**Controlling shareholder, institutional investors,earnings management**

Research Proposal

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***Abstract:***

In this paper, we use A shares of non-financial listed companies from 2012 to 2016 year, considering the listed companies "one single big" factors, to explore the impact of institutional investors on accrual and real earnings management. It can help the institutional investors to participate in the effective governance of Listed Companies in the equity concentrated market, improve the allocation rate of resources and increase the stability of the market, and improve the corporate governance structure.

**Key words:**Controlling shareholder institutional investors earnings management

***1 Introduction***

* 1. *Problem statement*

Earnings management is one of the behaviors used asymmetry information to whitewash performance by listed company.This kind of short-sighted behavior does harm to company’s long-term interests,misleading investors ecision-making,affecting the effective allocation of capital market. The earnings management consists of accrual earnings management and real earnings management. The domestic and foreign researches about real earnings management are less mature than accrual earnings management.

Institutional investors include: securities company, insurance company, QFII, the social security fund. With China in the stage of economic transition,institutional investors even become the major investors as its increasing stake.Compared with individual investors, institutional investors have advantages in terms of information collection and interpretation as well as the scale of investment, so that effective information can be obtained timely and at low cost.In the meanwhile, it has the potential to play a supervisory and governance role. At the same time, in our country, "a single dominant" phenomenon is more common, So when the major shareholders have absolute control over the enterprise, whether the impact of institutional investors on earnings management is limited?

The main issues we are going to discuss are as follows:

(1)To investigate the influence on the accrual and real earnings management activities of the institutional investors holding.

(2)To verify the influence of institutional investors on earnings management after considering the factors of absolute controlling by majority shareholder.

* 1. *Statement of the research objectives*

we can understand the direction and extent of institutional investors' influence on the two different ways of earnings. To investigate whether institutional investors play a role in restraining or promoting earnings management to some extent, and to further observe the adjustment factor of absolute control of large shareholders.

1. ***Literature Review***

Earnings management has two methods，one is by means of accounting (accounting estimates or changes in accounting policies) to manipulate earnings, such as reducing the provision for bad debts and change assets depreciation method, which is called accrued earnings management, generally only changes the distribution of each period of earnings, does not affect the enterprise total surplus and cash flow;the other is through the arrangement of real economic transactions to manipulate earnings, such as the sale of assets, reduce in-vestment, reduce R&D expenditure, accelerate the production and discount sales,which is called real earnings management, it not only changes the distribution of earnings,but also affect the overall level of earnings and cash flow.

*2.1 Institutional investors and accruals earnings management*

There are a large number of domestic and foreign literatures on the relatio-nship between institutional investors' shareholding and accruals earnings management behavior, and there are two main conclusions:

(1) The ownership of institutional investors can restrain accrual earnings management and play a supervisory role.

JC Coffee（1991）pointed that institutional investors are of a large scale with the ability to govern and supervise the company.

Rajgopal（1999）and etc found that the stock prices of companies with higher institutional shareholding levels often contain more information, and the extent of manipulated accruals decreases with the shareholding ratio of institutional investors.

1. The ownership of institutional investors does not inhibit the behavior of accrued earnings management, but has a positive correlation with the accrued earnings management, which can not play the role of supervision and governance.

Li Shuang-hai ,Li Hai-ying(2009) found that Institutional ownership reduces the quality of accounting earnings and does not play a role in protecting small and medium investors.

Yang Haiyan(2012) found that general corporate ownership in institutional investors reduces the reliability of financial reporting and increases the accrued earnings management of the company downwards.

The reasons for those conclusions above are inconsistent may be caused by selected sample data and research methods. It may also be due to the limited impact of institutional investors' earnings management, but ignore the existence of real activity earnings management.

*2.2 Institutional investors and real activity earnings management*

[Roychowdhury](http://xueshu.baidu.com/s?wd=author:(Sugata Roychowdhury) Sloan School of Management, Massachusetts Institute of Technology, Cambridge, MA 02142, USA&tn=SE_baiduxueshu_c1gjeupa&ie=utf-8&sc_f_para=sc_hilight=person" \t "http://xueshu.baidu.com/_blank)(2006)’s cross-sectional analysis reveals that these activities are less prevalent in the presence of sophisticated investors. Other factors that influence real activities manipulation include industry membership, the stock of inventories and receivables, and incentives to meet zero earnings. There is also some, though less robust, evidence of real activities manipulation to meet annual analyst forecasts.

Cohen found that after the enaction of the Sarbanes Oxley Act in 2002, the company accrued earnings management behavior significantly turn to the real earnings management activities. The main reason is that since the implementation of the act, the degree of investor protection has increased significantly, and the litigation risk of accrued earnings management has increased. Therefore, managers choose the way of real earnings management which is not easy to perceive.

2.3 Control of large shareholders and earnings management

Fan found that the agency problem between large shareholders and small shareholders makes information disclosure selective, which reduces the information quality of accounting reports and damages the interests of minority shareholders.

Li Wenzhou (2014) study shows that the nature of property rights has significant moderating effects on large shareholders' tunneling, executive compensation and earnings management relationship, compared with the state-owned listed companies, the tunneling behavior of non state-owned listed companies on executive compensation performance sensitivity, executive compensation and earnings management between the influence of sensitivity is more outstanding.

Through carding the literature above, we can find that:

➀There have been a large number of studies on the relationship between institutional investors and accrued earnings management, and the management of real activity earnings often has been ignored. In the Chinese market, there is a "substitution effect" between the real activity earnings management and the accrual earnings management. Therefore, a single way of manipulation is incomplete. We should discuss the impact of institutional investors on the basis of the relationship between the two.

➁The research of large shareholder control and earnings management has been relatively mature. However, few literatures have analyzed by combining the three:shareholders, institutional investors and earnings management.  
***3 Hypothesis***

Zang had found that the real earnings management activities often involve real economic transaction manipulation, which is time-consuming, had higher cost and more harm.Institutional investors in China is still in the preliminary stage of development, there exists some short-sighted behaviors.With the market gradually improves, the proportion of institutional investors is increasing, so as the cost of "vote by foot" . institutional investors gradually turn their attention to the long-term interests of enterprises, and to participate in the management and decision-making of the company.Institutional investors ,with relatively professional and scale,can recognize the manipulate of the investment company and treat the interests in a more long-term vision.So there is reason to believe that it has certain awareness on real earnings management activities.The hypothesis is put forward:

H1a: the higher the share of institutional investors, the lower the earnings management of real activities;

During the research on United States in 2002 issued on the Sarbanes-Oxley,Cohen found the company turn from the accrual earnings management to real earnings management activities.which suggests that there is obvious correlation between them.Chinese capital market is a typical emerging market economy in transition, market forces,such as legal environment , are relatively weak, enterprise use accrual earnings management to replace the real earnings management activities with the forced performance pressure and supervision of the institutional investors,. Therefore,we put this hypothesis:

H1b: the higher proportion of institutional investors holding, the higher the degree of accural earnings management.

Jiang shows that in the private property rights control of the company, the controlling shareholders often use their control right through abnormal trading, fund occupation and illegal guarantee way to transfer the resources of listed companies and invades the interestsof medium and small shareholders.When large shareholders are in absolute control position, they can control the favorable resources,giving impact on the board of directors, creditors, managers as participants of various governance mechanisms, grab the private benefits of control.If the shares are too concentrated, institutional investors as small investors are difficult to form an effective counterweight to major shareholders, acquired information quality decreased greatly and ability to find the real earnings management activities also decreased, therefore, the company with a larger proportion of large shareholdersis, institutional investors supervision on earnings management will weaken.We propose the following hypothesis:

H2a: large shareholders are in absolute control, which will weaken the supervision of institutional investors on earnings management of real activities.

If large shareholders are in absolute control position, profitability performed is higher than actual, and information asymmetry increased, information institutional investors accessed may be deceptive.China's Securities Regulatory Commission is also the main policy motive of the large shareholders' surplus report. The lower cost accrual management tendency will be more obvious in order to achieve the "allotment qualification line" and raise the issue price and attract institutional investment.We propose the following hypothesis:

H2b: If shareholders are in absolute control position, the influence of institutional investors on accrual earnings management is more significant.

1. ***Methods***

*4.1 Sample*

This paper selects non-financial listed companies of A shares for 2012-2015 years, and carries out the following treatment:

(1).exclude ST,PT companies

(2).excluede companies whose Asset liability ratio is greater than 1

(3).Since real earnings management requires three consecutive years of data, companies that have been listed for less than three years have been excluded.

*4.2 Variables Design*

*4.2.1 Variables*

Table 1 Variables Definition

|  |  |  |  |
| --- | --- | --- | --- |
| Explained variable | DA | Discretionary accruals | Modified Jones Model |
| Ab\_CFO | Abnormal operating cash flow | calculated by sales discretionary models |
| Ab\_PROD | Abnormal production cost | calculated by cost discretionary models |
| Ab\_DISEXP | Abnormal discretionary expense | calculated by discretionary expense models |
| REM | Real activity earnings management comprehensive index | Ab\_PROD+Ab\_CFO-Ab\_DISEXP |
| Explanatory variable | INS | Proportion of institutional investors | Number of shares held by institutional investors at the end of the year / number of tradable shares at the end of the year  (institutional investors include: investment fund, securities company, QFII, insurance company, social security fund, enterprise annuity, trust company, financial company and bank 9 subsidiary categories) |
| Control variable | SIZE | Company size | =ln（total assest） |
| LEV | Asset liability ratio | Total liabilities at the end of year/Total assets at the end of year |
| TOP | proportion of large shareholders | Proportion of the largest shareholder holding/number of tradable shares at the end of the year |
| ROA | The rate of return on total assets | profits/Total assets at the end of the period |
| PROPERTY | Property ownership | State-owned enterprise is one,and 0 otherwise |
| GROWTH | Growth rate | Growth of total assets/Total assets at the beginning of the period |
| BALANCE | Balance of ownership | Proportion of 2nd to fifth largest shareholder holdings/proportion of 1st largest shareholder holding |
| AGE | Listing time | The year of the company from IPO to the sample year |
| MB | Market value to book value of equity | Equity market value=Number of circulating shares\*price per share+Non tradable shares×net assest per share |
| TURNOVER | Asset trunover | Sales revenue/[（initial total assets+total assets at the end of the period）/2] |
| LOSS | Loss | It takes value 1 If net profit is negative，and 0 otherwise |
| OPION | Audit opion | Dummy variable that takes value 1 when audit opinion is standard without reservation,and 0 otherwise |
| INDUSTRY | Industry dummy variables | Dummy variable that takes value 1 when it belongs to some industry，and 0 otherwise |
| YEAR | Year dummy variables | Dummy variable that takes value 1 when it belongs to some year，and 0 otherwise |

*4.1.2 Measurement*

(1)measure of accrual earnings management

According to the modified Jones model, the total accounting accurals can be decomposed into discretionary and non-discretionary accruals.

(1)

TAi, t represents the overall accruals of the company, which is calculated by the difference between the net earnings of accounting and the cash flows from the operating activities. The estimation of the overall characteristic parameters is obtained by the regression of the basic Jones model:

 (2)

NDAi t is non discretionary accruals, Ai, t-1, the final total assets of last period,∆REVi, t is the difference of current period and last period revenues, ∆RECi, t is the difference of current period and last peirod ending balance of accounts receivable, FAi, t on behalf of the fixed assets of the company, IAi, t is the intangible assets of current period. β1i, β2i, andβ3i are the general characteristic parameters.

Using the models above, we obtain the discretionary accruals of the company.

(2)the measurement of real earnings management

Roychowdhury proposed to the aspects of sales, production, manipulation of discretionary expenditure of real earnings management model.

①Sales manipulation

This means that by increasing the discount and lending credit conditions to expand sales, thereby increasing profits, this manipulation leads to reduced operating cash flow per unit of sales.

 （3）



0 is Intercept,i is estimated coefficient,i=1,2,3 it is residual.

②production manipulation

It usually happens in manufacturing enterprises. Through the excessive production to reduce the fixed cost per unit allocation, so as to increase the unit product sales profit.

 (4)

③Dicretionary expense manipulation

The enterprise exaggerate profit by reducing the current R&D expenditure, advertising expenditure and maintenance expenses,which make the discretionary expense lower than the normal level.



 (5)

④Comprehensive index of real earnings management

With the reference of Cohen, the comprehensive index of real earnings management(REM) lead to the abnormal lower operating cash flow,higher production costs, lower abnormal discretionary costs low. The greater the REM, the greater the management level of earnings management upwards.　　 (6)

*4.3 OLS regression*

1. the model of influence of the earnings management of the institutional investors' corresponding projects

 (7)

1. the model of influence of institutional investors on real activity earnings management

 (8)

1. the model of influence of institutional investor holding on Earnings Management under the control of large shareholders

We use grouping method to test the large shareholders’s control on institutional investors governance role,all samples are divided into absolute control group of large shareholders control group and non shareholders by the absolute control stake of 50%, and correspondingly make earnings and real earnings regression.  
***5 Possible results***　 The share of institutional investors is negatively correlated with earnings management of real activities, that is to say, H1a is established. It shows that institutional investor holding can play a role of governance and supervision. Although institutional investors can significantly inhibit the real earnings management behavior, it will lead to the use of accruals manipulation to achieve earnings management objectives.

The proportion of institutional investors' shareholding is positively correlated with accruals' earnings management. That is, H1b is established.

Under the absolute control of large shareholders, the ability of institutional investors to obtain information is not enough to contend with the powerful power of large shareholders.Therefore, the governance role of real earnings will be severely weakened, but the corresponding earnings management can promote the role of earnings management.  
***6 Discussion***

Innovations:

(1)not only discuss the influence of institutional investors' counterplan earnings management, but also consider the impact on real activity earnings management.

(2)the substitution effect may exist between the accrued earnings management and the real activity earnings management. This paper comprehensively considers the net effect of institutional investors on the two.

(3)In China's listed companies, it is generally the mode of ownership concentration. Based on the control of large shareholders, this paper continues to discuss the impact of institutional investors' counterplans and real earnings management.

(4)enriches the related literature of the real activity earnings management and the combination of the three.

There are also some defects of this article:

1. The proportion of institutional investors is a static index, but the proportion of shareholding may change in the same year.Therefore,using single point to measure proportion of the shareholding can not reflect the the effect of institutional investors on earnings completely.But using dynamic index to measure is still difficult.
2. There may be an endogenous relationship between institutional investors' shareholding and earnings management.
3. This paper focuses on the ownership structure of the enterprise itself, without considering the external macro factors, for example, local laws and regulations, policy environment. if these factors are added in the follow-up study, there will be more helpful for us to understand the interaction of institutional investors and earnings management comprehensively and deeply. Thus institutional investors can play a better, positive role in the process of corporate governance.

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