Essays on Determinants of Corporate Earnings Management

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Corporate earnings management activities have recently drew considerable attention from various entities including regulators, practitioners and mass media. Researchers have intensively investigated determinants of earnings management. After reviewing large body of literature in Chapter 2, this dissertation points out that most of previous studies implement cross-sectional analyses regarding the relation between firm characteristics and earnings management, which are inevitably subject to endogeneity problems. Previous studies stress that corporate governance structures are a significant determinant of earnings management. To the best of my knowledge, however, there are not many papers regarding whether corporate governance structures affect earnings management as much as institutional factors like accounting standards. Recent studies also suggest that legal protection improves earnings quality. However, I argue that those studies have two important drawbacks: (a) analyses that use country-level legal protection indices, which are correlated to non-legal country characteristics (e.g. culture or religion), potentially find a seeming relation between legal protection and earnings management; (b) previous studies commonly use an aged legal protection index which has been recently subject to criticism on the coding problem.

This dissertation attempts to present empirical analyses of the issue that address the aforementioned concerns. Chapter 3 compares impacts of insiders’ incentives on earnings management to those of accounting standards by using Chinese data. Chinese firms experienced two important institutional changes during the past decade: the Split-share Structure Reform; the mandatory implementation of IFRS-convergent New Accounting Standards. These events that are likely to substantially change insiders’ incentives and accounting standards provide a good material to investigate: (a) whether corporate governance structures affect earnings management as much as accounting standards; (b) whether the change in corporate governance structures surrounding the important institutional change (Split-share Structure Reform) is related to the change in earnings management. The latter analysis is advantageous in mitigating endogeneity problems that annoy previous studies. We find that the introduction of New Accounting Standards significantly increased earnings management. Although we do not find evidence that the Split-share Structure Reform directly decreased earnings management of the average firm, the increase in earnings management surrounding the introduction of New Accounting Standards is negatively related to the reduction in non-tradable shares. These results suggest that accounting standards are the more important factor associated with the level of earnings management than corporate governance structures. Insiders’ incentives affect earnings management given a specific set of accounting standards.

Chapter 4 investigates whether legal protection affects earnings management in the single-country setting (China) which mitigates non-legal factors contaminating the results. An earlier work that adopts China implements cross-sectional regression analyses that are subject to endogeneity problems and biases
due to institutional changes. I implement firm fixed-effects model estimations of abnormal accruals that take a value for every single year to address these concerns. The analysis finds a negative and significant relationship between legal protection and earnings management before the Split-share Structure Reform. However, there is no evidence that regional legal protection affects earnings management during the Split-share Structure Reform and after the adoption of IFRS-convergent New Accounting Standards. These results suggest that legal protection effectively alleviates earnings management when there are no considerable changes in insiders’ incentives and opportunities of earnings management.

Nevertheless, single-country analyses have deficits in term of the generalizability of the results. In addition, Chinese legal protection index does not include a direct measure of investor protection, which has received particular attention from researchers. Chapter 5 re-examines effects of investor protection and individual corporate governance structures on earnings management by employing the latest investor protection indices. I find a positive and significant relationship between the latest legal investor protection indices and earnings management. Meanwhile, firms with concentrated ownership structures engage more in earnings management, especially in countries with weak legal investor protection. Firms with strict governance devices effectively decrease earnings management, especially in countries with strong investor protection. These results suggest that weak legal investor protection allows controlling shareholders to engage in earnings management to conceal expropriation problems, whereas strong investor protection provides legal infrastructure by which firm-level corporate governance devices work well.

The results in this dissertation imply that regulators should not ignore the potential unintended effects of new regulations especially in some countries with incompatible domestic environments. Meanwhile, due to the effect of institutional changes (the Split-share Structure Reform and the mandatory implementation of IFRS-convergent New Accounting Standards) on corporate earnings management, future analyses should control for these exogenous events when investigating determinants of earnings management in China. Finally, given the recent research movement and criticism on the coding problem of original legal index, it is particularly important to address the issue by using the renewed legal indices.