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Research on the Relationship Between Controlling Shareholder and Accounting Conservatism in China

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Abstract. In this paper, we examined the relationship between controlling shareholders and accounting conservatism in China. Using 5762 firm-years data about listed firms in China stock exchanges from 2001 to 2005, we find that the percentage of the largest shareholder ownership has significantly negative effect on accounting conservatism. After controlled by size, leverage and growth opportunity, the result is still robust. We thus provide evidence of an entrenchment effect, where the largest shareholder may influence firms to adopt aggressive accounting policies that reflect the wishes of the largest shareholder rather than reflect the economic substance of the business transactions.

Introduction

Accounting conservatism is an important convention in corporate financial report. Basu (1997)[1]notes that conservatism has influenced accounting practice for at least five hundred years. Watts(2003) [2]states that conservatism is the asymmetrical verification requirements for gains and losses. This interpretation allows for degrees of conservatism: the greater the difference in degree of verification required for gains versus losses, the greater the conservatism. Watts(2003) also argues that conservatism reduces managers' ability and incentives to overstate earnings and net assets by requiring higher verification standards for gain recognition and reduces managers' ability to withhold information on expected losses. Furthermore, Guay and Verrecchia(2006)[3]identify three key characteristics of conservative accounting: (1) Compared to accounting reports without conservatism, conservative accounting reports induce a downward bias in reported net assets; (2) Conservative accounting reports contain less timely information about gains than about losses; and (3) Conservative accounting rules impose greater costs on managers who wish to manipulate net assets upward. As Bushman and Pirtroski(2006)[4]argue, accounting conservatism confers benefits to economic agents who use, prepare or regulate financial reports.

Lafond et al.(2008)[5]examine the effect of managerial ownership on financial reporting conservatism. They find that conservatism as measured by the asymmetric timeliness of earnings declines with managerial ownership. The negative association between managerial ownership and asymmetric timeliness of earnings is robust to various controls, in particular, for the investment opportunity set. They thus provide evidence of a demand for conservatism from the firm's shareholders. Different from Lafond et al.(2008) [5] research, our study further investigate the demand for accounting conservatism from controlling shareholders in Chinese listed firms.

Literature and Hypothesis Development

China has two stock exchanges in mainland. The Shanghai Stock Exchange was established in December of 1990, followed by the Shenzhen Stock Exchange in April 1991. Also in 1991, the Chinese Securities Regulatory Commission (CSRC)—the Chinese equivalent of the U.S. Securities and Exchange Commission—was established to monitor and regulate the two stock exchanges and the listed firms.In China, there are several different "official" classes of shares. Shares are classified based on the residency of their owner as domestic (A shares) or foreign (B, H and N shares). Domestic A shares are further divided into State shares, Legal-Person shares, Tradable A shares, and other shares. Only Tradable A shares, as the name implies, are publicly traded on China's two stock exchanges.

In this paper, we discuss the relationship between controlling shareholders and accounting conservatism. Since controlling shareholder take a more active role in management, and have access to alternative (insider) sources of information, they will rely less on financial reporting. For example, controlling shareholders can directly communicate with managers to resolve the information asymmetry between them and managers. Because of having ability to get information except for financial report, controlling shareholder demand for accounting conservatism is likely to be lower than non-controlling shareholder. Furthermore, as La Porta *et al*.(1999) [6]present, controlling block holders also have incentives to expropriate wealth from minority shareholders, especially in countries with weak investor protection. This means that although controlling shareholders can mitigate the agency problem between managers and shareholders, controlling shareholders will increase another agency problem between controlling shareholder and minority shareholders. As Johnson *et al*.(2000)[7]also reported, a controlling shareholder can simply transfer resources from the firm for his own benefit through self-dealing transactions. Such transactions include outright theft or fraud, but also asset sales and contracts such as transfer pricing advantageous to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporate opportunities.

Legal protection for minority shareholders in China is weak where one shareholder or group of shareholders has a controlling stake in the firm. Thus, controlling shareholders have incentives to engage in tunneling funds from listed firms to controlling parent firms and undertake related party transactions to the determinant of other minority shareholders. Bai et al. (2004) [8]find evidence that parent companies expropriate other shareholders through various business dealings with the firm or by connected transactions. Fan and Wong (2002) [9] also find that listed firms engage in tunneling activities in the form of issuing guarantees for related firms controlled by the same parent firm. Therefore, in order to cover tunneling behavior, controlling shareholders have incentive to accelerate good news and delay bad news.

Based on above analysis, we can find that controlling shareholder can effectively reduce the information asymmetry between them and managers through directly communicating with managers while controlling shareholder will increase the information asymmetry between them and non-controlling shareholders in order to better tunneling interest from minority shareholders. Therefore, based on the weak incentive of controlling shareholders to enhance accounting conservatism, we provide the following hypothesis.

H2: Accounting conservatism is negatively related to the percentage of controlling shareholder.

Data

We choose our research samples and research period as following steps. Firstly, we select all the companies issuing A shares on the Shanghai Stock Exchange and the Shenzhen Stock Exchange from January 2001 to December 2005 sample research period. Secondly, we exclude financial companies. Thirdly, we also exclude firms that had their initial public offering in the year. Fourthly, we delete firms missing values in the stock return data. We obtained all data needed from the China Stock Market & Accounting Research Database. Finally, our sample consists of 5762 firm-years over the years 2001-2005. The annual number of observations is generally increasing over time, from 1033 in 2001 to 1276 in 2005.

Research Design and Empirical Results

Ball and Shivakumar (2005) [10] measure conservatism for a large sample of private UK firms. They develop an alternative measure of conditional conservatism based on the links between total accruals and operating cash flows. The intuition is that accounting earnings tend to anticipate the recognition of bad news and to delay the recognition of good news. Total accruals and cash flows are negatively associated, as has been documented by previous research. However, because of the asymmetric recognition of news in earnings, this negative association between total accrual and cash flows tends to be lower in periods with economic losses. Total accruals recognize the impact of negative economic events during the period when they take place; these adverse effects tend to affect cash

flows as well, lowering the negative correlation between cash flows and accruals. Ball and Shivakumar(2005) [10] use the following regression to measure this association between cash flows and accruals(firm and time subscripts are omitted).

$$ACC = \beta_0 + \beta_1 DCFO + \beta_2 CFO + \beta_3 DCFO*CFO + \varepsilon \quad (1)$$

Where:
ACC = total accruals scaled by beginning-of-period total assets
CFO = operating cash flows scaled by beginning-of-period total assets
DCF = a dummy variable that takes the value of 1 if CFO is lower than the annual market average, and 0 otherwise.
In equation (1), the coefficient on β_2 is expected to be significantly negative, reflecting the negative association between cash flows and accruals and mitigating the noise in cash flow.The coefficient on β_3 is expected to be positive, indicating that accrued loses are more likely in periods of negative cash flows. In this model,Ball and Shivakumar (2005) [10] mainly pays attention to the coefficient on β_3. If the coefficient on β_3 is significantly greater than zero, the model indicates that bad news can significantly mitigate the negative relationship between accrual and cash flow; that is ,financial report is more conservative. Ball and Shivakumar (2005) [10] provide evidence consistent with their predictions, documenting that β_2 is negative and β_3 is positive.
We estimate the relationship between controlling shareholder ownership and accounting conservatism using following extended BS model.

$$ACC = \beta_0 + \beta_1 DCFO + \beta_2 CFO + \beta_3 DCFO*CFO + \beta_4 SHARE + \beta_5 DCFO*SHARE + \beta_6 CFO*SHARE + \beta_7 DCFO*CFO*SHARE + + \beta_8 SIZE + \beta_9 DCFO* SIZE + \beta_{10} CFO* SIZE + \beta_{11} DCFO*CFO* SIZE + \beta_{12} LEV + \beta_{13} DCFO*LEV + \beta_{14} CFO* LEV + \beta_{15} DCFO*CFO* LEV + \beta_{16} MB + \beta_{17} DCFO* MB + \beta_{18} CFO* MB + \beta_{19} DCFO*CFO* MB + \varepsilon \quad (2)$$

Where : *SHARE* = the percentage of shares held by the largest shareholder.
Variables are defined as before.
Thus the coefficient on β_7 measures whether economic losses are incorporated into net income faster than economic gains as the percentage of the largest shareholder ownership increase. Our interest is the coefficient on β_7. We expect is the coefficient on β_7 negative.

Table 1 Controlling shareholders and conservatism(pooled data, without controlling variables)

	Coefficients	t-Statitics
Intercept	0.018**	2.548
DCFO	-0.048***	-6.019
CFO	-1.103***	-17.415
DCFO*CFO	0.434***	3.644
SHARE	-0.014	-1.043
DCFO* SHARE	0.070***	4.352
CFO* SHARE	0.410***	3.264
DCFO*CFO* SHARE	-0.688***	-2.828
N	5762	5762
Sample period	2001-2005	
F value	689.260	
Adjusted R-square	0.495	

Note:T-statistics are computed by the robust regression method which corrects for heteroscedascity in the pooled data. ***, *, and * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively.

Table 2 Controlling shareholders and conservatism(pooled data, with controlling variables)

	Coefficients	t-Statitics
Intercept	0.020***	2.681
DCFO	-0.037***	-4.710
CFO	-1.026***	-15.531
DCFO*CFO	0.352***	2.914
SHARE	-0.010	-0.712
DCFO* SHARE	0.044***	2.842
CFO* SHARE	0.195	1.617
DCFO*CFO* SHARE	-0.430*	-1.915
SIZE	0.007	1.142
DCFO*SIZE	0.018***	2.808
CFO*SIZE	0.128***	2.700
DCFO*CFO*SIZE	-0.289***	-3.135
LEV	-0.016***	-2.818
DCFO*LEV	-0.019***	-3.024
CFO*LEV	-0.005	-0.115
DCFO*CFO*LEV	0.267***	3.423
MB	-0.002	-0.380
DCFO*MB	0.009	1.403
CFO*MB	-0.087*	-1.944
DCFO*CFO*MB	-0.189**	-2.141
N	5762	5762
Sample period	2001-2005	
F value	545.320	
Adjusted R-square	0.547	

Note:T-statistics are computed by the robust regression method which corrects for heteroscedascity in the pooled data. ***, *, and * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively.

As reported in table 1, the coefficient on DCFO*CFO*SHARE(-0.688) is negative and significant at the 1% level. Furthermore, as reported in table 2,controlled by firm size, leverage and growth opportunity, the coefficient on DCFO*CFO* SHARE (-0.430) is negative and significant at the 10% . These results suggest that the percentage of largest shareholder has a significantly negative effect on accounting conservatism, consistent with the higher of the percentage share of the largest shareholder, the more power of controlling shareholder, and the less conservatism of financial report. Our results are consistent with that the high ownership concentration weakens the informativeness of reported earnings to outside investors. Meanwhile, our results support Firth et al(2007) [11]finding that the majority owners may expropriate the firm's assets away from the minority shareholders and distort the financial statements to help cover up that fact.

Sensitive Test

A11 of our above tests are based on collective samples. But some samples have one observation, while others have five observations in our research period from 2001-2005. This may lead to bias in our regression results. So we choose the listed firms that have observations for every year as the sample. Finally, we have 950 samples and 4750 observations. Using the balance data, we employ the fixed effect regressions to examine our hypothesis again.

Table 3 Controlling shareholders and conservatism(balance data, without controlling variables)

	Coefficients	t-Statitics
Intercept	0.033***	2.813
DCFO	-0.050***	-5.107
CFO	-1.196***	-15.312
DCFO*CFO	0.431***	4.214
SHARE	-0.047*	-1.842
DCFO* SHARE	0.089***	4.317
CFO* SHARE	0.407**	2.544
DCFO*CFO* SHARE	-0.608***	-2.759
N	4750	4750
Sample period	2001-2005	
F value	646.890	
Adjusted R-square	0.503	

Note:T-statistics are computed by the robust regression method which corrects for heteroscedascity in the pooled data. ***, *, and * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively.

Table 4 Controlling shareholders and conservatism(balance data, with controlling variables)

	Coefficients	t-Statitics
Intercept	0.054***	3.990
DCFO	-0.045***	-4.024
CFO	-1.151***	-12.798
DCFO*CFO	0.417***	3.498
SHARE	-0.081***	-3.160
DCFO* SHARE	0.079***	3.916
CFO* SHARE	0.365**	2.325
DCFO*CFO* SHARE	-0.478**	-2.232
SIZE	0.021***	2.820
DCFO*SIZE	0.010	1.363
CFO*SIZE	0.083	1.437
DCFO*CFO*SIZE	-0.264***	-3.335
LEV	-0.021***	-2.973
DCFO*LEV	-0.011	-1.625
CFO*LEV	0.021	0.380
DCFO*CFO*LEV	0.203***	2.719
MB	-0.004	-0.637
DCFO*MB	0.003	0.367
CFO*MB	-0.125**	-2.317
DCFO*CFO*MB	-0.133*	-1.866
N	4750	4750
Sample period	2001-2005	
F value	232.610	
Adjusted R-square	0.553	

Note:T-statistics are computed by the robust regression method which corrects for heteroscedascity in the pooled data. ***, *, and * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively.

As reported table 3, the coefficient on DCFO*CFO* SHARE is negative(-0.608) and significant at the 1% level. Furthermore, as reported in table 4, controlled by firm size, leverage and growth opportunity, and the coefficient on DCFO*CFO* SHARE is negative(-0.478) and significant at the 5% level. These results indicate that firms with higher largest shareholder ownership report less conservative earnings.

Conclusion

In this paper, we investigate the association between controlling shareholders and accounting conservatism. we find that firms with higher largest shareholder ownership have lower accounting conservatism. We attribute this to an entrenchment effect, where the largest shareholder may influence firms to adopt aggressive accounting policies that reflect the wishes of the largest shareholder rather than reflect the economic substance of the business transactions. Controlling shareholders may expropriate benefits from them or exploit private benefits, therefore they have less incentive to disclose information.

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