules on firms' earnings behaviors in developed countries where the investor protection environment is strong. We suggest that firms' shifting between the accrual and real-based earnings methods is an overlooked area for investors to consider in the emerging market context, and may require the attention of regulators.

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1. Introduction

Extensive research has well documented the positive effect of good corporate governance mechanisms on the information environment and quality of earnings. It can constrain managerial opportunistic behaviors and the expropriation of minority shareholders by controlling shareholders, thus mitigating information asymmetry and improving the *quality* of earnings (Armstrong, Balakrishnan, & Cohen, 2012; Beasley, 1996; Fan & Wong, 2002; Klein, 2002; Warfield, Wild, & Wild, 1995; Xie, Davidson, & DaDalt, 2003) (see Section 2.3 for details).¹ In the Chinese context, the Chinese stock market has featured a split structure, separating firms' stock into tradable (TS) and non-tradable shares (NTS). Nearly two-thirds of the A-shares were non-tradable and typically held by the state to retain control over listed firms in the early economic reform period (Li, Wang, Cheung, & Jiang, 2011; Yeh, Shu, Lee, & Su, 2009).² Severe corporate governance issues arose from this split structure as a result of a divergence of interests and incentives between controlling NTS principals and TS minority shareholders.

The split share structure reform (SSSREF) has exogenously created an incentive alignment effect, which strengthens corporate governance and improves the *quantity* of corporate financial information (see also Section 2.1 for more details).³ For instance, Liu and Tian (2012) indicate that both tunneling and excess leverage by controlling shareholders with excess control rights have been reduced after the SSSREF in China. Beltratti, Bortolotti, and Caccavaio (2012) demonstrate a positive stock market reaction upon the announcement of the SSSREF as firms' profitability and returns are expected to increase with the improvement in corporate governance. Hou, Kuo, and Lee (2012) also indicate that this incentive alignment effect brought by the SSSREF has reduced the incentive for controlling shareholders to withhold price-sensitive information and thus effectively improves corporate transparency.

However, it might be premature to conclude that firms have simultaneously reduced their earnings manipulation behaviors even though the reform brought an increasingly widespread availability of information to market participants. We therefore question the previous literature that the reform may not fully improve the *credibility* (*quality*) of firms' increasing disclosure of financial information by examining the changes in earnings manipulation behaviors. Apart from studying both accrual and real-based earnings management activities in the Chinese market, we attempt to make a threefold contribution.

¹ For example, some previous research uses empirical evidence from the U.S. market and demonstrates that accrual-based earnings management can be constrained by a larger number of independent board members and higher quality of audit committees (Beasley, 1996; Chang & Sun, 2009; Dechow, Sloan, & Sweeney, 1996; Klein, 2002; Xie et al., 2003). Hazarika, Karpoff, and Nahata (2012) also show that an effective board can restrain senior managers from pursuing aggressive earnings strategies to manipulate accruals. Similarly, Armstrong et al. (2012) find that the passage of antitakeover laws in the U.S. reinforces the external corporate governance mechanism, improving firms' financial statement informativeness (see also Section 2.3).

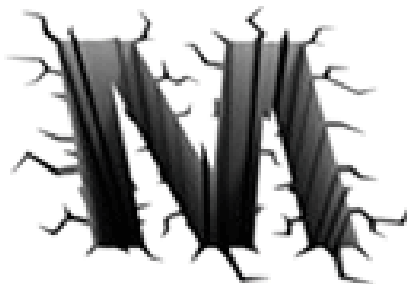
² China's listed shares (tradable) are classified into A shares for domestic investors to trade, and B, H, and N shares for foreign investors. A shares are quoted in Chinese Yuan and B shares are quoted in foreign currencies and both are listed in the Shanghai and Shenzhen Stock Exchanges. H shares are Chinese firms' shares listed in the Hong Kong Stock Exchange. N shares are traded in the U.S. stock markets in the form of American Depository Receipts (ADRs).

³ It has converted NTS to TS and tied the wealth of non-tradable shareholders to share prices, thereby aligning both tradable and non-tradable shareholders' interests to profit maximization (see Section 2.1 for more details).



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