Earnings Management and Price Informativeness

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Motivation: Price Informativeness

- **Based on Carpenter et. al (2021, *JFE*) : Equation (3) of current paper**

$$\frac{E_{t+k}}{A_t} = \alpha + \beta_k log(\frac{M_t}{A_t}) + \gamma \frac{E_t}{A_t} + \lambda \frac{D_t}{A_t} + \epsilon_t, \text{where } k \in \{1, 2, ..., 7\}.$$

  - Regressing (future reported) earnings on market cap and firm variables;
  - Coefficients (β) regarded as price informativeness (predicting earnings)

- **Key results from Carpenter et. al (2021):** sample period 1995-2016
  - Series of coef. β from the A-share market are *similar to* those of the US during **2004**-2016; also investment (as dep. var.) efficiency for non-SOEs;
  - Questions: are the A-share stock prices really as price 'informative' as that of the US? Different explanations for these findings?

This Paper

- **Part I: Re-run the tests in Eq (3) for the A share and US markets**
  - Time period: 1995-**2022**; ***portfolio*** and firm-level regressions;
  - "**Manipulate-to-cater**" hypothesis: earnings are 'inflated' due to manipulation, while naïve investors do not fully realize until later (when there is reversal…)
  - Relationship between E_{t+k} and prices ***weakens*** over longer horizons ($k > 5$); *reversal of earnings* (for high value stocks); no predictive power of prices on (future) payouts (D_t); these patterns are ***not*** observed in the US stock market
- **Part II: A specific form of earnings manipulation, NRGLs**
  - ***Non*-recurring** gains and losses: *one-time* income and expenses
  - Delisting rules announced in 2020 (退市新规); use of NRGLs dropped post-2020
  - Main finding (corr. between E_{t+k} and prices) also weakens after 2020.

Comment #1: *Limited* Predictive Power of Earnings

❑ The use of (dividend) payouts as dependent variable:

- Many A share firms do not pay cash dividends (or with very low payout)
- Since **cash flows** are less 'manipulatable' than earnings, should try (future) cash flows in the regressions (and compare the results with those using future earnings)? => This version of paper finds earnings have less predictive power on cash flows (OCF, Table IV) ✔
- Results from dual-listed (AH) stocks: no predictive power using HK-listed stocks (while A share stocks illustrate strong predictive power) ✔

❑ Can there be other reasons for the documented patterns?

- Are the reversal patterns strongest among certain 'growth' firms (from *strategically important* industries)?
- 'Fundamental' reasons for earnings reversal: These firms were 'propped up' by government (via fin. support and subsidies), and/or attracted much hype…

Comment #2: Earnings Management in China

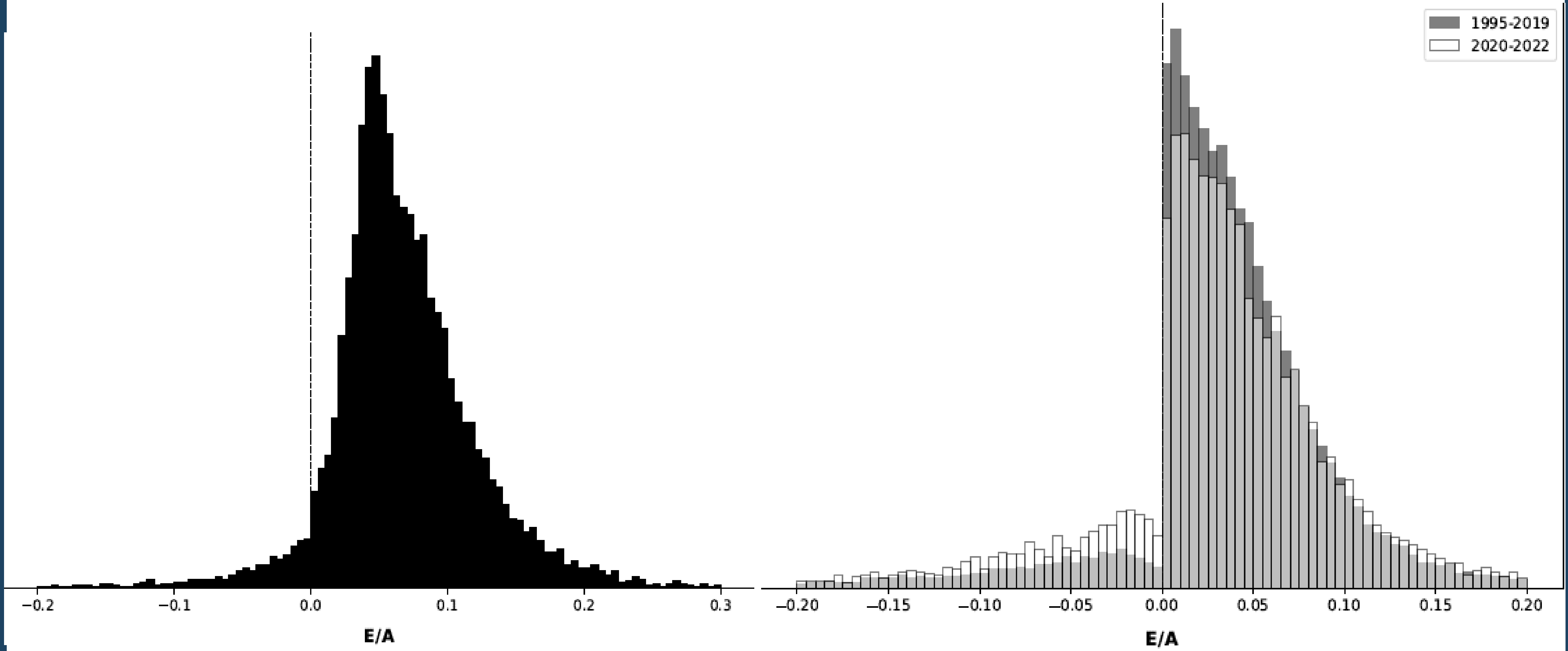

Figure IV Earnings Dist. of US Firms (S&P 500) and Chinese A share firms

Comment 2 (cont'd): Earnings Management in China

- **What are the common ways of earnings management in China?**
  - Most common device used (everywhere): **accruals** (accounts receivable etc.), no clear patterns found in the 'whole' sample (e.g., Liu et al., 2019, *JFE*)
  - An *event*-based approach? E.g., avoiding **a loss** (0 profit), **delisting**; fundraising
  - **Real earnings management**: e.g., cutting R&D expenses, no reversal…

- **The use of RPTs as a possible tool of earnings management:**
  - Definition: transactions between all the 'large' shareholders and their related parties and the listed firm; comprehensive disclosure requirements
  - Purposes of using RPTs: smooth earnings; prop up earnings; fraudulent behavior
  - Many forms of RPTs: accruals, real earnings management, etc.
  - Perhaps can focus on the following dimensions: a) Listed firms' **"other receivables" account;** b) RPTs that are **cash (or cash equivalent/loan) based;** c) firms with a **controlling (30%, 50%) shareholder.**

Comment #3: The Role of Retail Investors

- **Extensive (prior) work has shown retail investors in China illustrate behavioral biases**
  - Some institutional investors sometimes also illustrate similar patterns
- **To validate the "manipulate-to-cater" hypo., perhaps can run *stock*-level regressions:**
  - See if more earnings manipulation is indeed correlated with the presence of (irrational) retail investors;
  - Proxy: stocks with high (abnormal) turnover (Mei, Scheinkman, & Xiong, 2009)

Comment #4: NRGLs and the Policy Shock

- **Firms' use of NRGLs and changes over time:**
  - Propping up earnings and maintaining the listing status => ST firms and firms with high likelihood of becoming targets of reverse mergers
  - The 2020 Delisting Rules: makes it much more difficult to use NRGLs to maintain positive earnings and thus listing status
- **Interpretation of the results:**
  - Decrease in the use of NRGLs post-2020 and weaker relation (b/n E_{t+k} and prices): conclusion is based on the assumption that the use of ***other*** EM activities ***didn't*** change (or as much)
  - The period of 2020-2022 is 'special': pandemic and regime changes…
  - Once again, it would be good to look at other components of earnings management in order to obtain a clearer picture of what happened after 2020