Earnings Quality, Information Quality and Investor Protection: Evidence from Chinese Non-tradable Shares Reform

SHE ZHONGQIANG

MASTER OF PHILOSOPHY
CITY UNIVERSITY OF HONG KONG
JULY 2007
CITY UNIVERSITY OF HONG KONG
香港城市大學

Earnings Quality, Information Quality and Investor Protection: Evidence from Chinese Non-tradable Shares Reform
盈餘質量，信息質量和投資者保護：來自于中國股权分置改革的證據

Submitted to
Department of Accountancy
會計學係
in Fulfillment of the Requirements
for the Degree of Master of Philosophy
哲學碩士學位

by

SHE Zhong Qiang
佘中強

July 2007
二零零七年七月
CONTENTS………………………………………………………………...i
List of Tables……………………………………………………………….ii
ABSTRACT……………………………………………………………….iii
CHAPTER 1 Introduction………………………………………………...1
CHAPTER 2 Institutional Background………………………………....12
  2.1 Chinese Stock Market Institutions………………………………………12
  2.1.1 The Registration System ………………………………………………16
  2.1.2 The Channel System Phase of the Registration System ……………………16
  2.1.3 The Recommendation System Phase of the Registration System ………18
  2.2 Non-tradable Shares Reform ………………………………………………19
  2.2.1 Compensation Plans in the Reform …………………………………………22
CHAPTER 3 Literature Review…………………………………………27
  3.1 Earnings Quality…………………………………………………………….27
  3.2 Information Quality…………………………………………………………...32
  3.3 Investor Protection……………………………………………………………..34
  3.4 Conclusion on Interaction…………………………………………………..36
CHAPTER 4 Hypotheses Development…………………………………36
  4.1 Earnings Quality and Total Compensation Amount…………………………37
  4.2 Information Quality and Total Compensation Amount ……………………39
CHAPTER 5 Data Analysis and Methodology…………………………42
  5.1 Data…………………………………………………………………………………43
  5.2 Measurements…………………………………………………………………………43
  5.3 Regression Model Methodology……………………………………………49
  5.4 Results and Discussion………………………………………………………53
  5.5 Robustness Check ………………………………………………………………..58
  5.5.1 New Measurement of Discretionary Accruals ……………………………58
  5.5.2 Change in the Auditor Type Control Variable ……………………………61
  5.5.3 Substitution of ROA for ROE …………………………………………………63
  5.5.4 New Measurement of Discretionary Accruals (DD model) ………………65
  5.5.5 New Control Variable………………………………………………………67
CHAPTER 6 Discussion and Conclusion……………………………….69
References…………………………………………………………………74
List of Tables

Table 1 Summary descriptive statistics for variables..........................49
Table 2 Pearson correlation coefficients among variables..........................56
Table 3 Regression results (accruals from the Modified Jones Model).........57
Table 4 Sensitivity test results (Industry-adjusted accruals).......................60
Table 5 Sensitivity test results (Big 4 replaced by Top 10).........................62
Table 6 Sensitivity test results (ROE replaced by ROA)...........................64
Table 7 Sensitivity test results (accruals from the DD model)....................66
Table 8 Sensitivity test results (Price-to-book value of net assets).............68
Abstract

This dissertation examines the roles of earnings quality and information quality with regard to capital reform of the Chinese stock market. This is the first study of its kind to show that lower information quality and poor earnings quality will result in a higher “total compensation amount” to holders of tradable shares when switching non-tradable capital stock into tradable shares. The total compensation amount is the amount that holders of tradable shares receive in compensation for their losses due to the conversion of non-tradable shares into tradable shares. Earnings quality was measured by accruals quality to test hypotheses about the relationships between earnings quality, information quality and the total compensation amount. The regression results of 1,290 Chinese listed-companies which are involved in the capital reform confirm that lower earnings quality leads to higher compensation to holders of tradable shares and that the total compensation amount increases as information quality decreases.

Key Words: