

## Aims and Scope

The focus of the *China Journal of Accounting Research* is to publish theoretical and empirical research papers that use contemporary research methodologies to investigate issues about accounting, finance, auditing and corporate governance in China, the Greater China region and other emerging markets. The Journal also publishes insightful commentaries about China-related accounting research. The Journal encourages the application of economic and sociological theories to analyze and explain accounting issues under Chinese capital markets accurately and succinctly. The published research articles of the Journal will enable scholars to extract relevant issues about accounting, finance, auditing and corporate governance relate that to the capital markets and institutional environment of China.



## China Journal of Accounting Research

Website: <http://www.cnjar.com>  
<http://www.cb.cityu.edu.hk/research/cjar>

### Consulting Editors

**Bin Ke,**  
Nanyang Technological University  
**T.J. Wong,**  
The Chinese University of Hong Kong

### Editors-in-Chief

**Jeong-Bon Kim,**  
City University of Hong Kong  
**Minghai Wei,** Sun Yat-sen University

### Associate Editors

**Donghua Chen,** Nanjing University  
**Yuan Ding,**  
China Europe International Business School  
**Clive S. Lennox,**  
Nanyang Technological University  
**Oliver Zhen Li,**  
National University of Singapore  
**Feng Liu,** Xiamen University  
**Oliver Meng Rui,**  
China Europe International Business School  
**Xijia Su,**  
China Europe International Business School

### Editorial Board

**Sudipta Basu,** Temple University  
**Jeffrey Callen,** University of Toronto  
**Charles J.P. Chen,**  
China Europe International Business School  
**Shimin Chen,**  
China Europe International Business School  
**Shijun Cheng,** University of Maryland  
**Zhaoyang Gu,** University of Minnesota  
**Thomas Jeanjean,** Essec Business School  
**Guohua Jiang,** Peking University  
**Changjiang Lv,** Fudan University  
**Zengquan Li,**  
Shanghai University of Finance and Economics  
**Bin Lin,** Sun Yat-sen University  
**Gerald Lobo,** University of Houston  
**Suresh Radhakrishnan,**  
University of Texas at Dallas  
**Yifeng Shen,** Xiamen University  
**Dan A. Simunic,**  
The University of British Columbia  
**Hervé Stolowy,**  
HEC Paris  
**Yuetang Wang,** Nanjing University  
**Donghui Wu,**  
The Chinese University of Hong Kong  
**Liansheng Wu,** Peking University  
**Joanna Shuang Wu,**  
University of Rochester  
**Xi Wu,**  
Central University of Finance and Economics  
**Ze Zhong Xiao,** Cardiff University  
**Yu Xin,** Sun Yat-sen University  
**Tianyu Zhang,**  
The Chinese University of Hong Kong  
**Language Advisor**  
**John Nowland,** City University of Hong Kong

# China Journal of Accounting Research

### Guest Editors:

*Yuan Ding (CEIBS) and Hervé Stolowy (HEC Paris)*

### Preface

*Yuan Ding, Hervé Stolowy*

1

### Large shareholders and accounting research

*Ole-Kristian Hope*

3

### Audit pricing and nature of controlling shareholders: Evidence from France

*Chiraz Ben Ali, Cédric Lesage*

21

### The effect of fair disclosure regulation on timeliness and informativeness of earnings announcements

*Yeonhee Park, Inman Song, Dong-Hoon Yang, Mahmud Hossain, Jeong-Ho Koo*

35

### Chairman's government background, excess employment and government subsidies: Evidence from Chinese local state-owned enterprises

*Xiongyuan Wang, Shan Wang*

51



Production and hosting by Elsevier

Available online at [www.sciencedirect.com](http://www.sciencedirect.com)

SciVerse ScienceDirect

ISSN 1755-3091

Production and hosting by Elsevier  
Radarweg 29, 1043 NX Amsterdam, The Netherlands

ISSN 1755-3091

© China Journal of Accounting Research

Founded by Sun Yat-sen University and City University of Hong Kong

Sponsored by:  Hong Kong Institute of  
Certified Public Accountants  
香港會計師公會

Published quarterly in March, June, September, and December

All rights reserved. No part of this journal may be reproduced, stored in a retrieval system or transmitted in any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of Editorial Office of China Journal of Accounting Research.

#### Notice

No responsibility is assumed by China Journal of Accounting Research nor Elsevier for any injury and/or damage to persons, property as a matter of product liability, negligence, or otherwise, or from any use or operation of any methods, products, instructions, or ideas contained in the material herein. Although all advertising material is expected to conform to ethical standards, inclusion in this publication does not constitute a guarantee or endorsement of the quality or value of such product or of the claims made of it by its manufacturer.

## Guidelines for Manuscripts Submitted to The China Journal of Accounting Research

The **China Journal of Accounting Research** "CJAR" (ISSN 1755-3091) publishes quarterly. It contains peer-reviewed articles and commentaries on accounting, auditing and corporate governance issues that relate to the greater China region.

We welcome the submission of both theoretical and empirical research papers pertinent to researchers, regulators and practitioners. Authors should note:

1 Submissions must be original contributions and not under consideration by any other journal. The author must state the work is not submitted or published elsewhere.

2 Authors submitting articles, notes and comments will be entitled to two free copies. Each author of a book review will receive a copy of the relevant issue.

3 Authors should submit their manuscripts (in Word format) via email to china.jar@gmail.com. All text, including endnotes, must be double-spaced. Authors will be notified when manuscripts are received by CJAR.

4 Authors should note:

- a cover page showing the title of the paper, the author's name, title and affiliation, e-mail address, and any acknowledgment should be included.
- to promote anonymous review, author(s) should confine his/her identify (such as name, affiliation, biographical information, and acknowledgment) to the cover page only.
- supply an abstract of about 120 words, stating the study's findings, sample and methodology in that order.
- key terms used in the text should be defined or explained as early as possible after they are first introduced.
- words in a foreign language are to be in italics.
- all citations in the text should refer to the author's (or authors') name and the year of publication.

Examples: "the debt contracting explanation for conservatism (Watts and Zimmerman, 1986; Basu, 1997; Ahmed et al, 2002). Using the Basu (1997) asymmetric timeliness regression"

• include a list of reference for works cited as follows:

• reference to a journal publication:

Basu, S., Waymire, G.B., 2006. Record keeping and human evolution. *Accounting Horizons* 20 (3), 201–229.

• reference to a book:

Watts, R.L., Zimmerman, J.L., 1986. *Positive accounting theory*. Prentice Hall, Englewood Cliffs, NJ.

• reference to a chapter in an edited book:

Ball, R., 2001. Infrastructure requirements for an economically efficient system of public financial reporting and disclosure, 127–169. In: Litan, R., Herring, R. (Editors), *Brookings-Wharton Papers on Financial Services*. Brookings Institution Press, Washington, DC.

• omit all full stops in abbreviations. Example: 'eg', 'ie', 'Co', 'Ltd', 'etc'

• dates are in the order – date, month, year, eg '5 May 1975'

• quotation marks are single, but within a quotation are double.

• use endnotes rather than footnotes.

• put each table on a separate sheet; do not embed in the text but indicate where the table would best be inserted.

5 China Journal of Accounting Research copyright in works published by CJAR.

For additional information, please contact Irene Li, Department of Accountancy, City University of Hong Kong, Tat Chee Avenue, Kowloon Tong, Hong Kong. Telephone: +852 3442 7932. Fax: +852 3442 0349. E-mail: acwoo@cityu.edu.hk.

# CHINA JOURNAL OF ACCOUNTING RESEARCH

Volume 6/1 (2013)

Available online at [www.sciencedirect.com](http://www.sciencedirect.com)

**SciVerse ScienceDirect**



Production and hosting by Elsevier

**Consulting Editors:**

Bin Ke  
*Nanyang Technological University*

T.J. Wong  
*The Chinese University of Hong Kong*

**Editors-in-Chief**

Jeong-Bon Kim  
*City University of Hong Kong*

Minghai Wei  
*Sun Yat-sen University*

**Associate Editors**

Donghua Chen  
*Nanjing University*

Yuan Ding  
*China Europe International Business School*

Clive S. Lennox  
*Nanyang Technological University*

Oliver Zhen Li  
*National University of Singapore*

Feng Liu  
*Xiamen University*

Oliver Meng Rui  
*China Europe International Business School*

Xijia Su  
*China Europe International Business School*

**Editorial Board**

Sudipta Basu, *Temple University*  
Jeffrey Callen, *University of Toronto*  
Charles J.P. Chen, *China Europe International Business School*  
Shimin Chen, *China Europe International Business School*  
Shijun Cheng, *University of Maryland*  
Zhaoyang Gu, *University of Minnesota*  
Thomas Jeanjean, *Essec Business School*  
Guohua Jiang, *Peking University*  
Changjiang Lv, *Fudan University*  
Zengquan Li, *Shanghai University of Finance and Economics*  
Bin Lin, *Sun Yat-sen University*  
Gerald Lobo, *University of Houston*  
Suresh Radhakrishnan, *University of Texas at Dallas*  
Yifeng Shen, *Xiamen University*  
Dan A. Simunic, *The University of British Columbia*  
Hervé Stolowy, *HEC Paris*  
Yuetang Wang, *Nanjing University*  
Donghui Wu, *The Chinese University of Hong Kong*  
Liansheng Wu, *Peking University*  
Joanna Shuang Wu, *University of Rochester*  
Xi Wu, *Central University of Finance and Economics*  
Zezhong Xiao, *Cardiff University*  
Yu Xin, *Sun Yat-sen University*  
Tianyu Zhang, *The Chinese University of Hong Kong*

**Language Advisor**

John Nowland, *City University of Hong Kong*



Contents lists available at SciVerse ScienceDirect

## China Journal of Accounting Research

journal homepage: [www.elsevier.com/locate/cjar](http://www.elsevier.com/locate/cjar)

## Preface

Since the seminal JFE paper published by Jensen and Meckling in 1976 (Jensen and Meckling, 1976) the agency theory has been widely applied in numerous studies in the fields of corporate finance and accounting. Meanwhile, many researchers also notice that the conflicts between the principal (shareholder) and the agent (manager) may not be the predominant issue in most of the firms around the world, since the dispersed shareholding and separation between ownership and management are relatively uncommon phenomenon, limited to certain type of firms (listed firms) and to certain countries (like the USA).

In the continents like Asia or Europe, clearly identifiable large shareholders are very prevalent, even among listed companies. Some big corporate names are dominated by the state (like EDF, Finnair or PetroChina), or others are controlled by families (like Michelin, LVMH or Gome). Here, the interests of these large shareholders and their managers are often aligned but the conflicts between large shareholders and small ones are much present. This institutional setting extends our research frontiers and offers a very fertile ground for emerging research questions and conceiving new theories.

Therefore, we organized this themed symposium in Shanghai in March 2012 and succeeded to bring researchers from Asia, Europe and North America to explore different aspects of the large shareholder and its impacts on corporate governance and accounting. Carefully selected papers from the symposium are published in this special double issue after several rounds of revision following the symposium.

In the first part of the special issue, the leading paper is based on author's keynote address at the symposium. It focuses on the heterogeneity of large shareholders. The second paper brings in some perspectives from France. In particular, it examines the monitoring mechanism played by auditors in mitigating agency problems arising from different types of controlling shareholders. The third paper is focused on the Korean context where the predominance of large shareholders is prevalent among listed firms. It studies how the new Korean fair disclosure regulation affects the timeliness and informativeness of earnings announcements. The fourth paper looks into a major feature of Chinese capital market – the state-owned enterprises. It explores how the connections of the SOE chairmen impact on the firm's employment policies and the economic consequences of overstaffing. Enjoy your reading!

## Reference

Jensen, M.C., Meckling, W.H., 1976. Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (4), 305–360.

Yuan Ding  
*China Europe International Business School,*

Hervé Stolowy  
*HEC, Paris, France*







Contents lists available at SciVerse ScienceDirect

China Journal of Accounting Research

journal homepage: [www.elsevier.com/locate/cjar](http://www.elsevier.com/locate/cjar)



# Large shareholders and accounting research<sup>☆</sup>

Ole-Kristian Hope

University of Toronto, Rotman School of Management, Canada

## ARTICLE INFO

### Article history:

Received 5 April 2012

Accepted 11 July 2012

Available online 29 January 2013

### JEL classification:

G30

G32

G38

M20

M41

### Keywords:

Large shareholders

Agency costs

Controlling owners

Minority owners

Private firms

International

## ABSTRACT

Large shareholders are a potentially very important element of firms' corporate governance system. Whereas analytical research is typically vague on who these large shareholders are, in practice there are important variations in the types of large owners (and the different types of large owners could play very different governance roles). After briefly reviewing the standard agency cost arguments, in this article I emphasize the heterogeneity of concentrated ownership and in particular focus on the roles of families, institutions, governments, and employee ownership. I also discuss the role of large shareholders in private (i.e., unlisted) firms, where ownership tends to be more concentrated than in publicly traded firms. Finally, I briefly discuss variations in ownership structures across selected countries.

© 2013 China Journal of Accounting Research. Founded by Sun Yat-sen University and City University of Hong Kong. Production and hosting by Elsevier B.V. All rights reserved.

## 1. Introduction

This article is based on my keynote address at the 2012 *CJAR* Special Issue Symposium at CEIBS in Shanghai. The topic of the conference was “large shareholders” and I was honored to be given the opportunity to

E-mail addresses: [e.xia@elsevier.com](mailto:e.xia@elsevier.com), [okhope@rotman.utoronto.ca](mailto:okhope@rotman.utoronto.ca)



<sup>☆</sup> This article has been prepared for the *China Journal of Accounting Research* and forms the basis for my *CJAR* Special Issue Symposium presentation (March 30, 2012). I appreciate useful comments from Heather Li and acknowledge the financial support of the Deloitte Professorship.

make some comments on how large shareholders are important for (accounting) research. I should hasten to say that there are several well-cited survey studies on corporate governance in accounting, economics, finance, and management. Thus, in this paper I will not attempt a complete survey on the literature on large shareholders. Instead, I have decided to focus on one particular aspect – the *heterogeneity* of large shareholders.

We tell our PhD students that they should base their research on theory to the extent possible. At least in financial accounting the “theory” that is referred to is often analytical economics-based research. At the Rotman School we have the same emphasis on theory and I am personally a strong believer in anchoring your work in theory. However, most analytical models are vague (to put it mildly) when describing exactly who the large shareholders are and how they act. As this article will highlight, there is in fact rather considerable diversity in the *types of large shareholders* we observe, and it is very likely that these may have different effects on outcomes of interest to accounting researchers. Hence the reader can consider this article also as a call for “attention to the context” in which the study is conducted. For example, I would encourage “case-based” type studies that delve deeper into one particular form of large shareholder, such as state-owned enterprises in China.

I would like to offer three brief caveats. First, as already mentioned there are other, more comprehensive surveys on corporate governance issues and I would recommend that readers consult these if relevant. Second, although I consider several different types of large shareholders I could clearly have included additional types (e.g., the effect of foreign shareholders). Finally, there are important measurement issues in defining large shareholders (using cut-offs; multiple large owners; concentration ratios; ownership percentage versus voting rights; considering potential nonlinearities; organizational form; etc.).

Section 2 provides a brief review of the classic Jensen and Meckling (1976) arguments and discusses both vertical and horizontal agency costs. It also discusses the role of the second-largest shareholders and examines how large shareholders exercise their monitoring in practice. Section 3 focuses on who the large shareholders are. The chapter considers the roles of families, institutions, governments, and employee ownership. Large shareholders are particularly prominent in private (i.e., unlisted) firms, and Section 4 summarizes relevant research on these economically very important firms. Section 5 contains a discussion of variations across selected countries in the types of dominating ownership, and Section 6 concludes.

## 2. Overview of large shareholders and agency costs

### 2.1. Brief review of Jensen and Meckling (1976)

As this conference is motivated to a large extent by Jensen and Meckling (1976), it is worthwhile to first briefly revisit and review their seminal study.<sup>1</sup> Jensen and Meckling define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the value-reducing activities of the agent.<sup>2</sup>

If a wholly owned firm is managed by the owner, he will make decisions which maximize his utility. This situation is of course unusual other than for the smallest private firms and by definition not observed in publicly traded companies. In such cases, Jensen and Meckling argue that agency costs will be generated by the divergence between his interest and those of the outside shareholders, as he will then bear only a fraction of the costs of any non-pecuniary benefits he takes out in maximizing his own utility. Put differently, as the owner–manager’s fraction of the equity falls, his fractional claim on the outcomes falls and this will tend to encourage him to appropriate larger amounts of the corporate resources in the form of perquisites. This also makes it

<sup>1</sup> Jensen and Meckling’s article was in part motivated by the observation by Adam Smith (1776) that “The directors of such [joint-stock] companies, however, being the managers rather of other people’s money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.”

<sup>2</sup> In some situations it will pay the agent to expend resources to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions (referred to as “bonding”).



desirable for the minority shareholders to expend more resources in monitoring his behavior.<sup>3</sup> Important for us in accounting, this is clearly one of the reasons for the demand for accounting-related information. In fact, the genesis of accounting was in the “stewardship role” it can play in monitoring agents (see, e.g., Gjesdal, 1981 for a nice discussion). It is only more recently that the “valuation role” of accounting information has gained in prominence (and may well be the dominating role today). Related to the stewardship role (or governance) role of accounting, Jensen and Meckling argue that their theory can explain “why accounting reports would be provided voluntarily to creditors and stockholders, and why independent auditors would be engaged by management to testify to the accuracy and correctness of such reports.”

## 2.2. *More on the role of ownership concentration (or importance of large shareholders)*

There are two common approaches to corporate governance throughout most of the world (e.g., Shleifer and Vishny, 1997). First, investors’ rights are protected to varying degrees across the world through the legal process and legal environment. The second major approach, and the focus of this article, is ownership by large investors.

Research provides evidence that managers, when left unmonitored, are more likely to manage earnings, commit fraud, or make suboptimal investment decisions (e.g., Biddle and Hilary, 2006; Hope and Thomas, 2008). Thus, shareholder monitoring is an important mechanism by which agency costs can be reduced. However, while all shareholders have the responsibility to monitor managerial activities, the benefits of doing so by any individual shareholder are proportional to the percentage of shares owned (Jensen and Meckling, 1976; Shleifer and Vishny, 1997). Put another way, when ownership is widely dispersed, it is economically less feasible for any individual shareholder to incur significant monitoring costs, because she will receive only a small portion of benefits. Similarly, when ownership is dispersed, it is harder for shareholders to monitor managerial actions.

Thus, as the percentage of ownership by individual shareholders increases (i.e., concentration increases), the more willing individual shareholders are to incur necessary monitoring costs. That is, when ownership is limited to one or a few individuals, it is easier and more efficient for those individuals to directly monitor managerial actions. This is the typical “vertical agency cost” argument (i.e., conflicts between managers and owners) and leads to the general prediction that agency costs are expected to be lower as ownership concentration increases.<sup>4</sup>

Potential manager–owner conflicts are not the only relevant issues. Horizontal agency costs relate to how large shareholders can decrease a firm’s value through extracting private benefit from the minority shareholders (e.g., La Porta et al., 1999). Morck et al. (1988) argue that increased ownership concentration may entrench managers, as they are increasingly less subject to governance by boards of directors and to discipline by the market for corporate control. Controlling shareholders may either engage in outright expropriation from self-dealing transactions or exercise de facto expropriation through the pursuit of objectives that are not profit-maximizing in return for personal utilities. These controlling shareholders may attempt to hide these activities from other stakeholders (e.g., minority shareholders and creditors) by manipulating reported performance (an issue of obvious interest to accountants). In other words, a controlling owner can increase agency costs via the positive association with private benefits of control (e.g., Hope et al., 2012a).

To summarize the discussion, the presence of a controlling owner represents forces that work in opposite directions. For a researcher, this is both a challenge and an opportunity. It is an opportunity if the researcher is able to specify ex ante which set of agency costs is likely to be most significant. For example, in countries with less legal protection of the minority shareholders the main agency problem often exists between controlling shareholders and minority shareholders.

---

<sup>3</sup> Jensen and Meckling consider the term monitoring to include more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to “control” the behavior of the agent through budget restrictions, compensation policies, operating rules, etc.

<sup>4</sup> Furthermore, controlling shareholders could enable a long investment horizon which allows the building of strong relationships between the firms and outside providers of capital (Ellul et al., 2009). In fact, a controlling shareholder could increase business focus and make contracting negotiations easier.

### 2.3. *The role of the second-largest shareholder*

While the previous discussion explains the need for shareholders to monitor managers, the literature also establishes the need for shareholders to monitor one another. For example, controlling shareholders have the ability to exploit minority shareholders in closely-held corporations (e.g., Nagar et al., 2011). Such exploitation can include higher compensation to controlling shareholders, misappropriation of assets, and dilution of minority shareholders' interests through the issuance of stock or dividends (Gogineni et al., 2010). As the ownership stake of a second shareholder increases, so does her ability and willingness to effectively monitor the largest shareholder. The monitoring activities by the second largest shareholder would be similar to those used by the largest shareholder to monitor managers (Hope et al., 2012a).

Pagano and Roell (1998) specify conditions under which large shareholders monitor each other, reducing expropriation and improving firm performance. They predict that expropriation of minority shareholders is likely to be less severe when the ownership stake of non-controlling shareholders is more concentrated, as such concentration makes it easier and more effective to monitor the controlling shareholder. This is the typical "horizontal agency cost" argument (i.e., conflicts between majority and minority shareholders) and leads to the prediction that as ownership by the second largest shareholder increases, agency costs decrease.

### 2.4. *How do large shareholders exercise their monitoring?*

Often finance and accounting research is vague on the *mechanisms* through which monitoring happens. In practice monitoring by a large shareholder could take many forms. Perhaps the most commonly discussed means of monitoring discussed in the literature involves a large shareholder having a seat on the board. Several studies show in a variety of contexts the board's role in monitoring managers (e.g., Fama, 1980; Fama and Jensen, 1983; Adams et al., 2010). Other forms of direct monitoring would be a large shareholder actively participating in the firm's operations or having routine meetings with managers. As the proportion of ownership increases, the more beneficial it is for large shareholders to engage in these types of costly direct monitoring activities. Large shareholders can also serve to block business decisions that may be considered suboptimal (e.g., aggressive expansion through negative net present value projects). Doing so involves an investment in time and expertise by the shareholder to understand the consequences of major business decisions. Large shareholders are also likely to have more control over the firm's dividend (or capital distribution) policy, as a way to further discipline managers' actions.

## 3. *Who are the large shareholders? Does it matter?*

Analytical research on large shareholders tends to be rather generic and often does not consider that there may be very different types of large shareholders. There is surprisingly limited extant research on how different groups of large shareholders can affect corporate outcomes (e.g., financial reporting quality).<sup>5</sup> Here I briefly consider research on the following owner types: families (including the CEO as owner), institutional investors, governments, and employees.

### 3.1. *Family ownership*

A large fraction of businesses throughout the world are organized around families and there is a relatively large literature on family ownership (Bertrand and Schoar, 2006). Most of this research is on publicly listed companies. For example, family-controlled firms dominate in East Asia and Latin America. As an indication of the importance of family firms, La Porta et al. (1999) report that 65% of the 20 largest firms in Argentina have at least a 20% family stake; in Hong Kong this fraction is 70%. In contrast, in Japan the corresponding number is 5%.

<sup>5</sup> An exception is Cronqvist and Fahlenbrach (2009). They examine effects of different types of institutional investors in the US and find that investor type has significant effects on several corporate policies. The only study I'm aware of in accounting is Dou et al. (2012) who follow an approach similar to Cronqvist and Fahlenbrach (2009) and examine the effects of large shareholders on accounting practices for a large sample of US firms over the 2001–2009 period.

If a researcher is really interested in examining the effects of family ownership, it would seem that private (i.e., unlisted) firms offer even more fertile ground for research. Section 4 discusses private firms in more detail.

A stream of research has examined “family firms” included in the S&P 500. This line of research is primarily motivated by the fact that, notwithstanding the oft-cited idea that US publicly firms have widely dispersed ownership, Shleifer and Vishny (1986) (and others) document that large shareholders are common and, in particular, note that founding families continue to hold equity stakes and board seats in nearly 33% of the Fortune 500 firms. In other words, US firms may not be as different from those observed elsewhere in the world as thought by many. These founding families represent a unique class of long-term shareholders that hold poorly diversified portfolios and often control senior management positions. Family owners can thus exert influence and control over the firm, potentially leading to performance differences with nonfamily firms.

In a widely cited study, Anderson and Reeb (2003) investigate the relation between founding-family ownership and firm performance. They find that, contrary to their conjecture, family firms perform better than nonfamily firms. Additional analyses reveal that the relation between family holdings and firm performance is nonlinear and that when family members serve as CEO, performance is better than with outside CEOs. Overall, their results are inconsistent with the hypothesis that minority shareholders are adversely affected by family ownership, suggesting that family ownership may be an effective organizational structure.

Ali et al. (2007) recognize that, compared with nonfamily firms, family firms face less severe agency problems due to the separation of ownership and management. However, they face more severe agency problems that arise between controlling and non-controlling shareholders. These conflicting effects are often referred to as “entrenchment versus alignment.” Thus it is not clear what to predict regarding family firms’ disclosure practices relative to other firms. Using a sample of only S&P 500 firms, Ali et al. (2007) conclude that family firms report better quality earnings, are more likely to warn for a given magnitude of bad news, but make fewer disclosures about their corporate governance practices. Consistent with family firms making better financial disclosures, the authors find that family firms have larger analyst following, more informative analysts’ forecasts, and smaller bid–ask spreads.<sup>6</sup>

It is far from clear that the above findings should be generalized to other settings, even in the United States. First, although the firms classified as “family firms” by definition meet the definition of a family firm for these studies, others may employ a higher threshold for family ownership. Given the nonlinearities documented in the US setting, it is thus highly unclear what to expect in very different environments and with much higher family ownership (e.g., in private firms). Even more importantly, conflicting evidence exists on whether having family ownership increases or decreases a firm’s value, and it seems to be country dependent. Bertrand and Schoar (2006) conclude that there is no strong empirical evidence for the economic superiority of family-controlled businesses. According to Bertrand and Schoar (2006), family firms appear to underperform relative to nonfamily firms in most countries: for example, Claessens et al. (2002) for several Southeast Asian countries; Morck et al. (2000) for Canada; and Cronqvist and Nilsson (2003) for Sweden. Also, Bloom and Van Reenen (2007) find that family firms in France, Germany, the United Kingdom and the United States are systematically associated with worse managerial practices. Bertrand and Schoar (2006) note two important exceptions. Khanna and Palepu (2000) find that business groups in India, which are for the most part family-controlled, perform better than stand-alone firms in matched industries (see more on this below); and Sraer and Thesmar (2007) who find a premium for family firms in France.

### 3.1.1. *The role of the CEO in family firms*

There is comparatively limited research on the role of the CEO as part of the dominant family. A dominant belief in the literature is that as CEO ownership increases, her incentives align more with those of other shareholders, reducing the agency problem that arises from separation of ownership and control (e.g., Jensen and Meckling, 1976). This is known as the alignment effect which suggests reduced agency costs.

<sup>6</sup> In a closely related study, Chen et al. (2008) find that, compared with nonfamily firms, family firms provide fewer earnings forecasts and conference calls, but more earnings warnings. The authors interpret the former to be consistent with family owners having a longer investment horizon, better monitoring of management, and lower information asymmetry between owners and managers, they interpret the higher likelihood of earnings warnings to be consistent with family owners having greater litigation and reputation cost concerns. In another related paper, Wang (2006) finds that founding family ownership is associated with higher earnings quality in S&P 500 firms (but also shows that the relation is non-linear).

Major shareholders are often family members of the CEO for private firms (Hope et al., 2012a). There are interesting competing hypotheses when the CEO is related to the major shareholder. Because of the family relationship, these shareholders no longer act as independent monitors in disciplining CEOs' decisions. In addition, family-controlled firms are likely to suffer from greater horizontal agency costs. It may be easier for major shareholders, who are family members of the CEO, to extract private benefits from minority shareholders or other stakeholders. The reason it may be easier to extract these benefits is that major family owners typically have strong influence over choosing members of the board. Consequently, the monitoring effectiveness of the board may be impaired when its composition is determined primarily by the CEO's family. These arguments would support the idea that agency costs will increase when there is a family relation between the CEO and major shareholder (Hope et al., 2012a).

An alternative view is that family member CEOs are less likely to act in ways that opportunistically harm other family members. That is, installing a family member as the CEO could be a mechanism through which family-owned companies can increase their monitoring of management and reduce the need for external monitoring. If this effect dominates, the agency costs are smaller when the CEO is a family member because familial ties are likely to create closer alignment of the CEO's preferences with those of family owners.

In conclusion, vertical and horizontal agency costs supply opposite predictions for effects of family firms. In addition, there are strong differences in the degree to which families control business, to what extent the CEO comes from the dominant family, and in other institutional arrangements. In short, there is ample "tension" in terms of predictions and plenty of room for future research!

### 3.1.2. Hope et al. (2012a) on agency conflicts in (private) family firms

Hope et al. (2012a) are interested in understanding how agency conflicts in private firms arise through ownership structures and family relationships. They analyze auditors' increase of effort and firms' choice of auditors in situations with higher level of agency conflicts. For a large sample of private Norwegian firms, they use data obtained through special permission by the government to measure direct and ultimate ownership for each shareholder as well as extended family relationships. Family relationships are measured based on marriage and blood lines, going back four generations and extending out to fourth cousin, and cover all shareholders, board members, and CEOs.

The authors find that (excess) audit fees, their proxy for audit effort in the face of agency conflicts, vary as hypothesized with firm-level characteristics related to ownership structures and family relationships. Specifically, they show that fees relate negatively to ownership concentration and to the extent of ownership by the second-largest shareholder. Audit fees also relate negatively to the portion of shares held by the CEO, consistent with ownership aligning the incentives of the CEO and other stakeholders. Audit fees are further positively associated with family relationships between the CEO and the major shareholder (a signal of reduced monitoring and a situation in which expropriation by the family/major shareholder is easier).

With respect to board independence, they find that audit fees decline as the number of board members related to the largest shareholder increases, consistent with fewer agency conflicts between owners and the board. In contrast, as the number of board members related to the CEO increases, fees increase, suggesting less board independence and greater agency conflicts.

Hope et al. (2012a) report two interesting sets of results for the demand for Big 4 auditor. First, for agency settings that are *not* CEO family-related, they observe results consistent with those obtained for the auditor effort tests. Specifically, the propensity to hire a Big 4 auditor increases as ownership concentration decreases, ownership of the second largest owner decreases, and the major shareholder's family influence on the board decreases. These results are consistent with the demand for a Big 4 auditor being greater in higher agency cost settings. They do not find significant evidence of a relation between hiring a Big 4 auditor and the fraction of shares owned by the CEO for the main tests but they do in sensitivity tests.

The authors find no association between the choice to hire a Big 4 auditor and CEO family-related agency variables. Specifically, there is no significant evidence that the demand for a Big 4 auditor is affected when a family relationship exists between the CEO and the major shareholder or as the number of board members related to the CEO increases. While some CEOs in family-related agency settings may wish to signal more credible reporting by hiring a Big 4 auditor, other CEOs in these settings may feel a Big 4 auditor is either

unnecessary given close family ties or unwanted because of the gains from extracting private benefits which could be reduced by a Big 4 audit.

### 3.2. *Institutional ownership*

Institutional investors such as pension funds and mutual funds are often “large” shareholders. In addition, they are typically viewed as “sophisticated investors” in the literature. The extant theoretical literature generally predicts large institutional investors as an efficient form of corporate governance. However, large institutional holders are not using their own money to make investments. Thus, with regulatory constraints or lack of incentives, Coffee (1991) argues that institutional shareholders tend to be passive.

Prior research has documented that sophisticated investors behave differently from other, less informed investors (e.g., Callen et al., 2005). Sophisticated investors have superior abilities and consequently can learn better from experience (Bonner and Walker, 1994). Economic incentives are potentially important as well. Institutional investors have large investment portfolios and, therefore, have much more to gain or lose in absolute dollar terms from their investment decisions. Furthermore, the costs of engaging in in-depth firm analysis are lower for institutions, in part because of their superior access to databases and analytical tools.

Research documents the existence of distinct groups among institutions that differ in their objectives and information needs. Bushee (1998) classifies institutions into three groups – transient, dedicated, and quasi-indexers. “Transient” institutions have high portfolio turnover and highly diversified portfolio holdings. They focus on the short term and make investments based on the likelihood of short-term trading profits. According to Bushee (2001), the short investment horizons of transient investors create little incentive for them to gather information relevant to long-run value.

In contrast, “dedicated” investors and “quasi-indexers” focus on the long term and provide stable ownership to firms. Dedicated investors hold large stakes in a limited number of firms. Such ownership creates greater incentives to invest in monitoring management and to rely on information beyond current earnings to assess managers’ performance. Quasi-indexers generally follow indexing and buy-and-hold strategies, and are characterized by high diversification. Although quasi-indexers follow a passive investment strategy, these investors may also have strong incentives to monitor management to ensure that it is acting in the best interest of the firm.

Many studies report results that are consistent with a superior ability of sophisticated investors to gather, analyze, and price information. Price (1998) finds that informed investors appear to make greater use of accounting disclosures and non-earnings information to form more precise earnings expectations. Bonner et al. (2003) document that sophisticated investors incorporate the information inherent in the relative accuracy of analyst forecasts to a greater extent than less informed investors. In addition, Bhattacharya et al. (2007) provide evidence that sophisticated investors demonstrate less behavioral bias in the way they process pro forma earnings information relative to more sophisticated investors. Finally, the efficiency of a firm’s stock price is associated with the degree of sophistication of the firm’s marginal investor (e.g., Bartov et al., 2000).

As an example of my own work that includes institutional investors, Chen et al. (2012) shows that the difference between closed-end country funds’ net asset values and their trading prices (i.e., the fund discount) is positively associated with the earnings opacity of the underlying companies. In conditional analyses they further find that the positive relation between earnings opacity and fund discounts is weaker for those funds with a higher level of institutional ownership. In other words, investors who are better equipped at information acquisition than other investors are able to overcome some of the information disadvantage of being “non-local.” In an earlier study, Callen et al. (2005) find that the variance contribution of foreign earnings increases with the level of investment by long-term (but not short-term) institutional investors.

To sum, there is strong evidence that institutional investors are an important class of large shareholders, in part because of their greater expertise in analyzing accounting information. There is also extensive evidence that there is important variation among the different classes of institutional investors. Thus, yet again we conclude that there is significant diversity among even subgroups of large shareholders.

### 3.3. State ownership<sup>7</sup>

#### 3.3.1. History/background

State ownership of enterprises is far from new and is not solely confined to Continental Europe or Asia. In practice most states have relied on the state to kick start growth or at least to protect fragile industries. More recently, Singapore is often viewed as starting the new kind of state capitalism. Lee Kuan Yew, its founding father, was a tireless advocate of “Asian values,” by which he meant a mixture of family values and state control. However, state ownership is far from confined to quasi-authoritative states. In particular, many governments have found it desirable to have a tight control over their natural resources such as oil and gas. In China Deng Xiaoping transformed the economy by embracing globalization through creating special economic zones and inviting foreign companies in. He forced state enterprises to model themselves on Western companies and concentrated resources on national champions.<sup>8</sup>

#### 3.3.2. Scale and importance of state ownership

State ownership is prevalent around the world. The rich world still has a large number of state-owned or state-dominated companies. For example, France owns 85% of EDF, Japan owns 50% of Japan Tobacco, and Germany owns 32% of Deutsche Telekom. In total OECD state-owned enterprises have a combined value of almost \$2 trillion and employ 6 m people. However, state-owned enterprises are even more important in the emerging world. They make up most of the market capitalization of China’s and Russia’s stock markets and account for 28 of the emerging world’s 100 biggest companies. Finally, in terms of industry focus, state ownership is especially noticeable in the energy sector, with the 13 biggest oil firms in the world all being state-backed (as is the world’s biggest natural-gas company, Russia’s Gazprom).<sup>9</sup> These are also the companies in which governments tend to have the highest ownership stakes and the most direct control.

#### 3.3.3. Types of state ownership and quality of management

Property rights theory argues that ownership and control rights should be given to the parties that make ex-ante specific investments (e.g., Hart and Moore, 1996). According to the property rights theory SOE managers lack incentives to maximize corporate profitability, as the majority of the firm is owned by the state. Building on property rights theory, Hart et al. (1997) argue that privatized firms have a better incentive to minimize costs, but the systematic pursuit of profits may lead to poorer service quality. For example, following the privatization of railways in the UK and the Netherlands the quality of service visibly deteriorated. Schmidt (1996) argues that a trade-off exists for state-ownership. The benefit is that under state ownership the government has better information about the firm’s management. The cost is that the government tends to interfere too much for political reasons.

In practice not all SOEs are created equal and there is evidence that governments are becoming more sophisticated owners. Only a handful of SOEs are still reporting directly to government ministries.<sup>10</sup> In contrast most governments prefer to exercise control through their ownership of shares. Sometimes they hold all the shares, but increasingly they prefer to dilute their shareholdings.<sup>11</sup> There is also evidence that SOEs have become more productive as a result of restructuring. For example, in China their return on assets increased from 0.7% in 1998 to 6.3% in 2006 (although accounting figures obviously can be manipulated – which should provide a promising area for future research). I discuss more China-related issues in Section 5.2.

<sup>7</sup> The primary source for this subsection is The Economist Special Report “The Visible Hand” January 31, 2012.

<sup>8</sup> Similarly, the post-Soviet disaster created a craving for order and the Russian government reasserted direct state control over “strategic” industries.

<sup>9</sup> However, state firms can be found in almost any industry. China Mobile has 600 million customers. Saudi Basic Industries Corporation is a huge chemical company. Russia’s Sberbank is Europe’s third-largest bank. Dubai Ports is the world’s third-largest ports operator. In addition to having ownership stakes in companies, governments are also important large owners through sovereign wealth funds.

<sup>10</sup> Statoil of Norway is the world’s 13th-biggest oil company by revenue. Norway also has the third-biggest sovereign-wealth fund, the Government Pension Fund. Both are required to behave like regular companies.

<sup>11</sup> The United Nations Conference on Trade and Development defines a state-owned company as one in which the state owns more than 10% of the shares.

### 3.4. Employee ownership

Compared with the other groups discussed in this section, employees are typically less significant as owners. However, there is also significantly less research on employee ownership and there are interesting cross-country variations in how firms are structured and hence in the importance of employees in the governance of the firms, both of which create opportunities for future studies. Although clearly a generalization, it is probably fair to state that employees, including labor unions, have a relatively stronger say in Continental Europe than elsewhere.

The pros and cons of employee ownership have inspired much debate in recent years (Bova et al., 2012). On the one hand, advocates of employee ownership cite evidence which suggests that employee ownership leads to increasing employee–manager goal alignment and productivity gains that are ultimately reflected in higher shareholder returns (Kruse, Blasi, and Park, 2009). On the other hand, contrasting empirical evidence suggests that giving non-manager employees too much ownership in the company can erode shareholder value (La Porta et al., 1997).<sup>12</sup>

What is perhaps especially interesting about employees as an owner group is that there are three very different groups: managers, non-manager employees, and unions. There has been a fair amount of research on managerial ownership but much less on other employees and unions. Focusing on top managers' stock-based incentives, Nagar et al. (2003) find that stock-based incentives (and thus ownership) can reduce agency problems between managers and shareholders, and thus increase the incentives for managers to disclose information.

In contrast, Bova et al. (2012) investigate the role of non-manager employee ownership on voluntary disclosure. Specifically, they focus on the firm's employees as a group of stakeholders that have the potential to extract above-market rents from the firm and on employee ownership as a tool to mitigate this potential to extract rents. This provides for an interesting contrast between these two roles ("alignment" versus "rent extraction"). The literature provides evidence that managers have an incentive to keep information asymmetric with the market if employees can extract above-market rents from the firm – for example, in cases where the employee base is highly unionized. The benefit to the strategy of disclosing less is that reduced transparency should weaken the employees' bargaining position. However, an opaque disclosure policy keeps information asymmetric with not only employees, but also investors and other stakeholders. Employee ownership can thus potentially play an important role in mitigating this tension. Cramton et al. (2008) provides analytical and empirical evidence that employee stock ownership leads to a greater propensity for employees to internalize the costs of labor disputes, which in turn reduces employees' incentive to extract rents through costly strikes, which are deadweight losses. The decrease in the incentive arises as employee compensation becomes more closely linked to the stock returns of the firm, leading to any costly negotiation frictions (e.g., extended negotiations or strikes) impacting employee compensation to a greater extent.

Bova et al. (2012) employ a number of proxies for voluntary disclosure and find that firms whose non-manager employees have strong bargaining power provide less voluntary disclosure whereas firms whose employees have larger equity stakes in the firm provide greater voluntary disclosure. Furthermore, the effect of employee ownership in generating better disclosure is particularly strong, the greater employees' negotiation leverage. In other words, employee ownership appears to benefit the firm by not only aligning goals between the firm and its employees, but by also increasing disclosure from the firm to *all* of its stakeholders by mitigating the firm's need to keep information opaque.

In conclusion, there is limited research on employee ownership and great potential for future research to take advantage of cross-country variation in such ownership.

---

<sup>12</sup> For example, in 1995, United Airlines awarded employees 55% of the firm's equity in exchange for concessions on salaries and benefits. While the plan at the time was applauded by the US Federal government as an innovative way to heal the fractious nature of the union–management relationship, others remained skeptical of allowing a stakeholder that already contracted with the firm enough power to essentially control the firm's decision making (Bova et al., 2012).

#### 4. Private (i.e., unlisted) firms

##### 4.1. Importance of private firms

Private firms provide an important vehicle for economic growth around the world. More than 99% of limited liability companies, in most countries, are not listed on a stock exchange (e.g., Pacter, 2004; Chen et al., 2011). In the aggregate, non-listed firms have about four times more employees, three times higher revenues, and twice the amount of assets than do listed firms (Berzins et al., 2008). In 2008, *Forbes* reported that the 441 largest private companies in the United States accounted for \$1.8 trillion in revenues and employed 6.2 million people. Furthermore, according to the US Census Bureau, there are 29 million privately held companies in the United States, 7.6 million of which have paid employees, representing one-half of the nation's GDP (Hope et al., 2012b). Despite their obvious importance to the economy, there is limited extant research on private firms in general and in particular very little research related to accounting and auditing of such firms.

##### 4.2. How are private firms different?

Private firms are different from publicly traded firms in several respects. Private firms are more closely held, have different governance, and have greater managerial ownership. Moreover, their major capital providers often have insider access to corporate information and typically take a more active role in management. With greater ownership concentration than in public corporations, large shareholders have a greater potential to take advantage of their controlling positions and direct private benefits for personal consumption, which is the typical problem of expropriation of minority shareholders and creditors (e.g., Morck et al., 1988).

##### 4.3. The role of accounting and auditing in private firms

Some researchers take a strong position on whether accounting and auditing plays a lesser or stronger role in private compared with public firms. Personally I have no strong priors and I frankly believe there is not much evidence comparing the relative usefulness of accounting in these two sets of firms. In addition, I am not certain that it is fruitful to pursue such a line of inquiry *per se*.

The arguments in favor of reduced importance of accounting in private firms include the following. Most importantly, researchers often argue that there is lower demand for public accounting information in private firms as stakeholders may have access to private information. Furthermore, given the stronger ownership concentration, shareholder turnover is lower, and shareholders take a more active role in management, which some claim would reduce their reliance on financial statements for monitoring managers compared with public firms.

However, there are competing arguments also. Private firms typically have a weaker overall information environment compared with the relatively stronger disclosure environment of public firms. This suggests that, even if say the financial reporting quality (FRQ) is lower for private firms, accounting information could still play an important role since there are fewer competing sources of information.<sup>13</sup> For example, McNichols and Stubben (2008) emphasize the role that accounting information plays in internal decision making. Small firms are unlikely to have management accounting systems that are separate from financial accounting, potentially enhancing the role of accounting in internal decision making (Chen et al., 2011). Finally, it is possible that the lack of analyst coverage and lower media coverage makes accounting information a relatively greater component of the overall information set used for decision making by insiders or outsiders (Chen et al., 2011).

With respect to the role of auditing, it is not obvious whether external auditors play a lesser or a stronger role in private firms than in public firms (Hope and Langli, 2010; Hope et al., 2011, 2012). On the one hand, Coffee (2005) discusses how the existence of controlling (i.e., especially large) shareholders can affect auditor independence. That is, Coffee (2005) argues that it is difficult for the auditor to escape the control of the party that she is expected to monitor. On the other hand, it is possible that the monitoring value of auditing is higher

<sup>13</sup> For example, Indjejikian and Matejka (2009) highlight the importance of accounting information for private firms in compensation contracts.



in private firms because they are less vulnerable to takeovers and because they are required to disclose less accounting and non-accounting information than public firms (e.g., Lennox, 2005).

#### 4.4. *Some findings from the private firm setting*<sup>14</sup>

Not surprisingly, accounting research has focused primarily on properties of earnings and in particular on comparing financial reporting quality between private and public firms. There is clearly some tension in this question – whereas the “demand” perspective predicts higher FRQ for public firms, the “opportunism” perspective lead to the opposite prediction. While some research that has focused on specialized samples and industries have found higher FRQ in private firms, the large-sample investigations to date suggest that the demand hypothesis dominates and that FRQ is higher on average in public firms (e.g., Burgstahler et al., 2006 for European firms; Ball and Shivakumar, 2005 for UK firms; Hope et al., 2012b for US firms).

##### 4.4.1. *Hope et al. (2012b)*

There is very limited research to date on within-private firm variation in accounting. Hope et al. (2012b) provide the first exploration of cross-sectional variations in the FRQ of US private firms. They show that private firms with greater external financing needs and a greater presence of long-term debt have higher FRQ and greater conservatism.

More directly related to the topic of large shareholders, Hope et al. (2012) also investigate the expected impact of organizational form on FRQ from two perspectives – owner–manager separation and ownership dispersion. Because managers understand that their actions are not perfectly observable by the owner, managers have the ability to hide unfavorable performance by manipulating reported performance. Thus, firms which are more likely to suffer from agency costs (i.e., owner–manager separation) would be expected to have lower FRQ.

Owners are expected to take action by monitoring the activities of the manager. However, monitoring is costly, and owners are willing to incur monitoring costs only to the extent that the benefits outweigh the costs. These arguments suggest that when ownership dispersion is high, managers’ activities are less likely to be closely monitored and therefore manipulation of reported performance is more likely to occur. Based on these arguments, firms with owner–manager separation and higher ownership dispersion should have lower FRQ.

However, Hope et al. (2012) also discuss competing arguments which suggest that separated ownership may positively affect private firms’ FRQ. A controlling shareholder may have the ability to extract resources from the firm for personal consumption. These controlling shareholders may attempt to hide these activities from other stakeholders by manipulating reported performance. Such activities would lead to a positive relation between owner–manager separation and FRQ. In addition, the demand perspective would also predict a positive relation. In particular, when agency costs are higher, those contracting with the firm may demand more reliable financial information.

Hope et al.’s empirical findings indicate that private firms with more dispersed ownership (i.e., C corporations) have lower FRQ than other organizational structures as measured by three widely used FRQ proxies. These results are in line with the agency cost arguments (but not the demand arguments) described above.<sup>15</sup>

##### 4.4.2. *Hope et al. (2011)*

Hope et al. (2011) use a sample of private firms from 68 countries (mostly from emerging markets) obtained from the World Bank. They first show that firms with greater financial reporting credibility, operationalized as financial statements reviewed by an external auditor, experience significantly lower perceived problems in gaining access to external finance. More relevant to our topic, they additionally examine how this relation varies with ownership concentration and with cross-country institutional factors.

<sup>14</sup> Recall that the findings of Hope et al. (2011) are summarized in Section 3.1.

<sup>15</sup> They further find that C corporations exhibit higher conditional conservatism, which might be explained by the higher information asymmetry associated with C corporations creating the demand by investors, creditors, and others for more timely loss recognition. An alternative explanation for this finding relates to tax effects.

In their sample of private firms, the largest shareholder owns on average 74% of the shares and 69% of the firms have a controlling owner. Thus, their cross-country sample provides a rich setting for testing the effect of large shareholders.

Hope et al. (2011) are primarily interested in the effect of financial reporting credibility on financing constraints in the presence of a controlling owner. When there is a controlling shareholder, financial reporting credibility can play a greater role in reducing *costs* associated with agency and information problems. In other words, financial credibility matters more when there is a stronger need for it (i.e., high agency cost setting such as a controlling shareholder). In addition, there is no reason to expect increased financial credibility to reduce the *benefits* associated with a controlling owner. In fact, financial credibility may further improve monitoring and incentive alignment when a controlling owner exists. Therefore, regardless of whether the agency costs of a controlling owner outweigh the benefits, the authors unambiguously predict that financial credibility will have a greater effect on reducing financing constraints when a controlling owner exists. Their empirical results support this hypothesis – the effect of financial credibility on reducing perceived financing constraints is increasingly important in the presence of a controlling shareholder.

The study further examines the effect of cross-country variations in institutional factors. Recent cross-country literature places considerable emphasis on the adverse effects of private benefits of control (e.g., Dyck and Zingales, 2004). Countries which have better institutional properties (e.g., investor protection, legal enforcement, creditor rights, etc.) are better equipped to curb costs associated with private benefits of control. Hence, if agency costs related to private benefits of control are considered important by providers of external finance, then the mitigating role of financial credibility would likely be more pronounced in regimes with weaker institutions. In other words, financial credibility matters more when agency problems are more severe. Because private benefits of a controlling shareholder are less severe in countries with stronger institutions, there is less concern for these agency costs, and financial credibility is expected to have less of an effect. Consistent with these ideas, Hope et al. (2011) find that the impact of financial credibility in reducing financing constraints in the presence of a controlling owner is more pronounced in countries with weaker creditor rights.<sup>16</sup>

My conclusion from the limited extant research on private firms is that there is a wealth of opportunities for future research. For example, there are interesting data sources available for private firms in China, and such data bases could potentially be combined with data on political connections or other interesting issues relevant for the Chinese setting.

## 5. Country variations in the roles of large shareholders

### 5.1. Introduction

Although it is primarily the more general agency cost arguments from Jensen and Meckling (1976) that have been cited by subsequent literature, it is also highly relevant for our discussion that Jensen and Meckling discuss the important *role which the legal system and the law play* in social organizations, especially, the organization of economic activity. In other words, we should not necessarily expect the same organizational structures or the same economic outcomes across different environments. As Jensen and Meckling (1976) explain, statutory laws sets bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution. They focus on how the police and related powers of the state are used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate conflicts between contracting parties and establish precedents. Such government activities affect both the kinds of contracts executed and the extent to which contracting is relied upon.

For a recent example of accounting research on how cross-country variations in the extent to which contracts are enforced matter to accounting outcomes, Dou et al. (2013) predict (based on incomplete contracting

---

<sup>16</sup> Creditor rights are presumably one of the most important measures of legal protection associated with private firms.

theory) and find that firms that both reside in countries with weak contract enforceability and operate in industries with a greater need for relationship-specific investments tend to smooth reported earnings more.<sup>17,18</sup>

Perhaps even more interesting than how certain institutional factors vary across countries is what I will call “country peculiarities.” These are differences across countries that are due to a multitude of factors that are difficult to summarize for researchers. Hence it may make sense to separately analyze certain issues related to large shareholders in specific countries. In the following I briefly mention some examples from China, India, and Japan/Korea.

### 5.2. *China: the role of state-owned enterprises*

In China, the government plays a central role in corporate governance. In fact, the most obvious difference between China and many other countries is likely in the extent of state ownership of large companies. According to Li and Zhang (2010), China has by far the highest percentage of state-controlled firms in the countries they survey. Specifically, in their study the state is the “ultimate controller” for 63.15% of Chinese firms. In contrast, the corresponding figures for their other sample countries are: Singapore 23.5%, Germany 6.3%, France 5.11%, Hong Kong (included as a separate country in their study) 1.40%, Japan 0.80%, and the United Kingdom 0.08%. This huge difference in reliance on state ownership in China versus other countries suggests that the notion of large shareholders is likely quite different in China.

There are two types of state-owned listed companies in China: either the company is controlled by a parent (holding) company or the majority shares of the listed company are held by a state asset management (operational) company (Tomasic and Andrews, 2007). Tian (2001) finds that the government is the majority shareholder of 31.4% of the Chinese public listed companies. Thus, the state is often the largest shareholder for publicly traded companies resulting in many state-owned enterprises in the market. However, contradicting theoretical and empirical evidence exist on whether the state ownership is beneficial in creating market value.

Property rights theory argues that ownership and control rights should be given to the parties that make ex-ante specific investments (e.g., Hart and Moore, 1996). According to the property rights theory SOE managers lack incentives to maximize corporate profitability, as the majority of the firm is owned by the state. However, given the unique government structure in China, it is difficult to draw any solid predictions through just examining the theoretical literature.

Official statistics suggest that about one third of Chinese SOEs are loss makers, another third either break even or making losses and the remaining one third are marginally profitable (Bai, Liu, Lu, Song, and Zhang, 2003). Bai, Liu, Lu, Song, and Zhang (2003) empirically show that a firm’s performance is negatively affected when the largest shareholder is the government. Tomasic and Andrews (2007) conducted interviews with various corporate participants and outline how there is a lack of minority shareholder protection in the presence of state ownership in China.

However, state ownership can also be beneficiary. For example, state ownership can provide long-term and stable ownership and ensure financing is available also during crisis periods. Both Tian (2001) and Hess et al. (2010) conclude that there is a U-shaped relation between government shareholding and market value. The detected U-shape implies that firms dominated by the state players continue to maintain a greater respect by the market and outperform those with lower levels of state ownership. However, the effects of state ownership in mitigating minority shareholder expropriation or manipulation of the market at lower levels of state ownership are limited.

Whether state ownership is “good or bad” is not as relevant to accounting researchers as how it can affect interesting outcomes. In the following I very briefly review some recent studies that focus on ownership issues (and state ownership in particular) in China.

You and Du (2012) employ both agency and resource dependency theory to predict involuntary CEO dismissal and subsequent firm performance in Chinese firms. They find that board monitoring mechanisms

<sup>17</sup> Dou et al. (2012) further decompose income smoothing into “garbled” and “informational” components and find that results are driven by the informational component of income smoothing.

<sup>18</sup> Although not the focus of this article, I would recommend authors to look beyond the standard La Porta et al. measures when looking for country-level variations. This is not a criticism of the La Porta et al. measures; however there are many other interesting variables and new websites available.

explain very little of the outcomes, but political ties with government officials at the state, provincial, county, and city levels are highly predictive of CEO turnover and ultimately firm performance. In other words, they conclude that political ties overrule economic norms in China, lending stronger support for the resource dependency perspective and challenging the agency cost perspective in the Chinese context.

Li and Zhang (2010) use Shanghai National Accounting Institute's Chinese Firms' social responsibility ranking and observe a negative relation between corporate ownership dispersion and corporate social responsibility for a state-owned firm; whereas a positive relation exists for non-state-owned firms. The authors attribute their finding to the large degree of political interference in state-owned firms.<sup>19</sup>

Pi and Lowe (2011) find no association between Chinese CEO turnover and the percentage of shares held by CEOs. They interpret the finding to mean that CEOs do not derive significant power from their shareholder status in China. Furthermore, they find that CEOs in state-owned firms are significantly less likely to be replaced involuntarily and conclude that CEOs in state-owned firms are likely enjoying more discretion because state-owned firms have weaker corporate governance mechanisms and strong political connections.<sup>20</sup>

### 5.3. *India: the role of business groups*

Transaction cost theory suggests that the optimal structure of a firm depends on its institutional context. Khanna and Palepu (2000) discuss how diversified business groups dominate private sector activity in many emerging markets and in particular in India.<sup>21</sup> The typical Indian business groups are collections of publicly traded firms in a wide variety of industries, with a significant amount of common ownership and control, usually by a family. Prior US literature has documented that businesses affiliated with diversified firms underperform their focused competitors. Among the reasons cited for the underperformance of diversified corporations are inappropriate allocation of decision rights, inefficient allocation of capital, and poor internal governance.

In countries such as India there are a variety of market failures, caused by information and agency problems. For example, firms often provide limited financial disclosure and often have weak corporate governance and control. In addition, intermediaries such as financial analysts or the financial press are not fully evolved and securities regulations and related enforcement are weaker than in Western countries. There is thus a potential for diversified business groups that can act as an intermediary between individual entrepreneurs and imperfect markets.

Khanna and Palepu (2000) analyze the performance of affiliates of diversified Indian business groups relative to unaffiliated firms. They find that accounting and stock market measures of firm performance initially decline with group diversification and subsequently increase once group diversification exceeds a certain level. Interestingly, unlike US conglomerates' lines of business, affiliates of the most diversified business groups outperform unaffiliated firms. Of the potential sources of performance effects of group affiliation, Khanna and Palepu (2000) find the strongest effect related to group-affiliated firms' access to international capital markets (presumably due to the track record of the group as a whole).<sup>22</sup>

### 5.4. *Japan and Korea: the role of keiretsus and chaebols*

The ownership structure of Japanese (and also many Korean) firms is typically highly concentrated among corporate stockholders with financial institutions occupying a majority of the stock holdings (e.g., Douthett

<sup>19</sup> Bai et al. (2004) use a panel data of 32 two-digit industries in 29 Chinese regions over the period of 1985–1997 and find that the degree of regional specialization is low for firms with larger shares of state ownership. The finding indicates that local governments have strong incentives to protect their industries.

<sup>20</sup> Chang and Wong (2004) examine local party committees' role in China's economic reform and suggest publicly listed Chinese firms can improve firm performance through decreasing local political party members' existing control level, supporting the grabbing hand theory. In addition, Yang et al. (2011) also support the idea of decreasing state-ownership in China to improve corporate governance. Huang and Xu (2009) study large blocks of share transfer in China and find a positive correlation between private benefit of control and block price but a negative relation between trading restrictions and block price. Moreover, private institutions offer a higher price than state-owned institutions.

<sup>21</sup> Almeida and Wolfenzon (2006) provide a theoretical analysis of family business groups and in particular provide a new rationale for pyramidal ownership. A pyramid allows a family to access all retained earnings of a firm it already controls to set up a new firm, and to share the new firm's no diverted payoff with share-holders of the original firm.

<sup>22</sup> Rather surprisingly, there is very limited accounting research using Indian data, which suggests opportunities for future work.

and Jung, 2001). A significant portion of Japanese industrial firms' ownership is represented by small groups of enterprises – *keiretsus* – composed of firms in different industries. These firms are interrelated through cross holdings of equity ownership and generally rely on a large commercial bank for their primary banking needs. The keiretsu firms maintain close financial and personal ties through cross-shareholding, credit holding, interlocking corporate directorates within the group, and a variety of business transactions.

On the one hand, the *keiretsu* relationship has the potential to increase the monitoring of managerial performance. On the other hand, the keiretsu relationship may decrease the effectiveness of monitoring. Managers may entrench in an inefficient, low-effort arrangement in which managers protect each other in the market for corporate control, resulting in an anti-competitive and exclusionary environment.

As but one example from Japan, Douthett and Jung's (2001) find that Japanese keiretsu firms have higher earnings response coefficients (their proxy for informativeness of earnings) than those of non-keiretsu firms. In addition, the ERC increases as the strength of the keiretsu relationship increases. Finally, discretionary accruals by keiretsu firms are smaller than discretionary accruals of non-keiretsu firms. Douthett and Jung (2001) conclude that the monitoring ability of the *keiretsu* improves the informativeness of earnings.

Business practices in Korea are similar although not identical to Japan. There is widespread use of pyramid ownership structures and cross-holdings among firms that belong to a business group. This type of corporate structure allows controlling shareholders to exercise full control over a firm despite holding a relatively small portion of its cash flow rights (e.g., Baek et al., 2006). Such a divergence between ownership and control raises concerns about the degree to which the controlling shareholders siphon resources out of firms to increase their wealth, that is, the degree to which the controlling shareholders engage in tunneling.

Baek et al. (2006) find that Korean chaebol issuers involved in intragroup deals set the private securities offering prices to benefit their controlling shareholders. They also find that chaebol issuers realize an 8.8% higher announcement return than do other types of issuers if they sell private securities at a premium to other member firms, and if the controlling shareholders receive positive net gains from equity ownership in issuers and acquirers. These results are consistent with tunneling within business groups.<sup>23</sup>

The overall conclusion from this section is that standard agency cost theory predictions do not necessarily apply to all countries around the world. The legal, cultural, and other contexts in which ownership operates will likely influence the governance impact of large shareholders. It is incumbent upon us as researchers to both understand the environment that we are studying and to make use of such variations in the environment to come up with interesting new research questions to pursue. The good news is that there should be plenty of opportunities for future research!

## 6. Brief concluding remarks

This article has focused on highlighting the heterogeneity of large shareholders. Specifically, I discuss the importance of families, institutions, governments, and employees as shareholders. The roles of each of these is likely different and thus it is prudent to go beyond overly general notions of "large shareholders" and instead consider exactly who the owners are, and also suggests that further research on specific shareholder type effects on accounting outcomes would be welcome. I also emphasize that if researchers are really interested in researching ownership concentration, private firms may be the most fertile ground, both because these firms tend to have more concentrated ownership and because there is considerably less prior research on these economically important firms compared with publicly traded companies.

But perhaps most importantly, I would encourage readers to use their imagination and not just "follow the bandwagon" in terms of choosing research topics. I would recommend reading outside of accounting (both to find interesting topics and to bring methodological advances into accounting) and to follow closely what is happening in practice. There are many exciting research opportunities in China and I very much look forward to future issues of *CJAR* and to attending future conferences in China.

<sup>23</sup> Baek et al. (2008) examine intragroup propping within Korean chaebols. They find that the announcement of increased (decreased) earnings by a chaebol-affiliated firm has a positive (negative) effect on the market value of other non-announcing affiliates. This finding is consistent with the market's *ex ante* valuation of intragroup.

## References

- Adams, R.B., Hermalin, B.E., Weisbach, M.S., 2010. The role of boards of directors in corporate governance. A conceptual framework and survey. *Journal of Economic Literature* 48, 58–107.
- Ali, A., Chen, T.-Y., Radhakrishnan, S., 2007. Corporate disclosures by family firms. *Journal of Accounting and Economics* 44 (1–2), 238–286.
- Almeida, H.V., Wolfenzon, D., 2006. A theory of pyramidal ownership and family business groups. *Journal of Finance* 61 (2637–2680), 2006.
- Anderson, R.C., Reeb, D.M., 2003. Founding-family ownership and firm performance. Evidence from the S&P 500. *The Journal of Finance* 58 (3), 1301–1327.
- Bae, G.S., Cheon, Y.S., Kang, J.-K., 2008. Intra-group propping: evidence from the stock-price effects of earnings announcement by Korean business groups. *Review of Financial Studies* 21, 2015–2060.
- Baek, J.-S., Kang, J.-K., Lee, I., 2006. Business groups and tunneling: evidence from private securities offerings by Korean chaebols. *Journal of Finance* 61, 2415–2449.
- Bai, C.E., Liu, Q., Lu, J., Song, F.M., Zhang, J.X., 2003. Corporate governance and market valuation in China. Working Paper, University of Hong Kong.
- Bai, C.E., Du, Y., Tao, Z., Tong, S.Y., 2004. Local protectionism and regional specialization: evidence from China's industries. *Journal of International Economics* 63, 397–417.
- Ball, R., Shivakumar, L., 2005. Earnings quality in UK private firms: comparative loss recognition timeliness. *Journal of Accounting and Economics* 39 (1), 83–128.
- Bartov, E., Radakrishnan, S., Krinsky, I., 2000. Investor sophistication and patterns in stock returns after earnings announcements. *Accounting Review* 75 (1), 43–63.
- Bertrand, M., Schoar, A., 2006. Role of family in family firms. *Journal of Economic Perspectives* 20 (2), 73–96.
- Berzins, J., Böhren, Ø., Rydland, P., 2008. Corporate Finance and Governance in Firms with Limited Liability: Basic Characteristics. Research Report No. 1, Centre for Corporate Governance Research, Norwegian School of Management.
- Bhattacharya, N., Black, E.L., Christensen, T.E., Mergenthaler, R.D., 2007. Who trades on pro forma earnings information? *The Accounting Review* 82 (3), 581–619.
- Biddle, G., Hilary, G., 2006. Accounting quality and firm-level capital investment. *The Accounting Review* 81, 963–982.
- Bloom, N., Van Reenen, J., 2007. Measuring and explaining management practices across firms and countries. *The Quarterly Journal of Economics* 122 (4), 1351–1408.
- Bonner, S.E., Walker, P., 1994. The effects of instruction and experience on the acquisition of auditing knowledge. *Accounting Review* 69 (1), 157–178.
- Bonner, S.E., Walther, B.R., Young, S.M., 2003. Sophisticated and unsophisticated investors' reactions to analysts' forecast revisions conditional on factors that are associated with forecast accuracy. *Accounting Review* 78 (3), 679–706.
- Bova, F., Dou, Y., Hope, O.-K., 2012. Employee Ownership and Firm Disclosure. Working Paper, University of Toronto.
- Burgstahler, D., Hail, L., Leuz, C., 2006. The importance of reporting incentives: earnings management in European private and public firms. *The Accounting Review* 81, 983–1016.
- Bushee, B., 1998. The influence of institutional investors on myopic R&D investment behavior. *Accounting Review* 73 (3), 305–333.
- Bushee, B., 2001. Do institutional investors prefer near-term earnings over long-run value? *Contemporary Accounting Research* 18, 207–246.
- Callen, J., Hope, O.-K., Segal, D., 2005. Domestic and foreign earnings, stock return variability, and the impact of investor sophistication. *Journal of Accounting Research* 43, 377–412.
- Chang, E., Wong, S., 2004. Political control and performance in China's listed firms. *Journal of Comparative Economics* 32, 617–636.
- Chen, S., Chen, X., Cheng, Q., 2008. Do family firms provide more or less voluntary disclosure? *Journal of Accounting Research* 46 (3), 499–536.
- Chen, F., Hope, O.-K., Li, Q., Wang, X., 2011. Financial reporting quality and investment efficiency of private firms in emerging markets. *The Accounting Review* 86 (4), 1255–1288.
- Chen, F., Hope, O.-K., Li, Q., Wang, X., 2012. Earnings Opacity and Closed-End Country Fund Discounts. Working Paper, University of Toronto, Wuhan University, and University of Hong Kong.
- Claessens, Stijn, Djankov, Simeon, Fan, Joseph P.H., Lang, Larry H.P., 2002. Disentangling the incentive and entrenchment effects of large shareholdings. *Journal of Finance* 57 (6), 2741–2771.
- Coffee Jr., J.C., 1991. Liquidity versus control: the institutional investor as corporate monitor. *Columbia Law Review* 91, 1277–1368.
- Coffee Jr., J.C., 2005. A theory of corporate scandals: why the USA and Europe differ. *Oxford Review of Economic Policy* 21 (2), 198–211.
- Cramton, P., Mehran, H., Tracy, J., 2008. ESOP Fables: The Impact of Employee Stock Ownership Plans on Labor Disputes. FRB of New York Staff Report No. 347.
- Cronqvist, H., Fahlenbrach, R., 2009. Large shareholders and corporate policies. *Review of Financial Studies* 22 (10), 3941–3976.
- Cronqvist, H., Nilsson, M., 2003. Agency costs of controlling minority shareholder. *Journal of Financial and Quantitative Analysis* 38 (4), 695–719.
- Dou, Y., Hope, O.-K., Zou, Y., 2012. Large Shareholders and Accounting Choices. Working Paper, University of Toronto and New York University.
- Dou, Y., Hope, O.-K., Thomas, W.B., 2013. Relationship-specificity, contract enforceability, and income smoothing. *The Accounting Review*, forthcoming.

- Douthett Jr., E.B., Jung, K., 2001. Japanese corporate groupings (keiretsu) and the informativeness of earnings. *Journal of International Financial Management and Accounting* 12 (2), 133–159.
- Dyck, A., Zingales, L., 2004. Private benefits of control: an international comparison. *Journal of Finance* 59, 537–600.
- Ellul, A., Guntay, L., Lel, U., 2009. Blockholders, Debt Agency Costs and Legal Protection. Working Paper, FRB International Finance Discussion Paper No. 908.
- Fama, E., 1980. Agency problems and the theory of the firm. *Journal of Political Economy* 88 (2), 288–307.
- Fama, E., Jensen, M., 1983. Separation of ownership and control. *Journal of Law and Economics* 26 (2), 327–349.
- Gjesdal, F., 1981. Accounting for stewardship. *Journal of Accounting Research* 19 (1), 208–231.
- Gogineni, S., Linn, S.C., Yadav, P.K., 2010. Empirical Evidence on Ownership Structure, Management Control and Agency Costs. Working Paper, University of Oklahoma.
- Hart, O., Moore, J., 1996. The governance of exchanges: members' cooperatives versus outside ownership. *Oxford Review of Economic Policy* 12 (4), 53–69.
- Hart, J., Shleifer, A., Vishny, R.W., 1997. The proper scope of government: theory and an application to prisons. *Quarterly Journal of Economics* 112 (4), 1126–1161.
- Hess, K., Gunasekarage, A., Hovey, M., 2010. State-dominant and non-state-dominant ownership concentration and firm performance. Evidence from China. *International Journal of Managerial Finance* 6 (4), 264–289.
- Hope, O.-K., Thomas, W.B., 2008. Managerial empire building and firm disclosure. *Journal of Accounting Research* 46, 591–626.
- Hope, O.-K., Langli, J.C., 2010. Auditor independence in a private firm and low litigation setting. *The Accounting Review* 85 (2), 573–605.
- Hope, O.-K., Thomas, W.B., Vyas, D., 2011. Financial credibility, ownership, and financing constraints in private firms. *Journal of International Business Studies* 42 (7), 935–957.
- Hope, O.-K., Langli, J.C., Thomas, W.B., 2012a. Agency conflicts and auditing in private firms. *Accounting, Organizations, and Society* 37 (7), 500–517.
- Hope, O.-K., Thomas, W.B., Vyas, D., 2012. Financial Reporting Quality in US Private and Public Firms. Working Paper, University of Toronto, University of Oklahoma, and University of Minnesota.
- Huang, Z., Xu, X., 2009. Marketability, control, and the pricing of block shares. *Journal of Banking and Finance* 33, 88–97.
- Indjejikian, R., Matejka, M., 2009. CFO fiduciary responsibilities and annual bonus incentives. *Journal of Accounting Research* 47 (4), 1061–1093.
- Jensen, M.C., Meckling, W.H., 1976. Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (4), 305–360.
- Khanna, T., Palepu, K., 2000. Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups. *Journal of Finance* 55 (2), 867–891.
- Kruse, P., Blasi, J., Park, R., 2009. Shared Capitalism in the US Economy: Prevalence, Characteristics, and Employee Views of Financial Participation in Enterprises. *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options*, University of Chicago Press (Chapter 1).
- La Porta, R.L., Lopez-De-Silanes, F., Shleifer, A., 1999. Corporate ownership around the world. *The Journal of Finance* 54 (2), 471–517.
- Lennox, C.S., 2005. Management ownership and audit firm size. *Contemporary Accounting Research* 22 (1), 205–227.
- Li, W., Zhang, R., 2010. Corporate social responsibility, ownership structure, and political interference. Evidence from China. *Journal of Business Ethics* 96, 631–645.
- McNichols, M.F., Stubben, S.R., 2008. Does earnings management affect firms' investment decisions? *The Accounting Review* 83, 1571–1603.
- Morck, R., Shleifer, A., Vishny, R.W., 1988. Management ownership and market valuation: an empirical analysis. *Journal of Financial Economics* 20, 293–315.
- Morck, R.K., Stangeland, D.A., Yeung, B., 2000. Inherited Wealth, Corporate Control, and Economic Growth? In: Morck, Randall K. (Ed.), *Concentrated Corporate Ownership*, NBER Conference Volume. University of Chicago Press, Chicago.
- Nagar, V., Nanda, D., Wysocki, P., 2003. Discretionary disclosures and stock-based incentives. *Journal of Accounting and Economics* 34, 283–309.
- Nagar, V., Petroni, K., Wolfenzon, D., 2011. Governance problems in close corporations. *Journal of Financial and Quantitative Analysis* 46 (4), 943–966.
- Pacter, P., 2004. Financial reporting: SMEs-will the GAAP widen for SMEs? *Accountancy* 133, 118–119.
- Pagano, M., Roell, A., 1998. The choice of stock ownership structure; agency costs, monitoring and the decision to go public. *Quarterly Journal of Economics* 113, 187–225.
- Pi, L., Lowe, J., 2011. Can a powerful CEO avoid involuntary replacement? – An empirical study from China. *Asia Pacific Journal of Management* 28, 775–805.
- Price, R.E., 1998. Price Responsiveness of Informed Investors to Increases in Financial Statement Disclosure Quality. Working Paper, College of William and Mary.
- Schmidt, K., 1996. The costs and benefits of privatization: an incomplete contracts approach. *Journal of Law, Economics, and Organization* 12 (1), 1–24.
- Shleifer, A., Vishny, R.W., 1986. Large shareholders and corporate control. *Journal of Political Economy* 94 (3), 461–488.
- Shleifer, A., Vishny, R.W., 1997. A survey of corporate governance. *Journal of Finance* 52 (2), 737–783.
- Smith, A., 1776 (reprinted 1937), *The wealth of nations*, Cannan edition. Modern Library, New York.
- Sraer, D., Thesmar, D., 2007. Performance and behavior of family firms: evidence from the French stock market. *Journal of the European Economic Association* 5 (4), 709–751.

- Tian, L., 2001. Government Shareholding and the Value of China's Modern Firms. Working Paper, London Business School.
- Tomasic, R., Andrews, N., 2007. Minority Shareholder Protection in China's top 100 Listed Companies. Working Paper, Australian Research Council.
- Wang, D., 2006. Founding family ownership and earnings quality. *Journal of Accounting Research* 44 (3), 619–656.
- Yang, J., Chi, J., Young, M., 2011. A review of corporate governance in China. *Asian Pacific Economic Literature*.
- You, J., Du, G., 2012. Are political connections a blessing or a curse? Evidence from CEO turnover in china. *Corporate Governance: An International Review* 20 (2), 179–194.





# Audit pricing and nature of controlling shareholders: Evidence from France

Chiraz Ben Ali <sup>a,\*</sup>, Cédric Lesage <sup>b</sup>

<sup>a</sup> IPAG Business School, France

<sup>b</sup> HEC Paris, France

## ARTICLE INFO

### Article history:

Received 16 February 2012

Accepted 20 August 2012

Available online 8 November 2012

### JEL classification:

G32

M42

### Keywords:

Audit fees

Controlling shareholder identity

Minority expropriation

Agency conflict

## ABSTRACT

This study examines whether auditors are employed as a monitoring mechanism to mitigate agency problems arising from different types of controlling shareholders. In a context of concentrated ownership and poor investor protection, controlling shareholders can easily expropriate wealth from minority shareholders and profit from private benefits of control. However, this agency conflict has been rarely studied, as the most commonly assumed agency conflict occurs between managers and shareholders. Using an audit fee model derived from Simunic (1980), we study the impact of the nature of controlling shareholders on audit fees in French listed firms. Our results show: (1) a negative relationship between audit fees and government shareholdings; (2) a positive relationship between audit fees and institutional shareholdings; and (3) no relationship between audit fees and family shareholdings. These results illustrate the mixed effects of the nature of ownership on audit fees.

© 2012 China Journal of Accounting Research. Founded by Sun Yat-sen University and City University of Hong Kong. Production and hosting by Elsevier B.V. All rights reserved.

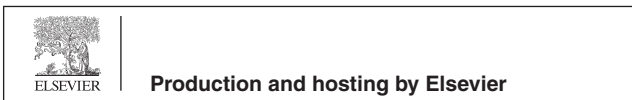
## 1. Introduction

Corporate governance studies have mainly focused on agency conflicts between managers and shareholders (named type I agency conflict). However some studies have demonstrated that ownership structures

\* Corresponding author. Address: IPAG Business School, 184 Boulevard Saint-Germain, 75006 Paris, France. Tel.: +33 (0) 1 55 04 11 45; fax: +33 (0) 1 45 44 40 46.

E-mail addresses: [Chiraz.benali@ipag.fr](mailto:Chiraz.benali@ipag.fr) (C. Ben Ali), [lesage@hec.fr](mailto:lesage@hec.fr) (C. Lesage).

URL: <http://www.ipag.fr> (C. Ben Ali).



around the world are more concentrated than previously assumed (Shleifer and Vishny, 1997; La Porta et al., 1999; Denis and McConnell, 2003; Gillan and Starks, 2003). Weaker investor protection gives shareholders incentives to maintain large shareholdings to better control managers (Shleifer and Vishny, 1997). Consequently, in low investor protection countries, such as France, ownership is more concentrated, meaning the type I agency conflict between managers and shareholders is reduced, but agency conflicts between controlling shareholders and minority shareholders (called type II agency conflict) are higher (La Porta et al., 1999).

In this paper, we investigate the influence of the nature of controlling shareholders on audit fees in France. The expropriation risk of minority shareholders is likely to influence the demand for audit services, which is usually measured by audit fees (Whisenant et al., 2003; Hope et al., 2010). Namely, auditing is a monitoring cost that depends on the extent of agency conflicts, in the sense that auditors need to increase the scope of their audit for firms with high agency conflicts because of increased audit risk (inherent and/or audit risk) and auditor business risk (litigation risk) (Khalil et al., 2008). To our best knowledge, very few studies have investigated the type II agency conflict in relation to the audit fees, including Fan and Wong (2005) in East Asia and Khalil et al. (2008) in Canada. But France presents an interesting context for three main reasons: (1) it is a country which has been used as a typical representative of a weak investor protection country (La Porta et al., 1998; Deminor, 2005); (2) listed firms have high ownership concentrations (La Porta et al., 1999; Faccio and Lang, 2002); and (3) there are varying ownership structures as a large proportion of firms are controlled by the state or by families which actively participate in management (Djama and Boutant, 2006; Trébuq, 2007).

However the nature of controlling shareholders is likely to influence the risk of minority expropriation. For instance Villalonga and Amit (2006) assume that families have stronger incentives to expropriate wealth from minority shareholders than widely-held corporations because private benefits of control are not diluted among several independent owners. Several papers call for research (Hay et al., 2006) about the relationship between the nature of ownership and audit fees, especially in a European continental setting where ownership structures are not as homogeneous as in Anglo-Saxon countries (Niemi, 2005).

We therefore investigate the influence of the identity of the controlling shareholder on audit fees using regression analysis of French non-financial listed firms during 2006–2008. Our results present new explanations for previous ambiguous results about the relationship between audit fees and controlling ownership (Niemi, 2005; Hay et al., 2006). First, we show two opposite effects (alignment vs. entrenchment) depending on the nature of ownership (family, institutional, government), while most prior studies assimilate both effects by using the sum of blockholder ownership (Peel and Clatworthy, 2001; Fan and Wong, 2005; Niemi, 2005). Then, while many previous studies assume that institutional investors play a monitoring role in the corporate governance of French listed firms (McConnell and Servaes, 1990; Rajgopal and Venkatachalam, 1997), we find that institutional ownership increases audit fees. We also find a negative relationship between government ownership and audit fees, which demonstrates that state representatives play a monitoring role in the corporate governance of French listed firms, which reduces audit risk and audit fees. Finally, we find no significant relation between family ownership and audit fees which may be explained by the existence of two opposite effects (entrenchment vs. alignment): family firms face less severe type I agency conflict but more severe type II agency conflict. Therefore, audit fees level may depend on the trade-off between the two types of agency conflicts.

We contribute to the existing literature in several ways. First, there is a lack of research on firm ownership as a determinant of audit fees, particularly on the identity of non-managerial controlling shareholders (Niemi, 2005; Hay et al., 2006). Second, this study contributes to the research on corporate governance mechanisms and provides evidence of the monitoring role of bureaucrats in state controlled firms in order to avoid reputational loss. Lastly, this research confirms that institutional investors constrain management to provide assurance that financial information is of high quality via high audit quality.

The paper is organized as follows. The next section (Section 2) provides the theoretical framework and Section 3 develops our hypotheses. Section 4 presents the research design and Section 5 provides the sample selection procedures and descriptive statistics. Regressions results are disclosed in Section 6. Finally, we discuss the results and conclude in Section 7.

## 2. Theoretical background

### 2.1. Controlling shareholders and agency conflicts

Holderness (2009) finds that controlling shareholders are present in most listed firms all over the world. Controlling shareholders can be defined as those that have the possibility to select the board of directors (or its majority) or exert pressure on them and influence the future of the firm (Berle and Means, 1932). While concentrated ownership is considered as a substitute for weak investor protection regulation (Shleifer and Vishny, 1997, p. 753), it raises a new concern: minority investor expropriation (La Porta et al., 1998, p. 1151, 2000, p. 4). In weak investor protection countries, controlling shareholders and minority shareholders both have the right to the same dividend per share (Denis and McConnell, 2003). However, the former have private benefits of control and can increase their wealth in consuming additional perquisites to the detriment of outsider shareholders. Consequently, when controlling shareholders have effective control of the firm via a high percentage of ownership, they have incentives to expropriate wealth from minority shareholders (Shleifer and Vishny, 1997), which leads to a higher agency conflict between controlling and minority shareholders, also called type II agency costs. Hence investor protection turns out to be crucial because, in many countries, expropriation of minority shareholders and creditors by the controlling shareholders is extensive (La Porta et al., 2000, p. 4).

Expropriation can take many forms. Insiders can simply steal profits, have excessive compensation or benefit from self-dealing transactions such as selling the output, assets or additional securities in the firm they control to another firm they own at below market prices (Johnson et al., 2000). “Tunnelling” allows controlling shareholders to transfer firm assets and benefits out of the reach of both creditors and minority shareholders (Johnson et al., 2000).

### 2.2. Auditing and agency conflicts

Since the role of auditing is to enforce the application of proper accounting policies (Francis and Dechow, 2008, p. 157), auditing is part of the corporate governance system (Francis et al., 2003) whose cost has to be born by shareholders as one key component of monitoring costs (Jensen and Meckling, 1976). It is therefore expected that auditors will spend more time, relative to the regular inspection of accounts, to inspect managers’ activities if agency problems are greater, which may lead to higher audit fees.

A large body of audit research has focused on the determinants of audit fees (Hay et al., 2006) since the seminal work of Simunic (1980). This author developed an audit fee model which has become a landmark in audit research. Its starting point is that auditors are jointly liable together with managers for financial information quality *vis-à-vis* financial statement users. Consequently, Simunic (1980) develops an audit fee model that includes two components: audit effort and risk premium.

$$\text{AUDFEE} = p * q + E(L)$$

where AUDFEE is the amount of audit fees,  $p$  the hourly pricing,  $q$  the number of auditing hours,  $E(L)$  is the risk premium, assessing the probability of expected losses.

The model is composed of two components: audit effort and risk premium. The first component ( $p * q$ ) that represents the audit effort needed is based on the auditor evaluation of two risks. First, the risk that a significant error exists in the financial statements (inherent risk). Second, the risk that the firm’s internal controls do not detect it (control risk). Hence, for a client presenting a higher risk level, the auditor asks for higher fees to cover higher costs (Simunic and Stein, 1996). Therefore, because firms facing opportunistic behavior of insiders (Jensen, 1986) present higher inherent risk and higher control risk (Khalil et al., 2008), auditors charge higher fee premiums. Many previous studies show that auditors consider agency costs, for instance the risk of asset embezzlement, abusive use of perquisites, excessive executive compensation (Gul and Tsui, 1997, 2001; Jensen and Payne, 2005; Khalil et al., 2008).

The second component of Simunic’s model deals with the risk premium. Lyon and Maher (2005) argue that much of the prior literature on auditor’s risk focuses on litigation risk, which is the risk of incurring liability payments and of damaged reputation for the quality of its services (Palmrose, 1986; Francis and Simon, 1987;

Simunic and Stein, 1996; Willenborg, 1999; Venkataraman et al., 2008; Feldmann et al., 2009). All these studies show the importance of the risk premium component in audit fee levels due to the positive relationship between audit fees and litigation risk. First, Lafond and Roychowdhury (2008) assert that agency costs are likely to increase the risk premium and therefore audit fees. As the French context has higher type II agency conflicts, then higher audit fees should be expected (Fan and Wong, 2005). Second, Hope et al. (2010) suggest that in a higher agency cost context, auditors are likely to provide greater effort to prevent misstatement related to moral hazard and adverse selection problems. We assume that higher agency conflicts are likely to increase the two components of audit fees presented in Simunic's model and therefore increase the total amount of audit fees.

### *2.3. Audit fees and the nature of ownership*

Hay et al. (2006) summarize the large body of audit fee determinants research using a meta-analysis and conclude that the results on the relationship between blockholder ownership and audit fees are mixed. For instance, Chan et al. (1993) find a significant relationship between insider ownership and audit fees for his small firm sub-sample. Firth (1997) finds a non-significant relationship between insider ownership concentration and audit fees on a sample of Norwegian firms. In France, Piot (2001) finds a non-significant relationship between insider ownership and the choice of big audit firms (audit quality). Finally Niemi (2005) tests Chan et al. (1993) model on Finnish firms and finds a non-significant relationship between audit fees and a measure of combined managerial and non-managerial ownership concentration. This author argues that one explanation for these mixed results is that these studies do not differentiate between managerial and non-managerial ownership concentration, since the two types should have opposite effects on audit fees. Niemi (2005) then improves the explanatory power of his previous model when adding variables considering the type of controlling shareholders. Villalonga and Amit (2006) also suggest that the identity of controlling shareholders is likely to influence minority expropriation risk. Indeed, when the dominant shareholder is a financial institution or a dispersed capital firm, the private benefits of control are shared by all independent owners, which leads to a dilution of the inherent advantage. However, when the dominant shareholder is an individual or a family, the advantage resulting from the expropriation is superior because the benefits are concentrated in the hands of family members. Indeed, families or individuals have stronger motivations to expropriate. This demonstrates the importance of the type of controlling ownership in the production and pricing of an audit. However, there is a gap in the literature on this particular issue despite calls for such research (Hay et al., 2006).

In the following section we develop our hypotheses by distinguishing between three types of controlling owners: family-controlled, institutional-controlled and state-controlled firms.

## **3. Hypotheses development**

### *3.1. Family ownership*

Previous studies show that the most common type of a controlling owner in France is a founding family that usually participates in daily operations of the corporation (La Porta et al., 1999; Faccio and Lang, 2002; Labelle and Schatt, 2005). Hope et al. (2010) argue that it is easier to extract private benefits for major family owners that can strongly influence the board (for instance by choosing its members). The monitoring effectiveness of the board could therefore be impaired when its composition is determined primarily by the CEO's family. The authors suggest that this situation is likely to increase agency costs when there is a family relation between the CEO and the major shareholder and auditors need to supply more effort.

As previously mentioned, expropriation risk is higher when the controlling shareholder is a family since the private benefits remain within the family. Moreover, families often have voting rights in excess of their cash flow rights (La Porta et al., 1999, p. 26), which increases expropriation risk. Hirigoyen (2002) gives the example of the Marine-Wendel family in France that utilizes financial mechanisms to allocate to the family more voting rights than their regular capital rights.

Other studies document a negative influence of the board dominated by family members. For instance, Ho and Wong (2001) posit the inefficacy of boards dominated by families. Jaggi and Leung (2007) find that the

effectiveness of audit committees is significantly reduced when family members are present on corporate boards, especially when family members dominate the corporate board. These characteristics are likely to increase minority shareholder expropriation risk and consequently the type II agency conflict, which leads to higher audit fees.

However, other arguments suggest the opposite: a negative relationship between family ownership and audit fees. First, in the majority of family controlled firms, family members participate in management (Pochet, 1998; La Porta et al., 1999; Hirigoyen, 2002). Hence, the control of the firm is directly exercised by the major shareholders that have an evident interest in the company. Therefore, the agency conflict between managers and shareholders (type I agency conflict) is reduced in these firms (Pochet, 1998). As suggested before, audit fees are influenced by agency conflicts, therefore, auditors should ask for lower fees when auditing family firms.

Also, family members that are in the top of the company have free access to information about the firm (Chau and Gray, 2002; Hirigoyen, 2002; Pichard-Stamford, 2002). Hence, firms with significant family ownership are likely to have less information asymmetry problems than their counterparts because there is less separation of ownership and control (Ali et al., 2007; Francis et al., 2009). Therefore, there is lower demand for assurance that the financial statements do not include significant errors. Francis et al. (2009) show a negative relationship in France between family ownership and audit quality, measured by the choice of Big four auditing firms. Other research shows that family-owned firms have higher firm value and are associated with higher earnings quality, proxied by lower abnormal accruals, greater earnings informativeness and less persistence of transitory loss components in earnings (Mishra et al., 2001; Lennox, 2005; Dechun, 2006). Hence, auditors spend less audit effort and ask for a lower risk premium for family firms. Following these arguments, we state hypothesis H1 as follows:

**H1.** Audit fees are negatively associated with family ownership.

### 3.2. Government ownership

Niemi (2005) asserts that government ownership differs from other forms of ownership. Denis and McConnell (2003, p. 3) posit that “Government ownership represents an interesting hybrid of dispersed and concentrated ownership”. Indeed, the authors claim that although state-owned corporations formally have very concentrated ownership, they ultimately belong to people of the state, and in this regard ultimate ownership is extremely dispersed. Niemi (2005, p. 309) suggests that this situation “creates a more pronounced free-rider problem than in large listed companies with a diffuse ownership structure, where the shareholders have no strong incentive to directly monitor management themselves because each shareholder has only a small investment in the firm”. However, in state controlled firms, the *de facto* control rights belong to bureaucrats: “These bureaucrats can be thought of as having extremely concentrated control rights, but no significant cash flow rights because the cash flow ownership of state firms is effectively dispersed amongst the taxpayers of the country” (Shleifer and Vishny, 1997, p. 768). Also, Chen et al. (2011) argue that directors who are nominated by the government are easily in the position of controlling every aspect of decision making without proper monitoring. These arguments therefore suggest high audit fees.

However, other arguments suggest lower audit fees. First, government representatives have an incentive to monitor management for reputation purposes. “Reputation signals the quality of a director and its influence outweighs the negative busyness effect” (Chun-An and Chuan-Ying, 2008, p. 134) which contributes to a decrease in firm risk and hence in audit fees. Also, if government representatives fail to monitor management effectively, they may suffer reputation costs. Second, other authors show that government ownership is a mechanism of shareholder protection and can avoid minority expropriation. Using a sample of 634 privatized enterprises listed on Chinese stock exchanges during the period 1994–1998, Sun and Tong (2003, p. 188) show that “being the largest stakeholder of partially privatized state owned enterprises, the government sends a credible signal to the market that it is not expropriating shareholders’ wealth”. This situation could negatively influence audit fees as it decreases the scope of the audit.

Also, using signaling theory, Mok and Hui (1998) find that Chinese firms with high government ownership have higher firm value. The authors argue that high equity retention by the state after the IPO is likely to

decrease the ex-ante uncertainty of domestic investors because investors interpret that as a sign of the government's confidence in the company and its business model. This situation suggests that these firms have lower business risk and that auditors will therefore spend less effort to audit these firms and ask for lower audit fees. Trien and Chizema (2011) explain the positive relationship between performance and government holdings as the support of these firms by the state. The authors argue that after privatization when a dominant shareholder is the state, it is very likely to provide firms with financial and political support through a "helping hand". Finally "state owned firms have both the motives and the expertise to monitor managers of listed spin-off firms and to provide strategic advice" (Chen et al., 2009, p. 174). We therefore state the following hypothesis:

**H2.** Audit fees are negatively associated with government ownership.

### 3.3. Institutional ownership

Mitra et al. (2007) suggest that institutional and non-institutional blockholders are likely to have different abilities to monitor firm management because of differences in their analytical and information processing resources. Therefore, the authors argue that "the effect of their monitoring on a firm's inherent risk or the effect of their demand for high-quality audit coverage may lead to differential relationships between the nature of the blockholder stock ownership and audit fees" (Mitra et al., 2007, p. 266).

Previous studies document that institutional investors are on average better informed than individual investors because of their large-scale development and analysis of timely and valuable firm-specific information. Moreover, in order to satisfy their fiduciary responsibilities, institutional investors are active monitors, which in turn reduces agency costs (McConnell and Servaes, 1990; Rajgopal and Venkatachalam, 1997; Bushee, 1998; Mitra and Cready, 2005). For instance, Rajgopal and Venkatachalam (1997) find a negative relationship between institutional ownership and discretionary accounting behavior (measured by discretionary accruals). The authors conclude that institutional owners constrain managerial discretion by mitigating earnings manipulation. Also Bushee (1998) uses two subsamples (high vs. low institutional ownership firms) and finds that low institutional ownership firms manipulate R&D expenditure to meet short-term earnings goals. He concludes that institutional investors play a monitoring role by reducing management's discretion. Mitra and Cready (2005) find evidence that institutional stockholders constrain management's ability to opportunistically manage abnormal accruals in the financial reporting process. Firms with substantial institutional stock ownership exercise less accounting discretion to manage abnormal accruals than firms with low levels of institutional ownership. Consistent with the above notion, Mitra et al. (2007) suggest that institutional blockholders are engaged in the company's affairs, including the financial accounting and reporting process which is likely to reduce the inherent risk of material misstatements in financial reporting. Hence this low-risk situation leads to lower engagement effort from auditors and a lower risk premium, therefore audit fees should decrease in institutional controlled firms. Consistent with the arguments above (monitoring role of institutional investors), Mitra et al. (2007) find a negative relationship between institutional blockholders and audit fees.

However, other empirical studies investigating institutional monitoring find mixed evidence (Smith, 1996; Wahal, 1996). For instance, Smith (1996) finds no significant change in operating performance for the 51 firms targeted by CalPERS studied over the 1987–93 period. Also, Wahal (1996) find no evidence of significant long-term performance improvement for firms targeted by pension funds.

Moreover other arguments sustain a positive relation between institutional stock ownership and audit fees. Auditors are external parties that verify the quality and reliability of the information provided to shareholders by managers. Therefore, prior research shows that high quality auditing translates into high earnings quality (Becker et al., 1998; Kane and Velury, 2004). For instance, Becker et al. (1998) measure audit quality with Big Six audit/non-Big Six auditors. The authors find that clients of non-Big Six auditors (weak audit) report discretionary accruals that are, on average, 1.5–2.1% of total assets higher than the discretionary accruals reported by clients of Big Six auditors. Because institutional investors demand high quality information, they demand high audit quality. Kane and Velury (2004) find a positive association between institutional ownership and auditor size (as a measure of audit quality) and suggest that institutional investors have a positive influence on audit services. The authors argue that "because earnings information is important for business

valuation purposes, institutional investors demand high quality information” (Kane and Velury, 2004, p. 978). Hence, when institutional investors hold large voting rights, they have the means to successfully encourage management to provide assurance that financial information is of high quality via high audit quality. Finally, Mitra et al. (2007) also suggest that firms may tend to purchase high-quality audit services to create a positive perception about financial reporting quality in order to attract institutional investment, which therefore should increase audit fees. Following these arguments, we state the following hypothesis:

**H3.** Audit fees are positively associated with institutional ownership.

#### 4. Research design

We use the following regression model to test our hypotheses:

$$\text{LOGFEE} = \beta_0 + \beta_1 \% \text{FAM} + \beta_2 \% \text{GOUV} + \beta_3 \% \text{INST} + \delta_1 \text{LOGASSET} + \delta_2 \text{INTSALE} \\ + \delta_3 \text{INVREC} + \delta_4 \text{LEV} + \delta_5 \text{ROA} + \text{Fixed effects} + \epsilon$$

where LOGFEE is defined by the natural logarithm of audit fees (in K€). All variables are defined in Table 1.

The test variable for H1 is %FAM and represents family control of the firm, as proxied by the percentage of shares owned by identified individuals or families with more than 5%. The coefficient on %FAM ( $\beta_1$ ) thus captures the audit fee discount/premium in the case of family ownership. As H1 states a negative relationship between audit fees and family ownership, we expect  $\beta_1$  to be negative.

In a similar way, the test variable for H2 is %GOUV and represents state control of the firm, as proxied by the percentage of shares owned by the state with more than 5%. The coefficient on %GOUV ( $\beta_2$ ) thus captures the audit fee discount/premium in the case of state ownership. As H2 states a negative relationship between audit fees and state ownership, we expect  $\beta_2$  to be negative. Finally, the test variable for H3 is %INST and represents control of the firm by institutional investors, as proxied by the percentage of shares owned by institutional investors with more than 5%. The coefficient on %INST ( $\beta_3$ ) thus captures the audit fee premium in the case of institutional ownership. As H3 states a positive relationship between audit fees and institutional ownership, we expect  $\beta_3$  to be positive.

Our audit fee model includes two types of firm specific control variables, which control for: (1) audit costs (size and complexity); and (2) the risk of loss that an audit could face in the future (Simunic, 1980; Francis,

Table 1  
Variable definitions.

Variable	Empirical definition	Data source
<i>Dependent variable and test variables for Firm i in Year t</i>		
LOGFEE <sub>it</sub>	Natural log of audit fees (in k€)	Worldscope
FAM <sub>it</sub>	1 If at least one shareholder owning more than 5% of the share rights is an identified individual or family, 0 otherwise.	Thomson
GOUV <sub>it</sub>	1 If at least one shareholder owning more than 5% of the share rights is a state agency, 0 otherwise.	Thomson
INST <sub>it</sub>	1 If at least one shareholder owning more than 5% of the share rights is an institutional investor, 0 otherwise.	Thomson
FAM1 <sub>it</sub>	1 If the primary shareholder is an identified individual or family, 0 otherwise.	Thomson
GOUV1 <sub>it</sub>	1 If the primary shareholder is a state agency, 0 otherwise.	Thomson
INST1 <sub>it</sub>	1 If the primary shareholder is an institutional investor, 0 otherwise.	Thomson
%FAM <sub>it</sub>	% Of shares owned by families with more than 5%.	Thomson
%GOUV <sub>it</sub>	% Of shares owned by state agencies with more than 5%.	Thomson
%INST <sub>it</sub>	% Of shares owned by institutional investors with more than 5%.	Thomson
<i>Firm-Specific control variables for Firm i in Year t</i>		
LOGASSET <sub>it</sub>	Natural log of total assets (in k€)	Worldscope
LEV <sub>it</sub>	The ratio of year-end total debt to total assets	Worldscope
INVEC <sub>it</sub>	The sum of inventories and receivables divided by total sales	Worldscope
INTSALE <sub>it</sub>	Foreign sales divided by total sales	Worldscope
ROA <sub>it</sub>	Return on assets	Worldscope

1984; Hay et al., 2006). Audit cost is estimated by LOGASSET which proxies for client size, and two variables which proxy for client complexity: INVREC and INTSALE. Similar to Simunic (1980) and Choi et al. (2009), we include LEV and ROA to measure client-specific litigation risk potentially borne by auditors<sup>1</sup>. As client size, client complexity and client-specific risks should be positively related to audit fees, we expect all the coefficients from  $\delta_1$  to  $\delta_4$  to be positive and  $\delta_5$  to be negative. Finally, our model also includes fixed year effects and an error term ( $\varepsilon$ ).

## 5. Sample

### 5.1. Data collection

Our sample is initially composed of all listed firms on the SBF 250 French index, meaning 244 firms over the period 2006–2008. The French auditing context is characterized by (1) a mandatory joint audit for all listed firms and all firms reporting consolidated financial statements; (2) the prohibition of non-audit service provision for statutory auditors; and (3) a 6 year-tenure. These institutional characteristics are aimed at improving auditor's independence by reducing the economic bondage between the client and its auditors.

Audit fee data and financial data are collected from Worldscope and ownership data is collected from Thomson. We exclude 33 financial institutions (Standard Industrial Classification [SIC] 6000–6999) and observations with missing financial data from Worldscope. All continuous dependent variables are winsorized at the 1st percentile. We finally obtained a sample of 476 firm-year observations (hereafter named firm observations for ease of notation).

### 5.2. Descriptive statistics

Table 2 presents descriptive statistics of the dependent and independent variables.

According to Table 2, Panel A average audit fees are 5.09 M€ (median: 1.30) over the period (2006–2008). This average amount is consistent with previous literature (mean: 4.45 M€ (median: 1.38 M€) for Gonthier-Besacier and Schatt (2007) on the SBF 250 index in 2002, and mean: 4.8 M€ for Broye (2009) on the Eurolist in 2005). We observe a wide diversity with a minimum of 0.02 M€ and a maximum of 52.50 M€. Table 2, Panel B presents the time evolution of audit fees over the period. We report the audit fees scaled by total sales (FEE-PCT) to control for the size effect which is the first driver of audit fees (Hay et al., 2006). On average, audit fees represent 0.18% of sales across the period, with significant annual variations from 0.16% in 2006 to 0.19% in 2008.

Control variables display a large range, which illustrates the great diversity of the firms selected in our sample. For instance, the leverage ratio has a minimum of 0.1% and a maximum of 64.8%, with a mean of 24.1%, and ROA has a minimum of –22.5% and a maximum of 25.9%, with a mean of 6.2%.

Table 3 details the sample according to the nature of the shareholders.

We use two dummy variables: the nature of the controlling shareholder owning more than 5% of the capital shares and the nature of the first shareholder. If we take the first (second) definition, we observe that our sample includes 38.4% (34.0%) family firms, 6.1% (5.7%) state controlled firms and 42.6% (19.7%) firms controlled by institutional investors (funds, banks, insurance companies, etc.). Both measures report similar results: family and state shareholders are mainly the primary shareholders, whereas institutional shareholders are mostly not the primary shareholder.

Table 3 also shows the level of concentration of shareholdings in France, as reported by the variable %SHARE which corresponds to %FAM (%GOUV and %INST) when the major shareholders are family (state and institutional investors). We see that family-controlled firms own 48% of outstanding shares. Overall we observe an average family ownership concentration of 18.5%, which is consistent with Francis et al. (2009) who report average family ownership of 25% in France. This concentration is higher than the mean of 7.4% for family ownership concentration observed for Standards & Poors listed US firms (Dechun, 2006). State

<sup>1</sup> We did not include audit firm size (BIG) to capture the Big 4 premium (Francis, 1984), as Worldscope publishes only one auditor's name, while France makes joint audit mandatory for listed firms.



Table 2  
Descriptive statistics.

		N	Mean	sd	Min	p25	p50	p75	Max
<i>Panel A: continuous variables</i>									
Audit fees (k€)	FEE	476	5 088	8 037	16	524	1 297	6 635	52 500
Log (audit fees (k€))	LOGFEE	476	7.4	1.6	2.7	6.3	7.2	8.8	10.9
% Shares owned by families with more than 5%	%FAM	476	0.185	0.269	0	0	0	0.381	0.935
% Shares owned by state agencies with more than 5%	%GOUV	476	0.030	0.133	0	0	0	0	0.873
% Shares owned by institutional investors with more than 5%	%INST	476	0.077	0.143	0	0	0	0.089	0.857
Total assets (M€)	ASSET	476	10	20	57	405	1 310	7 610	104 000
Log (total assets (k€))	LOGASSET	476	14.4	1.9	11.0	12.9	14.1	15.8	18.5
(Accounts receivables + inventory)/total assets	INVREC	476	0.338	0.176	0.033	0.21	0.311	0.452	0.788
Internationals sales/total sales	INTSALE	476	0.448	0.291		0.217	0.468	0.684	1
Leverage	LEV	476	0.241	0.149	0.001	0.134	0.227	0.342	0.648
Return on assets	ROA	476	0.062	0.059	-0.225	0.036	0.058	0.087	0.259
		2006	2007			2008			Average
<i>Panel B: audit fees by year</i>									
Audit fees (k€)	FEE	5 456	4 898			4 954			5 088
Audit fees/sales	FEEPCT	0.16%	0.19%			0.19%			0.18%
	N	145	164			167			476

Note: All continuous dependent variables are winsorized (0.01).

Table 3  
Nature of shareholders.

	Variable	N	%	%SHARE	FEEPCT	Variable	N	%	%SHARE	FEEPCT		
Non-family	FAM	=0	293	61.6%	0.00%	0.19%	FAM1	=0	314	66.0%	0.01%	0.18%
Family		=1	183	38.4%	48.0%	0.17%		=1	162	34.0%	52.3%	0.17%
Total			476	100.0%	18.5%	0.18%			476	100.0%	18.5%	0.18%
<i>t</i> -Tests ( <i>t</i> -values)												0.382
Non-government	GOUV	=0	447	93.9%	0.00%	0.19%	GOUV1	=0	449	94.3%	0.01%	0.19%
Government		=1	29	6.1%	49.8%	0.07%		=1	27	5.7%	53.06%	0.06%
Total			476	100.0%	3.00%	0.18%			476	100.0%	3.00%	0.18%
<i>t</i> -Tests ( <i>t</i> -values)												5.831***
Non-institutional	INST	=0	273	57.4%	0.00%	0.16%	INST1	=0	382	80.3%	3.2%	0.16%
Institutional		=1	203	42.6%	18.2%	0.20%		=1	94	19.7%	26.0%	0.25%
Total			476	100.0%	7.70%	0.18%			476	100.0%	7.70%	0.18%
<i>t</i> -Tests ( <i>t</i> -values)												-1.081

FEEPCT = Audit fees/sales; FAM = 1 if at least one shareholder owning more than 5% of the share rights is an identified individual or family, 0 otherwise; GOUV = 1 if at least one shareholder owning more than 5% of the share rights is a state agency, 0 otherwise; INST = 1 if at least one shareholder owning more than 5% of the share rights is an institutional investor, 0 otherwise; FAM1 = 1 if the primary shareholder is an identified individual or family, 0 otherwise; GOUV1 = 1 if the primary shareholder is a state agency, 0 otherwise; INST1 = 1 if the primary shareholder is an institutional investor, 0 otherwise; and %SHARE = % of shares owned by (families/state agencies/institutional investors) with more than 5%.

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ , two-tailed tests, two-sample *t*-test with unequal variances.

controlled-firms own 49.8%, while institutional investor-owned firms own only 18.2%. This overall level of concentration is consistent with the high risk of minority expropriation as identified by La Porta et al. (1998) for France, for whom the capital concentration equals 34% (1998, p. 1149) for the top 3 shareholders of the top ten non-financial listed French firms.

Finally Table 3 discloses the audit fees (in % of sales: FEEPCT) according to the nature of the shareholder. We observe that audit fees are not statistically different in family vs. non-family firms and to a lesser extent

also in firms controlled vs. non-controlled by institutional investors. However, state controlled firms exhibit lower audit fees than non-state controlled firms (FEETPCT = 0.07% vs. 0.19%,  $p < 0.01$ ).

## 6. Results

Table 4 displays the correlation matrix of the dependent variable (LOGFEE) and the set of independent variables.

This matrix shows that the independent variable (LOGFEE) is negatively and significantly correlated at 1% with the family nature of ownership concentration (%FAM), the inventory and receivables account (INVREC) and Return On Assets (ROA). LOGFEE is also positively and significantly correlated at 1% with the state nature of ownership concentration (%GOUV), assets (LOGASSET), leverage (LEV) and international sales (INTPCT). The direction of correlations is only partially consistent with our hypotheses. We therefore must run the multivariate analysis before reaching any conclusions on the relationships.

The magnitudes of the pairwise correlations among firm specific variables do not exceed 0.5, with the highest significant correlation being between LOGASSET and INTSALES (coeff. = 0.349,  $p < 0.01$ ). We therefore may have no strong colinearity issues, which we will monitor by reporting VIF indicators. Lastly, the three proxies of the nature of ownership are obviously highly correlated, which raises no concerns as these measures will not be included in the same regressions.

Table 5 presents our multivariate regression results and reports the ordinary least squares (OLS) estimates for the model discussed above.  $P$ -values are computed using robust standard errors, adjusted for heteroskedasticity and clustered at the firm level. We include fixed year effects in all regressions.

First, we observe a non-significant relationship between audit fees (LOGFEE) and family-controlled firms, which contradicts H1: “Audit fees are negatively associated with family ownership”. One possible explanation is the presence of two opposite effects: entrenchment effect and alignment effect of family ownership as suggested by Chau and Leung (2006) and Ali et al. (2007). Hence, the relationship between audit fees and family ownership is dependent on the trade-off between these two conflicts (Ali et al., 2007, p. 242).

Second, our model reports a negative and significant coefficient between audit fees (LOGFEE) and state ownership (coeff. =  $-0.639$ ,  $p < 0.01$ ). Hence H2: “Audit fees are negatively associated with state ownership” is validated. This result is consistent with the argument of Sun and Tong (2003) about the role of government ownership in preventing shareholders’ wealth expropriation, which should reduce audit fees. Also, state representatives should effectively control managers because if they fail to do so, they may bear reputation costs. This finding also confirms the result of Mok and Hui (1998) that a high state shareholding is a signal to the

Table 4  
Correlations.

	LOGFEE	%FAM	%GOUV	%INST	LOGASSET	INVREC	INTSALE	LEV	ROA
LOGFEE	1								
%FAM	-0.400***	1							
%GOUV	0.180***	-0.156***	1						
%INST	-0.053	-0.194***	-0.098**	1					
LOGASSET	0.905***	-0.395***	0.275***	-0.105**	1				
INVREC	-0.197***	0.208***	-0.155***	-0.023	-0.253***	1			
INTSALE	0.453***	-0.245***	-0.087*	-0.0232	0.349***	0.044	1		
LEV	0.178***	-0.061	-0.0476	0.0697	0.244***	-0.224***	-0.038	1	
ROA	-0.199***	0.112**	-0.062	-0.001	-0.158***	-0.002	0.012	-0.200***	1

Two-tailed tests.

LOGFEE = natural log of audit fees (k€); %FAM = % of shares owned by families with more than 5%; %GOUV = % of shares owned by state agencies with more than 5%; %INST = % of shares owned by institutional investors with more than 5%; LOGASSET = natural log of total assets (k€); LEV = ratio of year-end total debt to total assets; INVEC = sum of inventories and receivables divided by total sales; INTSALE = foreign sales divided by total sales; and ROA = return on assets.

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ , two-tailed tests.

Table 5  
Regressions.

LOGFEE	Expected Signs	Model		
		b	p	vif
%FAM	±	-0.108	0.535	1.346
%GOUV	±	-0.639***	0.006	1.181
%INST	±	0.371*	0.093	1.12
LOGASSET	+	0.722***	0.001	1.647
INVREC	+	0.013	0.964	1.155
INTSALE	+	0.767***	0.001	1.269
LEV	+	-0.518	0.208	1.197
ROA	-	-2.094***	0.004	1.091
Constant		-3.098***	0.001	
Year effect				Included
N				476
Adjusted R2				0.847
p-Value				0.001
Schwartz BIC				959
Mean (VIF)				1.27

LOGFEE = natural log of audit fees (k€); %FAM = % of shares owned by families with more than 5%; %GOUV = % of shares owned by state agencies with more than 5%; %INST = % of shares owned by institutional investors with more than 5%; LOGASSET = natural log of total assets (k€); LEV = ratio of year-end total debt to total assets; INVEC = sum of inventories and receivables divided by total sales; INTSALE = foreign sales divided by total sales; and ROA = return on assets.

\* $p < 0.10$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$ , two-tailed tests.

market of the government's confidence in the company and its business model which should reduce agency conflicts causing a decrease in audit fees.

Third, we find a positive and significant coefficient between audit fees (LOGFEE) and institutional investor ownership (coeff. = 0.371,  $p < 0.10$ ). Hence H3: "Audit fees are positively associated with institutional ownership" is validated.

Our result is consistent with previous results that find a positive association between institutional ownership and auditor size (Kane and Velury, 2004) and confirms that institutional investors demand high quality information and therefore ask for high audit quality (proxied by audit size). These authors suggest that institutional investors increase audit services which is likely to increase audit fees. One other explanation of the positive relationship between audit fees and institutional holdings is that firms may purchase high-quality audit services to send a positive signal to the market about their financial reporting quality in order to attract institutional investment (Mitra et al., 2007).

We run additional analyses with alternative proxies to check the robustness of our main analysis. First we use alternative measures as control variables (such as log(sales) instead of log(assets), and lagged loss or lagged roa instead of current loss or roa). Second, we add other control variables (such as number of business segments, and busy season) and industry effects. Lastly, given the joint audit specificity of the French auditing context, we hand collect the auditors names for one year (2008), and include a binary variable coding for the presence of at least one Big audit firm (we also test an ordinary variable coding for 0, 1 or 2 Bigs). In all cases, our regressions include a smaller number of observations due to missing data, but results are similar to the main analysis.

## 7. Conclusion

The present study examines the empirical relationship between ownership type and audit fees. The basic premise is that the identity of controlling shareholders influences the risk of minority expropriation and the effectiveness of blockholders to monitor corporate affairs, particularly the financial reporting process. Globally speaking, our results provide differentiated evidence, instead of mixed results stated by previous literature (Hay et al., 2006), about the association between audit fees and ownership structure.

Our study contributes to the literature in several ways. First, we progress the extant research on corporate governance mechanisms by examining the existence of type II agency conflicts in a civil law country (La Porta et al., 1998). We provide a new explanation about previous mixed results on the relationship between ownership concentration and audit fees by examining the identity of controlling shareholders. We find opposite results for institutional blockholder ownership and state blockholder ownership and audit fees. However, we find no evidence of a relationship between family ownership and audit fees. One possible explanation is the existence of a trade-off effect between the decrease in type I agency conflict for family controlled firms and the increase of type II agency conflict, which both influence the magnitude of audit fees.

However, this study suffers from some limitations. First, our variables related to ownership are direct and not ultimate ownership. Second, following Fan and Wong (2005), we assume that controlling and management ownership are stable over the studied period. Despite these limitations, our study aims to improve our understanding of the complex relationships between audit fees and ownership structure, by studying non-managerial ownership (Niemi, 2005; Hay et al., 2006). We aim to generalize these results in future research and examine other institutional contexts of investors' protection.

### Acknowledgements

Cédric Lesage acknowledges the financial support of the Fondation HEC (Project F0802) and of the INTA-CCT program (European Union, Contract No. MRTN-CT-2006-035850). He is a member of GREGHEC, CNRS Unit, UMR 2959. The authors are pleased to thank A. Khalik, Yuan Ding and participants at the CJAR Symposium (2012).

### References

- Ali, A., Chen, T.-Y., Radhakrishnan, S., 2007. Corporate disclosures by family firms. *Journal of Accounting and Economics* 44 (1–2), 238–286.
- Becker, C.L., Defond, M.L., Jambalvo, J., Subramanyam, K.R., 1998. The effect of audit quality on earnings management. *Contemporary Accounting Research* 15 (1), 1–24.
- Berle, A.A., Means, G.C., 1932. *The Modern Corporation and Private Property*. MacMillan, New York.
- Broye, G., 2009. Honoraires d'audit et comités d'audit: Le cas de la France. *Comptabilité Contrôle Audit* 15 (1), 199–224.
- Bushee, B., 1998. The influence of institutional investors on myopic r&d investment behavior. *The Accounting Review* 73, 305–333.
- Chan, P., Ezzamel, M., Gwilliam, D., 1993. Determinants of audit fees for quoted UK companies. *Journal of Business Finance & Accounting* 20 (6), 765–786.
- Chau, G.K., Gray, S.J., 2002. Ownership structure and corporate voluntary disclosure in Hong Kong and Singapore. *The International Journal of Accounting* 37 (2), 247–265.
- Chau, G., Leung, P., 2006. The impact of board composition and family ownership on audit committee formation: evidence from Hong Kong. *Journal of International Accounting, Auditing & Taxation* 15 (1), 1–15.
- Chen, G., Firth, M., Xu, L., 2009. Does the type of ownership control matter? Evidence from china's listed companies. *Journal of Banking & Finance* 33 (1), 171–181.
- Chen, R., Zhen Qi, C., Lin, T.W., 2011. Ownership structure and corporate governance among chinese securities firms. *International Journal of Management* 28 (3), 789–805.
- Choi, J.-H., Kim, J.-B., Liu, X., Simunic, D.A., 2009. Cross-listing audit fee premiums: theory and evidence. *Accounting Review* 84 (5), 1429–1463.
- Chun-An, L., Chuan-Ying, H., 2008. The influence and determinants of directors' reputation. In: *Proceedings for the Northeast Region Decision Sciences Institute (NEDSI)*. pp. 132–137.
- Dechun, W., 2006. Founding family ownership and earnings quality. *Journal of Accounting Research* 44 (3), 619–656.
- Deminor, 2005. Association of British Insurers.
- Denis, D.K., McConnell, J.J., 2003. International corporate governance. *Journal of Financial & Quantitative Analysis* 38 (1), 1–36.
- Djama, C., Boutant, J., 2006. Stratégie comptable des dirigeants et parité d'échange: Le cas des fusions françaises. *Comptabilité Contrôle Audit* 12 (2), 191–217.
- Faccio, M., Lang, L.H.P., 2002. The ultimate ownership of Western European corporations. *Journal of Financial Economics* 65 (3), 365–395.
- Fan, J.P.H., Wong, T.J., 2005. Do external auditors perform a corporate governance role in emerging markets? Evidence from East Asia. *Journal of Accounting Research* 43 (1), 35–72.
- Feldmann, D.A., Read, W.J., Abdolmohammadi, M.J., 2009. Financial restatements, audit fees, and the moderating effect of cfo turnover. *Auditing* 28 (1), 205–223.

- Firth, M., 1997. The provision of nonaudit services by accounting firms to their audit clients. *Contemporary Accounting Research* 14 (2), 1–21.
- Francis, J.R., 1984. The effect of audit firm size on audit prices : a study of the Australian market. *Journal of Accounting and Economics* 6 (2), 133–151.
- Francis, J.R., Dechow, W., 2008. The joint effect of investor protection and Big four audits on earnings quality around the world. *Contemporary Accounting Research* 25 (1), 157–191.
- Francis, J.R., Simon, D.T., 1987. A test of audit pricing in the small-client segment of the U.S. Audit market. *Accounting Review* 62 (1), 145–157.
- Francis, J.R., Khurana, I.K., Pereira, R., 2003. The role of accounting and auditing in corporate governance and the development of financial markets around the world. *Asia-Pacific Journal of Accounting & Economics* 10, 1–30.
- Francis, J.R., Vanstraelen, A., Richard, C., 2009. Assessing France's joint audit requirement: are two heads better than one ? *Auditing* 28 (2), 35–63.
- Gillan, S.L., Starks, L.T., 2003. Corporate governance, corporate ownership, and the role of institutional investors: a global perspective. *Journal of Applied Finance* 13 (2), 4–22.
- Gonthier-Besacier, N., Schatt, A., 2007. Determinants of audit fees for French quoted firms. *Managerial Auditing Journal* 22 (2), 139–160.
- Gul, F.A., Tsui, J.S.L., 1997. A test of the free cash flow and debt monitoring hypotheses: evidence from audit pricing. *Journal of Accounting and Economics* 24 (2), 219–237.
- Gul, F.A., Tsui, J.S.L., 2001. Free cash flow, debt monitoring, and audit pricing: further evidence on the role of director equity ownership. *Auditing* 20 (2), 4.
- Hay, D.C., Knechel, W.R., Wong, N., 2006. Audit fees: a meta-analysis of the effect of supply and demand attributes. *Contemporary Accounting Research* 23 (1), 141–191.
- Hirigoyen, G., 2002. In: Hirigoyen, G., Caby, J. (Eds.). *La gestion des entreprises familiales*. Economica.
- Ho, S., Wong, K.S., 2001. A study of the relationship between corporate governance structures and the extent of voluntary disclosure. *Journal of International Accounting, Auditing & Taxation* 10 (2), 139–156.
- Holderness, C.G., 2009. The myth of diffuse ownership in the United States. *Review of Financial Studies* 22 (4), 1377–1408.
- Hope, O.-K., Langli, J.C., Thomas, W.B., 2010. Agency conflicts and auditing in private firms. SSRN eLibrary.
- Jaggi, B., Leung, S., 2007. Impact of family dominance on monitoring of earnings management by audit committees: evidence from Hong Kong. *Journal of International Accounting, Auditing & Taxation* 16 (1), 27–50.
- Jensen, M.C., 1986. Agency costs of free cash flow, corporate finance, and takeovers. *American Economic Review* 76 (2), 323.
- Jensen, M., Meckling, W., 1976. Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (4), 305–360.
- Jensen, K.L., Payne, J.L., 2005. Audit procurement: managing audit quality and audit fees in response to agency costs. *Auditing* 24 (2), 27–48.
- Johnson, S., La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 2000. Tunneling. *American Economic Review* 90 (2), 22–27.
- Kane, G.D., Velury, U., 2004. The role of institutional ownership in the market for auditing services: an empirical investigation. *Journal of Business Research* 57 (9), 976–983.
- Khalil, S., Magnan, M.L., Cohen, J.R., 2008. Dual-class shares and audit pricing: evidence from the Canadian markets. *Auditing* 27 (2), 199–216.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., 1998. Law and finance. *Journal of Political Economy* 106 (6), 1113–1155.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 1999. Corporate ownership around the world. *Journal of Finance* 54 (2), 471–517.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., 2000. Investor protection and corporate governance. *Journal of Financial Economics* 58 (1–2), 3–27.
- Labelle, R., Schatt, A., 2005. Structure de propriété et communication financière des entreprises françaises. *Finance Contrôle Stratégie* 8 (3), 77–104.
- Lafond, R., Roychowdhury, S., 2008. Managerial ownership and accounting conservatism. *Journal of Accounting Research* 46 (1), 101–135.
- Lennox, C., 2005. Management ownership and audit firm size. *Contemporary Accounting Research* 22 (1), 205–227.
- Lyon, J.D., Maher, M.W., 2005. The importance of business risk in setting audit fees: evidence from cases of client misconduct. *Journal of Accounting Research* 43 (1), 133–151.
- McConnell, J.J., Servaes, H., 1990. Additional evidence on equity ownership and corporate value. *Journal of Financial Economics* 27 (2), 595–612.
- Mishra, C.S., Randoy, T., Jenssen, J.I., 2001. *Journal of International Financial Management & Accounting* 12, 235, Blackwell Publishing Limited.
- Mitra, S., Cready, W.M., 2005. Institutional stock ownership, accrual management, and information environment. *Journal of Accounting, Auditing & Finance* 20 (3), 257–286.
- Mitra, S., Hossain, M., Deis, D., 2007. The empirical relationship between ownership characteristics and audit fees. *Review of Quantitative Finance & Accounting* 28 (3), 257–285.
- Mok, H.M.K., Hui, Y.V., 1998. Underpricing and aftermarket performance of IPOs in Shanghai, China. *Pacific-Basin Finance Journal* 6 (5), 453–474.
- Niemi, L., 2005. Audit effort and fees under concentrated client ownership: evidence from four international audit firms. *The International Journal of Accounting* 40 (4), 303–323.
- Palmrose, Z.-V., 1986. Audit fees and auditor size: further evidence. *Journal of Accounting Research* 24 (1), 97–110.

- Peel, M.J., Clatworthy, M.A., 2001. The relationship between governance structure and audit fees pre-cadbury: some empirical findings. *Corporate Governance: An International Review* 9 (4), 286.
- Pichard-Stamford, J.P., 2002. In: Hirigoyen, G., Caby, J. (Eds.). *La gestion des entreprises familiales*. Economica, Paris.
- Piot, C., 2001. Agency costs and audit quality: evidence from France. *European Accounting Review* 10 (3), 461–499.
- Pochet, C., 1998. Inefficacité des mécanismes de contrôle managérial: Le rôle de l'information comptable dans le gouvernement de l'entreprise. *Comptabilité Contrôle Audit* 4 (2), 71–88.
- Rajgopal, S., Venkatachalam, M., 1997. In: Working Papers (Faculty) – Stanford Graduate School of Business Stanford Business School, pp. 1–1.
- Shleifer, A., Vishny, R.W., 1997. A survey of corporate governance. *Journal of Finance* 52 (2), 737–783.
- Simunic, D.A., 1980. The pricing of audit services: theory and evidence. *Journal of Accounting Research* 18 (1), 161–190.
- Simunic, D.A., Stein, M.T., 1996. The impact of litigation risk on audit pricing: a review of the economics and the evidence. *Auditing* 15 (2), 119–134.
- Smith, M.P., 1996. Shareholder activism by institutional investors: evidence from calpers. *Journal of Finance* 51 (1), 227–252.
- Sun, Q., Tong, W.H.S., 2003. China share issue privatization: the extent of its success. *Journal of Financial Economics* 70 (2), 183.
- Trébucq, S., 2007. Minority shareholders and auditors: a brief history of a litigious french merger. *Accounting, Business & Financial History* 17 (2), 313–332.
- Trien, L., Chizema, A., 2011. State ownership and firm performance: evidence from chinese listed firms. *Organizations & Markets in Emerging Economies* 2 (2), 72–90.
- Venkataraman, R., Weber, J.P., Willenborg, M., 2008. Litigation risk, audit quality, and audit fees: evidence from initial public offerings. *Accounting Review* 83 (5), 1315–1345.
- Villalonga, B., Amit, R., 2006. How do family ownership, control and management affect firm value? *Journal of Financial Economics* 80 (2), 385–417.
- Wahal, S., 1996. Pension fund activism and firm performance. *Journal of Financial & Quantitative Analysis* 31 (1), 1–23.
- Whisenant, S., Sankaraguruswamy, S., Raghunandan, K., 2003. Evidence on the joint determination of audit and non-audit fees. *Journal of Accounting Research* 41 (4), 721–744.
- Willenborg, M., 1999. Empirical analysis of the economic demand for auditing in the initial public offerings market. *Journal of Accounting Research* 37 (1), 225–238.



## The effect of fair disclosure regulation on timeliness and informativeness of earnings announcements

Yeonhee Park<sup>a,1</sup>, Inman Song<sup>b,2</sup>, Dong-Hoon Yang<sup>c,d,\*</sup>, Mahmud Hossain<sup>e,3</sup>, Jeong-Ho Koo<sup>f,4</sup>

<sup>a</sup> Department of Business Information Education, Kongju National University, Republic of Korea

<sup>b</sup> Department of Accounting, SungKyunKwan University, Republic of Korea

<sup>c</sup> School of Accountancy, University of Hawaii at Manoa, USA

<sup>d</sup> Dongguk Business School, Dongguk University, 3-26 Pil-dong, Chung-gu, Seoul 100-715, Republic of Korea

<sup>e</sup> School of Accounting, Curtin University, Australia

<sup>f</sup> Department of Accounting, Kumoh National Institute of Technology, Republic of Korea

### ARTICLE INFO

#### Article history:

Received 8 November 2012

Accepted 13 December 2012

Available online 4 February 2013

#### JEL classification:

G14

G32

M41

M48

#### Keywords:

Fair disclosure

Preliminary reports

### ABSTRACT

This paper examines the effect of Korea's fair disclosure regulation on the timeliness and informativeness of earnings announcements. The present regulation for Korean listed firms requires that if a company's sales revenue, operating income (or loss) and net income (or loss) have changed by over 30% compared to the prior year, the firm must disclose this information through a preliminary financial report (PFR) even before the company is audited by external auditors. To analyze the effects of this policy, we first investigate the timeliness of preliminary financial report disclosures. We examine the extent to which Korean listed companies actually comply with the requirement for prompt notification of information concerning material changes in financial performance. Second, we investigate the informativeness of preliminary financial reports by analyzing differential stock market reactions to different timings of preliminary financial report disclosures. Our empirical results reveal that more than half of our sample firms release their preliminary financial

\* Corresponding author. Address: Dongguk Business School, Dongguk University, 3-26 Pil-dong, Chung-gu, Seoul 100-715, Republic of Korea (D.-H. Yang). Tel.: +82 2 2260 8655; fax: +82 2 2260 3684.

E-mail addresses: parkyh@kongju.ac.kr (Y. Park), imsong@skku.edu (I. Song), dyang@dongguk.edu (D.-H. Yang), Mahmud.Hossain@curtin.edu.au (M. Hossain), jhk2001@kumoh.ac.kr (J.-H. Koo).

<sup>1</sup> Tel.: +82 41 850 8253; fax: +82 41 850 8255, Hel.: +82 41 850 8253.

<sup>2</sup> Tel.: +82 2 760 0501; fax: +82 2 745 4566.

<sup>3</sup> Tel.: +61 8 9266 7742; fax: +61 8 9266 7196.

<sup>4</sup> Tel.: +82 54 478 7849; fax: +82 54 478 7859.



Production and hosting by Elsevier

Interim information  
Timeliness of information  
Korea

reports after external audits are completed, thereby potentially invalidating the effectiveness of the regulation. In addition, we find that preliminary financial reports have information value only if they are disclosed prior to annual audit report dates. This finding supports the notion that timeliness increases the informativeness of preliminary financial report disclosure by curbing insiders' ability to potentially profit from their information advantage.

© 2013 China Journal of Accounting Research. Founded by Sun Yat-sen University and City University of Hong Kong. Production and hosting by Elsevier B.V. All rights reserved.

## 1. Introduction

In October 2000, the Financial Supervisory Service of Korea (Korean SEC, "FSS") implemented a fair disclosure (FD) regulation for listed firms. This regulation calls for the public disclosure of preliminary financial reports even before they are audited by external auditors if a firm's sales revenue, operating income (or loss) and net income (or loss) have changed by over 30% compared to the prior year.<sup>5,6</sup> Such preliminary financial reports ("PFRs" hereafter) may convey useful information to all investors, even though the reports are not verified by an auditor. The aim of this new regulation is to level the playing field for all investors by mandating timely disclosure that pre-empts information advantages for insiders.<sup>7</sup> Without such a requirement, market-sensitive information can be delivered privately (or selectively) to certain enumerated persons (such as securities market professionals and holders of the issuer's securities) who may profit from their information advantage (SEC, 2000; Irani and Karamanou, 2003). Brown et al. (2004) show that the frequent and timely disclosure of material information can reduce the information advantage (asymmetry) of management. These authors explain that the regular timely release of information makes investors aware of private information concerning the future earnings of a firm, which in turn alleviates information asymmetry between management and outside shareholders.<sup>8</sup> Therefore, timely disclosures can affect the informativeness of accounting earnings.

Under the current regulation, however, the PFR has to be released *only* prior to the public notice date of the shareholders' meeting ("public notice date" hereafter), and this date typically comes far later than the audit report date, when the company receives its audit report from the independent auditors ("audit report date" hereafter). Consequently, firms may release PFRs even after the audit report date without violating the regulation. This is particularly likely when managers have concerns about subsequent changes in earnings after the completion of the external audit. Managers may face greater disclosure-related legal liability if the actual financial results differ from those disclosed in a PFR, as such reports inevitably involve *pro forma* financial performance information. Pawlewicz (2011) maintains that firms may respond to the increased regulatory

<sup>5</sup> In August 2000, the US SEC also passed Regulation Fair Disclosure (Reg. FD), which requires that firms release material information that may affect their share prices to all investors simultaneously. The purpose is to prohibit the "selective disclosure" of market-sensitive information to a select group of analysts and institutional investors who may well trade on the basis of the information.

<sup>6</sup> The European Union has also enacted a "Market Abuse Directive" (MAD) requiring that company managers inform the public of inside information concerning the company as soon as possible. (We thank a participant at the CJAR Symposium 2012, Bernard Raffournier, of the University of Geneva, for providing this information.)

<sup>7</sup> Gintschel and Markov (2004), for example, provide evidence that Reg. FD may be achieving the immediate aim of the regulators. These researchers document that the average price effect associated with the dissemination of analysts' information is significantly lower, by 28%, than the pre-regulation level. This finding is consistent with Reg. FD curtailing the flow of information from managers to analysts. In a similar vein, Bailey et al., (2003) examine the effect of Reg. FD on stock market responses to earnings releases, on the earnings forecasts produced by analysts and on the extent to which corporations voluntarily disclose information. These authors provide evidence of significant increases in trading volume and forecast dispersion, but they find no evidence of significant changes in return volatility. Although this evidence is consistent with managers substituting public disclosure for selective disclosure, it also suggests that Reg. FD imposes greater demands on investment professionals, resulting in the increased production of private information.

<sup>8</sup> In another context, Eleswarapu et al. (2004) find that information asymmetry, as reflected in trading costs at earnings announcements, has declined under Reg. FD. Their analysis of stock return volatility suggests that information flows around mandatory earnings announcements have decreased since the regulation came into effect. These results suggest that the SEC has been successful in diminishing the advantage of informed investors, without increasing volatility.



scrutiny of earnings announcements by exerting greater effort to verify their earnings announcement disclosures. Managers and their auditors could therefore delay earnings announcements until after the required date to review the figures more intensely and ensure that their announcements are free of errors before their public release. Consistent with this conjecture, we find that more than half of Korean listed companies disclose their PFRs after the audit report dates (when external audits on financial reports are completed), thereby potentially invalidating the effectiveness of the regulation. Obviously, these delays happen because the current regulation requires that companies release the PFRs only prior to the public notice date.

Griffin et al. (2011) find that some US companies post their FD filings well after the due date, thereby gaining unfairly by acting on the FD information prior to public disclosure. Pawlewicz (2011) also examines the effects of Regulation G on the timeliness of filings and on the reactions of investors to earnings announcement press releases.<sup>9</sup> He finds evidence that since Regulation G took effect, companies have taken longer to make their earnings announcements and that increased regulatory oversight has improved the perceived reliability of earnings announcements.

This study has two purposes. First, it analyzes the timeliness of PFR disclosures by examining the extent to which Korean listed companies comply with the fair disclosure regulation and actually issue prompt notification of material changes in their financial performance. The Financial Accounting Standards Board (FASB, 2010) notes that timeliness is an enhancing qualitative characteristic of financial reporting and that more timely earnings announcements are relevant to market fairness. The second purpose of this study is to empirically investigate the informativeness of PFRs by testing differential stock market reactions to different timings of PFR disclosures. Understanding the regulation's effect on timeliness and the informativeness of earnings announcements is important for preparers, users and regulatory bodies concerned with the relevance and reliability of financial reporting.

Our analysis indicates that most Korean companies release PFRs around their audit report dates or their public notice dates. This finding suggests that the primary objective of the current fair disclosure regulation may not be achieved, due to a “regulatory loophole” arising from unwarranted timeliness of disclosure. In addition, we find that PFRs have information value only if they are disclosed prior to audit report dates. This is consistent with the notion that timeliness increases the informativeness of PFR disclosure by curbing insiders' ability to potentially profit from their information advantage. In additional analysis, we investigate the association between ownership concentration and earnings informativeness. Our findings suggest that ownership structure does not play an important role in determining the marginal effect of timing the disclosure of PFRs to occur before the audit report date. Even so, a negative coefficient on the “owner's largest shareholder” interaction term provides a clue that firms with highly concentrated share ownership may have lower earnings informativeness, which is consistent with an entrenchment effect.

Our research makes two main contributions to the literature on the regulation of financial markets. First, although earlier research on Korean firms examines the effect of firm-specific characteristics on corporate disclosure, no previous study on Korean businesses has, to our knowledge, examined the association between the fair disclosure of preliminary financial reports and stock market reactions. This study thus tests the link between the timing of PRF releases (i.e., fair disclosure) and security market reactions. Second, our research contributes to an understanding of the mediating effects of the timeliness of fair disclosure in relation to the release of preliminary financial reports and security market reactions. Fair disclosure has received much attention in the US and the issue has become more significant in emerging markets due to the global rise in cross-border equity investments in recent years. This study also adds to the literature that examines the role and consequences of fair disclosure in capital markets and the information environment.

The remaining sections of this paper are organized as follows. Section 2 presents the related literature. Section 3 discusses current disclosure regulations in Korea. Section 4 describes the empirical specifications and sample. Section 5 discusses the results and Section 6 presents the study's conclusions.

---

<sup>9</sup> Pawlewicz (2011) explains that effective for all earnings announcements made on or after March 28, 2003, Regulation G requires that: (1) all firms must furnish their earnings announcement press releases to the SEC on a Form 8-K, and (2) firms that disclose measures not in accordance with Generally Accepted Accounting Principles (GAAPs), such as *pro forma* measures, must disclose the “most directly comparable GAAP financial measure,” and reconcile the non-GAAP figures to the closest GAAP measure.

## 2. Related literature

Several analytical and empirical studies have examined the effects of fair disclosure requirements on the information environment and on the quality of the information content disclosed. Ahmed and Schneible (2007) document that FD has reduced differences in the quality of information available to investors prior to earnings announcements, which is consistent with the intent of the regulation for leveling the information playing field. However, this reduction of information inequality is driven mainly by small firms and high-technology firms, not by the large firms targeted by the SEC. In addition, the regulation has not improved the average quality of information that investors have prior to earnings announcements for any subset of firms. Contrary to the assertions of the SEC, the requirements of FD have worsened the information environment for some firms, particularly small or high-tech firms.

In a related study, Callen et al. (2006) examine the relative value and relevance of information about cash flows, accruals and expected returns, according to the dates of SEC-required preliminary financial reports. They find that news of expected returns and earnings is value-relevant on the dates of preliminary earnings reports and SEC filing dates, and that news concerning earnings, cash flows and accruals is more value-relevant on the SEC filing dates for 10-K forms than on the filing dates for 10-Q forms. These authors also document that three informational components (i.e., news about the firm's risk, accruals and cash flows) contain less value-relevant information at the SEC filing date for firms with a higher proportion of long-term sophisticated investors than for those with a higher proportion of short-term investors. Extant research also documents the market reactions to firms releasing a number of alternative financial reports.

Grant (1980) documents that the amount of interim information (as an alternative form of preliminary information) that is available about OTC firms in particular may be systematically less than that available concerning NYSE firms, which suggests that firm size is positively related to the tendency to disclose preliminary information (such as interim information). Grant also finds that the annual earnings announcements of OTC firms appear to offer more information content than those of NYSE firms, as the timeliness of annual earnings announcements may be conditional on the amount of interim information available. The results of Grant's study suggest that although the accounting numbers presented in the annual earnings announcements may still be value-relevant, the information content of the numbers is, to a large extent, anticipated by the market prior to the date of release, due to the existing interim sources of information.

Similarly, Firth (1981), among others, finds that the week a preliminary announcement is made has the highest weekly level of "information" exchange, which suggests that preliminary reporting pre-empts insider trading by putting information into the public domain that would otherwise be privately held. Firth's results also indicate that interim reports have high levels of information content.

Opong (1995) extends Firth's study (1981) by investigating whether the information value of interim reports is reduced due to reliability problems that might arise because these reports are not subject to third-party certification. The study checks if interim financial reports in the UK contain value-relevant information. The results of the study, however, provide evidence to the contrary, showing that interim financial reports do contain information relevant to investment decisions on the days they are released.

Opong (1996) further examines the information content of preliminary annual financial reports in the UK by using hourly share price data. The results indicate that a significant price response to the release of annual preliminary reports occurs in the hour when the reports are released.

For the Korean market environment, Song (1989) examines the information content of *voluntary* disclosures of preliminary annual financial reports by using weekly share price data from the 1986 to 1987 period. The results indicate that substantial information is conveyed to the stock market by the release of preliminary annual financial reports. However, the information released at annual shareholders' meetings (which usually take place about two weeks subsequent to the release of preliminary annual financial reports) does not appear to give significant information to investors. Song suggests that the effect reports have on prices is usually confined to the week when the announcements are made.

Jang and Cheon (2003) extend Song's study (1989) by using daily returns data on a different sample and over a different time period. These authors examine the informativeness of *voluntary* announcements of preliminary earnings by investigating whether they pre-empt market reactions to annual earnings announcements. Their results reveal that stock markets react significantly to *voluntary* preliminary earnings

announcements, but that the market reaction to annual earnings announcements is not significant. This finding suggests that the information contained in annual reports is pre-empted by preliminary earnings announcements.

Both of the abovementioned studies attempt to assess whether the release of financial results in the form of *voluntary* preliminary announcements provides investors with significant value-relevant information. Both studies suggest that the release of actual earnings figures at annual shareholders' meetings does not provide significant additional information, because the earnings announcements are, to a large extent, anticipated by the market following preliminary announcements.

Previous studies collectively suggest that alternative forms of preliminary information, voluntary or mandatory, provide value-relevant information around their announcement periods and thus pre-empt the informativeness of actual earnings announcements. With respect to measuring the degree to which PFRs pre-empt the actual earnings information, previous studies consider dates related to a firm's annual report at its different stages, namely the public notice date (Firth, 1981; Sohn and Lee, 2005) and the date of the annual shareholders' meeting (Grant, 1980; Firth, 1981; Song, 1989; Jang and Cheon, 2003). However, these studies fail to identify the "audit report date" (when the company receives its audit report from the independent auditors) as a benchmark date for investigating the potential pre-emption of actual earnings information.

We argue that if the purpose of mandatory preliminary earnings announcements (such as PFRs) is to level the playing field for all investors by curbing insiders' ability to profit from their information advantage, then it is important to identify the earliest date at which the actual (i.e., audited) earnings are known if we are to assess the effectiveness of the disclosure regulation. Identifying the earliest benchmark event date is particularly crucial in the absence of a formal test for the existence of insider trading. In this regard, we examine the market reaction to PFR around the audit report date, as this is deemed to be the earliest announcement date of actual earnings.

### 3. Current Korean disclosure system

In Korea, the corporation disclosure system is governed by three related rules: commercial law, Securities and Exchange Act and External Audit Act. These rules specify filing schedules for important financial reporting events, including PFRs, audit reports to client companies (audit report dates), public notices of shareholders' meetings (public notice dates) and filings of final audit reports to shareholders ("filing date of audit report" hereafter).

According to the present rules, a listed company has to disclose PFRs before its public notice date whenever its sales revenue, operating income (or loss) and net income (or loss) have changed by over 30% compared to the prior year.<sup>10</sup> To eliminate the possible pre-emption of fair disclosure through potential information leakage and/or alternative disclosure sources, there should not be any other significant financial reporting event (for example, an audit report date) between the PFR disclosure and the public notice date. The current regulation, however, requires that independent auditors submit audit reports to their client companies within four weeks after receiving the client companies' financial statements.<sup>11</sup> In addition, companies are required to provide their financial statements to independent auditors six weeks prior to their annual shareholders' meetings.<sup>12</sup>

Given that the dates of annual shareholders' meetings are to be publicly announced only two weeks before the meetings are held and within three months after their fiscal year ends,<sup>13</sup> their audit report dates may fall between their PFR disclosure and public notice dates. This is particularly likely when client companies provide their financial statements to independent auditors shortly after fiscal year end. As a result, firms may release PFRs even after the audit report date without violating the regulation. This implies that material information about changes in the firm's financial performance may be selectively disclosed to privileged individuals

<sup>10</sup> Article 191-10(3), Securities Exchange Act.

<sup>11</sup> Article 447-4, commercial law.

<sup>12</sup> Article 7, External Audit Act.

<sup>13</sup> Article 4-2, Regulations on Listed Companies, Securities Exchange Act.

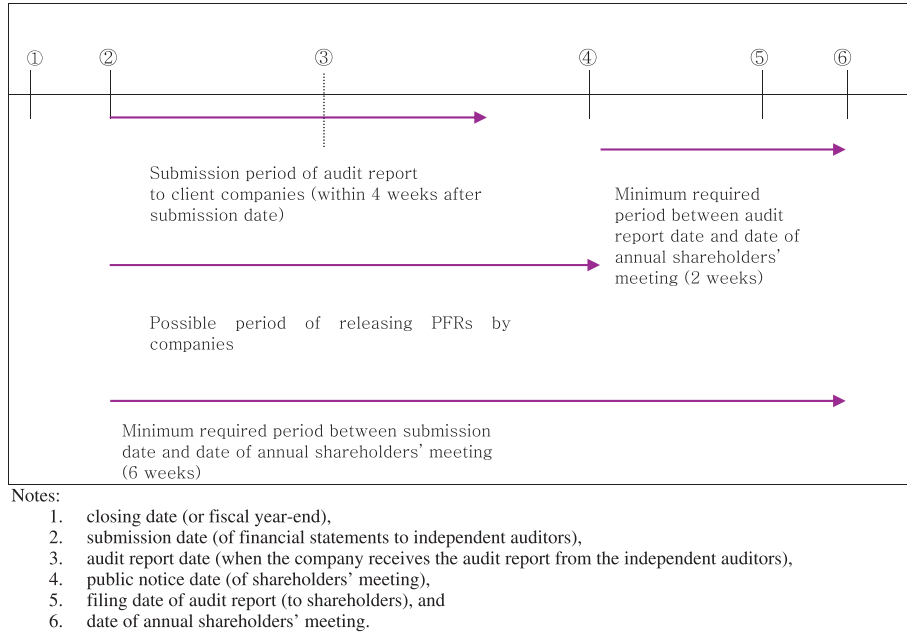


Fig. 1. Filing schedule for important financial reporting events.

between the audit report date and the disclosure date of a PFR, thereby pre-empting the informativeness of the PFR and invalidating the effectiveness of the fair disclosure regulation.

A summary of filing schedules for important financial reporting events of Korean listed companies under the current regulations is depicted in Fig. 1.

#### 4. Research methods

##### 4.1. Empirical models

To investigate the informational value of PFR content, we first analyze the cumulative abnormal returns (CARs) that accrue to shareholders around the date of the public release of the reports. From the KOSPI or the KOSDAQ equally weighted market index,<sup>14</sup> we obtain market model parameters that are measured over a 75-day period beginning 100 days prior to each event date. Once the parameters are estimated, the abnormal return (AR) for each sample firm is estimated for the announcement period that includes the announcement date (day 0) and the other days of interest (e.g., “day +1” after the announcement date) using the following equation:

$$AR_{jt} = R_{jt} - \hat{a}_j - \hat{b}_j R_{mt} = \varepsilon_{jt},$$

where  $R_{jt}$  is the realized return of firm  $j$  at time  $t$ ;  $R_{mt}$  is the realized return on a market index (e.g., the KOSPI index) at time  $t$ ; and  $a_j, b_j =$  parameters of the regression equation.

The CAR is the sum of abnormal returns for each sample firm for the announcement period from day  $t_0$  to day  $t_1$ , as calculated using the following equation:

$$CAR_j(t_0, t_1) = \sum_{t=t_0}^{t_1} AR_{jt}.$$

We then examine the informativeness of PFRs by estimating the following regression equation:

<sup>14</sup> KOSPI and KOSDAQ stand for the Korean Composite Stock Price Index and the Korean Securities Dealers Automated Quotations, respectively.

$$CAR_{jt}(-1, 0, 1) = a_1 + a_2PUE_{jt} + a_3DB_{PFR} * PUE_{jt} + a_4D_{NEG} * PUE_{jt} + a_5SIZE_{jt} + a_{6-8}YD + e_{jt}, \quad (1)$$

where  $CAR_{jt}(-1, 0, 1)$  is the cumulative abnormal return from “day  $-1$ ” to “day  $+1$ ” of firm  $j$  at time  $t$  (“day  $0$ ” denotes the date of the relevant earnings announcement);  $PUE_{jt}$  is the unexpected PFR earnings ( $PFR\ NI_{jt} - \text{actual } NI_{jt-1}$ ) of firm  $j$  at time  $t$ , deflated by the beginning market value of equity;  $DB_{PFR}$  has a value of 1 if PFR is disclosed *before* the audit report date, 0 otherwise;  $D_{NEG}$  has a value of 1 if net income is negative, 0 otherwise;  $SIZE$  is the beginning market value of equity; and  $YD$  represents year dummies.

The test of the information content of the PFRs analyzes the abnormal returns that accrue to shareholders. If information contained in a PFR is pre-empted by potential information leakage due to the delay of its disclosure until after the audit report date, then the parameter of unexpected PFR earnings,  $a_2$ , is expected to be not significantly different from zero, whereas the dummy interaction term ( $DB_{PFR}$ ), denoting that the PFR is released before the audit report date  $a_3$ , is expected to be positive.

Previous studies provide evidence that the amount of unexpected information conveyed to the market by actual earnings reports is inversely related to firm capitalization (Grant, 1980; Firth, 1981; Atiase, 1985; Jang and Cheon, 2003; Choen et al., 2004; Sohn and Lee, 2005). Thus, we include firm size ( $SIZE$ ) to control for the “size” effect. The model also includes the additional dummy interaction term ( $D_{NEG}$ ) to control for any differential return-earnings association of reported losses (Hayn, 1995; Sohn and Lee, 2005).

## 4.2. Sample and data

Two databases are used to select the sample for this study. Our sample firms are drawn from the Korean Information Service-Financial Analysis System (“KIS-FAS”) database for the period 2001–2009. All non-financial sector firms that satisfy all of the following criteria are selected: (1) Korean Stock Exchange listing; (2) fiscal year ending December 31; and (3) availability of dates of the relevant financial reporting events including audit report date, public notice date and filing date of the audit report. The dates of relevant financial reporting events are obtained from the Data Analysis, Retrieval and Transfer (“DART”) system of the Financial Supervisory Service of Korea (Korean SEC, FSS). These requirements provide an initial sample of 5557 firm-year observations.

Eliminating firms that have not issued PFRs leaves 3129 observations. Among these, 319 firm-year observations with missing audit dates or public notice dates were deleted. The resulting sample of 2810 firm-year observations is used to perform our analysis of the timeliness of PFR reports.

For the sample to test the value of information content in PFRs, we require that sample firms release PFRs at least two days before their audit report dates, to ensure that the earnings information contained in PFRs is not affected by the audit report’s statement of actual earnings. This requirement leaves a final sample of 2187 firm-year observations to test the market reaction to PFR announcements. Table 1 summarizes our sample selection procedures.

## 5. Results

### 5.1. Trend in PFR reporting lag and timeliness of reports

To analyze timeliness in our sample of PFRs, we examine both compliance with the statutory filing deadline and the number of calendar days between the statutory deadline and the actual disclosure date. For our sample of 3129 PFRs disclosed during the 2001–2009 period, 1943 sample firms (62%) released PFRs after the audit report dates. As discussed earlier, these firms are not violating the current regulation, as it only requires that PFRs have to be released prior to the public notice date of the shareholders’ meeting. However, information that should be conveyed to all investors by PFRs might be pre-empted by potential private information delivery to certain enumerated persons.<sup>15</sup>

<sup>15</sup> Pawlewicz (2011) provides similar evidence that earnings announcements have come 5.37 days later for the fourth fiscal quarter (i.e., fiscal year-end) since the implementation of Regulation G (compared to before Regulation G). In contrast, Griffin et al. (2011) show that the length of time by which companies allegedly exceed FD requirements is quite short – in four cases, *only* two trading days or less.

Table 1

Description of sample selection procedure.

Total observations on the Korea Information Service-Financial Analysis System (“KIS-FAS”) database and the Data Analysis, Retrieval and Transfer (“DART”) system on FSS that satisfy all of the following initial sample criteria:	5557
(1) Korean Stock Exchange listing,	
(2) Fiscal year ending December 31, and	
(3) Availability of dates of relevant financial reporting events including audit report date, public notice date and filing date of the audit report.	
Less: Observations without announcements of PFRs	(2428)
<b>Sub total</b>	<b>3129</b>
Less: Observations with missing audit dates or public notice dates	(319)
<b>Sample used to analyze the timeliness of PFR reports</b>	<b>2810</b>
Less: Observations with PFR releases later than 2 days after the audit report date	(623)
<b>Final sample for testing the market reaction to PFR announcements</b>	<b>2187</b>

A total of 981 firms (31%) disclosed PFRs even after the public notice dates of their shareholders’ meetings, which suggests that a nontrivial portion of the sample firms are violating the current regulation. Furthermore, we observe 14 companies that disclosed PFRs on or after the filing date of audit reports to shareholders.

Table 2 summarizes the PFR reporting lag compared to related financial reporting event dates.

To gain further insight into the trends in PFR timeliness and other related financial reporting events, we analyze the number of calendar days between financial statement dates and five relevant financial reporting events, including the PFR disclosure date, the audit report date, the public notice date, the date that the audit report is filed and the date of the annual shareholders’ meeting. As shown in Table 3, the average (median) date of PFR disclosure for the sample period (2001–2009) is 50.71 (52) days after the fiscal year-end, but the average (median) for the audit report date is only 46.37 (46) days after the fiscal year-end. This evidence corroborates our earlier finding that a significant number (about 69%) of sample firms release PFRs after their audit report dates. The results of our analyses for individual years exhibit a similar pattern and show that average audit report dates are two to three days earlier than the PFR disclosure dates.

Taken together, the results of our analysis presented in Tables 2 and 3 suggest that the current regulation for PFRs may not be effective in fulfilling its intended main objective of providing a level playing field to all investors by mandating more timely disclosure to curb insiders’ ability to profit from their information advantage. Indeed, any financial information released after the audit report date could be potentially based on the audited figures and therefore it is no longer *preliminary* because external auditing processes are substantially completed at the audit report date.

The question that emerges from the above analysis is why firm managers show a tendency to disclose PFRs as late as possible. We conjecture that firm managers might try to avoid unnecessary disclosure-related legal liability due to audited financial results differing from those announced in PFRs. One way to avoid this risk is to disclose the PFR after the audit report date. Consistent with this conjecture, the analysis presented in Table 4 indicates that 884 out of the 3129 firms (28.3%) over the sample period either overestimated or underestimated PFR earnings, compared to those audited. Among firms that overestimated or underestimated PFR earnings, 484 firms overestimated and 400 underestimated their forthcoming actual earnings. This finding suggests that management tends to announce optimistic preliminary earnings (e.g., Cheon and Sohn, 2005).

## 5.2. Market tests

### 5.2.1. Market reaction to unexpected PFR earnings

The information content of PFRs is evaluated using cumulative abnormal returns (CARs) around the dates of the public release of the reports. Table 5 shows market reactions to announcements of unexpected net income in PFRs at different timings of their releases to the market. As the first column of Table 5 shows, the coefficient of preliminary unexpected earnings (PUEs) reported in PFRs for the full sample is positive and significant at  $p < 0.01$ , suggesting that the stock market may respond to PUE regardless of the timing of its release. To check this possibility, and more importantly to directly test our hypothesis, we add a dummy interaction term (DB\*PUE) to the regression model, which disentangles the marginal effect of the disclosure timing of PFR before the audit report date as a linear function of unexpected net income announced in PFRs.

Consistent with our prediction that PFRs convey information to the stock market only if they are disclosed prior to the audit report date, the regression results in the second column of Table 5 shows that the coefficient on the dummy interaction term is positive and marginally significant at  $p < 0.1$ . The last two columns of Table 5 report the results of estimating the regressions after dividing the sample into two groups, based on whether the timing of PFR disclosure is before or after the audit report date. Consistent with the results of the full sample reported earlier, the estimated coefficient on unexpected net income for the sub-sample that releases its PFRs *before* the audit report date is 0.003 and significantly greater than zero at  $p < 0.01$ . For the sub-sample that releases PFRs *after* the audit report date, the corresponding PUE coefficient of 0.011 is not statistically greater than zero at conventional levels.

### 5.2.2. Market reaction to unexpected actual earnings

In this subsection, we provide collaborating evidence that the informativeness of actual earnings reports could be pre-empted by PFRs when the audit report date is followed by the PFR release date. To gather this evidence, we assess the market reaction to actual unexpected net income around the audit report date. The regression results for the full sample, as reported in the first column of Table 6, indicate that actual unexpected earnings information has, on average, no information content. The regression coefficient on actual unexpected earnings (UEs) is positive and not significantly different from zero at conventional levels. This result is somewhat surprising in that it contradicts the conventional evidence that earnings announcements convey useful information to the stock market.

Table 6 also indicates that the coefficients on the  $DB_{PFR} * UE$  and  $DNO_{PFR} * UE$  interaction terms are not statistically significant, which suggests that actual earnings announcements convey no information to the market when the PFR is disclosed before the audit report date or if no PFR is disclosed at all.<sup>16</sup> However, the regression coefficient on the  $DA_{PFR} * UE$  interaction term is positive and significant at less than the 5% level. This confirms that the informativeness of unexpected actual net income is warranted only when audit report dates precede PFR release dates.

### 5.3. Ownership structure and differential market reaction to unexpected PFR earnings

The results of our main analysis provide evidence that announcements of unexpected net income in PFRs are informative only when they are disclosed prior to audit report dates. This result could be due in part to differences in ownership structure. Previous studies offer conflicting evidence on the relationship between corporate ownership structure and the informativeness of earnings reports. For example, Firth et al. (2007) document that firms in China with highly concentrated share ownership have lower earnings informativeness. These authors attribute their finding to an entrenchment effect, in which large shareholders may influence firms to adopt accounting policies that reflect the wishes of the large owners rather than the economic substance of the business transactions. However, Jung and Kwon (2002) provide evidence that among Korean firms, earnings reports become more informative as the shareholdings of the owner increase, which supports the convergence-of-interest hypothesis for large shareholders. Sarikhani and Ebrahimi (2011) also find a positive and meaningful relationship between ownership concentration and earnings informativeness for a sample of Iranian companies.<sup>17</sup> In light of the above conflicting evidence, we further examine whether ownership concentration is associated with earnings informativeness in PFR releases.

Jung and Kwon (2002) contend that the ownership structure of Korean firms is characterized by the predominant role of the owner-largest shareholder. The owner-largest shareholder effectively controls the whole company by holding a significant proportion of its shares. We investigate the association between ownership concentration and earnings informativeness by adding the interaction term  $DB_{PFR} * PUE_{jt} * OWN$  in Eq. (1). Following Jung and Kwon (2002), the dichotomous variable OWN is coded as one if the percentage of stocks held by the owner-largest shareholder is above the median of the sample firms, and zero otherwise.

<sup>16</sup> To compare the information content of actual earnings for PFR-releasing firms with that of non-PFR-releasing firms, we extend our sample by adding 680 firm-year observations on firms that do not release PFRs. The estimation results for this larger sample are qualitatively the same as those reported in Table 6.

<sup>17</sup> Similarly, Fan and Wong (2002) find that the entrenchment effect due to concentrated ownership reduces the informativeness of reported earnings in Hong Kong, Indonesia, South Korea, Malaysia, Singapore, Taiwan and Thailand.

Table 2  
PFR reporting lag ( $N = 3129$ ).

Disclosure timing compared to PFR date Compared to PFR disclosure date <sup>a</sup>	-22 or less	-21 to -15	-14 to -8	-7 to -1	0	1-7	8-14	15-21	22 or more
Audit report date	403	308	422	626	184	677	230	104	175
Public notice date of shareholders' meeting	13	23	204	355	386	610	471	328	739
Date of annual shareholders' meeting <sup>b</sup>	4			3	6	139	486	764	1727

<sup>a</sup> Number of calendar days between the PFR disclosure date and the day of the audit report, the public notice of shareholders' meeting or the annual shareholders' meeting.

<sup>b</sup> It is extraordinary that in 13 firms, the PFR disclosure date is the same as or later than the filing date of the audit report.

Table 3  
Timing of financial reporting events.

Description	Number of firms	Average number of calendar days	Std. dev.	Minimum	Median	Maximum
PFR disclosure date <sup>a</sup>	2001	225	49.19	12.60	15	80
	2002	332	42.48	13.05	13	76
	2003	331	43.81	12.62	9	77
	2004	375	42.12	14.20	5	72
	2005	374	52.97	16.71	11	88
	2006	357	54.93	16.46	10	87
	2007	363	56.62	17.13	9	85
	2008	394	57.88	16.17	11	89
	2009	378	54.75	17.32	10	89
	<b>2001 ~ 2009</b>	<b>3129</b>	<b>50.71</b>	<b>16.53</b>	<b>5</b>	<b>52</b>
Audit report date <sup>b</sup>	2001	225	44.82	13.19	14	87
	2002	332	42.15	12.68	13	85
	2003	331	42.90	11.33	12	79
	2004	375	40.71	12.75	9	76
	2005	374	40.42	12.39	12	97
	2006	357	45.43	14.56	12	84
	2007	363	50.95	14.93	17	83
	2008	394	53.36	13.99	20	89
	2009	378	54.85	14.49	21	84
	<b>2001 ~ 2009</b>	<b>3129</b>	<b>46.37</b>	<b>14.46</b>	<b>9</b>	<b>46</b>

<sup>a</sup> PFR disclosure date – financial statement date.

<sup>b</sup> Audit report date – financial statement date.

Table 7 presents findings from the investigation into the association between unexpected PFR earnings and ownership concentration around the release dates. The regression coefficient of the interaction term  $DB_{PFR} * PUE_{jt} * OWN$  for the full sample is positive (0.003) but statistically insignificant. This finding suggests that ownership structure does not play an important role in determining the marginal effect of disclosing PFRs before the audit report date ( $DB_{PFR} * PUE$ ). Despite this finding, a positive coefficient on the owner-largest shareholder ownership interaction term provides a clue that firms with highly concentrated share ownership may have higher earnings informativeness, which is consistent with the convergence-of-interest hypothesis. The results from dividing the sample into two groups based on the timing of PFR disclosure (before and after the audit report date) remain qualitatively similar to the results for the full sample.

#### 5.4. Alternative market expectation of earnings<sup>18</sup>

In measuring earnings surprise, we rely on the random walk model in which unexpected earnings is defined as the difference between PFR earnings and last year's net income. This approach may have limitations, in that the model implicitly assumes that annual reports are the only source of information, which may be acceptable

<sup>18</sup> We thank Bernard Raffournier, again, for pointing out this issue.



Table 4  
Overestimation vs. underestimation of PFR earnings (Millions of Korean Won).

Year	Description	Number of firms	PFR earnings (A)	Audited earnings (B)	Difference (A – B)
2001	Overestimated	61	-35,897	-47,665	11,768
	Underestimated	54	112,913	117,711	-4,798
	No difference	110	-44	-44	0
	2001 Total	225	8739	6745	1994
2002	Overestimated	127	38,340	26,590	11,750
	Underestimated	55	18,909	25,176	-6,267
	No difference	150	92,684	92,684	0
	2002 Total	332	65,603	62,349	3,253
2003	Overestimated	98	3748	1348	2400
	Underestimated	71	44,780	45,468	-689
	No difference	162	108,323	108,323	0
	2003 Total	331	61,780	61,153	627
2004	Overestimated	92	69,147	68,323	824
	Underestimated	70	53,103	54,325	-1,221
	No difference	213	191,030	191,030	0
	2004 Total	375	100,378	100,462	-84
2005	Overestimated	32	79,271	59,067	20,204
	Underestimated	39	305,099	395,251	-90,152
	No difference	303	67,020	67,020	0
	2005 Total	374	95,907	104,472	-8565
2006	Overestimated	31	115,375	106,468	8907
	Underestimated	34	99,817	209,366	-109,549
	No difference	292	54,154	54,154	0
	2006 Total	357	64,706	75,252	-10,546
2007	Overestimated	14	245,576	232,396	13,180
	Underestimated	37	94,968	147,457	-52,489
	No difference	312	62,852	62,852	0
	2007 Total	363	76,379	81,530	-5151
2008	Overestimated	11	37,698	6021	31,677
	Underestimated	19	86,247	128,455	-42,208
	No difference	364	45,617	45,617	0
	2008 Total	394	47,493	48,736	-1,239
2009	Overestimated	18	567,711	429,034	138,676
	Underestimated	21	90,511	270,774	-180,263
	No difference	339	43,395	43,395	0
	2009 Total	378	72,603	76,214	-3,612
<b>2001 ~ 2009</b>	<b>Overestimated</b>	<b>484</b>	<b>86,351</b>	<b>72,156</b>	<b>14,196</b>
	<b>Underestimated</b>	<b>400</b>	<b>79,015</b>	<b>118,828</b>	<b>-39,813</b>
	<b>No difference</b>	<b>2245</b>	<b>59,558</b>	<b>59,558</b>	<b>0</b>
	<b>Total</b>	<b>3129</b>	<b>299,150</b>	<b>326,733</b>	<b>-27,583</b>

Table 5

Market reaction to unexpected PFR earnings. Model:  $CAR_{jt}(-1,0,1) = a_1 + a_2PUE_{jt} + a_3DB_{PFR} * PUE_{jt} + a_4D_{NEG} * PUE_{jt} + a_5SIZE_{jt} + a_{6-8}YD + e_{jt}$ .

Model	Full sample ( $n = 2187$ )	Full sample with $DB * PUE$ ( $n = 2187$ )	Sub-sample with PFR release <i>before</i> audit report date ( $n = 820$ )	Sub-sample with PFR release <i>after</i> audit report date ( $n = 1241$ )
Intercept	0.077 (3.71)***	0.076 (3.65)***	0.080 (2.69)***	0.072 (1.63)
PUE	<b>0.001 (3.27)***</b>	0.001 (2.35)**	<b>0.003 (2.98)***</b>	0.011 (1.64)
$DB_{PFR} * PUE$		<b>0.002 (1.94)*</b>		
$D_{NEG} * PUE$	-0.018 (-5.55)***	-0.018 (-5.42)***	-0.002 (-4.33)***	-0.025 (-3.26)***
SIZE	-0.002 (-3.30)***	-0.002 (-3.25)***	-0.002 (-2.41)***	-0.002 (-1.39)
Adj $R^2$	2.27%	2.23%	4.28%	3.17%

Max value was adjusted by average  $\pm 3$ \*standard deviation.

$CAR_{jt}(-1,0,1)$ : cumulative abnormal return from “day -1” to “day +1” of firm  $j$  at time  $t$  (“day 0” denotes the PFR release date).

$PUE_{jt}$ : unexpected PFR earnings (PFR  $NI_{jt} - \text{actual } NI_{jt-1}$ ) of firm  $j$  at time  $t$  deflated by beginning market value of equity.

$DB_{PFR}$ : 1 if PFR is disclosed *before* audit report date, 0 otherwise.

$D_{NEG}$ : 1 if net income is negative, 0 otherwise.

SIZE: beginning market value of equity.

YD: year dummies.

\* 10% Significance level.

\*\* 5% Significance level.

\*\*\* 1% Significance level.

Table 6

Market reaction to unexpected actual earnings. Model:  $CAR_{jt}(-1,0,1) = a_1 + a_2UE_{jt} + a_3DB_{PFR}$  (or  $DA_{PFR}$  or  $DNO_{PFR}$ )\* $UE_{jt} + a_4D_{NEG} * UE_{jt} + a_5SIZE_{jt} + a_{6-8}YD + e_{jt}$ .

Model ( $n = 2,187$ )	Basic model	Model 1	Model 2	Model 3
Intercept	0.040 (2.33)**	0.046 (1.88)*	0.044 (1.81)*	0.049 (2.17)**
UE	0.002 (0.70)	-0.001 (-0.12)	-0.007 (-0.37)	0.002 (0.68)
$DB_{PFR} * UE$		0.003 (0.66)		
$DA_{PFR} * UE$			0.013 (2.38)**	
$DNO_{PFR} * UE$				-0.001 (0.59)
$D_{NEG} * UE$	0.009 (1.80)	0.004 (0.81)	0.008 (1.65)	0.008 (0.05)
SIZE	-0.001 (-2.06)**	-0.001 (-1.71)*	-0.002 (-2.19)**	-0.001 (-1.99)**
Adj $R^2$	1.35%	0.99%	1.19%	0.96%

$CAR_{jt}(-1,0,1)$ : cumulative abnormal return from “day -1” to “day +1” of firm  $j$  at time  $t$  (“day 0” denotes audit report date).

$UE_{jt}$ : unexpected actual earnings (actual  $NI_{jt} - \text{actual } NI_{jt-1}$ ) of firm  $j$  at time  $t$  deflated by beginning market value of equity.

$DB_{PFR}$ : 1 if PFR is disclosed *before* audit report date, 0 otherwise.

$DA_{PFR}$ : 1 if PFR is disclosed *after* audit report date, 0 otherwise.

$DNO_{PFR}$ : 1 if PFR is *not* disclosed, 0 otherwise.

$D_{NEG}$ : 1 if net income is negative, 0 otherwise.

SIZE: beginning market value of equity.

YD: year dummies.

\*\*\* 1% Significance level.

\* 10% Significance level.

\*\* 5% Significance level.

for small- or medium-sized firms, but not for large firms that are followed by financial analysts (Kothari, 2001). To address this concern, we define earnings surprise as the difference between PFR earnings and the market expectation of net income, represented as the forecast consensus of analysts.

The second and third columns in Table 8 report the market reaction to PFR announcements of unexpected net income (PUE1) based on the timing of their release into the market. Consistent with our prediction and the result reported in Table 5, the estimated coefficient on unexpected net income for the sub-sample that releases PFRs *before* the audit report date is 0.151 and significantly greater than zero at  $p < 0.01$ . For the sub-sample

Table 7

Effect of ownership concentration on the informativeness of unexpected PFR earnings. Model:  $CAR_{jt}(-1,0,1) = a_1 + a_2PUE_{jt} + a_3DB_{PFR} * PUE_{jt} + a_4DB_{PFR} * PUE_{jt} * OWN + a_5D_{NEG} * PUE_{jt} + a_6SIZE_{jt} + a_{7-9}YD + \epsilon_{jt}$ .

Model	Full sample with DB*PUE (n = 2187)	Sub-sample with PFR release <i>before</i> audit report date (n = 820)	Sub-sample with PFR release <i>after</i> audit report date (n = 1241)
Intercept	0.071 (3.40)***	0.080 (2.55)**	0.050 (1.51)
PUE	0.015 (3.77)***	0.012 (2.70)***	0.016 (2.91)**
PUE*OWN		-0.001 (-0.11)	-0.025 (-1.96)*
DB <sub>PFR</sub> *PUE	-0.001 (-0.32)		
DB <sub>PFR</sub> *PUE*OWN	0.0003 (0.03)		
D <sub>NEG</sub> *PUE	-0.015 (-4.35)***	-0.002 (-3.34)***	-0.010 (-2.21)**
SIZE	-0.002 (-3.11)***	-0.002 (-2.36)**	-0.001 (-1.36)
Adj R <sup>2</sup>	2.55%	4.03%	1.32%

Max value was adjusted by average  $\pm 3$ \*standard deviation.

CAR<sub>jt</sub>(-1,0,1): cumulative abnormal return from “day -1” to “day +1” of firm *j* at time *t* (“day 0” denotes the PFR release date).

PUE<sub>jt</sub>: unexpected PFR earnings (PFR NI<sub>jt</sub> - actual NI<sub>jt-1</sub>) of firm *j* at time *t* deflated by beginning market value of equity.

DB<sub>PFR</sub>: 1 if PFR is disclosed *before* audit report date, 0 otherwise.

OWN: 1 if the percentage of stocks held by the owner-largest shareholder is above the median of the sample firms, 0 otherwise.

D<sub>NEG</sub>: 1 if net income is negative, 0 otherwise.

SIZE: beginning market value of equity.

YD: year dummies.

\* 10% Significance level.

\*\* 5% Significance level.

\*\*\* 1% Significance level.

Table 8

Market reaction to unexpected PFR (actual) earnings: alternative market expectation of earnings (Analysts' Consensus).

Model	Market reaction to unexpected PFR (PUE1)		Market reaction to unexpected actual earnings (UE1)	
	Sub-sample with PFR release <i>before</i> audit report date (n = 331)	Sub-sample with PFR release <i>after</i> audit report date (n = 432)	Sub-sample with actual earnings release <i>before</i> audit report date (n = 331)	Sub-sample with actual earnings release <i>after</i> audit report date (n = 432)
Intercept	0.079 (2.11)**	-0.004 (-0.11)	-0.007 (-0.22)	-0.020 (-0.52)
PUE1 (or UE1)	0.151 (2.73)***	0.070 (1.27)	-0.012 (-0.19)	-0.020 (-0.65)
D <sub>NEG</sub> *PUE1 (or UE1)	-0.025 (-0.32)	-0.042 (-0.57)	-0.001 (-0.33)	0.001 (0.73)
SIZE	-0.003 (-2.25)**	0.021 (0.56)	0.031 (0.08)	0.001 (0.73)
Adj R <sup>2</sup>	6.15%	0.39%	1.65%	0.39%

Max value was adjusted by average  $\pm 3$ \*standard deviation.

PUE1<sub>jt</sub>: unexpected PFR earnings (PFR NI<sub>jt</sub> - analysts' consensus forecast<sub>jt</sub>) of firm *j* at time *t* deflated by beginning market value of equity.

UE1<sub>jt</sub>: unexpected actual earnings (actual NI<sub>jt</sub> - analysts' consensus forecast<sub>jt</sub>) of firm *j* at time *t* deflated by beginning market value of equity.

\*10% Significance level.

\*\* 5% Significance level.

\*\*\* 1% Significance level.

that releases PFRs *after* the audit report date, the corresponding PUE coefficient of 0.070 is not statistically greater than zero at conventional levels.

The last two columns in Table 8 report the results of estimating the regressions after dividing the sample into two sub-groups, based on the timing of actual earnings disclosures before or after the audit report date. The estimated coefficient on unexpected actual earnings (UE1) for the sub-sample that releases PFRs *before* (*after*) the audit report date is -0.012 (-0.020) and not statistically greater than zero at the conventional level. This finding suggests that actual earnings announcements convey no information to the market, whether

the actual earnings are disclosed before or after the audit report date. Such a result is somewhat surprising, in that the regression coefficient on the  $DA_{PFR} * UE$  interaction term in Table 6 is significantly positive, suggesting that reports of unexpected actual net income convey information to the market only when the audit report date precedes the PFR release date. We attribute our Table 8 result to the possibility (subject to future verification) that the use of analysts' consensus forecasts could limit the sample to mainly large firms with analyst following, thereby reducing the statistical power of the test and inducing sample-selection bias.<sup>19</sup> Considering that firm size is positively related to the tendency to disclose alternative value-relevant information (Grant, 1980), the information content of earnings is anticipated by the market prior to the date of release.

## 6. Summary and conclusions

We analyze the timeliness of preliminary financial reports (PFRs) in our sample of Korean firms, examining the value of the informational content in these releases to the public domain. The results of this study indicate that more than half of our sample firms released PFRs after their audit report dates. This finding raises concerns that any financial information released after the audit report dates could potentially be based on the audited figures, which would mean that they could no longer be considered *preliminary* because external auditing processes are substantially completed by the audit report date. Consistent with this analysis, our regression results reveal that announcements of unexpected net income are only informative when they are disclosed prior to the audit report date. Further analysis suggests that owner-largest shareholders do not play an important role in determining the marginal effects of PFRs disclosed before audit report dates.

Collectively, our findings have implications for accounting policymakers, who should pay increased attention to PFR reporting issues. The current regulation for PFRs in Korea may not be effective in fulfilling its main objective of pre-empting insider trading by getting information that would otherwise be privately held into the public domain. To achieve this, it may be necessary to amend the current PFR regulation and require that firms release PFRs well before independent auditors complete their audits.

## References

- Ahmed, A., Schneible Jr., R., 2007. The impact of regulation fair disclosure on investors' prior information quality – evidence from an analysis of changes in trading volume and stock price reactions to earnings announcements. *Journal of Corporate Finance* 13 (June), 282–299.
- Atiase, R., 1985. Predisclosure information, firm capitalization, and security price behavior around earnings announcement. *Journal of Accounting Research* 23 (1), 21–36.
- Bailey, W., Li, H., Mao, C., Zhong, R., 2003. Regulation Fair Disclosure and Earnings Information: Market, Analyst, and Corporate Responses, Working Paper, Cornell University.
- Brown, S., Hillegeist, S.A., Loh, K., 2004. Conference calls and information asymmetry. *Journal of Accounting and Economics* 37 (3), 343–366.
- Callen, J.L., Livant, J., Segal, D., 2006. The information content of SEC filings and information environment: a variance decomposition analysis. *The Accounting Review* 81 (5), 1017–1043.
- Cheon, Y.S., Sohn, J., 2005. Firm characteristics and the market monitoring of optimistic preliminary earnings announcements. *The Korean Accounting Review* 30, 79–105.
- Choen, Y., Rho, J., Bae, G., 2004. The effect of the DART system on the timing that earnings information is impounded in stock prices. *Korean Accounting Journal* 13, 77–100.
- Eleswarapu, V., Thomson, R., Venkataraman, K., 2004. The impact of regulation fair disclosure: trading costs and information asymmetry. *Journal of Financial and Quantitative Analysis* 39 (2), 209–225.
- Fan, J., Wong, T., 2002. Corporate governance structure and the informativeness of accounting earnings in East Asia. *Journal of Accounting and Economics* 33, 401–425.
- Financial Accounting Standards Board (FASB). 2010. Conceptual Framework for Financial Reporting. Statement of Financial Accounting Concepts No. 8.
- Firth, M., 1981. The relative information content of the release of financial results data by firms. *Journal of Accounting Research* 19 (2), 521–529.

<sup>19</sup> The use of analysts' consensus forecasts for the market expectation of earnings reduces our sample size from 2187 to 763 firm-year observations. We collect analyst forecasts from the FnGuide database. Among 905 firm-year observations with analyst forecasts, we delete 142 observations with PFR releases later than two days after the audit report dates.

- Firth, M., Fung, P., Rui, O., 2007. Ownership, two-tier board structure, and the informativeness of earnings – evidence from China. *Journal of Accounting and Public Policy* 26, 463–496.
- Gintschel, A., Markov, S., 2004. The effectiveness of regulation FD. *Journal of Accounting and Economics* 37, 293–314.
- Grant, E.B., 1980. Market implications of differential amounts of interim information. *Journal of Accounting Research* 18, 255–268.
- Griffin, P., Lont, D., Segal, B., 2011. Enforcement and disclosure under regulation fair disclosure: an empirical analysis. *Accounting and Finance* 51, 947–983.
- Hayn, C., 1995. The information content of losses. *Journal of Accounting and Economics* 20, 125–153.
- Irani, A.J., Karamanou, I., 2003. Regulation fair disclosure, analyst following, and analysts forecast dispersion. *Accounting Horizons* 17 (March), 15–29.
- Jang, J., Cheon, Y., 2003. Preliminary-earnings-announcement, firm characteristics and preemption of market reactions to actual earnings announcements. *The Korean Accounting Review* 28, 79–107.
- Jung, K., Kwon, S., 2002. Ownership Structure and Earnings Informativeness: Evidence from Korea. *The International Journal of Accounting*, 301–325.
- Kothari, S.P., 2001. Capital markets research in accounting. *Journal of Accounting and Economics* 31, 105–231.
- Opong, K.K., 1995. The information content of interim financial reports: UK evidence. *Journal of Business Finance and Accounting* 22 (2), 269–279.
- Opong, K.K., 1996. Hourly share price response to the release of preliminary annual financial reports: some UK evidence. *British Accounting Review* 28, 187–202.
- Pawlewicz, R., 2011. The Effect of Regulation G on the Timeliness and Perceived Reliability of Earnings Announcements, Working Paper. Baruch College, City University of New York.
- Sarikhani, M., Ebrahimi, M., 2011. Corporate governance and earnings informativeness: evidence from Iran. *International Research Journal of Finance and Economics* 65, 43–50.
- Sohn, S., Lee, E., 2005. Information content study of timely disclosure regarding income structural changes. *Korean Accounting Journal* 14, 29–56.
- Song, I.M., 1989. An empirical study of usefulness of accounting earnings: review of the timing of the accounting earnings disclosures using weekly returns. *The Korean Accounting Review* 9, 1–24.





Contents lists available at SciVerse ScienceDirect

China Journal of Accounting Research

journal homepage: [www.elsevier.com/locate/cjar](http://www.elsevier.com/locate/cjar)



# Chairman's government background, excess employment and government subsidies: Evidence from Chinese local state-owned enterprises

Xiongyuan Wang<sup>a</sup>, Shan Wang<sup>b,\*</sup>

<sup>a</sup> School of Accounting, Zhongnan University of Economics and Law, China

<sup>b</sup> Antai College of Economics and Management, Shanghai JiaoTong University, China

## ARTICLE INFO

### Article history:

Received 28 June 2012

Accepted 28 August 2012

Available online 21 December 2012

### JEL classification:

D73

G28

G32

H2

### Keywords:

Government background

Excess employment

Government intervention

## ABSTRACT

Local state-owned enterprises (SOEs) in China continue to face government interference in their operations. They are influenced both by the government's "grabbing hand" and by its "helping hand." Our study examines how SOE chairmen with connections to government influence their firm's employment policies and the economic consequences of overstaffing. Using a sample of China's listed local state-owned enterprises, we find that the scale of overstaffing in these SOEs is negatively related to the firms' political connections to government. However, this relationship turns positive when the firm's chairman has a government background. Appointing chairmen who have government backgrounds is a mechanism through which the government can intervene in local SOEs and influence firms' staffing decisions. We also find that in compensation for the expenses of overstaffing, local SOEs receive more government subsidies and bank loans. However, the chairmen themselves do not get increased pay or promotion opportunities for supporting overstaffing. Further analysis indicates that whereas the "grabbing hand" of government does harm to a firm's economic performance, the "helping hand" provides only weak positive effects, and such government intervention actually reduces the efficiency of social resource allocation.

© 2012 China Journal of Accounting Research. Founded by Sun Yat-sen University and City University of Hong Kong. Production and hosting by Elsevier B.V. All rights reserved.

\* Corresponding author.

E-mail addresses: [wangxiongyuan72@163.com](mailto:wangxiongyuan72@163.com) (W. Xiongyuan), [sunny05fly@yahoo.com.cn](mailto:sunny05fly@yahoo.com.cn) (W. Shan).



## 1. Introduction

Companies normally make decisions to maximize their profits, so managers would not be expected to accept projects that harm their firm's economic performance. However, when managers of state-owned enterprises (hereafter, SOEs) make decisions about employment, they tend to hire more people than necessary, because these entities are especially established by the government to enhance the country's rate of employment (Sappington and Stiglitz, 1987; Boycko et al., 1996; Dong and Putterman, 2001). Although a number of studies (Dewenter and Malatesta, 2001; Dong and Putterman, 2003) have demonstrated that political pressure or government intervention causes excess employment in SOEs, previous researchers do not clearly explain the connection between government intervention and overstaffing. In this study, we attempt to fill this void.

Our study addresses questions such as how governments intervene in corporations and by what mechanism governments influence SOEs to employ extra people. We consider that politicians may choose to focus their interventions on SOEs because it is much more costly for them to interfere in private firms. Boycko et al. (1996) argue that politicians cause government-owned firms to employ a surplus of workers. Similarly, Dewenter and Malatesta (2001) find that government-sponsored firms tend to use more labor than their private-sector counterparts, because private firms are more difficult for governments to influence. Also, it has already been proven that appointing corporate executives who have a government background is an effective way for the government to influence SOEs. The power of politicians to appoint SOE chairmen and to control costs or rewards for businesses open up opportunities for governments to exert direct influence on SOEs (Tenev et al., 2002). More importantly, we argue that most SOE executives are motivated to earn more money and gain more opportunities for promotion, and these motives can lead them to facilitate government priorities.

Political connections are considered a very important factor influencing the way firms perform (Fan et al., 2007) and the question naturally arises as to whether political connections affect company employment decisions. There are several reasons why China provides a natural laboratory for examining the effects of political connections on firm behavior. (1) State ownership is prevalent and the state sector is far from homogeneous, as most SOEs are controlled either by the central government or local governments (provincial or county level). (2) The government maintains heavy control over the economy and it often uses SOEs to serve political and social objectives, such as reducing unemployment or fiscal deficits. (3) The market for chairmen is underdeveloped in China, with many managers possessing close political ties to local and central governments but lacking professional qualifications or managerial experience.

Therefore, we predict that examining the political connections of SOEs may provide answers for our questions concerning appointed chairmen and company employment policies. We investigate these possibilities further by examining a sample of local SOEs and considering a new determinant of overstaffing that previous studies have not explored.

Although we mainly focus on the effect of chairmen with government backgrounds on excess staffing, we address several other issues as well. Particularly, we investigate whether overstaffing adversely affects corporate performance (Li and Liang, 1998; Xu et al., 2005; Zeng and Chen, 2006; Xue and Bai, 2008). We ask what benefits a corporation will receive if it hires more people than it really needs. Lin and Tan (1999) show that firms that practice overstaffing receive compensation in the form of lower taxes, more government grants and preferential treatment in competition for contracts. We expect that the problems of overstaffing may result from an exchange of benefits between firms and the government. If a firm agrees to employ redundant workers, then that firm will enjoy opportunities for easy access to bank loans and grants or preferential tax treatment. The firm receives such benefits, but do the firms' executives gain any benefits? Another concern of our study is to determine whether corporate executives, especially chairmen, receive promotions or higher pay for supporting excess employees.

To answer these questions, we manually collect detailed information on the chairmen of all of the local SOEs listed in A-share markets in China from 2004 to 2009. This information includes the chairmen's past employment records, including any background they may have in government. We classify a company as being politically connected if its chairman is a current or an ex-government official. Then we compare the hiring practices of politically connected companies with those of other companies. Our findings are



as follows. First, after controlling for other factors that influence firms' staffing, we find that having politically connected chairmen has a significant positive relationship with excess employment by local SOEs. We consistently find that the overstaffing problems in firms run by politically connected chairmen are more serious than in firms that are otherwise similar. Second, our analysis of the economic consequences from such political influence shows two main effects. The evidence indicates that local SOEs with chairmen who have government backgrounds receive more bank loans and more government grants than those without such a political connection. However, we find no evidence that excess staffing is positively related to debt financing or to government subsidies. Also, we find that excess employment is negatively related to the chairman's prospects for promotion, which is contrary to our prediction. Concerning the chairman's compensation, a firm's overstaffing has a negative effect on its chairman's total compensation, but a positive effect on the chairman's relative compensation.

To better understand the overstaffing problem of China's local SOEs, our study (1) performs additional analysis on the connections between excess employment and firm performance (or labor costs), and (2) investigates how the social objectives of politicians influence the appointment of politically connected CEOs.

By controlling for other factors that influence firm performance (labor costs), we find that a firm's scale of overstaffing is negatively related to its accounting performance and positively related (to a significant degree) to its total labor costs. Finally, a listed company's chairman is more likely to be politically connected when the company belongs to a region with a lower per capita GDP and a higher unemployment rate.

Our study contributes to several strands of the literature. First, the evidence from this research enriches our understanding by showing how the appointment of chairmen with government backgrounds helps the government to promote overstaffing by SOEs. Prior studies (Shleifer and Vishny, 1994; Dong and Putterman, 2003; Lin and Tan, 1999) have focused on government interventions that affect excess employment. However, we concentrate on how governments actually influence corporations to hire more people. We find that appointing politically connected chairmen is the main mechanism through which the government intervenes in firms to promote the hiring of more employees.

Second, our paper adds to a growing literature that explores the effects of political connections on business. Political connections are already considered an important factor in the valuation of firms (Fisman, 2001; Johnson and Mitton, 2003), in company performance (Fan et al., 2007) and in mode of operations (Bertrand et al., 2006; Li et al., 2008; Claessens et al., 2008). However, the question of whether or how the political connections of company chairmen affect excess employment is not well explored. One of the few studies - examining this issue is that of Liu et al. (2010). Using cross-sectional data, these authors find that the effect of political connections on employee allocation efficiency is influenced by the firm's ultimate controller. However, Liu et al. (2010) do not examine the economic consequences of excess employment. This study attempts to fill this void in the literature and examine the effects of excess employment on firms in greater depth.

Finally, our paper contributes to the literature on how government policy affects business in general. The evidence from our paper supports both the "grabbing hand" model (showing how politicians can intervene at the expense of business activities) and the "helping hand" model (showing how politicians can provide privileges and benefits to corporations) (Shleifer and Vishny, 1994). We consider government pressure for excess employment as a typical example of the "grabbing hand" and compensatory bank loans or government subsidies as examples of the "helping hand."

The remainder of this paper is organized as follows. Section 2 discusses the prior literature and develops the hypotheses. Section 3 describes the sample and variables, and outlines the econometric specifications. Section 4 presents the data and descriptive statistics. Section 5 empirically tests the hypotheses and reports the results. Section 6 provides conclusions.

## **2. Institutional background and hypotheses**

In this section, we discuss the institutional background of China's business environment and develop our hypotheses regarding the effects of political connections on excess employment and on the economic consequences of the overstaffing problem.

## 2.1. Background

During the economic reforms of the 1980s, the Chinese government launched a program allowing bureaucrats to quit their government positions and join the business community, a phenomenon that later came to be known as “*xiahai*” (jumping into the sea). Starting in the mid-1980s, many government agencies began to establish business entities and many bureaucrats became managers of these businesses (Li, 1998). Although these ex-bureaucrats have officially quit the government, they still keep good relations with their friends or ex-colleagues in government. These ties help to keep government and business linked together.

As a relationship-based transitional economy, Chinese society is pervaded by the ubiquitous phenomenon of *guanxi* (or relationships). The word describes a subset of Chinese personal connections in which one individual is able to prevail upon another to perform a favor or service (Chung and Hamilton, 2002). Political connections are one type of “*guanxi*.” The state gives preferential treatment to firms with political connections and uses its political power to intervene in the firms’ operations or corporate governance.

As the promotion of regional officials to higher-ranking positions depends largely on their region’s economic growth, or GDP, these officials have an interest in keeping regional rates of development and employment high during their periods in office (Li and Zhou, 2005). Therefore, officials at all levels of government have an incentive to intervene in SOEs and use these firms to help solve political and social problems.

## 2.2. Hypotheses development

In this section, we develop our hypotheses concerning the relationships between excess employment in local SOEs and the government backgrounds of SOE chairmen.

### 2.2.1. Chairman’s government background and excess employment

A series of studies beginning with Roberts (1990) point out that political connections in corporations are a worldwide phenomenon in both developing and developed countries. However, such connections are more common in countries that are perceived as highly corrupt or that impose restrictions on foreign investments by their citizens, than in countries with more transparent systems (Faccio, 2006).

What are the causes of political relations in business? There are two explanations. First, concerning the government’s “helping hand,” political connections are a kind of reputation-building mechanism (Luo and Zhen, 2008). Firms take this mechanism as a kind of social resource, with which they can seek benefits or rents directly from the authorities (Michelson, 2007; Yu et al., 2010). Second, in view of the government’s “grabbing hand,” political connections are a substitute for the presently flawed institutions in transitional countries. If a company has a good political connection with the government, it can effectively defend itself against infringements that the authorities seek to impose on companies. A number of recent studies (Chen et al., 2005; Faccio, 2006; Li et al., 2006; Yu and Pan, 2008) suggest that private firms are far more likely to participate in political affairs in countries with high levels of corruption and low levels of property protection (Chen et al., 2005; Faccio, 2006; Li et al., 2006). Under conditions of discriminative policies, private entrepreneurs search for new approaches to protect themselves. Many company managers feel it has been proven that keeping a close connection with the government is the most effective means of self-protection. Obviously, this view emphasizes the role of political connections for resisting the government’s “grabbing hand.” However, the Chinese government’s pressure to hire extra employees is a typical instance of the grabbing hand, because overstaffing results in higher labor costs and worsens firm performance. Some firms might hope that political connections will protect them from such pressure, but we argue that excess employment has a negative relationship with political connections.

Although theoretical analysis suggests that political connections negatively affect a firm’s scale of overstaffing, there is little empirical evidence for this argument. A few empirical studies examine the relationship between political connections and excess employment and show that politically connected corporations undertake too many tasks for politicians (Bertrand et al., 2006). Business managers do this because politicians require their closely connected firms to help solve unemployment problems by hiring extra workers (Bennedsen, 2000; Yuan, 2011).

To work out these contradictory results concerning political connections, the following questions need clarification. In what kinds of firms is the government likely to interfere? Also, through what kinds of political connections can the government most effectively intervene?

Prior studies have already provided us the answer to the first question. Local governments often choose to intervene in SOEs (Sappington and Stiglitz, 1987; Boycko et al., 1996). These researchers believe that SOEs are much more easily influenced by government intervention and much more likely to pursue social objectives rather than maximizing profits. As it is more costly for the government to intervene in private firms, SOEs usually sustain a much greater burden of overstaffing than other firms (Dewenter and Malatesta, 2001; Zeng and Chen, 2006).

As to the second question concerning the means of intervention, recent studies show that appointing people with government backgrounds as SOE chairmen helps politicians to achieve their employment goals. In China's gradual process of SOE reform, the government still firmly controls appointments and dismissals of key personnel in these companies (Qian, 1995). Although each listed firm has a board of directors, the chairmen of SOEs are generally nominated by the government and then rubber-stamped by the board. These chairmen, especially those who have political connections, enjoy the same promotion and compensation mechanisms as politicians. Like politicians, they are affected by their region's performance in various political and social objectives. They feel it is important to improve the employment rate under their jurisdiction. In conclusion, through appointing politically connected chairmen, the government achieves its intervention for excess employment by local SOEs.

The above analysis leads to our first hypothesis:

**Hypothesis 1.** Local SOEs with chairmen who have a government background are more likely to support excess employment.

### 2.2.2. Economic consequences of excess employment: firm/chairman level

If a chairman who has a government background does not gain any personal benefits, why would he voluntarily act as the link for government intervention in promoting excess employment? If the government does not compensate local SOEs for their losses from overstaffing, why would these firms employ more people? We predict that an exchange of benefits exists among local governments, chairmen and local SOEs.

Concerning the chairman, it may be that he is willing to help the government intervene in his firm in exchange for higher pay or more promotion opportunities (Brickley et al., 1999; Gillan et al., 2009). However, Cao et al. (2012) find that CEOs with a higher likelihood of political promotion have lower pay levels, which shows that political promotion could be a substitute for pay. Chairmen are judged by their firm's economic performance, but the promotion and the compensation of politically connected chairmen are more affected by their performance toward various political and economical goals such as growth in GDP or the employment rate (Liu, 2005). If a chairman is interested in political promotion, then he exhibits a politician's objective function: he tries his best to cater to the will of the government (Zhang, 1999; Chen et al., 2008).

Consequently, if a politically connected chairman facilitates the government's agenda for overstaffing, we expect there is a reward of promotion or higher pay for the chairman. We also expect that the relationship between excess employment and the chairmen's promotions (or compensation levels) will be strongest in politically related firms.

In terms of the firm, local SOEs may receive some policy favors for supporting excess employment. Prior studies conclude that redundant employees cause either increased labor costs (Zeng and Chen, 2006) or decreased firm performance (Li and Liang, 1998; Xu et al., 2005). If the government does not grant these firms some benefits, the firms may sustain losses and suffer severe financial problems in the short run. Hence, firms with redundant employees request the government to offer some policy favors. Consistent with this argument, Lin and Tan (1999) demonstrate theoretically that in exchange for supporting redundant workers, the enterprises bargain with the government for *ex ante* policy favors, such as low-interest loans, tax reductions, tariff protections, legal monopolies, and so on. Furthermore, an empirical study by Xue and Bai (2008) uses Chinese data and finds that firms with redundant workers receive more government subsidies.

A number of studies find that political connections play the role of a “helping hand” for firms in transitional countries. Chen (2003) and Bertrand et al. (2006) show that politicians give aid to politically connected firms. Similarly, Wu et al. (2009) demonstrate that chairmen with experience working in government have a positive relationship with the authorities and smaller tax expenses. Empirical evidence (Johnson and Mitton, 2003; Faccio, 2006; Claessens et al., 2008) indicates that politically connected firms have greater access to debt financing than their non-connected peers.

Therefore, we argue that if local SOEs take on excess employees, they may be compensated for their expenses by gaining preferential access to financing and government subsidies. Additionally, a chairman’s government background will strengthen the positive political connection, allowing more debt financing or grants.

The above analysis leads to our second hypothesis, which is expressed in two parts:

**Hypothesis 2A.** Chairmen in firms with excess employment are more likely to receive higher pay or promotions, and this likelihood is higher if the chairman has a government background.

**Hypothesis 2B.** Firms with excess employment are more likely to have better access to debt financing or government subsidies, and this likelihood is higher if the chairman has a government background.

### 3. Research design

#### 3.1. Sample selection

To test these hypotheses, we restrict our focus to A-share local SOEs listed on China’s stock markets, whose ultimate owners did not change from 2004 to 2009. Our sample period begins in 2004 because it was not until this year that the CSRC (China Securities Regulatory Commission) explicitly required listed corporations to disclose their executives’ work experience in annual reports, including CEOs’ biographical profiles, from which we can obtain information about chairmen’s government backgrounds. Also, listed firms began to formally disclose their ultimate controllers in annual reports starting in 2004.

Our study calls for identifying local SOEs according to the identity of their ultimate controllers. The information on SOE controllers is gathered from the CCER China stocks database, which provides detailed information on the ownership of China’s ten largest shareholders and the ultimate shareholders of stock market-listed firms. The CCER classifies firms into the following three types: (1) local SOEs that are owned by various local governments, (2) central SOEs that are owned by the central government, and (3) non-state firms (or private firms), whose ultimate owners are non-government units such as individual entrepreneurs. In this study, we mainly focus on local SOEs. We differentiate between central and local SOEs because they are affected differently by different levels of government.

We manually collect the chairmen’s information from the CSMAR financial database, which provides detailed information including age, gender, education, professional background and employment history on most corporate executives. We also examine the credibility of this personal information through Internet searches. According to each CEO’s profile information, we traced their political connections by examining whether he/she is currently or was formerly a government official.

The accounting and financial data of listed firms was also obtained from the CSMAR database. For our tests, we need lagged firm performance information, so this data starts from 2003. Within the sample, firms in the financial industry sector are excluded because their accounting measurements different from those of others. Furthermore, firms listed in the province of Xizang are also excluded because their macroeconomic data is not completely disclosed. We also exclude firms with fewer than 200 employees according to Zeng and Chen (2006). Finally, we also exclude firms with missing data on necessary variables.

For our tests of chairmen’s government backgrounds and firms’ excess employment, data on unemployment rates and per capita GDP for different regions in our sample period are retrieved from the China Statistical Year Book.

### 3.2. Models and variables

To test our hypotheses, we use the following three regression models. Model (1) tests the relationship between politically connected chairmen and their firms' excess employment for H1. Then models (2) and (3) test the economic consequences of excess employment for H2A and H2B, respectively.

$$Exc\_L_{it} = \alpha + \beta_1 Political_{it} \text{ or } Gov\_Political_{it} + \beta'_2 Controls_{it} + \varepsilon_{it} \quad (1)$$

$$Pay_{it} \text{ or } Promotion_{it} = \alpha + \beta_1 Gov\_Political_{it} + \beta_2 Exc\_L_{it} + \beta_3 Gov\_Political_{it} * Exc\_L_{it} + \beta'_4 Controls_{it} + \varepsilon_{it} \quad (2)$$

$$Debt_{it} \text{ or } Subsidy_{it} = \alpha + \beta_1 Gov\_Political_{it} + \beta_2 Exc\_L_{it} + \beta_3 Gov\_Political_{it} * Exc\_L_{it} + \beta'_4 Controls_{it} + \varepsilon_{it} \quad (3)$$

where  $i$  denotes the sample firm and  $t$  denotes the year in the sample period.

#### 3.2.1. Dependent and independent variables for model (1)

Excess employment ( $Exc\_L$ ), the dependent variable, is calculated as follows. According to the Jones model system, we use the following expectation model suggested by prior studies (Zeng and Chen, 2006) to control for the determinants of firm's employees, for each firm  $i$  in year  $t$ :

$$Act\_L_{it} = a + b_1 Size_{it} + b_2 AssetsGrowth_{it} + b_3 SalesGrowth_{it} + b_4 FixedAssets_{it} + \varepsilon_{it} \quad (4)$$

where  $Act\_L$  is the number of employees at the end of a fiscal year divided by the millions of dollars of firm sales,  $Size$  is the logarithmic transformation of total sales,  $AssetGrowth$  is the growth ratio of capital investment,  $SalesGrowth$  is the growth ratio of sales and  $FixedAssets$  is fixed assets divided by total assets.

Ordinary least squares is used to obtain estimates of  $a$ ,  $b_1$ ,  $b_2$ ,  $b_3$  and  $b_4$  respectively. Then we define the prediction error as excess employment and construct two variables to measure excess employment. The first variable is  $Exc\_L$ , which equals the prediction error if it is greater than 0, and 0 otherwise. The second variable is  $Exc\_L\_Dummy$ , which equals 1 if it is greater than 0, and 0 otherwise. We run a Tobit regression for the first measurement and a logistic regression for the likelihood of firms' excess employment.

Political connection ( $Political$ ), the explanatory variable in Hypothesis 1, equals 1 if the chairman of the firm is a current or former government official, and 0 otherwise. To particularly examine the special role that the chairman plays in a firm's excess employment, we employ a variable,  $Gov\_Political$ . If the firm's chairman is or ever was the head of the industry that his or her firm belongs to, the variable  $Gov\_Political$  equals 1. This rating would apply, for instance, if a firm is classified in the textile industry and its chairman has worked as head of the government's department of textiles.

Following the example of prior studies on excess employment (Dewenter and Malatesta, 2001; Xue and Bai, 2008), we include variables in the model controlling for size, asset growth, sales growth, asset structure, performance, leverage and firm age. We also control for chairman duality, the stock percentage of the largest shareholder and regional institutional variables such as per capita GDP, unemployment rate and marketization index. To control for industry and year effects, industry and year dummies are also included.

#### 3.2.2. Dependent and independent variables for model (2)

$Pay$  and  $Promotion$  are the dependent variables in this model.  $DirectorPay1$  is a continuous variable for the chairman's compensation. We define this variable as the logarithm of the chairman's compensation. As the compensation data for each chairman is not completely disclosed, we use the compensation of the firm's top three managers to proxy for it. We also employ another proxy variable ( $DirectorPay2$ ) to measure chairmen's compensation. Here,  $DirectorPay2 = \text{Ln}(\text{top three manager's compensation}/\text{employees total compensation})$ .

$Promotion$  is a dichotomous measure for chairman promotion, which equals 1 when there is a promotion for the chairman of the firm  $i$  in year  $t$ , and 0 otherwise.

Drawing from previous research (Wang and Wang, 2007; Fang, 2009), we include the following control variables in the model: managerial ownership, chairman's age and tenure, chairman-CEO duality and the

stock percentage of the largest shareholder. We also control for firm characteristics such as size, leverage and performance. Finally, year and industry dummies are also included.

### 3.2.3. *Dependent and independent variables for model (3)*

*Debt* and *Subsidy* are the two dependent variables in this model. Following prior studies (Faccio et al., 2006; Yu and Pan, 2008), we employ three measures to capture debt financing: (1) *Debt1*, or debt maturity (defined as long-term debt plus the current portion of long-term debt divided by total debts); (2) *Debt2*, or short-term debt ratio (calculated as short-term debt divided by total assets); and (3) *Debt3*, or long-term debt ratio (calculated as long-term debt plus the current portion of long-term debt divided by total assets).

To examine the effect of excess employment on the receipt of government subsidies, we introduce the variable *Subsidy*. Government subsidies are calculated as the sum of direct government subsidies, financial refunds and tax refunds from the financial statements of the listed firms, divided by total assets (or net income).

For model (3), besides firm characteristics and year dummies, we control for different variables in *debt* and *subsidy* regressions. In the *debt* model, we include an industry variable that equals 1 if the firm is in a monopolized industry (e.g., electric power, telecommunication, etc.), and 0 otherwise. In the *subsidy* model, we include marketization indexes according to Yu et al. (2010).

The definitions of the regression variables are provided in Appendix A.

## 4. Data and descriptive statistics

### 4.1. *Definition of politically connected chairmen*

There are various definitions of “political connections.” Siegel (2007) defines all CEOs who are from the same region as the president as politically connected CEOs. Others define CEOs who are friends, former colleagues and relatives of incumbent bureaucrats as politically connected CEOs (Fisman, 2001; Johnson and Mitton, 2003). However, in our paper, based on the analysis in Section 2.2.1 and on prior studies (Bertrand et al., 2006; Fan et al., 2007), we define politically connected CEOs as CEOs who are former bureaucrats. More specifically, this study focuses on firms’ chairmen. We define chairmen with government backgrounds as chairmen who have government experience in the same industry in which they are now working.

### 4.2. *Descriptive statistics*

Table 1 provides a description of the sample. Panel A of Table 1 presents the number of politically connected chairmen of listed local SOEs between 2004 and 2009. This panel shows that the number of chairmen with government backgrounds is similar across this period and approximately 35.27% of the chairmen in our sample have political connections with the government. This suggests that the government maintains direct influence in a significant portion of firms through appointing politically connected chairmen. In the subsample of political connections (1040 observations), 601 firms or 57.79%, have chairmen with government backgrounds.

Panel B reports the distribution of politically connected firms in different industry sectors, with the industry categories classified by the CSRC (China Securities Regulatory Commission). These results show that of the 1040 observations of firms with political connections, 94 are in the natural resources sector, 125 in the services and trade sector, 443 in the manufacturing sector, 65 in the public utilities sector and 116 in the transportation sector. Although the proportion of chairmen with political connections is similar across industries, there are relatively more politically connected chairmen in the manufacturing industries. Panel B also presents the percentage of chairmen with government backgrounds in these politically connected firms across industries. We can see from the table that in the agriculture, manufacturing, electric power, transportation, retail and utility industry sectors, over half of the corporations have chairmen with government backgrounds.

Table 2 provides the mean, standard deviation (std. dev.), minimum value (Min.), and maximum value (Max.) of the continuous variables for the subsample where firm chairmen are politically connected. The mean value for *Exc\_L* is 0.49, suggesting that the average number of excess employees for every 1 million in sales is

Table 1  
Numbers of politically connected chairmen.

Year	2004	2005	2006	2007	2008	2009	Total
<i>Panel A Distribution of firms by year</i>							
Local SOEs	466	487	486	501	506	503	2949
Without political connection	299	320	311	321	328	330	1909
With political connection	167	167	175	180	178	173	1040
Proportion (%)	35.84	34.29	36.01	35.93	35.18	34.39	35.27
Government background	99	103	102	105	98	94	601
Proportion (%)	59.28	61.68	58.29	58.33	55.06	54.34	57.79
Industry	Government background		Political connection		Total	Government background (%)	
<i>Panel B Distribution of firms by industry</i>							
Farming	17		12		29	58.62	
Mining	7		10		17	41.18	
Manufacturing	257		186		443	58.01	
Electric power	65		29		94	69.15	
Construction	10		13		23	43.48	
Transportation	75		41		116	64.66	
Information technology	1		12		13	7.69	
Wholesale and retail	89		36		125	71.20	
Real estate	21		20		41	51.22	
Social service	44		21		65	67.69	
Culture	0		10		10	0.00	
Integrated industry	15		49		64	23.44	
Total	601		439		1040	57.79	

Table 2  
Descriptive statistics.

Variables	Obs.	Mean	Std. dev.	Min	Max
Exc_L	1040	0.4937	1.1004	0	7.0947
Debt1	1040	0.2592	0.1644	0	0.8495
Debt2	1040	0.1694	0.1312	0	0.7843
Subsidy1	1040	0.0059	0.0102	0.0000	0.0526
Subsidy2	1040	0.3269	0.8588	-0.2645	5.3520
DirectorPay1	1040	12.3351	0.8207	9.5598	14.9106
DirectorPay2	1040	5.9251	5.1851	0.7427	25.3311
Marindex	1040	8.5998	1.9019	3.1	11.71
Govindex	1040	9.1930	1.1282	4.86	10.65
Lawindex	1040	8.1356	3.6824	1.53	16.61
FixedAsset	1040	0.3417	0.2031	0.0042	0.9599
AssetGrowth	1040	0.0601	0.0630	0.0000	0.6022
SaleSize	1040	21.0923	1.1498	15.6033	24.5475
SaleGrowth	1040	0.1609	0.3199	-0.4032	1.4294
Leverage	1040	0.5149	0.1854	0.1430	0.8779
ExistAge	1040	12.7971	3.8384	5	29
FirstShare	1040	40.6724	15.2121	10	84.85
Mshare	1040	0.0002	0.0011	0	0.0192

0.49. To reduce the influence of extreme observations in the results, we winsorize the continuous variables at the top and bottom 2%.

Table 3 reports the mean and median values of the dependent variables for the sub-samples distinguished by *Gov\_Political*, as well as test statistics for differences in the mean and median values between the subsamples. We first examine the statistics of *Exc\_L*. Consistent with hypothesis 1, we find that for firms with a political connection the mean of excess employment is 0.557 per 1 million sales, but only 0.4071 for firms whose

Table 3  
Mean and median tests.

Variables	Government background (Yes)			Government background (No)			T	Wilcoxon
	Obs.	Mean	Median	Obs.	Mean	Median	Statistics	Z
Exc_L	601	0.557	0	439	0.4071	0	-2.1749**	-1.192
Debt1	601	0.264	0.2624	439	0.2526	0.2552	-1.1012	-1.174
Debt2	601	0.1721	0.1527	439	0.1658	0.1508	-0.7638	-0.409
Subsidy1	601	0.0061	0.0022	439	0.0056	0.0019	-0.8752	-0.735
Subsidy2	601	0.3576	0.0571	439	0.2849	0.0508	-1.3484	-1.505
DirectorPay1	601	12.2969	12.3985	439	12.3872	12.5179	1.7442*	1.497
DirectorPay2	601	5.7416	3.8926	439	6.1757	4.3938	1.327	1.816*
Promotion	71	0.4086	0	58	0.431	0	0.2567	0.258

\*\*\* Significance at the 1% levels.

\* Significance at the 10% levels.

\*\* Significance at the 5% levels.

Table 4  
Pearson correlation matrix.

	Exc_L	Gov_Political	Debt1	Debt2	Debt3	Subsidy1	Subsidy2	Director Pay1	Director Pay2	ROA	TobinQ
Exc_L	1.0000										
Gov_Political	0.0674**	1.0000									
Debt1	0.0231	0.0342	1.0000								
Debt2	0.0665**	0.0237	0.7287***	1.0000							
Debt3	-0.0435	0.0221	0.6075***	-0.1013***	1.0000						
Subsidy1	0.0710**	0.0273	0.0026	0.0676***	-0.0747**	1.0000					
Subsidy2	0.0087	0.0421	0.0202	0.0711**	-0.0532*	0.5892***	1.0000				
DirectorPay1	-0.1930***	-0.0543*	-0.2000***	-0.2451***	-0.0065	0.0540*	-0.0807***	1.0000			
DirectorPay2	0.2828***	-0.0418	-0.1314***	-0.0939***	-0.0824***	0.0885***	-0.0627**	0.5135***	1.0000		
ROA	-0.1439***	0.0406	-0.3858***	-0.4457***	-0.0436	-0.0218	-0.0754**	0.3324***	0.1060***	1.0000	
TobinQ	-0.0409	-0.0515*	-0.1718***	-0.1211***	-0.1091***	0.0439	-0.0465	0.1115***	0.0602*	0.1688***	1.0000

\* Significance at the 10% levels.

\*\* Significance at the 5% levels.

\*\*\* Significance at the 1% levels.

chairman is not politically connected. The 0.15 drop in the mean is statistically significant using a two-tailed *t* test. Similarly, the mean pay for chairmen is 12.29 for local SOEs with chairmen of a government background. The difference between the mean values of firms with and without political connections is statistically significant.

The Pearson correlation coefficients for the dependent variables used in our analysis are reported in Table 4. As expected, the correlation between *Exc\_L* and *Gov\_Political* is positive and significant at the 5% level. The table shows a positive correlation between *Exc\_L*, *Debt2* and *Subsidy1*, but a negative correlation between *Exc\_L*, *DirectorPay1* and *ROA*.

## 5. Empirical analysis

### 5.1. Government background and excess employment

Table 5 reports the results of model (1). The variables that we want to investigate are significantly correlated (as the Pearson correlation matrix of Table 4 has shown), so we introduce the two variables, *Political* and *Gov\_Political*. These variables represent political connection and government background respectively. In this regression, the dependent variable in columns 1 and 3 is *Exc\_L*, and in columns 2 and 4 the dependent variable is *Exc\_L\_Dummy*.



Table 5  
Government background and excess employment.

Excess employment	Total sample (2949)		Political connection (1040)	
	Exc_L	Exc_L_Dummy	Exc_L	Exc_L_Dummy
Constant	3.138*** 7.47	-4.644*** -5.92	3.196*** 4.42	-4.085*** -2.81
Political	-0.127*** -2.78	-0.409*** -4.80		
Gov_Political			0.137** 1.98	0.0663 0.47
Govindex	-0.103*** -5.60	-0.225*** -6.59	-0.145*** -4.46	-0.304*** -4.67
Unemploy	0.0342 0.80	0.211*** 2.69	0.116* 1.66	0.263* 1.87
FixedAsset	0.0447 0.38	-0.181 -0.82	-0.357* -1.95	-0.808** -2.13
AssetGrowth	0.486 1.28	0.603 0.86	0.483 0.81	-0.0887 -0.07
SaleSize	-0.0885*** -4.32	0.278*** 7.18	-0.0606* -1.76	0.294*** 4.14
SaleGrowth	-0.0930 -1.31	-0.0251 -0.19	-0.150 -1.34	-0.155 -0.68
ROA <sub>t-1</sub>	-2.004*** -4.39	-3.644*** -4.25	-1.247* -1.75	-3.130** -2.19
Leverage	0.00903 0.07	-0.101 -0.39	-0.200 -0.96	-0.726* -1.71
ExistAge	0.0116* 1.85	0.0428*** 3.60	-0.00300 -0.27	0.0444** 2.00
Audittype	0.204** 2.01	0.345* 1.85	0.183 1.29	0.555** 2.00
Dual	-0.141** -2.07	-0.136 -1.07	0.0980 0.86	0.0665 0.29
FirstShare	0.00315** 2.08	0.000555 0.20	0.000342 0.13	-0.00145 -0.28
Observations	2949	2949	1040	1040
R <sup>2</sup>	0.0623		0.0649	
Adj-R <sup>2</sup> or Pseudo R <sup>2</sup>	0.0561	0.0422	0.0470	0.0475
F-value	10.01		3.64	

Note: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

The regression results in columns 1 and 2 of Table 5 show that political connections are negatively related to excess employment, at a significance level of 1%. This means that the general political connections can potentially help firms resist government intervention, such as pressure to employ more people. However, the further analysis in columns 3 and 4 demonstrate that having a chairman with a government background has a significant positive relationship (5%) with overstaffing in the politically connected subsample (1040 observations). This indicates that the chairman's government background is the mechanism through which the government realizes its intervention for overstaffing in local SOEs.

Table 5 also shows that local SOEs with higher government intervention index scores are less likely to sustain excess employment, as evidenced by the negative and significant coefficient on *Govindex*. The higher government intervention index score means less government intervention. Local SOEs in regions with weak institutions are more likely to face the problem of overstaffing, which is consistent with the findings of Shleifer and Vishny (1994) and Lin and Tan (1999). Table 5 indicates that firms located in regions with higher unemployment rates tend to hire more employees, as shown by the positive relationship between *Exc\_L* and *Unemploy*. In addition, the results show that *ROA<sub>t-1</sub>* is significantly and negatively related to the dependent variable, which implies that the government tends to intervene to promote overstaffing in firms with poorer performance, rather than in better-performing firms.

In summary, the above results support our prediction that local SOEs are more likely to sustain excess employment when chairmen have a government background.

### 5.2. The effects of excess employment on Local SOEs – chairman level

Prior research indicates that overstaffing is negatively related to a firm's performance. The above-mentioned evidence shows that local SOEs tend to sustain excess employment when their chairmen have a government background. Therefore we ask, what does the chairman gain from this behavior? As previously discussed, a chairman who promotes overstaffing may receive more money or greater promotion opportunities as compensation for incurring these negative effects on the firm. This section of our paper will examine the results of supporting excess employment for the firms' chairmen.

Table 6 presents the empirical results on the relationship between excess employment and chairmen's compensation. Contrary to our initial projections, excess employment is negatively related to chairmen's compensation at the absolute level. In other words, when a firm incurs the expenses of overstaffing, its chairman does not enjoy an increase in his/her pay. One explanation for this result may be that our measure of the chairmen's compensation is based on the compensation of the top three executives in each firm, which is not an exact measurement. However, when it comes to the relative level of chairmen's payment (as shown in columns 4, 5, and 6), the coefficients of *Exc\_L* on *DirectorPay2* are significantly positive (1%), just as we predicted in Section 2.2.2.

Table 6 also shows that in firms whose chairmen have a government background, the chairpersons themselves get much less pay than their counterparts when their companies sustain an overstaffing problem. The

Table 6  
Excess employment and chairman's compensation.

	Director Pay1	Director Pay1	Director Pay1	Director Pay2	Director Pay2	Director Pay2
Constant	7.509*** (18.17)	7.502*** (18.17)	7.502*** (18.13)	-10.42*** (-3.55)	-10.47*** (-3.58)	-10.49*** (-3.57)
Exc_L	-0.0770*** (-4.04)	-0.0743*** (-3.89)	-0.0740* (-2.16)	1.493*** (11.04)	1.513*** (11.17)	1.537*** (6.32)
Gov_Political		-0.0794* (-1.88)	-0.0792* (-1.72)		-0.582* (-1.95)	-0.566* (-1.73)
Gov_Political * Exc_L			-0.000451 (-0.01)			-0.0353 (-0.12)
FixedAsset	-0.377*** (-3.59)	-0.365*** (-3.47)	-0.365*** (-3.47)	-0.824 (-1.11)	-0.734 (-0.99)	-0.732 (-0.98)
SaleSize	0.263*** (13.15)	0.265*** (13.24)	0.265*** (13.23)	0.854*** (6.01)	0.868*** (6.12)	0.869*** (6.11)
ROA	3.482*** (7.92)	3.506*** (7.98)	3.505*** (7.95)	15.28*** (4.90)	15.46*** (4.96)	15.43*** (4.93)
Leverage	-0.352*** (-2.66)	-0.356*** (-2.69)	-0.356*** (-2.69)	0.869 (0.93)	0.841 (0.90)	0.837 (0.89)
Dual	0.0787 (1.15)	0.0722 (1.05)	0.0722 (1.05)	1.192** (2.45)	1.144** (2.36)	1.144** (2.35)
FirstShare	-0.00635*** (-4.29)	-0.00625*** (-4.23)	-0.00625*** (-4.23)	-0.0619*** (-5.91)	-0.0612*** (-5.84)	-0.0612*** (-5.84)
Mshare	31.17* (1.74)	29.73* (1.66)	29.73* (1.66)	-17.97 (-0.14)	-28.56 (-0.22)	-28.38 (-0.22)
Auditttype	0.178** (2.05)	0.190** (2.18)	0.190** (2.18)	0.493 (0.80)	0.575 (0.93)	0.574 (0.93)
Observations	1029	1029	1029	1029	1029	1029
R <sup>2</sup>	0.3649	0.3671	0.3671	0.1997	0.1997	0.2027
Adj-R <sup>2</sup>	0.3555	0.3571	0.3565	0.1878	0.1878	0.1893
F-value	38.80	36.69	34.50	16.85	16.85	15.12

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

chairmen's government backgrounds do not overcome the negative effects of excess employment on their compensation.

In local SOEs that have more sales (greater size) and better accounting performance, the chairmen tend to gain more compensation at both the absolute and relative levels, as shown by the positive coefficients of *SaleSize* and *ROA* on *DirectorPay1* and *DirectorPay2*. This result is consistent with prior results in this research area.

The other part of Hypothesis 2A concerns the chairmen's prospects of promotion. To study the relationship between excess employment in local SOEs and their chairmen's promotion in this model, we introduce only the firms that changed their chairmen between 2004 and 2009. Because there may be a dynamic lag in the factors influencing the turnover of firms' chairmen, we introduce the lagged variables of *Exc\_L*, *Gov\_Political*, *ROA* and *Leverage*. Table 7 provides the results. The results are presented in the first column. The term *Exc\_L*, which is the primary variable of interest, has a negative coefficient that is significant at the 10% level, which shows that a policy of overstaffing tends to decrease the chairmen's promotion opportunities. This result could possibly indicate that chairmen who practice overstaffing had already been promoted by governments before they were appointed to act as the local SOEs' chairmen. Furthermore, it should be emphasized that this sample only includes 120 observations, which may affect the results. Also, the chairmen's age is negatively related to promotion opportunities, which means that chairmen have less opportunity for promotion as they grow older. This finding is also consistent with the promotion trend for younger managers in China.

In the second column of Table 7, we add *Gov\_Political* and find that there is no significant relationship between the chairmen's promotions and the firms' levels of overstaffing, although the sign of the coefficient is negative.

### 5.3. The effects of excess employment on local SOEs – firm level

Next we test Hypothesis 2B, to investigate whether local SOEs whose chairmen have government backgrounds receive more bank loans or government grants. In Table 8, we run the regressions to test the

Table 7  
Excess employment and chairman's promotion.

Promotion	(1)	(2)	(3)
Constant	15.81*** (3.10)	16.24*** (3.17)	16.29*** (3.17)
<i>Exc_L</i> <sub><i>t</i>-1</sub>	-0.402* (-1.74)	-0.384 (-1.64)	-0.867* (-1.79)
<i>Gov_Political</i> <sub><i>t</i>-1</sub>		-0.541 (-1.18)	-0.848 (-1.64)
<i>Exc_L</i> <sub><i>t</i>-1</sub> * <i>Gov_Political</i> <sub><i>t</i>-1</sub>			0.742 (1.30)
<i>ROA</i> <sub><i>t</i>-1</sub>	8.340* (1.85)	8.618* (1.91)	9.916** (2.11)
<i>SaleSize</i>	-0.545** (-2.28)	-0.555** (-2.33)	-0.544** (-2.27)
<i>SaleGrowth</i>	0.635 (1.03)	0.688 (1.10)	0.557 (0.88)
<i>Leverage</i> <sub><i>t</i>-1</sub>	-0.206 (-0.15)	-0.292 (-0.21)	0.122 (0.09)
<i>Age</i>	-0.0713** (-2.22)	-0.0700** (-2.16)	-0.0762** (-2.27)
<i>Tenure</i>	-0.118 (-1.44)	-0.120 (-1.49)	-0.126 (-1.51)
Observations	120	120	120
<i>P</i> -value	0.0019	0.0020	0.0018
Pseudo <i>R</i> <sup>2</sup>	0.1830	0.1918	0.2038
<i>F</i> -value	29.56	30.97	32.91

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

Table 8  
Excess employment and local SOEs' debt financing.

Debt1	(1)	(2)	(3)
Constant	0.350** (4.86)	0.352*** (4.90)	0.351*** (4.91)
Exc_L	0.000388 (0.12)	-0.000223 (-0.07)	-0.000539 (-0.09)
Gov_Political		0.0176** (2.44)	0.0174** (2.21)
Exc_L * Gov_Political			0.000454 (0.06)
FixedAsset	0.165*** (9.14)	0.162*** (8.99)	0.162*** (8.98)
SaleSize	-0.0202*** (-5.92)	-0.0208*** (-6.08)	-0.0208*** (-6.08)
SaleGrowth	0.00616 (0.52)	0.00581 (0.49)	0.00579 (0.48)
ROA	-0.298*** (-3.82)	-0.303*** (-3.90)	-0.302*** (-3.87)
Leverage	0.607*** (26.69)	0.609*** (26.81)	0.609*** (26.78)
Auditttype	-0.0264* (-1.77)	-0.0288* (-1.93)	-0.0288* (-1.93)
ExistAge	-0.00265** (-2.51)	-0.00263** (-2.49)	-0.00262** (-2.48)
Observations	1040	1040	1040
R <sup>2</sup>	0.5270	0.5297	0.5297
Adj-R <sup>2</sup>	0.5205	0.5228	0.5224
F-value	81.57	76.89	72.02

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

relationship between debt maturity and excess employment. The results shown in the table indicate that the firms' levels of overstaffing are not significantly related to the amount of long-term debt the firms receive from banks. However, consistent with the findings of Yu and Pan (2008), politically connected firms have greater access to debt than firms without political connections.

In addition, we use another two variables, *Debt 2* and *Debt 3*, to examine this hypothesis. The results, given in Table 9, are similar to those shown in Table 8.

We perform OLS regressions to identify government grants that could be influenced by the firms' excess employment and Table 9 shows the regression results. We find that excess employment by firms is not related to the government subsidies those firms receive. The government background variable (*Gov\_Political*) is positively related to government subsidies, as expected, and the relationship is statistically significant. We also find that the regional marketization level (*Marindex*) is significantly and positively related to government subsidies. This finding indicates that when the local economy develops well, the firms in these regions are more likely to receive government subsidies from the local government. Although the firm's overstaffing scale is irrelevant to the level of government subsidies, the actual number of employees (*Alsale*) is statistically significant and positively related to government grants. This positive relationship may suggest that firms with more employees attract more government subsidies, because they help the government with the unemployment rate.

#### 5.4. Additional analysis

The above tests show that governments intervene into local SOEs' employment decisions by nominating chairmen who have government backgrounds. The tests also show the effects of overstaffing problems on firms and on their chairmen. However, we also need to know how these factors influence the firms' performance. To provide insight into whether and/or how excess employment, debt financing and government subsidies influence a firm's labor costs or accounting performance, we conduct further analysis in this section.

Table 9  
Excess employment and government subsidies.

	Subsidy1	Subsidy1	Subsidy1	Subsidy2	Subsidy2	Subsidy2
Constant	−0.000445 (−0.05)	−0.000345 (−0.04)	−0.000501 (−0.06)	0.497 (0.73)	0.507 (0.74)	0.474 (0.70)
Exc_L	−0.000678 (−1.25)	−0.000686 (−1.26)	−0.000349 (−0.50)	−0.0917** (−2.00)	−0.0925** (−2.02)	−0.0202 (−0.34)
Gov_Political		0.00108* (1.71)	0.00129* (1.87)		0.115** (2.16)	0.161*** (2.77)
Gov_Political * Exc_L			−0.000472 (−0.77)			−0.101** (−1.96)
Marindex	0.00059*** (3.26)	0.00061*** (3.33)	0.000603*** (3.31)	0.0287* (1.87)	0.0299* (1.95)	0.0294* (1.92)
Alsale	0.00103*** (3.17)	0.00102*** (3.13)	0.00101*** (3.10)	0.0621** (2.27)	0.0606** (2.22)	0.0587** (2.15)
SaleSize	0.0000503 (0.13)	0.0000197 (0.05)	0.0000226 (0.06)	−0.0159 (−0.50)	−0.0192 (−0.61)	−0.0186 (−0.59)
ROA <sub>t−1</sub>	−0.0113* (−1.79)	−0.0115* (−1.82)	−0.0118* (−1.86)	−2.639*** (−4.93)	−2.662*** (−4.99)	−2.725*** (−5.10)
Leverage	0.00282 (1.50)	0.00292 (1.55)	0.00288 (1.53)	−0.0108 (−0.07)	0.000138 (0.00)	−0.01000 (−0.06)
FirstShare	−0.00007*** (−3.17)	−0.00007*** (−3.28)	−0.00007*** (−3.29)	−0.00274 (−1.47)	−0.00301 (−1.61)	−0.00304 (−1.63)
Unemploy	0.000869 (1.36)	0.000842 (1.32)	0.000834 (1.31)	0.116** (2.15)	0.113** (2.10)	0.111** (2.07)
Observations	1017	1017	1017	1017	1017	1017
R <sup>2</sup>	0.0766	0.0793	0.0798	0.0660	0.0703	0.0738
Adj-R <sup>2</sup>	0.0637	0.0655	0.0651	0.0529	0.0564	0.0590
F-value	5.93	5.74	5.42	5.05	5.05	4.98

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

First, we perform regressions to examine the factors that influence the companies' labor costs. The dependent variable is a continuous variable and we introduce two measurements to proxy for this. The first measurement is *Total Labor Cost*, which is calculated as "cash paid to and on behalf of employees" from the cash-flow statement divided by total sales. The other measurement is *Average Labor Cost*, which is calculated as the logarithm of "cash paid to and on behalf of employees" divided by the total number of employees. In these regressions, we exclude the compensation and the number of employees who are related to their firm's chairman. The most important independent variable of interest is the firm's excess employment (*Exc\_L*). The control variables (as defined in Appendix A) include the regional macroeconomic variables of GDP per capita and unemployment rate, and a number of firm-level variables including the firms' percentage of fixed assets in relation to total assets, asset growth, sales growth, log of total sales,  $ROA_{t-1}$ , leverage percentage of ownership by the largest shareholder and age of the firm. Year and industry dummies are also included in the regression but not reported.

Table 10 reports the regression results. Consistent with the findings of Zeng and Chen (2006), the firms' scale of overstaffing is significantly and positively related to total labor costs, and negatively related to the average labor costs. These results confirm that excess employment is a typical result of the government's "grabbing hand," which does harm to the firms' operations. Although excess employment increases the firms' total labor costs, it also decreases the average salaries that employees receive.

Table 11 reports the results concerning the relationships between the state owned firms' excess employment, debt, subsidies and accounting performance. We use *ROA* and *TobinQ* to measure the firms' accounting performance. The independent variables include *Exc\_L*, *Debt1*, *Subsidy1* and several firm-level variables.

The results in Table 11 are as follows. (1) Consistent with the findings of Xu et al. (2005) and Xue and Bai (2008), a firm's excess employment decreases its accounting performance, as shown by the significant negative coefficients on *Exc\_L*. (2) Debt financing is negatively related to firm performance, but the relationship is not

Table 10  
Tests of labor costs.

	Total labor costs			Average labor costs		
	(1)	(2)	(3)	(4)	(5)	(6)
Constant	0.443*** 15.05	0.442*** 15.03	0.440*** 14.94	7.203*** 17.80	7.184*** 17.79	7.192*** 17.78
Exc_L	0.0199*** 15.41	0.0198*** 15.30	0.0235*** 10.21	-0.286*** -16.09	-0.289*** -16.25	-0.298*** -9.42
Gov_Political		0.00321 1.13	0.00565* 1.82		0.0929** 2.38	0.0863** 2.02
Exc_L * Gov_Political			-0.00541* -1.95			0.0145 0.38
FixedAsset	0.0345*** 4.60	0.0340*** 4.52	0.0343*** 4.57	-0.360*** -3.48	-0.374*** -3.63	-0.375*** -3.64
AssetGrowth	0.0895*** 3.64	0.0893*** 3.64	0.0904*** 3.69	0.242 0.72	0.238 0.71	0.235 0.70
SaleGrowth	-0.0139*** -3.02	-0.0141*** -3.05	-0.0140*** -3.03	-0.245*** -3.85	-0.250*** -3.94	-0.250*** -3.95
SaleSize	-0.0172*** -12.18	-0.0173*** -12.20	-0.0171*** -12.12	0.215*** 11.03	0.214*** 11.02	0.214*** 10.99
ROA <sub>t-1</sub>	0.0240 0.82	0.0235 0.80	0.0195 0.66	0.262 0.65	0.247 0.61	0.258 0.64
Leverage	-0.0288*** -3.37	-0.0286*** -3.35	-0.0290*** -3.39	-0.332*** -2.83	-0.326*** -2.78	-0.324*** -2.77
FirstShare	0.000320*** 2.99	0.000313*** 2.92	0.000305*** 2.85	0.00248* 1.69	0.00229 1.55	0.00231 1.57
ExistAge	0.000904** 1.99	0.000905** 1.99	0.000827* 1.81	0.000319 0.05	0.000329 0.05	0.000537 0.09
GDP	-0.00851** -2.44	-0.00837** -2.40	-0.00820** -2.36	-0.317** -6.61	-0.312*** -6.53	-0.313*** -6.54
Unemploy	-0.00564* -1.91	-0.00578* -1.96	-0.00590** -2.00	-0.0274 -0.67	-0.0315 -0.78	-0.0311 -0.77
Observations	1040	1040	1040	1040	1040	1040
R <sup>2</sup>	0.3998	0.4006	0.4028	0.4388	0.4420	0.4421
Adj-R <sup>2</sup>	0.3896	0.3897	0.3915	0.4293	0.4319	0.4314
F-value	39.14	37.05	35.40	45.95	43.92	41.58

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

statistically significant. The reason may be that debt financing, as a rent-seeking process, does harm for both the firm and the government, and therefore hinders firm performance. (3) Having chairmen with government backgrounds is positively related to *ROA* and *TobinQ*, but not to a significant degree. To summarize, the negative effects of the government's "grabbing hand" are obvious and the "helping hand" effect is not so obvious. In both cases, however, government intervention does harm to firms.

### 5.5. Robustness tests

One concern with our analysis is the potential for reverse causality. Specifically, it is possible that the government assigns candidates to firms with excess employment. The government maintains the ultimate authority regarding appointments of CEOs or chairmen in SOEs and may do so according to its own priorities. In attempting to mitigate this endogeneity issue, we perform the following three tests.

#### 5.5.1. Redefining political connections

In the previous sections of this paper, we only focus on the political connections of SOE chairmen. However, the boards of these firms are often responsible for overseeing managers, especially CEOs, and board members may also have political connections. Consequently, to account for this type of political connection,

Table 11  
Tests of the government's "Grabbing Hand" and "Helping Hand".

	ROA		TobinQ	
	(1)	(2)	(3)	(4)
Constant	-0.143*** -4.82	-0.146*** -4.93	4.544*** 14.06	4.564*** 14.05
Exc_L	-0.00331** -2.59	0.00118 0.52	-0.0308** -2.21	-0.0487* -1.96
Debt1	0.00232 0.81	-0.00159 -0.28	-0.0489 -1.57	-0.0593 -0.97
Subsidy1	-0.0522*** -3.96	-0.0645*** -3.95	-0.0652 -0.45	-0.0635 -0.36
Gov_Political	0.271** 1.97	0.137 0.63	1.886 1.26	1.722 0.72
Exc_L * Gov_Political		-0.00643** -2.39		0.0257 0.87
Debt1 * Gov_Political		0.0222 1.31		-0.0122 -0.07
Subsidy1 * Gov_Political		0.189 0.68		0.315 0.10
FixedAsset	-0.0220*** -2.65	-0.0205** -2.47	0.0651 0.72	0.0612 0.68
AssetGrowth	0.126*** 5.45	0.124*** 5.36	0.572** 2.28	0.575** 2.28
SaleSize	0.0116*** 8.40	0.0118*** 8.55	-0.113*** -7.52	-0.113*** -7.51
SaleGrowth	0.0304*** 6.87	0.0305*** 6.89	0.0394 0.82	0.0388 0.80
Leverage	-0.105*** -8.62	-0.106*** -8.67	-0.446*** -3.35	-0.445*** -3.33
Observations	1040	1040	1040	1040
R <sup>2</sup>	0.4429	0.4471	0.4990	0.4994
Adj-R <sup>2</sup>	0.4246	0.4272	0.4825	0.4814
F-value	24.24	22.53	30.36	27.79

Notes: (1) \*, \*\*, \*\*\* indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regression but not reported.

we collect information on board members and rate the members who have political connections as a proxy for political connections according to the following variables. *Boardrate* = the number of board directors with political connections/board size. *Boardrate1* = the number of board directors with industry-related government background/board size. Furthermore, instead of just focusing on the chairmen's political backgrounds, we also examine the CEO's political backgrounds, and the effect these connections have on firm employment levels.

The results are tabulated in Table 12. The regression results in columns 1 and 2 show that the rate of political connections on boards is negatively related to excess employment, which means that the more politically connected board members a firm has, the lower its level of excess employment. However, when it comes to columns 3 and 4, the results show no significant positive relationship between the proportion of board directors with industry-related political backgrounds and excess employment in their firms.

Table 13 reports the results from the examination of the CEOs' political connections. We find that there is no significant relationship between the CEOs' political connections and overstaffing in their firms. However, the subsample shows that the CEOs' industry-related political backgrounds are negatively related to excess employment (statistically significant), which is a different result from that found in Table 5. The results in Tables 12 and 13 confirm that appointing politically connected board directors or CEOs is not the mechanism for the government to solve the employment problem. Redefining political connectedness according to board member or CEO connections cannot substitute for a focus on the chairmen's political connections in explaining overemployment.

Table 12  
Board political connections and excess employment.

Excess Employment	Exc_L	Exc_L_Dummy	Exc_L	Exc_L_Dummy
Constant	3.5342*** (8.69)	-4.4173*** (-5.63)	2.8553*** (5.77)	-5.8339*** (-5.94)
Boardrate	-0.5111** (-2.48)	-1.1934*** (-3.02)		
Boardrate1			-0.1992 (-0.47)	0.5367 (0.66)
Govindex	-0.1065*** (-5.84)	-0.2397*** (-7.06)	-0.1068*** (-4.81)	-0.2923*** (-6.85)
Unemploy	0.0358 (0.84)	0.2129*** (2.71)	0.0112 (0.22)	0.1248 (1.30)
FixedAsset	0.0391 (0.33)	-0.2046 (-0.93)	-0.2461* (-1.75)	-0.4947* (-1.84)
AssetGrowth	0.4860 (1.28)	0.6486 (0.93)	1.0163** (2.17)	0.9066 (1.02)
SaleSize	-0.0902*** (-4.40)	0.2746*** (7.11)	-0.0610** (-2.44)	0.3371*** (6.98)
SaleGrowth	-0.0909 (-1.28)	-0.0171 (-0.13)	-0.1042 (-1.25)	0.0396 (0.25)
ROA <sub>t-1</sub>	-2.0207*** (-4.42)	-3.6790*** (-4.29)	-2.3949*** (-4.41)	-4.0312*** (-3.89)
Leverage	0.0096 (0.07)	-0.1061 (-0.41)	-0.0538 (-0.33)	-0.3587 (-1.17)
ExistAge	0.0111* (1.77)	0.0408*** (3.46)	0.0143** (1.98)	0.0710*** (4.86)
Audittype	0.1858* (1.83)	0.2894 (1.56)	0.3691*** (3.23)	0.4509** (2.11)
Dual	-0.1303* (-1.91)	-0.1073 (-0.85)	-0.0607 (-0.79)	0.1041 (0.72)
FirstShare	0.0029* (1.88)	-0.0003 (-0.11)	0.0019 (1.08)	0.0017 (0.49)
Observations	2881	2881	1990	1990
R <sup>2</sup>	0.062		0.056	
Adj-R <sup>2</sup> or Pseudo R <sup>2</sup>	0.056	0.039	0.047	0.049
F-value	9.9214		6.1157	

Notes: (1) \*, \*\*, \*\*\* indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

### 5.5.2. Excess employment around chairman turnover

To examine the reverse causality problem more deeply, we identify exogenous changes in the firms' chairmen that are not caused by policy reasons. To do this, we divide the total sample into two groups, according to whether the firms have experienced a chairman turnover during the 2004–2009 period. Some 343 cases of chairman turnover appear among the 1500 firm observations. In Table 14, we present summary statistics comparing the employment situations of the turnover and the non-turnover groups. In addition, we test the differences before and after a chairman turnover for the turnover group. The cross-sectional mean (median) values of the firms' employment situations are reported, as well as the *t*-statistic and the Wilcoxon values of the difference tests.

To compare the employment situations of the two groups, panel A shows that the level of excess employment ( $t = -2.85$ , 1%) and the absolute number of employees ( $Z = -4.13$ , 1%) in the turnover group are significantly higher than in the non-turnover group. Panel B shows the results of employment differences before and after the chairman turnovers in the turnover group. We can see that the firms' excess employment before the chairman turnovers is significantly lower than it is after the turnovers. This is consistent with the previously demonstrated negative relationship between political connections and excess employment.

We also identify cases among local SOEs in which the previous chairmen were not politically connected and the new chairmen who replaced them had political connections. Panel C of Table 14 shows that both the



Table 13  
CEO political background and excess employment.

Excess Employment	Exc_L	Exc_L_Dummy	Exc_L	Exc_L_Dummy
Constant	3.4333*** (8.46)	-4.6992*** (-6.00)	2.2465*** (2.91)	-9.4710*** (-5.67)
CEO_Political	0.0101 (0.20)	0.2094** (2.25)		
CEO_Gov_Political			-0.2344** (-2.30)	-0.5335** (-2.55)
Govindex	-0.1104*** (-6.06)	-0.2505*** (-7.40)	-0.1510*** (-4.48)	-0.2352*** (-3.49)
Unemploy	0.0311 (0.73)	0.2030*** (2.59)	-0.0990 (-1.22)	0.2645 (1.63)
FixedAsset	0.0298 (0.25)	-0.2503 (-1.13)	-0.3999* (-1.86)	-0.7102 (-1.64)
AssetGrowth	0.5374 (1.41)	0.7954 (1.14)	-0.0118 (-0.02)	-1.5647 (-1.02)
SaleSize	-0.0875*** (-4.27)	0.2804*** (7.28)	0.0019 (0.05)	0.4984*** (6.26)
SaleGrowth	-0.0893 (-1.26)	-0.0177 (-0.14)	-0.1397 (-1.07)	-0.1567 (-0.60)
ROA <sub>t-1</sub>	-2.0008*** (-4.37)	-3.6367*** (-4.25)	-2.8138*** (-3.28)	-3.4772** (-2.02)
Leverage	0.0070 (0.05)	-0.0825 (-0.32)	-0.4852* (-1.81)	-0.6858 (-1.26)
ExistAge	0.0112* (1.78)	0.0419*** (3.55)	0.0214* (1.69)	0.0858*** (3.33)
Audittype	0.1890* (1.86)	0.3132* (1.68)	0.6946*** (2.94)	0.7697 (1.64)
Dual	-0.1412** (-2.02)	-0.1891 (-1.45)	0.1149 (1.17)	-0.0602 (-0.31)
FirstShare	0.0031** (2.01)	0.0002 (0.07)	0.0050* (1.66)	0.0068 (1.12)
Observations	2881	2881	749	749
R <sup>2</sup>	0.060		0.096	
Adj-R <sup>2</sup> or Pseudo R <sup>2</sup>	0.054	0.038	0.073	0.083
F-value	9.5804		4.0897	

Notes: (1) CEO\_Political and CEO\_Gov\_Political are proxies for CEO's political connection and government background, respectively. (2) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (3) Year and industry dummies are also included in the regressions but not reported.

overstaffing scale and the staff numbers are statistically and significantly lower after the chairman turnovers. Panel D focuses on the chairmen's government backgrounds and shows no significant difference in employment levels before or after turnover in this subsample.

Similarly, we test how employment levels change when a chairman with a political background is replaced by a new chairman with such a background. The results (not reported) show no significant difference for employment levels for this type of turnover.

### 5.5.3. Determinants of chairmen's political ties

In further attempting to mitigate the endogeneity issue, we use a two-stage approach. In the first stage we perform logistic regressions to identify factors that influence the election of politically connected chairmen. According to Fan et al. (2007) and Yu and Pan (2008), we control for the following variables. The dependent variable is a dummy variable, equal to 1 if the chairman is a current or ex-government bureaucrat, and 0 otherwise. The independent variables, as defined in Appendix A, include regional macroeconomic factors of per capita GDP, unemployment rate and process of marketization, and a few industry- and firm-level variables, including a regulated industry dummy, the ownership percentage of the largest shareholder, *ROA* and leverage. Year dummies are included in the regression but not reported.

Table 14  
Univariate tests of employment around chairman turnover.

	Turnover group	Non-turnover group	T-test
<i>Panel A</i>			
Exc_L	0.6259 (0)	0.5048 (0)	−2.85*** (−1.06)
Staff No.	4493 (2355)	4674 (2022)	0.68 (−4.13***)
	Post-turnover	Pre-turnover	
<i>Panel B</i>			
Exc_L	0.5034 (0)	0.7923 (0)	4.37*** (2.89***)
Staff No.	4500 (2327)	4484 (2428)	−0.05 (1.6)
<i>Panel C</i>			
Exc_L	0.5169 (0)	1.2138 (0.3206)	3.14*** (3.17***)
Staff No.	4748 (2420)	5739 (4202)	1.18 (2.67***)
<i>Panel D</i>			
Exc_L	0.3073 (0)	0.3299 (0)	0.16 (−1.03)
Staff No.	4749 (1951)	2598 (903)	−1.48 (−1.65*)

Notes: (1) Staff No. is calculated as the absolute number of the firm's employees. (2) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively.

Table 15 reports the regression results. GDP is negatively related and the local unemployment rate is significantly and positively related to the appointment of politically connected chairmen. These regression results suggest that when local governments are facing the challenge of meeting economic and employment targets, they have an incentive to appoint politically connected chairmen. We also find that a local SOE is more likely

Table 15  
Test of the determinants of chairmen's political ties.

	Political	Gov_Political
Constant	53.92 (0.20)	53.04 (0.12)
GDP	−0.168 (−1.46)	−0.484** (−2.49)
Unemploy	0.197** (2.35)	0.193 (1.45)
Marindex	0.182*** (6.76)	−0.126*** (−2.72)
Industry	0.396*** (3.94)	0.0457 (0.29)
FirstShare	0.000854 (0.32)	0.00886** (1.97)
ROA	−1.131 (−1.44)	1.095 (0.87)
Leverage	−0.195 (−0.81)	−0.188 (−0.49)
N	2949	1040
Pseudo R <sup>2</sup>	0.0304	0.0133

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year dummies are included in the regressions but not reported.

Table 16  
Regression results of two-stage approach.

	(1)	(2)
Constant	2.995*** (6.75)	2.907*** (3.76)
Political	-0.904** (-2.02)	
Gov_Political		0.929* (1.81)
Govindex	-0.0606* (-1.87)	-0.137*** (-3.95)
Unemploy	0.0587 (1.27)	0.0744 (0.95)
FixedAsset	0.122 (0.91)	-0.459** (-2.17)
AssetGrowth	0.257 (0.59)	0.437 (0.69)
SaleSize	-0.0859*** (-3.90)	-0.0624* (-1.65)
SaleGrowth	-0.122 (-1.60)	-0.187 (-1.54)
ROA <sub>t-1</sub>	-2.329*** (-4.63)	-1.534** (-1.99)
Leverage	-0.0186 (-0.12)	-0.141 (-0.61)
ExistAge	0.0150** (2.22)	-0.00498 (-0.43)
Audittypee	0.361*** (2.79)	0.0932 (0.53)
Dual	-0.140* (-1.94)	0.193 (1.47)
FirstShare	0.00379** (2.34)	-0.00151 (-0.51)
Observations	2855	1008
Pseudo R <sup>2</sup>	1.175	1.1266

Notes: (1) \*, \*\*, \*\*\* Indicate significance at the 10%, 5% and 1% levels, respectively. (2) Year and industry dummies are included in the regressions but not reported.

to get a politically connected chairman if the firm is in a regulated industry. This finding may indicate that firms in regulated industries may need more political connections to help them succeed.

In the second stage regression, we use the model from Table 5 but include the first-stage model's predictions of the probability of politically connected chairmen. The results of this two-stage approach, as shown in Table 16, remain qualitatively similar to previously reported findings. The predicted relationship between politically connected chairmen and excess employment is negative and statistically significant (at 5%). As predicted, having a chairman with a government background is positively and significantly (10%) related to excess employment.

## 6. Conclusions and limitations

This paper explores the influence of government interventions on listed local Chinese SOEs and specifically investigates the affects of interventions to nominate politically connected people as chairmen in SOEs. We study the role of chairmen with government backgrounds in shaping firms' employment decisions and the effects of overstaffing on both the chairmen's income and the firms' operations. As evidence, we use comprehensive financial and accounting data from 2004 to 2009, together with detailed information on SOE chairmen and macroeconomic data for local regions in China. After studying the relationship between excess employment and the chairmen's government backgrounds, we examine the consequences of excess employment on local SOEs. We find evidence supporting the argument that appointing chairmen with government backgrounds is the mechanism through which the government intervenes in these firms' employment decisions.

First, we find that local SOEs whose chairmen have only general political connections are less likely to hire extra staff than chairmen with a professional background in government. This finding implies that different kinds of political relationships play different roles. Second, contrary to our prediction, excess hiring by firms does not bring much benefit to the chairmen personally, but does provide firms with better access to debt financing and government subsidies. This finding indicates that governments tend to compensate firms for helping to reduce the social burden of unemployment. Additional analysis indicates that the negative effects of the government's "grabbing hand" are obvious, and the positive effects of its "helping hand" are very weak. This indicates that government intervention in firms disturbs their normal operations and reduces the efficiency of resource distribution.

This analysis has very strong policy implications. We demonstrate that appointing chairmen is an indirect way for the government to intervene in local SOEs. Also, the support that governments offer firms in return for overstaffing does not significantly improve the firms' long-term performance. This finding suggests that the government should reduce interference in local SOEs and take more effective measures to improve the positive value of government subsidies.

This study is subject to the following limitations. First, there is a possibility that SOEs with low efficiency or excessive labor forces are more likely to hire ex-government bureaucrats as chairmen. Our two-stage approach for mitigating this endogeneity issue continues to provide support for the relationship between excess employment and political connections, but we cannot completely rule out this endogeneity concern. Second, the firms selected in our sample are all local SOEs. This may cause a problem of sample selection and limit the generalizability of the results. Prior studies demonstrate that firms with different kinds of ownership tend to operate in different ways. Therefore, future research should examine central government SOEs and private firms in comparison with the situation of local SOEs.

## Appendix A

See Table A1.

Table A1  
Variable definitions.

Variable	Definition
Age	Age of the chairman (continuous variable)
AssetGrowth	(Cash paid to acquire fixed assets and intangible assets)/total assets
Audittype	Dummy variable, which equals 1 if the auditors issue a modified audit opinion about the financial reports
Dual	Dummy variable, which equals 1 when the chairman is also the CEO of the company
ExistAge	Number of years the firm has existed
FirstShare	Percentage of shares owned by the largest immediate shareholder
FixedAsset	Fixed assets/total assets
GDP	Dummy variable, which equals 1 if regional GDP per capita is below the median
Total labor cost	(Cash paid to and on behalf of employees – the firm's top three managers' compensation)/total sales
Average labor cost	Ln (cash paid to and on behalf of employees/total number of employees)
Leverage	Total liabilities/total assets
Marindex	This is a comprehensive index that captures regional market development. The higher the index, the more market-oriented. The data is obtained from the NERI Index of Marketization of China's provinces, in Fan et al. (2010).
Mshare	Percentage of shares owned by the firm's management
ROA	Recurring income/total assets
SaleGrowth	(Total sales in year $t$ – sales in year $t-1$ )/sales in year $t-1$
SaleSize	Ln (total sales)
Tenure	Number of years the chairman has spent in the company
TobinQ	The sum of the market value of equity and the book value of liabilities divided by total assets, adjusted for non-tradable shares. The ratio is calculated as (year-end stock price of A shares * number of A shares + year-end stock price of B shares * number of B shares + year-end stock price of H shares * number of H shares + book value of nontransferable shares + total liabilities)/total assets
Unemploy	Dummy variable, which equals 1 if the regional unemployment rate is above the median

## References

- Bennedsen, Morten, 2000. Political ownership. *Journal of Public Economics* 76 (3), 559–581.
- Bertrand, M., Kramarz, F., Schoar, A., Thesmar, D., 2006. Politicians, Firms and the Political Business Cycle: Evidence from France. Working Paper. University of Chicago.
- Boycko, M., Shleifer, A., Vishny, R.W., 1996. A theory of privatisation. *The Economic Journal* 106 (435), 309–319.
- Brickley, J.A., Coles, J., Linck, J.S., 1999. What happens to CEOs after they retire? New evidence on career concerns, horizon problems, and CEO incentives. *Journal of Financial Economics* 52 (3), 341–377.
- Cao, J., Lemmon, Michael, Pan, Xiaofei, Qian, Meijun, Tian, Gary, 2012. Political Promotion, CEO Incentives, and the Relationship between Pay and Performance. Working Paper. SSRN.
- Chen, Donghua, 2003. A study and analysis on local government, corporate government: empirical evidence from subsidy in china. *Economic Research Journal* 9, 15–21.
- Chen, C., Li, Z., Su, X., 2005. Rent Seeking Incentives, Political Connections and Organization Structure: Empirical Evidence from Listed Family Firms in China. Working Paper. The Chinese University of Hong Kong.
- Chen, G., Firth, M., Xin, Y., Xu, L., 2008. Control transfers, privatization, and corporate performance: efficiency gains in China's listed companies. *Journal of Financial and Quantitative Analysis* 43 (1), 161–190.
- Chung, Wai-Keung, Hamilton, Gary G., 2002. Social logia as business logic: Guanxi, trustworthiness, and the embeddedness of Chinese business practices. In: Appelbaum, Richard P., Felstiner, William L.F. (Eds.), *Rules and Networks*. Hart Publishing, Oxford.
- Claessens, Stijn, Feijen, Erik, Laeven, Luc, 2008. Political Connections and preferential access to finance: the role of campaign contributions. *Journal of Financial Economics* 88 (3), 554–580.
- Dewenter, K.L., Malatesta, Paul H., 2001. State-owned and privately owned firms: an empirical analysis of profitability, lever age, and labor intensity. *The American Economic Association* 49 (1), 320–334.
- Dong, X.Y., Putterman, Louis, 2001. On the emergence of labour redundancy in China's state industry: findings from a 1980–1994 data panel. *Comparative Economic Studies* 2, 111–128.
- Dong, X.Y., Putterman, Louis, 2003. Soft budget constraints, social burdens, and labor redundancy in China's state industry. *Journal of Comparative Economics* 31, 110–133.
- Faccio, M., 2006. Politically connected firms. *American Economic Review* 96 (1), 369–386.
- Faccio, Mara, McConnell, John J., Masulis, Ronald W., 2006. Political connections and corporate bailouts. *Journal of Finance* 61 (6), 2597–2635.
- Fan, J.P.H., Wong, T.J., Zhang, T.Y., 2007. Politically-connected CEOs, corporate governance and post-IPO performance of China's partially privatized firms. *Journal of Financial Economics* 84 (2), 330–357.
- Fan, Gang, Wang, Xiaolu, Zhu, Hengpeng, 2010. NERI INDEX of Marketization of China's Provinces 2009 Report. Economic Science Press.
- Fisman, R., 2001. Estimating the value of political connections. *American Economic Review* 91 (4), 1095–1102.
- Gillan, S.L., Hartzell, J.C., Parrino, R., 2009. Explicit versus implicit contracts: evidence from CEO employment agreements. *Journal of Finance* 64 (4), 1629–1655.
- Johnson, S., Mitton, T., 2003. Cronyism and capital controls: evidence from Malaysia. *Journal of Financial Economics* 67 (2), 351–382.
- Li, David D., 1998. Changing incentives of Chinese bureaucracy. *The American Economic Review Papers and Proceedings* 88 (2), 393–397.
- Li, David D., Liang, Minsong, 1998. Causes of the soft budget constraint: evidence on three explanations. *Journal of Comparative Economics* 26, 104–116.
- Li, Hongbin, Zhou, Li-an, 2005. Political turnover and economic performance: the incentive role of personnel control in China. *Journal of Public Economics* 89, 1743–1762.
- Li, H., Meng, L., Zhang, J., 2006. Why do entrepreneurs enter politics. *Economic Inquiry* 44 (3), 559–578.
- Li, H., Meng, L., Wang, Q., Zhou, L., 2008. Political connections, financing and firm performance: evidence from chinese private entrepreneurs. *Journal of Development Economics* 87 (2), 283–299.
- Lin, J.Y., Tan, G., 1999. Policy burdens, accountability, and the soft budget constraint. *American Economic Review Papers and Proceedings* 89 (2), 426–431.
- Liu, Huilong, Zhang, Min, Wang, Yaping, Wu, Liansheng, 2010. Political connections, compensation incentives, and employee allocation efficiency. *Economic Research Journal* 9, 109–121.
- Luo, Donglun, Zhen, Mingli, 2008. Privately control, political relationship and financing constraint: an empirical evidence of private enterprises listed in China. *Journal of Financial Research* 12, 164–178.
- Michelson, Ethan, 2007. Climbing the dispute Pagoda: grievances and appeals to the official justice system in Rural China. *American Sociological Review* 72 (3), 459–485.
- Qian, Y., 1995. Reforming corporate governance and finance in China. In: Aoki, M., Kim, H. (Eds.), *Corporate Governance in Transitional Economies*. World Bank, Washington, DC.
- Roberts, B.E., 1990. A dead senator tells no lies: seniority and the distribution of federal benefits. *American Journal of Political Science* 34, 31–58.
- Sappington, D., Stiglitz, J., 1987. Privatization, information and incentives. *Journal of Policy Analysis and Management* 6 (4), 567–582.
- Shleifer, A., Vishny, R., 1994. Politicians and firms. *Quarterly Journal of Economics* 109, 995–1025.
- Siegel, Jordan I., 2007. Contingent political capital and international alliances: evidence from South Korea. *Administrative Science Quarterly* 52 (4), 621–666.

- Tenev, S., Zhang, C., Bafort, L., 2002. Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets. Work Bank and International Finance Corporation.
- Wang, Kemin, Wang, Zhichao, 2007. Executive control power, compensation and earnings management. *Management World* 7, 111–119.
- Wu, Wenfeng, Wu, Chongfeng, Rui, Meng, 2009. CEO's government background of chinese listed companies and tax preferences. *Management World* 3, 34–42.
- Xu, L.C., Zhu, Tian, Lin, Yimin, 2005. Politician control, agency problems and ownership reform: evidence from China. *Economics of Transition* 13 (1), 1–24.
- Xue, Yunkui, Bai, Yunxia, 2008. State ownership, redundant employees and firm performance. *Management World* 10, 96–105.
- Yu, Minggui, Pan, Hongbo, 2008. The relationship between politics, institutional environments and private enterprises' access to bank loans. *Management World* 8, 9–21.
- Yu, Minggui, Hui, Yafu, Pan, Hongbo, 2010. Political connections, rent seeking, and the fiscal subsidy efficiency of local governments. *Economic Research Journal* 3, 65–77.
- Yuan, Q., 2011. Public Governance, Political Connectedness, and CEO Turnover: Evidence from Chinese State-Owned Enterprises. Working Paper. SSRN.
- Zeng, Qingsheng, Chen, Xinyuan, 2006. State stockholder, excessive employment and labor cost. *Economic Research Journal* 5, 74–86.
- Zhang, Weiyong, 1999. *The Theory of the Firm and the Reform of Chinese Enterprises*. Peking University Press.