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Earnings Management and Ownership Concentration - Based on the Impact of Restricted Shares

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Abstract: Based on the data of A-share listed companies in China's securities market, this paper examines the relationship between earnings management and ownership concentration. It is found that the ownership concentration has a significant governance effect on earnings management when the restricted shares are excluded. The higher the ownership concentration is, the lower the level of earnings management is. In the case of restricted shares, the opposite is true. The higher the equity concentration is, the higher the level of earnings management is.

Keywords: earnings management; equity concentration; restricted shares

1. Introduction

The relationship between ownership concentration and earnings management has attracted the attention of many scholars at home and abroad. Many foreign scholars have found that the ownership concentration has a negative correlation with the level of earnings management. The higher the ownership concentration is, the lower the level of earnings management is. Berle and means (1932) believe that the highly decentralized ownership structure leads to the serious separation of ownership and management rights, which leads to the phenomenon that managers control the company. The internal management uses information asymmetry to pursue the maximization of the management's own interests, and adopts earnings management behavior that deviates from the shareholders' interests. Salamon and Smith (1979) conducted an empirical study on American companies, and found that companies with highly decentralized equity (i.e. managers controlled companies) are more likely to conduct earnings management than companies with highly concentrated equity (i.e. owners controlled companies), adjust the published financial report data, achieve the expected financial objectives, and mislead external investors Investment decision. Donnelly and Lynch (2002) divided the enterprises into manager equity led enterprises, equity decentralized enterprises and external large shareholder led enterprises according to the different equity concentration. The empirical results show that the lower the equity concentration, the more common the earnings management behavior. Hoffmann and itrriaga (2005) have found that the increase of equity concentration can reduce managers' management of earnings.

The research of domestic scholars has reached almost the opposite conclusion. Some scholars have found a positive correlation between ownership concentration and earnings management (Zhang Guohua, 2006; Jiang Ping and

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Ge Wenlei, 2007). Mao Hongtao and Wu Jiangjun (2007) believed that the high proportion of the first largest shareholder led to conflicts of interest with other investors. The more concentrated the equity of listed companies, the more easily the company's accrued profits were manipulated by large shareholders. Pei Yu (2012) thinks that the degree of earnings management of Listed Companies in China increases with the increase of equity concentration. Jian Yufeng and Liu Changsheng (2013) take the data of A-share listed companies in 2009-2011 as a sample, and find that the higher the degree of control of the controlling shareholders over the listed companies, the more serious their earnings management behavior, while the improvement of the concentration of non controlling shareholders' equity has a positive impact on earnings management behavior. Fu Yunying and Tian Qiong (2014) found that the relationship between ownership concentration and earnings management U-type is not significant. In the high equity concentration area on the right side of U-type, the positive correlation between ownership concentration and earnings management is significant.

It can be seen that, in terms of the relationship between equity concentration and earnings management, most of the foreign literatures think that equity concentration has binding force and governance effect on earnings management level. The higher the equity concentration is, the lower the level of earnings management is. On the contrary, the domestic literatures think that the higher the equity concentration is, the higher the level of earnings management is.

The contribution of this paper mainly lies in the following aspects: it finds out the reasons why the research on the relationship between equity concentration and earnings management at home and abroad gets the opposite result, because the research on equity concentration at home includes restricted shares, while the research on restricted shares at abroad has little impact. It is the first time to analyze the relationship between equity concentration and earnings management from the perspective of restricted shares.

2. Research background and hypothesis

The existing corporate governance studies believe that equity concentration is an effective external governance mechanism, which has an external governance effect on earnings managemen (Salamonand Smith, 1979; Donnelly and Lynch, 2002; Hoffmann and Iturriaga, 2005; Fernando *et al.*, 2008).

The existence of restricted shares is the interference of ownership concentration on earnings management governance effect. In the past studies, restricted shares and earnings management have always been closely linked. He Xin and Liu Qing (2012) believe that enterprises have significant positive earnings management before and during the period of lifting the ban on restricted shares, and the degree of earnings management is directly proportional to the scale of lifting the ban. Enterprises with earnings management are more likely to carry out earnings management in order to lift the ban. Wu Kejiao (2014) found that the company had significant positive earnings management behavior before the lifting of restricted shares.

As the existence of restricted shares interferes with the governance of equity concentration on earnings management, if the impact of restricted shares is not eliminated when calculating the equity concentration, the equity concentration and earnings management should be positively correlated, the higher the equity concentration is, the higher the level of earnings management; if the impact of restricted shares is eliminated when calculating the equity concentration, the equity concentration and earnings management should be negatively correlated. The higher the concentration, the lower the level of earnings management.

Based on the above discussion, we propose the following expectations and build models (1) and (2):

Hypothesis 1: excluding restricted shares, the ownership concentration has governance effect on earnings management. The higher the ownership concentration, the lower the level of earnings management.

If the hypothesis holds, $\alpha 1$ in model (1) should be significantly negative.

Hypothesis 2: the higher the concentration of equity, the higher the level of earnings management.

If the hypothesis holds, $\alpha 1$ in model (2) should be significantly positive.

3. Research design and variable description

In the existing literature, equity concentration as a governance mechanism is likely to have a governance effect on Earnings Management (Salamon and Smith, 1979; Hoffmann and itrriaga, 2005; Fernando *et al*., 2008), while the existence of restricted shares is a significant interference to corporate governance. Previous studies have shown that there is a significant correlation between the lifting of restricted shares and earnings management (He Xin and Liu Qing, 2012; Zhang Rongxing, 2012; Wu Kejiao, 2014). Therefore, when studying the governance effect of equity concentration on earnings management, this paper considers the impact of restricted shares, which is different from any previous research. The basic model is set as follows:

$$ABSDA = \alpha_0 + \alpha_1 CR10 + \alpha_2 Size + \alpha_3 Growth + \alpha_4 Lev + \alpha_5 Roe + \alpha_6 Auditing + \alpha_7 Ratecash + \varepsilon \text{(model 1)}$$

$$ABSDA = \alpha_0 + \alpha_1 \mathrm{X}CR10 + \alpha_2 Size + \alpha_3 Growth + \alpha_4 Lev + \alpha_5 Roe + \alpha_6 Auditing + \alpha_7 Ratecash + \varepsilon \text{(model 2)}$$

Variable	Variable definition
ABSDA	absolute value of controllable accruals
CR10	Equity concentration, measured by the proportion of the number of shares held by the top ten shareholders of unlimited scale to the share capital of unlimited scale (denominator excluding restricted shares)
XCR10	Equity concentration, measured by the shareholding ratio of the top 10 shareholders of the company including restricted shares
Size	Assets scale of the company
Growth	Growth rate of main business income
Lev	Asset liability ratio
Roe	Return on equity
Auditing	Virtual variable. The audit opinion is non-standard audit opinion. The value is 1, otherwise 0.
Cash	Net operating cash flow per share

Table 1. Definition of main variables

4. Empirical research results and analysis

4.1 Research samples

The sample interval selected in this paper is 2013-2014. The industry classification of this paper follows the industry classification guidelines of listed companies issued by CSRC. The data processing and follow-up empirical analysis are carried out by spss22 software.

4.2 Regression analysis

	Equity concentration excluding restricted shares（model1）		Equity concentration including restricted shares（model2）	
	B	**T**	**B**	**T**
CR10	-0.044***	-2.852		
XCR10			0.126***	2.618
Size	-0.007*	-1.882	-0.008*	-1.906
Growth	0.275***	15.396	0.290***	16.045
Lev	0.108***	5.933	0.110***	5.980
Roe	-0.072***	-3.964	-0.073***	-3.971
Auditing	0.020	1.491	0.022	1.493
Cash	0.031*	1.801	0.030*	1.803
Constant	0.174	1.085	0.175*	1.808
Annual effect	control	control	control	control
Industry effect	control	control	control	control
Adjusted R-squre	10%		10.02%	
F	45.057		45.166	

Table 2. Earnings management and equity concentration -- based on the impact of restricted shares

Regression results show that the coefficient of CR10 is significantly negative, hypothesis one holds; xcr10 is significantly positive, hypothesis two holds. The F value of the two models and the adjusted R-square are both high, and the model fitting effect is good.

5. Conclusion

Whether the relationship between ownership concentration and earnings management is positive or negative is contradictory. Foreign studies generally believe that the relationship between ownership concentration and earnings management is negative, and ownership concentration has governance effect on earnings management. Domestic research generally believes that the relationship between equity concentration and earnings management is positive correlation, and equity concentration has negative governance effect on earnings management. This paper finds out the reason for the contradiction between domestic and foreign research conclusions, that is, the interference of restricted shares on the governance effect of equity concentration. As long as the influence of restricted shares is eliminated, equity concentration has significant governance effect on earnings management.

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