Earnings Management: A comparative study between China and Pakistan

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1- Earnings management.

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FORWARDING SHEET

The thesis entitled "EARNINGS MANAGEMNET, A COMPARATIVE STUDY BETWEEN CHINA AND PAKISTAN" submitted by Mr. Nasir Abbas in partial fulfillment of M.S degree in Management Sciences with specialization in Finance, has been completed under my guidance and supervision. I am satisfied with the quality of student's research work and allow him to submit this thesis for further process as per IIU rules & regulations.

Date:____________________

Signature:________________

Name : Dr. Syed Zulfiqar Ali Shah

IN THE NAME OF
ALLAH, THE MOST MERCIFUL AND BENEFICIENT

Dedication

"To my parents, brothers and sisters for their un-conditional love, prayers, and support to make my dreams come true."

ABSTRACT

A hot debate is raging on the issue of earnings management after recent accounting scandals. The purpose of this study is to compare earnings management behavior in the two economies, Pakistan and China. Both are important emerging markets in Asia, having different cultures and corporate governance systems. A set of companies in both of the countries are investigated to compare the earnings management behavior for the year 2006 to 2008. Modified Cross Sectional Jones Model is used to determine the abnormal accruals. For comparative analysis of earnings management practices in Pakistan and China, the companies are ranked into four quartiles on the basis of magnitude and location of earnings management. The findings provided evidence that Chinese firms exhibited more positive earnings management location as compared to Pakistani firms. Whereas downward earnings manipulation was more apparent in Pakistani firms in contrast to Chinese firms. The findings also revealed that the magnitude of earnings management is much higher in Pakistani firms when gauged against Chinese firms. The Mann-Whitney test results showed that there is significant difference of the earnings management practices in the two countries. Which suggested that cultural and institutional differences of countries influence earnings management practices. Thus, financial reporting process may be affected by some of the socio-cultural distinctiveness of those countries.

Keywords: Earnings management, abnormal accruals, Pakistan and China

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DECLARATION

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No portion of the work, presented in this thesis, has been submitted in support of any application for any degree or qualification of this or any other university or institute of learning.

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Nasir Abbas

Table of Contents

LIST OF TABLES

Abbreviations

GAAP	Generally Accepted Accounting Principles
FIFO	First In First Out
R & D	Research and Development
NAC	Normal Accruals
ANAC	Abnormal Accruals
|NAC|	Absolute Normal Accruals
|ANAC|	Absolute Abnormal Accruals
TAC	Total Accruals
TA	Total Assets
RV	Total Revenues
PE	Plants and Equipments
RC	Total Receivables
SOE	State Owned Enterprises
ROE	Return on Equity
CSRC	China Securities Regulatory Commission
OECD	Organization for Economic Co-operation and Development
IMF	International Monetary Fund
IAS	International Accounting Standards

CHAPTER 1

INTRODUCTION

1. Introduction

Financial reports are used as a medium to convey information about the operations and profitability of the firms and therefore are the basic point of interest for the stakeholders. After high profile accounting scandals of highly ranked companies such as Enron and Xeron, the truthfulness of financial reporting has become a consistent concern for practitioners, regulators and academic scholars. Earnings represent the most important item in financial reporting which portray a company's economic health to its investors. Accounting earning statistics provide insights of firms' business activities and decisions made by the management. Earnings of a firm is directly linked with the firm's value, higher earnings may strengthen firm's value to the public, while low earnings reduce the value of firm. The reported earnings in company's financial statement not only reflect current performance but also provide roots to foresee the future development of the company (Yun et al 2007).

The firm's manager is accountable for preparing and publishing accounting documents in the form of financial reports to convey information about the company. For effective decision making, it is necessary that the available information presented in these reports should be reliable and based on facts. Stockholders of a company depend entirely on these reports while making decisions, as they do not have direct access to the company's accounting statistics. For this reason, managers may intend to exercise some judgment in computing firm's earnings either greater or lesser than the actual earnings, without violating generally accepted accounting principles (Prior et al., 2007). In this study, an attempt has been made to explore whether earnings are manipulated or not to create an impression by the firms in different economies. Pakistan and China have been selected as the target economies.

Prior studies have explored different ways through which managers can influence the accounting numbers. For example, managers can adjust these accounting figures through under or over assessment on expected useful life and salvage values of tangible assets. They can also alter the reported earnings by accelerating revenue recognition and delaying expense recognition while recording business transactions. Such sort of accounting techniques facilitates the firms to shift their earnings from one period to another period. In addition, GAAP also provide open space for the managers to make discretion in adopting different accounting methods such as inventory valuation methods (FIFO, average weighted), depreciation methods (the straight-line or accelerated), in order to record the same transactions. Numerous receivable policies, timing of inventory purchases and inventory level management are the grounds with which managers can use their judgments to invent the desired financial performance of the firm.

Earnings management is an activity of making discretion in earnings which leads to a set of financial reports that mask the true financial performance of the firm. When the firms engage in such practices, the information provided in the financial report is biased, reducing the quality and reliability of these reports. There is much evidence in accounting literature that the managers use their judgments in financial reporting which may mislead users about the economic performance of the company (Christie and Zimmerman, 1994, Healy & Wahlen 1999; Holthausen et al 1995; Payne and Robb, 2000, Burgstahler and Eames, 2003; Noronha et al., 2008).

Gunny (2005) categorizes earnings management in three broad types: 1) Fraudulent accounting 2) Accruals management and 3) Real earnings management. Fraudulent accounting involves accounting choices that are beyond the rules and regulations stated by GAAP. The second type of earnings management involves within-GAAP choices of accounting policies in order to represent desired level of financial position. It is crucial that the managers have to use their judgment for different business situations to make appropriate adjustments to accruals. So, in order to estimate these accruals, the use of this required judgment opens the door to alter the reported earnings. The third type occurs when managers alter economic activities of the firms in order to overstate or understate the reported earnings. For example, decrease R&D, advertisement and maintenance expenses etc. Gunny (2005) further argues that firms usually engage in accrual earnings management through the choice of different accounting methods and on the other hand for real earnings management they change firms' underlying operations.

Mitra and Rodrigue, (2002) stress that accruals management is the most critical concern for the effectiveness of financial reports because investors are uninformed about the existence of such accruals. Accruals are the residual as a difference between the earnings and cash flow from operating activities. In prior studies of earnings management, accruals are decomposed into non-discretionary (normal) accruals and discretionary (abnormal) accruals. Discretionary part of accruals have been used as the proxy of earnings management and is defined as accounting amendments to cash flows chosen by the managers while using their judgments, while non-discretionary or abnormal accruals are accounting amendments to the firm's cash flows authorized by the accounting rules and regulations (Rao and Dandale, 2008). A vast literature has focused the use of abnormal accruals to misrepresent the reported earnings around different types of corporate events. Jones (1990) investigates earnings discretions in particular event of import relief and argues that firms employ abnormal accruals to influence the outcomes of such events. Cahan (1992) concludes that firms use abnormal accruals to decrease their earnings during antitrust investigations. Perry and Williams (1994) confirm the use of income reducing accruals just before management buyout offers. DeFond and Jiambalvo (1994) find evidence relating to use of accruals by financially distressed firms in order to avoid violating debt covenants. The separation of discretionary and non- discretionary accruals is not simple as such accruals cannot be easily measured from financial reports provided by the company. In order to estimate the discretionary part of accruals; prior studies have developed different models e.g. Healy (1985) model, DeAngelo (1986) Model, The Jones (1991) model, The modified Jones (Dechow et al., 1995), and The Industry model (Dechow and Sloan, 1991). Hence, the good fitness of research findings depends solely on the power of such models in determining how different situations affect accruals.

Armstrong (1993) has emphasized that discretion of earnings is a hot raging ethical issue of financial reporting for the accountants. Investors, creditors and other stakeholders are solely dependent on accountants to get true and reliable financial information of the firms. The users of such report must be assured that the reports provided by the firm are accurate, because their decisions are based on these financial reports. Firms that are engaged in earnings manipulation practices may deceive the users of financial reports about the true economic health of the firm.

After recent accounting scandals, general public recognizes that managers use such practices opportunistically with the objective to gain some private benefits. However, a series of academic research works have emphasized that these practices may be informational or beneficial instead of opportunistic because it probably enhances the information value of earnings. These studies have highlighted the beneficial aspects of earnings manipulations and argue that such practices may be intended to convey private information to the user (Arya et al , 2003; Demski, 1998; Guay et al, 1996; Subramanyam, 1996). Jiraporn et al (2006) have used agency theory as a means to make a distinction between different perspectives of earnings management i.e., opportunistic and beneficial. In this study they find inverse relationship between extent of earrings management and agency cost. Furthermore, they also find a direct relation between firm value and the extent of earnings management. So, the results have supported the beneficial perspective of the earnings management.

A wide literature has attempted to examine earnings management in several circumstances. Teoh, et al., (1998) confirm that firms appealing equity offerings are more likely to increase reported earnings prior to the offering. Dechow and Sloan (1991) suggest that CEOs make discretion in reported earnings in their last years of employment in order to exploit their compensation settlements. Healy and Wahlen (1999) by investigating the past literature of earnings management have explored three incentives of earnings management i.e. (1) capital market motivation, (2) contracting motivation, and (3) regulatory motivation. Leuz et al (2003) using data of 31 countries have studied the relationship of earnings management with investor protection in different economies and discover that strong investor protection reduces the earnings manipulations. Shen and Chih (2005) investigated international comparative study of earnings management in context of banking sector and report similar findings as Leuz et al (2003) in financial sectors. Burgstahler and Dichev (1997) conclude that firms usually make discretions over earnings in order to stay away from losses. DeGeorge et al (1999) propose that firms manipulate their earnings for the objective to meet analysts' earnings forecasts.

Prior Literature has widely discussed the issue of earnings management, these studies varying from managerial compensation (Healy 1985, Clinch and Margliolo 1993, Gaver et al. 1995, and Holthausen et al 1995 , Bergstresser and Philippon 2006, Cohen et al. 2004), debt contracts (Healy and Palepu, 1990; Beneish and Press 1993, DeFond and Jiambalvo, 1994; Sweeney, 1994, Hall 1994) ; equity offerings (Rangan 1998 and Teoh et al. 1998b, DuCharme et al. 2001, Rahman and Abdullah 2005), Corporate Tax Shelters (Desai and Dharmapala, 2001), meet analysts' expectations (Kasznik (1999); Dechow et al., 2000, Brown, 1997 ; Degeorge et al., 1999; and Payne and Robb 2000), political cost minimization (Cormier et al., 1998; Garrod et al, 2007).

Earnings management has become a hot raging issue not only in context of prevailing accounting standards but also in the discussion of good corporate governance. The recent unexpected collapse of highly ranked companies who hid the seriousness of the crisis by alteration of accounting numbers has attracted considerable attention of regulators, financial institutions and media regarding to effectiveness of corporate governance mechanism. Considerable prior studies have examined the earnings management issues with different corporate governance attributes i.e. board independence (Park & Shin, 2004, Peasnell et al., 2005; Klein, 2002; Ebrahim 2007; and Davidson et al. 2005) management ownership (Shivaram et al. (1999), Niu (2006) and Mohd Saleh et al. (2005,Kim & Yi, 2005; and Cheng & Warfield, 2005) CEO duality (Bowen et al. 2002; and Carapeto et al., 2005, Johari et al (2008) board size Chtourou et al. (2001), Dechow et al. (1996), Xie et al. (2003), and Ebrahim (2007). Audit quality (Becker et al., 1998; Francis et al 1999 and Gore et al., 2001).

Earnings management has been extensively studied in prior studies and most of the studies are based on single socio-economic situation. However, little consideration has been given on the comparison of earning management practices between countries having different culture, socio economic and institutional systems. Along with the other factors, these factors may also have influence on managers' judgment while preparing financial reports to either overstate or understate the reported earnings. Leuz et al. (2003) compared the differences of earnings management by using data from 31 countries. They found negative relationship between investor protection and earnings management and conclude that strong investor protection at a country level decrease firms' earnings management practices. Shen and Chih (2005) used data from 48 countries of financial industries to determine earnings management and found anti-director right, legal enforcement, accounting disclosure and inside trading to be determinants of the variation of earning management across the countries. Doupnik (2008) concluded that the variation in the earnings management explained by cultural dimension is greater than that of the investor protection variable.

1.1. Motivation of the study

This study focuses on comparison of earnings management practices in terms of location and magnitude between China and Pakistan. Earnings management takes place when managers use accounting rules or discretionary accruals to overstate or understate reported earnings. Such activities happen when there is a separation of owner and management, which leads to conflict of interest between the owners and managers.

One of the primary reasons beyond comparing earnings management practices in Pakistani firms with the Chinese firms is that China has gained rapid economic growth in last couple of decades which has amazed the economic world. Furthermore, these economies are the important emerging markets in Asia having different business environment and institutional system. In both countries, most of the listed companies are characterized by group concentrated ownership structure. Such sort of characteristics of firms discourages the true implementation of good corporate governance, which provides opportunities to engage in earnings management practices. Realizing the importance of corporate governance, both countries are emphasizing on improving corporate governance (Shah et al 2010).

Despite the fact that considerable research has been done on earnings management, most of them are based on western economies. In Asia, particularly in Pakistan, research regarding earnings manipulation issues has been extremely limited. Further, most of studies conducted in western countries are limited to a single country; cross country comparison on this issue has been neglected.

1.2. Objectives of the study

The objective of this study is twofold.

- This study seeks to investigate the issue that whether firms in the two neighboring countries engage in earnings management practices.
- Secondly, we examine whether earnings management activities are significantly different across these two economies.

Our contribution is to compare earnings management practices in two neighboring countries i.e. Pakistan and China. Both are important emerging markets in Asia, having different culture and corporate governance system. The results will identify the existence of earnings management in term of location and magnitude, which provides a better understanding about the quality of accounting earnings in both countries. The findings of this study will open new doors for investors to make effective and efficient decisions which improve their decision making processes. The existence of earnings management practices will raise the question about the reliability of financial reports prepared by firms in both countries. This enables firms to think about the efficiency of prevailing corporate governance mechanisms in order to enhance the reliability and information contents of financial reports. Hence, by making necessary measures to provide reliable information about the corporate performance to the shareholder will strengthen their trust with the corporation.

1.3. Organization of study

The remainder of the thesis is structured as follows. Chapter 2 summarizes the past literature related to the objectives of this research. This section provides an in-depth overview with definition, motives, measurement and cultural perspectives of earnings management which are discussed in prior research works. The latest expansion in the literature of earnings management in context of China and Pakistan is also discussed. Chapter 3 describes methodology and defines the sample, and empirical models to be tested. The empirical results and discussion on these results are presented in Chapter 4. The final section of the article consists of the main conclusions, contributions and directions for future studies.

CHAPTER 2

LITERATURE REVIEW

2. Literature review

2.1. Earnings management

In accounting literature, there are numerous well documented studies related to earnings management in different economies. Despite the abundant earnings management literature, there is no consensus on the proper definition of earnings management among scholars. According to the objective, scholars have developed their own definitions. The widely used definition of earnings management is proposed by Healy & Wahlen (1999);

"*Earnings management occurs when managers use judgment in financial reporting in structuring transactions to alter financial reports, to either mislead some stakeholders about the underlying economic performance of the economy, or to influence contractual outcomes that depends on reported accounting numbers.*"

Schipper (1989) describes earnings management as manager's intervention in the process of financial reporting for the achievement of some private gain. In view of Noronha et al (2008) , it is decisive interventions of managers in the financial reporting process, which ranges from lawful activities (within GAAP) to fraud (violating GAAP), with the objective to mislead some stakeholders. Shiue and Lin (2004) refer it as exploitation of earnings by using certain methods in financial reporting to accomplish managers' objectives. All the above definitions have emphasized the decisive intervention of managers in financial reporting processes and the objectives of making discretions over earnings, but this intervention should only be opportunistic in nature is not clear yet.

Beneish (2001) proposes the twin perspective of earnings management; opportunistic and informative. A school of thought believes that earnings management is always opportunistic in nature. They state that managers always exercise such activities to give a constructive impression about underlying economics of the company hence; these are harmful for the users of financial reports. Holthausen et al (1995) and Healy (1985) found evidences that managers opportunistically alter reported earnings to strengthen their compensation benefits. DeAngelo (1986) argues that managers may exercise discretion in financial reporting process in order to create an impression of their excellent performance in the company. Another school of thought believes in the informational perspective of earnings management and state that such discretion may be aimed to convey inside information of the company to other stakeholder (Demski, 1998; Guay et al, 1996; Healy and Palepu, 1993). This helps the users of financial reports to forecast the firms' future cash flow which represents the beneficial aspect of earnings discretions (Holthausen and Leftwich, 1983). Considerable studies in literature highlight the beneficial aspects of earnings management as it raises the information value of earnings (Arya et al, 2003; Holthausen, 1990 and Subramanyam, 1996). These studies argue that managers may exploit earnings statistics to communicate private information to the general public and the stockholders. Subramanyam (1996) also supports this argument that managerial discretion in financial reporting aims to improve the ability of earnings to reflect fundamental value. Dechow and Skinner (2000) view that managers may also use discretions with the aim to communicate information to investors, so these discretions should not to be opportunistic at all. Jiraporn et al (2006) findings also reveal that earnings management is on average not detrimental. Beneish (2001) concludes with the remark that past studies on earnings management have not been able to settle this issue, whether the objective of managers exercising accounting discretion is to deceive or to inform the stakeholders of the company.

2.2. *Motives of earnings management*

What motives drive managers to alter the reported earnings has been one of the important queries in the literature of earnings management. There is a wide literature emphasizing the motives of earnings management. One of the important incentives for managers to alter the reported earnings is compensation. There is significant evidence in literature that managerial discretion in financial reporting links with maximization of managerial compensation benefits (Healy, 1985; Gaver et al., 1995 and Holthausen et al., 1995). These studies provide interesting insights that managers influence the reported earnings to uplift their compensation benefits. Gao and Shrieves (2002) provide empirical confirmation which shows that the extent of earnings management is directly associated with the managerial compensation contract design. They further conclude that amounts of stock options and bonuses are positively related to reported earnings discretion intensity. Shuto (2007) investigated the influence of managers' discretionary accounting choices on managerial compensation in Japan by exploring the link of earnings and compensation. The results show that the use of such accounting choices increases the executive compensation. Dechow et al. (1995) claim that managers may shrink research and development expenses in their final year of their profession at the company to indicate high earnings with the aim to provide the view that the company has retained a sound financial positions under their supervision. Such sort of proceed is intended to get compensation benefits, which are usually based on short period nature.

Several prior studies suggest that managers may exploit reported earnings in order to minimize the likelihood of debt covenant violations (DeFond and Jiambalvo (1994) and Sweeney (1994) and Fields et al, 2001) . Watts and Zimmerman (1990) argue that the nearer the firm is to disobeying financial reports based debt deal; the probability of firm to engage in income increasing activity also increase. Sweeney (1994) propose that disobedience of accounting contracts are costly to debtors as compared to creditors, so debtors are more prone to alter reported accounting statistics to stay away from default.

Many prior studies investigated managerial discretions in financial reporting processes to blow up the earnings around initial public offerings (Aharony et al, 1993; Friedlan ,1994; Teoh et al 1998 and Teoh et al 1998a). Friendlan (1994) by using 155 US initial public offerings sample during 1981- 1984 finds that firms use income-increasing discretionary accruals in the financial reports released in the IPO prospectus. Rahman and Abdullah (2005) investigated earnings exploitation of firms involved in IPOs in Malaysia. The findings confirm the existence of earnings discretions earlier to the IPO, but no considerable relationship between earnings discretions and post-IPO. Rangan (1998) and Teoh et al. (1998b) have studied earnings management in the context of seasoned equity offerings. These studies provide facts that firms have high positive earnings and abnormal accruals at issue year.

Some prior research studies show that managers alter financial reports to meet analysts' expectations and management forecasts (Burgstahler and Eames, 1998; Dechow et al., 2000; Degeorge et al., 1999; and Payne and Robb 2000). Bannister and Newman (1996) conclude that firms will increase earnings when the reported earnings decrease to analysts' forecasts. Kasznik (1999) in support of above argument concludes that firms having high earnings forecast are probably more close to altering reported earnings in their financial reports.

Tax avoidance is probably another factor motivating firms to engage in earning management practices. Prior studies have explored the earnings discretion in response to changes in the corporate tax rate in different countries. Scholes et al (1992) examine the impact of Tax Reforms Act 1986 on earnings management behaviors of US firms. The findings reveal that firms adjust earnings by deferring the recognition of revenue and accelerating the recognition of expenses in anticipation of decline in the corporate tax rate, which is aimed to reduce their tax expense. Guenther (1994) also investigated alteration of reported earnings in response to the Tax Reform Act of 1986 by US firms and finds that firms reported significantly lower current accruals in the year preceding a tax rate reduction compared to the following year. Yamashita and Otogawa (2007) study firms behaviors of managing their book income in reaction to variation of corporate income taxes in context of Japan. They provide evidences that Japanese firms engage in earnings management by using high negative discretionary accruals for the years immediately preceding to tax rate reduction. Roubi and Richardson (1998) also investigated this particular motive of managing reported earnings in response to changes in the deviation corporate income tax rates in three countries. i.e., Canada, Malaysia, and Singapore. They also confirm that firms in these countries manage their reported earnings to minimize tax costs.

Furthermore, there are well documented studies that demonstrate earnings management motives in different context e.g. political cost minimization (Garrod et al, 2007), to obtain import relief (Jones, 1991); incentives to decrease earnings in periods surrounding union negotiations (Liberty and Zimmerman, 1986), decrease earnings practices in periods preceding management buyouts (DeAngelo, 1986; Perry and Williams, 1994), downward earnings management in the year CEO change, upward earnings management in the following years (Godfrey et al., 2003) and upward earnings management in the year when CEO retires (Reitenga and Tearny, 2003 and Dechow et al, 1995).

2.3. Earnings management: cultural dimensions perspective

Considerable prior studies show influence of environment on accounting standards and practices in different countries. These studies have identified factors that influence accounting system as culture, economic development, political system, capital market, inflation levels, tax laws and legal system (Meek & Saudagaran, 1990; Doupnik & Salter, 1995). Hassan (2003) suggests that the change in the environment, demand and use of financial information leads to development and change in accounting. Along with the other factors of environment, the importance of culture has been widely recognized in accounting literature. Accounting is a socio-technical phenomenon which is undertaken by the support of both human and non human resources; the presence of this interaction accounting cannot be culture free (Othman and Zeghal, 2006). Past studies suggest that accounting practices and disclosures have been influenced by a nation's cultural values. These studies argue that accounting is affected by the culture of the country in which it operates (Gray, 1988; Perera, 1989; Doupnik and Salter, 1995). In this regard, accounting literature is also well surrounded by a series of research works which have focused influence of cultural differences between societies on earnings management behavior (Guan et al, 2006; Nabar and Boonlert-U-Thai, 2007; Desende et al, 2008; Doupnik, 2008). These studies have confirmed the influence of culture differences across countries on earnings manipulation extent. Cultural dimensions proposed by Hosftede (1980) have been used in most of these studies. By conducting survey from approximately 116,000 IBM employees across 39 countries, Hofstede has originated four different sets of dimensions of culture along with each county can be positioned: individualism versus collectivism, strong versus weak uncertainty avoidance, large versus small power distance, masculinity versus femininity. Later on, Gray (1988) uses these dimensions to explore the association of these cultural values with accounting values. This study proposes four dimensions of accounting values: professionalism versus statutory control; uniformity versus conformity; conservatism versus optimism, and; secrecy versus transparency. This attempt has made an important contribution to explain the impact of

Hofstede's (1980) cultural values on various dimensions of accounting systems in different societies. Many researchers have used this model in several research studies to examine international accounting issues (e.g., Jaggi & Low, 2000; Salter & Niswander, 1995; Sudarwan & Fogerty, 1996). Guan et al. (2006) use Gray's model of the influence of culture on accounting, across five Asian–Pacific countries (Australia, Hong Kong, Japan, Malaysia and Singapore) and find significant influence of culture on earnings management. Nabar and Boonlert-U-Thai (2007) use OLS and Cross country analysis of 30 countries find that earnings management is relatively high in countries with high uncertainty avoidance. Further, their research findings also indicate that masculinity is also positively associated with earnings discretion. Desender et al (2008) find negative association of Individualism with earnings discretion, but no relationship of Uncertainty avoidance, Masculinity, Power distance with earnings discretions. Further, Doupnik (2008) find no association of Masculinity, Power distance with earnings discretions but find positive relationship of Uncertainty avoidance and discretion.

2.4. Financial reporting in china: An overview

With the economic globalization and the development of market economy, China has experienced fast economic growth, international trade and securities markets, which, in turn, demanded new objectives for financial reporting. Even in state-owned enterprises now operate like profit-oriented businesses, managers, as well as other stakeholders require reliable and relevant financial information to make efficient and effective decisions. This growing economy increasingly demanded a framework of accounting standards to meet the needs of investors and creditors as well as management and government. As a result, significant accounting reforms were undertaken in the past two decades.

The Accounting Law of China was first enacted 1985 and was last revised as of 1 July 2000. It is the highest authority on accounting in China. It sets out general principles of accounting for all enterprises.

The law sets out the general principles of accounting for all enterprises and also empowers the Ministry of Finance (MOF) to administer accounting affairs and establish uniform accounting regulations and systems. Under the mandate of Accounting Law, the MOF has issued various accounting regulations that apply to different categories of enterprises. It issued the first Chinese Accounting Standard (CAS) in 1997 with another 16 standards following this, in order to develop a body of CAS that is broadly in line with IAS. In January 2001, the MOF further adopted a comprehensive accounting system for business enterprises. The most updated accounting standards (38 standards) were issued by the MOF on February 15, 2006 and became effective on January 1, 2007. Listed companies must adopt the new rules, and non-listed companies are encouraged to adopt them as well.

In China, public companies issue two kinds of shares – A-shares to domestic investors and B-shares to foreign investors. A-shares are denominated in RMB and issued only to Chinese citizens, while B-shares are denominated in U.S. dollars on the Shanghai Stock Exchange or in Hong Kong dollars on the Shenzhen Stock Exchange and issued only to foreign residents before Year 2001 (Sami and Zhou, 2004). Both A-shares and B-shares convey equal rights though they are different in terms of ownership. However, A-share investors receive accounting information prepared under the Chinese GAAP and audited by local CPA firms, while B-share investors receive accounting information prepared under the IAS and audited primarily by international accounting firms. Therefore, the Chinese emerging market provides a unique environment in which one can examine whether accounting information prepared under the IAS has higher earnings quality than that prepared under local GAAP.

2.5. Financial reporting in Pakistan: An overview

Pakistan, after gaining independence in 1947 adopted Companies Act 1913 and the Auditors Certificate Rules 1932 enacted by the British Government in subcontinent before partition.

In 1952 a private body known as the Pakistan Institute of Accountants (PIA) was formed to look after their own interests and to take up the accounting professional matters with the government. Soon after, there was a major post-independence development in the accounting profession - the formation of the Institute of Chartered Accountants of Pakistan (ICAP) in 1961. This was the result of both persistent pressure from the Pakistan Institute of Accountants and a realization by the government that the profession has now grown in stature and in importance to a level that warrants autonomous status. Another major development that followed quickly was the establishment of the Institute of Cost and Management Accountants of Pakistan (ICMAP) in 1966 (as a follow up to the formation of Pakistan Institute of Industrial Accountants) to regulate the profession of cost and management accountants. (Saeed, 1993).

In 1970, the Securities and Exchange Authority, a semi autonomous body created by the government, developed certain rules to improve financial reporting practices in the country. These rules were published in 1971 and became effective in 1972. These rules required substantially increased disclosures. For the first time, the publication of semiannual accounts for listed companies was made mandatory.

Soon after the formation of The International Accounting Standard Committee (IASC), Pakistan became its member in 1974. Since Pakistan never had any national accounting standard of its own, Institute of Chartered Accountants of Pakistan (ICAP) encouraged its members to recommend to their corporate clients to prepare their financial statements inconformity with the International Accounting Standards (IAS). It was not mandated that incorporated businesses should prepare their financial statements on the basis of IAS. Later, the Companies Ordinance 1984, Section 234 made it mandatory for listed companies to comply with all those IAS that have been notified by Corporate Law Authority on the recommendation of ICAP. The unlisted companies were and are still not required to comply with requirements of IAS (now known as International Financial Reporting Standards, IFRS). Annexed to Companies Ordinance 1984 were the Fourth and Fifth Schedule, providing disclosure requirements for listed and unlisted companies, respectively. Listed companies were hence required to comply with requirements of the Fourth Schedule as well as IFRS.

Financial statements of listed companies continued to improve into 1990s with a number of new international accounting standards issued by the IASC (now known as the International Accounting Standards Board IASB). These standards were issued as part of core standards project specified by International Organization of Securities Commissions (IOSCO) to IASC before it would consider endorsing IAS for cross-border listing of companies on the international stock exchanges of the world. Most of these standards were adopted by SECP (Securities and Exchange Commission of Pakistan) on the recommendation of ICAP along with many old standards that were not adopted earlier.

2.6. Earnings management in China

China established stock markets in early 1990s in order to facilitate economic reforms namely Shanghai stock exchange and Shenzhen stock exchange. From its time of starting China's market has gained considerable momentum and within less than 12 years, China's stock market has acquired its position as the fastest growing and as the eight largest markets in the world. No doubt this economic success is the consequences of China's economic reforms from socialist economy to market based economy. This transition period is characterized by evolution of private sector and decline in the state owned enterprises. Inspired by the fast growing economy, China has taken considerable attentions toward the improvement of corporate governance mechanism, particularly in the area of company and securities laws. But still establishment of a well defined corporate governance framework is a challenge for Chinese government.

Public companies in china issue two types of share i.e. A share and B share which are denominated in RMB and U.S. dollars (on the Shanghai Stock Exchange) or Hong Kong dollars (on the Shenzhen Stock Exchange) respectively. The first type of share is issued only to the citizens of China and the former is issued only to foreign investors before Year 2001 (Sami and Zhou, 2004). For A-share investors financial reports prepared in accordance with the Chinese GAAP and audited by local audit firms, while for B-share investor financial reports prepared in accordance with the IAS and audited by international audit firms. Zhou et al (2006) investigated whether firms implementing IAS is associated with less earnings management than that of Chinese GAAP implementing firms in the context of China. They found evidence that firms using IAS manipulate earnings less as compared to firms using local GAAP.

Shah et al., (2010) argue that formerly Most of Chinese listed companies were owned by state, so these companies do not have the efficient control system and lacked real owners. In this situation managers have the opportunity to exercise their judgments to benefits their self on the cost of shareholder's benefit.

Regardless of transition of SOEs to private firms, the ownership structure of Chinese listed companies is largely concentrated in the control of government representing more than

70% of the total share of the market (Liu and Lu, 2007). This causes conflict of interest between the majority shareholders and minority shareholders. Liu (2003) proposed that the existence of agency problem between majority shareholders and minority shareholders is the foremost cause which motivates firms to make discretions over earnings in Chinese listed companies.

In order to attract foreign investment, most of the developing economies use tax reductions schemes that allow firms to pay taxes at reduced rate for a specific time span. Such schemes provide a distinct sitting to study the effect of different tax rate on the financial reporting behavior. Lin (2006) investigated of financial reporting behavior of foreign investment enterprises in China in response to tax holidays. The findings reveal that firms use higher abnormal current accruals in the period of tax holidays to get the benefit of tax reduction.

In earnings management literatures, it is confirmed that managers have incentives to alter financial reports when a contract or regulation is subjected to accounting statistics (Chen and Yuan, 2001). With the fastest momentum of capital market, considerable studies have focused on the earnings management practices under special regulation regime in the context of China. In China, the China Securities Regulatory Commission obliges firms to meet some regulatory requirement for the issues of right. During the period of 1996-1998, it was the basic regulatory requirements for companies to have minimum of 10% ROE for the three years prior to the offering. From year 1999 to 2000 it was both at 6% and 10% and in 2001, CSRC set new requirements that oblige firms to have an average of 6% over last three years (Jian and Wong, 2004). Yu et al. (2006) investigate Chinese firms' discretions over reported earnings to meet the regulatory requirements during the period of 1994-2002. The empirical results show that these firms have adjusted their reported earnings with the changes in regulatory thresholds. They concluded that during the period of 1994-2002, these firms engaged in earnings management practices in order to fulfill the right issue requirements. Chen and Yuan (2004) study earnings manipulation behaviors of firms to fulfill the minimum 10% ROE constrained for rights issues during the period 1996–1998. They also confirm that these companies engage in earnings management to fulfill statutory requirements in the given study period.

Chen at el. (2008) investigate a special case of earnings mistreatment by listed companies where local governments help state-owned companies to engage in such practices for fulfillment of the central government's regulation in the context of China. They find that local government has violently participated in earnings manipulations of these firms by providing subsidies to increase their earnings higher than the regulatory requirements.

Lu (1999) study earnings manipulations by loss firms using 22 loss firms in Shanghai Exchange before 1997 and finds that these firms employ earnings management practices by means of abnormal accruals to avoid losses. Sun and Wang (1999) investigated resource allocation and earnings management by illustrating the distribution diagram of return on equity (ROE) of all firms and find that financially sound SOEs engage in earnings management slightly and SEOs having losses take such activities profoundly.

There are also some studies that emphasize earnings management through specific activities in the context of Chinese economy. Jian and Wong (2004) using 131 Chinese listed firms provide evidence that these firms use high level of related party sales for altering the reported earnings with the objective to avoid being delisted or prior to rights issues. They further confirm that firms owned by groups are more engaged in earnings management activities. Chen and Yuan (2004) argue Non-core operations are a convenient means to engage in earnings management for China's listed companies and find that those firms using such earnings management practice subsequently executed poor performance.

Noronha and Zeng (2008) investigated motives of Chinese firms to engage in earnings management and try to identify the most frequently used earnings management techniques. The findings reveal that the size and ownership structure of companies influence the motives and techniques of earnings management in China. They also conclude that the most important motive to manage reported earnings for public owned companies is management compensation and for private companies is tax saving. In addition, they also mention that Chinese firms favor to use simple and direct techniques like adjusting accounts receivable and using related parties' transactions to manage the report earnings rather than using complicated techniques.

2.7. Earnings management in Pakistan

Pakistan is an important emerging market in South Asia having three stock exchanges at Karachi, Lahore and Islamabad. Karachi Stock exchange is the oldest and largest capital market in Pakistan. In 2002, this market was acknowledged as the "Best Performing Stock market of the World by "Business Week". Most of the companies in Pakistan are owned and controlled by families; hence such companies are the basic attribute of Pakistani economy. Due to the family owned and shareholding concentration characteristics of Firms, the true implementation of corporate governance cannot be achieved in Pakistan (Shah et al, 2009). McGee (2008) examines application of several corporate governance attributes as proposed by the OECD, World Bank and IMF in eight selected Asian Countries including Pakistan. The findings reveal that all of these countries are unable to get perfect corporate governance score of 50. India came closest with a score of 42, Pakistan was at third place with a score of 39 and Vietnam at last place with a score of only 24. The author argues that the scores for each of these countries will possibly improve with the passage of time due to internal and external pressures.

Leuz et al (2002) provides comparative evidence on the differences of earnings management using data of non financial firms from 31 countries including Pakistan. The findings reveal that strong investor protection confines insiders' ability to achieve private benefits, so the probability of firms to engage in earnings management practices decreases with strong investor protection economies. They estimate aggregate earnings management score by averaging four earnings management measures for each countries. Country having high score of estimated aggregate earnings management represents high level of earnings management. According to their findings Austria is on the top and America is on the lowest place having 28.3 and 2 scores respectively. Further, Pakistan is at 17^{th} place (from the bottom) having estimated score of 17.8. This score is high enough representing the existence of moderate earnings management practices in the context of Pakistan.

Shen and Chin (2005) examine issues related to the earnings management using financial sector data from 48 countries including Pakistani Banks. They provide evidences that nearly all banks engage in earnings management practices for all sample countries including Pakistan. They also conclude that strong investor protection reduces the earnings management incentives of banks.

No doubt earnings management has been investigated comprehensively in prior studies, most of them are conducted in western countries especially in the context of USA. We hardly find few studies relating to earnings management which has focused only on Pakistan. Iqbal et al (2009) investigated the existence of earnings management around the privatization of government enterprises using 31 companies over the period of 1991-2005. By employing modified Jones Model they found evidence representing the existence of upward manipulation of reported earnings before the privatization period. They further argue that the investors must cautiously think about the shift of reported earnings of firms being privatized.

Shah et al (2009) examine the relationship of corporate governance and earnings management by using 53 companies from KSE 100 for the year 2006. This study uses the Modified Jones model to estimate discretionary apart of accruals and find surprisingly direct relationship of Corporate Governance quality and extent of discretionary accruals. The main rationale of finding opposing results might be the use of very limited corporate governance attribute. Such findings can be validated by conducting more research works on this particular issue in the context of Pakistan.

In a recent study Shah et al.. (2010) conducted a comparative study between China and Pakistan to explore the relationship of dividend payout policy and earnings management for the two neighboring countries. This study used the dividend payout to measure dividend policy and discretionary accruals to determine the earnings management in each country. The finding shows that discretionary part accruals are much higher for Pakistan than that of China having mean values of 1.366 and 0.131 respectively. The authors of study are unable to find the impact of dividend payout policy on discretionary accruals in both countries.

Hassan and Butt (2009) argue that corporate governance practices in Pakistan are at very preliminary stage. They further claim that corporate governance is commonly linked with the existence of agency problem. Shah et al 2010 argue that the major agency problem exists between the majority shareholders and minority shareholders due to the large number of family owned companies in Pakistan. Such situations boost earnings manipulation behavior of firms to achieve benefits at the expense of other shareholders.

Due to lack of true implementation of corporate governance, political instability, economic distress and terrorist threats to Pakistani economy we assume that Pakistani firms will exhibit more earnings management in term of location and magnitude as compared to the Chinese firms. Due to the differences of culture, socio economic and institutional factors, we further assume that there will be significant difference in the behavior of earnings management practices in both study economies.

CHAPTER 3

METHODOLOGY

3. Methodology

3.1. Sample size

The sample of this study consists of 100 Chinese companies and 100 Pakistani companies for the period of 2006-2008. Required financial data for Pakistani firms have been collected from annual balance sheet analysis published by state bank of Pakistan. The financials of Chinese companies have been collected from their respective official company web sites. Appendix A and B shows names and industrial types of firms selected as a sample from China and Pakistan respectively.

3.2. Measuring earnings management

Earnings management studies have got remarkable interest for the researchers, practitioners and regulators as these studies provide insights on managers' reporting behavior and issues of financial reporting integrity. As no consensus exists in academia on a standardized definition of earnings management, in the same way different researchers adopt different methods to measure this phenomenon as per their study purposes. Major stream of literature commonly used accruals to verify the existence of earnings management. These studies examine accruals by distinguishing discretionary and non discretionary accruals. The existence of discretionary accruals indicates earnings management. Despite rich literature, there is again no consensus regarding which method is superior for estimating discretionary accruals. However, four main approaches with varying modifications and characteristics have been used in literature to measure earning management practices. The first approach is based on the total accruals e.g. The Healy (1985) model, The DeAngelo (1986) Model, The Jones (1991) model, The modified Jones (Dechow et al., 1995), and The Industry model (Dechow and Sloan, 1991). Secondly, some prior studies have examined earnings management by specific accruals e.g. provision for bad debts and deferred tax expenses etc (McNicholes and Wilson, 1988 and Beaver and McNichols, 1998). Thirdly, some studies focused on discontinuities in distribution of earnings to study earnings management (Burgstahler and Dichev, 1997 and Degeorge et al, 1999). Finally, some studies investigated earnings management in context of specific activities i.e. R&D strategies, Assets sales and overproduction etc (Bizjak et al, 1993; Bushuu, 1998; Graver, 1995; Bartov, 1993 and Roychowdhury, 2003).

3.3.1. Aggregate accruals approach

Numerous prior studies in the literature of accounting used discretionary accruals (abnormal accrual) estimated by the difference of total accruals and non discretionary accruals (normal accruals) to evaluate the extent of earnings management.

The Healy Model

Healy (1985) investigated earnings discretion manners of firms by comparing mean of total accrual. He estimates the normal accruals as the mean of total accruals from the study periods with the conjecture that accruals remain unchanged over time. Any variation from the mean point out the earnings discretion and the proposed model is given below:

$$NAC_{\tau} = \frac{1}{T} * \frac{\sum_{t} TAC_{t}}{TA}$$

NAC $_{\tau}$ = Estimated Normal accruals (non discretionary accruals) in year τ

TAC = Total accruals in year t;

TA = Total Assets

t = different year in study period i.e. 1, 2, 3,........

Where, "T" represents total number of years.

By employing the above model, Healy (1985) found results which support his assumption which state that managers exercise discretions over earnings to get the benefit of bonus plans.

The DeAngelo Model

DeAngelo (1986) calculated normal accruals of firms by using the last period's total accruals. This model is the extended version of Healy's model in which normal accrual is dependent on last period total accruals as an alternative of mean of total accruals in the study period.

$$NAC_t = TAC_{t-1}$$

The similarity in these above models is that they use aggregate accruals to calculate the normal part of accruals. Despite of this similarity, these two models are somewhat dissimilar, for the reason that in second model the study period for normal accruals is limited to the previous year's data. The basic criticism on these two models is that these models do not encounter the effect of varying economic situations on the normal accruals.

The Jones model

In order to resolve above criticism Jones (1991) proposed two step regression based model which aims to manage the influences of changing economic condition of firms on normal accruals. In first step total accruals are determined by:

$$\frac{TAC_n}{TA_{n-1}} = a_1 \frac{1}{TA_{n-1}} + a_2 \frac{\Delta RV_n}{TA_{n-1}} + a_3 \frac{PE_n}{TA_{n-1}} + \varepsilon_n$$

TAC_n = Total accruals in year n

ΔRV_n = Difference in revenues in year n from year n - 1

PE_n = Gross property plant and equipment in year n

TA_{n-1} = Total assets in year n-1.

□$_1$, □$_2$, □$_3$ = Regression estimates

In this model, ΔRV and ΔPE variables are anticipated to control normal part of total accruals linked with change in operating activities and depreciation respectively. In second step, the abnormal accruals are calculated as follow:

$$NAC_n = \hat{a}_1 \frac{1}{TA_{n-1}} + \hat{a}_2 \frac{\Delta RV_n}{TA_{n-1}} + \hat{a}_3 \frac{PE_n}{TA_{n-1}}$$

Abnormal portion of total accrual are determined as below:

$$ANAC_n = \frac{TAC_n}{TA_{n-1}} - \left(\hat{a}_1 \frac{1}{TA_{n-1}} + \hat{a}_2 \frac{\Delta RV_n}{TA_{n-1}} + \hat{a}_3 \frac{PE_n}{TA_{n-1}} \right)$$

The Industry Model

Dechow and Sloan (1991) proposed a substitute model to estimate normal accrual which is acknowledged as the Industry model. The basic assumption of the model is that the deviations in the components of normal accruals remain unchanged for all companies within the same industry. They model normal accruals in term of median value of total accruals for each industry with company specific parameters. They conclude that any deviation from this median in particular industry highlights abnormal part of accruals.

$$NAC_n = a_1 + a_2 Median_i \left(\frac{TAC_n}{TA_{n-1}} \right)$$

Where,

$Median_i$ (TAC_n / TA_{n-1}) represents the median value of total accruals in year n for all non-sample firms in the same two-digit SIC.

The plus point in this model is that it controls the industry effect but it cannot offset the deviation of normal accruals specific to each company which is the main disadvantage of this model.

The Modified Jones model

Dechow et al (1995) criticized the Jones model by arguing that all changes in revenue in this model are assumed to be normal, so measuring abnormal accruals does not manifest the impact of sale based exploitation. Therefore, to confine revenue based discretions Dechow et al (1995) customized the Jones model by only a single adjustment i.e. the change in revenue is adjusted for the change in receivables in Jones model. The difference in the two models is that the classical Jones Model believes that manipulation is not applied over revenue but amended version of Jones model supposes that all adjustments in credit sales lead to earnings misstatement.

$$NAC_n = \hat{a}_1 \frac{1}{TA_{n-1}} + \hat{a}_2 \frac{\Delta RV_n - \Delta RC_n}{TA_{n-1}} + \hat{a}_3 \frac{PE_n}{TA_{n-1}}$$

To sum up, most of the studies in earnings management literature have richly used aggregate accrual models to measure managerial discretions in financial reporting processes. Despite of the popularity of this approach, the validity and reliability of such models has been criticized by many studies (e.g. Bernard & Skinner 1996; Guay et al. 1996; Beneish 1997, 1998; Thomas and Zhang 2000; McNichols (2000), Peasnell et al. 2000; Xie 2001).

3.3.2. Specific accruals approach

Several prior studies have linked managing reported earnings with the use of specifics accruals in respect to definite situation and a specific industry (Moyer, 1990; Petroni 1992; Beneish, 1997; Beaver and McNichols; 1998; Penalva, 1998; Petroni et al., 2000; and Nelson, 2000). These researches found a significant evidence of managerial discretions in a specific accrual or a set of accruals. The main focus of specific accruals studies is to investigate the manners of each specific accrual to classify its normal and abnormal portion (McNichols 2000). Some studies describe the expansion of this specific accruals approach by the criticizing the conventional aggregate accrual approach in determining the earnings manipulations (Guay et al. 1996; McNicholes, 2000 and Beneish, 2001). Beneish (1997) proposed a model based on several financial statement ratios, in this study a large amount of ratios are linked to specific accruals i.e. account receivable, payable and inventory. Marquardt and Wiedman (2004) investigated use of specific accruals in three earnings manipulation conditions i.e. equity offerings, management buyouts and earnings diminish period. McNichols and Wilson (1988) investigated bad debt provisions and find evidences relating to the application of earnings discretions by managers in the case of estimating bad debt provisions for firms having high earnings. Philips et al. (2003) studied deferred tax expense to measure earnings manipulations and conclude measuring of earnings management activities by deferred tax expanses is more appropriate and effective than that of aggregate accrual approach. Some past studies focused on the use of specific accruals in different industries and provide evidence of managed earnings in each industry, e.g. accruals like pension funds (Capalbo, 2003) and allowances for loan losses (Gray and Clarke, 2004) in banking sector, loss reserve accruals in insurance industry (Beaver et al., 2003) and valuation of property in investment property companies (Dietrich et al., 2001).

3.3.3. Distribution of earnings approach

Some streams of studies Burgstahler and Dichev (1997) Degeorge et al. (1999) have examined the distribution of earnings approach in literature of earnings management. These studies investigated discontinuities in the distribution of reported earnings around three thresholds: (1) zero earnings, (2) last year's earnings, (3) this year's analysts' expectations and found evidence that there tend to be less (more) observations than expected for earnings amounts just below (above) the zero earnings and last's years' earnings thresholds. Beneish (2001) comments that this approach is informative as it identifies which firms are suppose to manage reported earnings, but this approach does not signify the form and extent of earning management.

3.3.4. Specific activities approach

Some prior studies emphasized that instead of using accruals, some managers can also turn to real activities i.e. Assets sale , R&D Strategies, offering price discount and overproduction to engage in earnings management.(Baber et al., 1991; Bushee, 1998; Thomas and Zhang, 2002; Graham et al, 2005; Roychowdhury, 2006). Managers are more keen to manipulate reported earnings through economic activities relatively than using accruals (Graham et al, 2005). Most of the studies on economic activities management focused on the opportunistic reduction of R&D expenditures to reduce reported expenses as a mean of earnings manipulation (Barber et al., 1991; Bushee, 1998; Smith and Watts 1992; Bizaj et al 1993 and Mande et al 2000). Thomas and Zhang (2002) explore the discretion through overproduction and find that firms manufacture extra quantity of goods than the demand in the market for the accomplishment of sales target which is also aimed at minimizing the cost of goods sold. Roy Chowdhury (2006) examined earnings management in the context of price discounts and found evidence that firms offer price discounts with the objective to boost sales and overproduction in order to reduce the cost of goods sold. Emphasizing on advertising and marketing expense, Cohen et al. (2007) finds evidences that managers shrink their advertising expenses in order to attain the financial reporting goals.

There is extensive debate surrounding the measurement of earnings management. This study focuses on the discretion of earnings to be means of accrual management and abnormal accruals are used as proxy of earnings manipulation. Accruals are more open to make discretions in reported earnings because adjustment of some portion of these accruals necessitates managers' judgment in determining sign and magnitude (Yu, 2008). In prior earnings management studies accruals are categorized into normal and abnormal accruals for which the abnormal portion is used as proxy of earnings management in different context i.e. Teoh, et al, (1998a) in context of initial public offerings , Teoh, et al., (1998b) and Shivakumar (2000) in seasoned equity offerings , Erickson and Wang, (1999) in case of mergers and acquisitions , DeFond and Jiambalvo, (1994) in debt covenants , Healy, (1985); Holthausen et al., (1995); Bergstresser and Philippon, (2006); Burns and Kedia, (2006) in compensation plans. In relevant to past studies, this study also estimate abnormal part accruals (ANAC) by the difference of total accruals (TAC) and normal accruals (NAC) by the following equation.

$$ANAC = TAC - NAC \dots\dots\dots\dots\dots\dots\dots\dots(1)$$

Total accruals are estimated as the difference between net income (NI) and cash flow from operations (CFO) by adopting income statement approach followed by Collins and Hribar (2000) and Hribar and Collins (2002) i.e.,

$$TAC = NI - CFO \dots\dots\dots\dots\dots\dots\dots\dots\dots. (2)$$

Recent studies of accounting literature have used accrual models based on time-series or cross-sectional regressions to evaluate abnormal accruals (Boynton, et al. 1993; Cahan, 1992; Dechow et al., 1995); Guenther, 1994; Jones, 1991; and Teoh et al., 1998a, 1998b). Consistent with past researches in earnings management literature, namely Klein (2002), Xie et al. (2003), and Dechow et al. (1995), this study also uses cross sectional Modified Jones model to estimate abnormal portion of firms in the study sample. Dechow et al. (1995) made an attempt of comparing several accrual models and proposed modified Jones model as the most powerful one among the other models. We model accruals as follow:

$$\frac{TAC_n}{TA_{n-1}} = a_1 \frac{1}{TA_{n-1}} + a_2 \frac{\Delta RV_n - \Delta RC_n}{TA_{n-1}} + a_3 \frac{\Delta PE_n}{TA_{n-1}} + \varepsilon_n \dots\dots\dots (3)$$

TAC_n = Total accruals in year n

ΔRV_n = Difference in revenues in year n from year n - 1

PE_n = Gross property plant and equipment in year n

TA_{n-1} = Total assets in year n-1.

ΔRC_n = Difference in account receivables in year n from year n - 1

□₁, □₂, □₃ = Regression estimates

Using the estimated coefficients from equation 3, the normal accruals portion of total accruals for each firm in year t is calculated as follow:

$$NA_n = \hat{a}_1 \frac{1}{TA_{n-1}} + \hat{a}_2 \frac{\Delta RV_n - \Delta RC_n}{TA_{n-1}} + \hat{a}_3 \frac{\Delta PE_n}{TA_{n-1}} \text{..........} \quad (4)$$

NA_n = Normal accruals in year n

□ˆ1, □ˆ2, □ˆ3 = firm specific parameters

The values of ANAC signify the location of earnings manipulation. Positive values show that the firms are engaged in upward management practices while the negative values indicate downward manipulations of earnings. In addition, the values of |ANAC| show the magnitude of earnings management by the firms in the given study period.

In order to compare the earnings management practices in Pakistan and China, we have ranked the ANAC and |ANAC| into quartiles i.e. 1st, 2nd, 3rd, and 4th quartiles for each observation period. This categorization enables us to process comparative analysis into high positive, moderate positive and negative and high negative earnings management practices. Within each quartile, ANAC reflects the location and absolute value of abnormal accruals |ANAC| indicates the magnitude of earnings management practice.

Kolmogorov-Smirnov and Shapiro- Wilk test has been used to check the normality of ANAC and |ANAC| for each quartile in each study period. The findings reveal that normality of ANAC and |ANAC| is rejected. Thus, independent samples nonparametric Mann-Whitney test is used to compare the location and magnitude of earnings management practices between China and Pakistan in each quartile for the year 2007 and 2008.

CHAPTER 4

RESULTS AND DISCUSSION

4. Results and discussion

4.1. Descriptive statistics of ANAC and |ANAC|

This study focuses on the estimation of location and magnitude of earnings mistreatment in both countries Pakistan and China. The value of ANAC represents the location of earnings manipulation i.e. positive ANAC shows upward earnings manipulation and negative ANAC indicates downward earnings manipulation. While the magnitude of earnings discretion is determined by the absolute value of abnormal accruals and it is represented by |ANAC|.

To examine the differences of earnings management in Pakistan and China, we rank firms on the basis of the values of ANAC and |ANAC| into quartiles in each observation period. Table 1 provides descriptive statistics of ANAC and |ANAC| for Pakistani and Chinese firms arranged in quartiles for the year 2007 and 2008. From Table 1, 1st quartile consists of firms which have a highly positive ANAC; the 2nd quartile consists of firms having low positive ANAC. The 3rd quartile comprises firms with a high negative ANAC and the 4th quartile having firms with very high negative ANAC. Within each quartile, the absolute values of abnormal accruals indicate the magnitude of earnings manipulation practices in each observation period.

For 1st quartiles in Table 1, the mean of ANAC is 0.5048 and 0.2648 for 13 Chinese and 10 Pakistani firms in year 2007 respectively. In year 2008, the mean of ANAC for 15 Chinese firms is 0.4846 and for 17 Pakistani firms is 0.1807. In both observation periods, Chinese firms lying in this quartile exhibit more positive earnings management location than Pakistani firms. For the 2nd quartile, the mean of ANAC is 0.0560 for 41 Chinese firms and 0.0631 for 34 Chinese firms while for Pakistani firms the mean is 0.0205 for 23 firms in 2007 and 0.0408 for 22 firms in year 2008.

Table 1: Descriptive Statistics of ANAC and lANACl for the Year 2007 & 2008

Quartile			N		Mean		Maximum		Minimum		Std. Deviation	
					2007	2008	2007	2008	2007	2008	2007	2008
1st Quartile	ANAC	China	13	15	.5048	0.4846	2.05	0.91	.17	0.21	.508	0.266
		Pakistan	10	17	.2648	0.1807	.62	0.34	.14	0.10	.161	0.072
	lANACl	China	7	13	.8270	0.6492	2.05	0.91	.41	0.41	.561	0.166
		Pakistan	14	15	.8270	0.9059	1.02	1.04	.64	0.68	.123	0.104
2nd Quartile	ANAC	China	41	34	.0560	0.0631	.15	0.18	.00	0.00	.044	0.045
		Pakistan	23	22	.0205	0.0408	.13	0.10	.00	0.00	.0366	0.031
	lANACl	China	19	19	.2349	0.2405	.37	0.40	.14	0.17	.074	0.064
		Pakistan	10	14	.3629	0.3004	.62	0.38	.22	0.25	.159	0.044
3rd Quartile	ANAC	China	34	33	-.0485	-0.0569	.00	0.00	-.11	-0.15	.0357	0.045
		Pakistan	49	43	-.0799	-0.1184	.00	0.00	-.22	-0.32	.0549	0.913
	lANACl	China	33	31	.0886	0.1035	.13	0.17	.05	0.06	.022	0.031
		Pakistan	35	37	.1258	0.1332	.20	0.21	.08	0.08	.032	0.382
4th Quartile	ANAC	China	12	18	-.2930	-0.3262	-.13	-0.15	-.78	-0.76	.179	0.183
		Pakistan	18	18	-.7322	-0.8154	-.25	-0.34	-1.02	-1.04	.227	0.228
	lANACl	China	41	37	.0206	0.0256	.05	0.06	.00	0.00	.014	0.015
		Pakistan	41	34	.0418	0.0299	.08	0.08	.00	0.00	.0225	0.022
All sample Quartile	ANAC	China	100	100	.0369	0.0166	2.05	0.19	-.78	-0.76	.284	0.272
		Pakistan	100	100	-.1282	-0.1580	.62	0.34	-1.02	-1.04	.324	0.348
	lANACl	China	100	100	.1402	0.1717	2.05	0.91	.00	0.00	.249	0.211
		Pakistan	100		.2136	0.2374	1.02	1.04	.00	0.00	.275	0.299

In 2nd quartile, firms form both countries exhibit positive earnings management in each observation period and this positive earnings management practice is more pronounced in Chinese firms than Pakistani firms. In 3rd quartile, the mean of ANAC is -0.0485 for 34 Chinese firms and -0.0569 for 33 Chinese firms and for Pakistani firms the mean of 49 firms is -0.0799 and the mean of 43 firms is -0.1184 in year 2007 and 2008 respectively. While the 4th quartile is concerned, , the mean of ANAC is -0.2930 for 12 Chinese firms and -0.3262 for 18 Chinese firms and for Pakistani firms the mean of 41 firms is -0.7322 and -0.8154 for 34 firms in year 2007 and 2008 respectively. In 3rd and 4th quartiles, firms of both countries show downward earnings management practices and this practice is more prominent in Pakistani firms than Chinese firms in year 2007 and 2008 as well.

For the entire sample, ANAC ranges from 2.05 to -0.78 with mean of 0.0369 for Chinese firms and from 0.62 to -1.02 with mean of -0.1281 for the Pakistani sample in year 2007. In 2008, the mean of ANAC is 0.0369 for all Chinese sample firms having range from 0.19 to -0.76 and for all Pakistani sample firms it ranges from 0.34 to -1.0 with mean of -0.1580. The findings reveal that in both observation periods, on average, Chinese firms' exhibit positive earnings management and Pakistani firms exhibit negative earnings management. In other words, Chinese firms usually practice upward earnings management and Pakistani firms practice downward earnings management which is consistent in both study periods.

The standard deviation of ANAC in entire sample quartile is 0.2841 and 0.2725 for all Chinese firms and for all Pakistani firms is 0.3244 and 0.3483 in year 2007 and 2008 respectively. This reveal that the volatility of Pakistani sample firms to make discretion in reported earnings is higher than that of Chinese firms which is consistent in both observation periods.

|ANAC| represents magnitude of earnings management, the mean of |ANAC| for the all Pakistani sample firms is 0.2136 and 0.2374 and for all Chinese firms it is 0.1402 and 0.1717 in 2007 and 2008 respectively. So, in each period, the discretion of earnings in terms of magnitude is more pronounce in Pakistani sample firms than the Chinese firms.

Overall, the above descriptive statistics indicate the existence of earnings management practices in terms of location (i.e., both upward and downward) and magnitude in the two neighboring countries. Nevertheless, positive earnings management is more pronounced in Chinese firms than that of Pakistani firms and negative earnings management practices is more prominent in Pakistani firms than that of Chinese firms. As for as magnitude of earnings management is concerned, the findings reveal that magnitude of earnings management is more for Pakistani firms than that of Chinese firms.

Table 2 shows Kolmogorov-Smirnov and Shapiro- Wilk test results of normality distribution for the ANAC and |ANAC| quartiles of all firms in year 2007 and 2008. These tests are used as a goodness fit test for normality of ANAC and |ANAC| distribution. Approximately, Z statistics are significant at the 0.01 level for all quartiles in 2007 and 2008. Hence, the null hypothesis for normality is rejected.

Table 2: Kolmogorov-Smirnov and Shapiro-Wilk test for normality in 2007 & 2008

		China				Pakistan			
		Kolmogorov- Smirnov		Shapiro-Wilk		Kolmogorov- Smirnov		Shapiro-Wilk	
		2007	2008	2007	2008	2007	2008	2007	2008
		Z statistics P Values				Z statistics P Values			
1st Quartile	N	13	15	13	15	10	17	10	17
	ANAC	.256 *(0.003)***	0.237 *(0.023)***	.692 *(0.001)***	0.840 *(0.013)***	.298 *(0.012)***	0.261 *(0.003)***	.756 *(0.004)***	0.843 *(0.008)***
	N	7	13	7	13	14	15	14	15
	IANACI	.290 *(0.000)***	.179 *(0.021)***	.505 *(0.010)***	.423 *(0.031)***	.768 *(0.005)***	0.233 *(0.009)***	.894 *(0.014)***	0.719 *(0.010)***
2nd Quartile	N	41	34	41	34	23	22	23	22
	ANAC	.191 *(0.200)*	.238 *(0.022)***	.894 *(0.010)***	.868 *(0.031)***	.219 *(0.036)***	.219 *(0.030)***	.898 *(0.002)***	.854 *(0.012)***
	N	18	19	18	19	10	14	10	14
	IANACI	.123 *(0.200)*	.282 *(0.000)***	.931 *(0.091)*	.580 *(0.000)***	.162 *(0.088)*	.152 *(0.141)*	.905 *(0.023)***	.907 *(0.026)***
3rd Quartile	N	34	33	34	33	49	43	49	43
	ANAC	.130 (0.*200*)	.233 (0.*044*)**	.957 (0.719)	.862 (0.*024*)**	.377 (0.*031*)**	.275 (0.*177*)	.911 (0.*031*)**	.887 (0.*036*)**
	N	33	31	33	31	35	37	35	37
	IANACI	.167 *(0.071)***	.274 *(0.000)***	.936 *(0.123)*	.655 *(0.000)***	.126 *(0.200)*	.147 *(0.171)*	.945 *(0.189)*	.935 *(0.114)*
4th Quartile	N	12	18	12	18	18	18	18	18
	ANAC	.202 *(0.001)***	.228 *(0.002)***	.873 *(0.017)***	.810 *(0.000)***	.259 *(0.056)*	.215 *(0.004)***	.885 *(0.043)***	.812 *(0.000)***
	N	41	37	41	37	41	34	41	34
	IANACI	.108 *(0.200)*	.262 *(0.000)***	.565 *(0.000)***	.792 *(0.000)***	.162 *(0.089)*	.073 *(0.200)*	.934 *(0.110)*	.972 *(0.703)*
All sample Quartiles	N	100	100	100	100	100	100	100	100
	ANAC	.290 *(0.000)***	.253 *(0.000)***	.565 *(0.000)***	.807 *(0.000)***	.230 *(0.001)***	.162 *(0.088)*	.677 *(0.000)***	.895 *(0.014)***
	IANACI	.280 *(0.000)***	.189 *(0.021)***	.605 *(0.000)***	.823 *(0.001)***	.159 *(0.105)*	.228 *(0.002)***	.890 *(0.014)***	.815 *(0.000)***

4.2. Comparison of earnings management Practices

The basic emphasis of this study is to compare location and magnitude of earnings management in China and Pakistan. The location and magnitude of earnings management are supposed to be influenced by the socio economic incentive.

Table 3 summarizes the mean rank and Z statistic of Mann-Whitney test for the difference of earnings management practices between China and Pakistan in term of magnitude and location for each study period. For 1st quartile, the mean rank of ANAC for 13 Chinese firms is 14.38 and for 10 Pakistani firms these are 8.90 in 2007. In year 2008, the mean rank of ANAC for 15 Chinese firms is 23.60 and for 17 Pakistani firms these are 10.24. The Z statistic is -4.002 which suggest that mean rank of ANAC for Chinese firms in the 1st quartile for the year 2008 is significantly higher than that of Pakistani firms at 0.01 significance level. This reveals that excessive upward earnings management practice is higher in Chinese firms as compared to Pakistani firms in each year.

In 2nd quartile, the mean rank of ANAC is 29.85 and 31.41 for Chinese firms and 37.22 and 24.00 for Pakistani sample firms in year 2007 and 2008 respectively. The Z statistic and P-values reveal that the moderate upward earnings management practice is significantly higher in Chinese firms than that of Pakistani firms. In 3rd quartile, the mean rank of ANAC is 50.29 and 46.64 for Chinese firms and 36.24 and 32.26 for Pakistani sample firms in year 2007 and 2008 respectively. The mean rank of highly negative ANAC for Chinese firms is significantly higher than Pakistani firms.

Table 3: Mann-Whitney comparison test for ANAC and |ANAC| in 2007& 2008

		China	Pakistan	China	Pakistan
		2007		2008	
		Mean Rank Z statistics *(P Value)*			
1st Quartile	N	13	10	15	17
	ANAC	**14.38**	**8.90**	**23.96**	**10.24**
		-1.923 *(0.055)*		**-4.002** *(0.000)***	
	N	7	14	13	15
	|ANAC|	**7.57**	**12.72**	**8.38**	**19.80**
		-3.153 *(0.002)***		***-3.662*** *(0.000)***	
2nd Quartiles	N	41	23	34	22
	ANAC	**29.85**	**37.22**	**31.41**	**24.00**
		-2.518 *(0.009)***		**-2.661** *(0.017)***	
	N	19	10	19	14
	|ANAC|	**12.32**	**20.10**	**12.58**	**22.00**
		-2.340 *(0.019)***		**-3.060** *(0.002)***	
3rd Quartiles	N	34	49	33	43
	ANAC	**50.29**	**36.24**	**46.64**	**32.26**
		-2.611 *(0.009)***		**-2.814** *(0.005)***	
	N	33	35	31	37
	|ANAC|	**22.97**	**45.37**	**25.90**	**41.70**
		-4.669 *(0.000)***		**-3.282** *(0.001)***	
4th Quartiles	N	12	18	18	18
	ANAC	**22.92**	**10.56**	**26.28**	**10.72**
		-3.768 *(0.000)***		**-4.429** *(0.000)***	
	N	41	41	37	34
	|ANAC|	**30.54**	**52.46**	**35.05**	**37.03**
		-4.169 **(0.000)****		**-.403** **(0.068)**	
All sample Quartiles	N	100	100	100	100
	ANAC	**113.78**	**87.22**	**110.77**	**90.23**
		-3.245 *(0.001)***		**-2.509** *(0.012)***	
	N	100	100	100	100
	|ANAC|	**89.68**	**111.32**	**94.72**	**106.28**
		-2.644 *(0.008)***		**-1.412** *(0.158)*	

Similarly, in 4th quartile, the mean rank of extremely high negative ANAC for Chinese firms is also significantly higher than Pakistani firm and this is consistent in each observation period. This suggests that, on average, income-increasing practice is much higher in Pakistani firms than Chinese firms.

For all sample quartile, the mean rank of ANAC for Chinese is 113.78 and 87.22 for Pakistan in year 2007. The Z statistic (-3.245) and P-value (0.001**) in year 2007 proposes that on average, location of earnings management is much higher for all Chinese firms than that of all Pakistani firms. In 2008, the mean rank of ANAC is 110.77 and 90.23 for all Chinese and Pakistani firms respective. Consistent with the result in year 2007, the Z statistic and p-value suggests that the average earnings management practice of Chinese firms is significantly high than Pakistani firms in year 2008.

CHAPTER 5

CONCLUSION

5. Conclusion

5.1. Summary of findings

This study examines the existence of earnings management practices in China and Pakistan by using 100 companies from each country during the period of 2006-2008. Recent approach in earnings management literature is to examine different incentives to alter the reported earnings. For this purpose different researchers have extended various models for computing discretionary accruals as per their study objectives. In this particular thesis, we are not investigating any incentives of earnings management. This study provides only a cautious fact relating to existence of earnings management in the two economies since we have employed the modified Jones model in determining the discretionary part of accruals.

Using a sample of 100 Chinese companies and 100 Pakistani companies for the period of 2006 to 2008, I examined the earnings management practices in terms of location and magnitude in the two emerging economies. Discretionary accrual have been used as proxy of earnings management, Positive values of discretionary accruals show that the firms are engaged in upward management practices while the negative values indicate downward manipulations of earnings. In addition, the values of absolute values of discretionary accruals show the magnitude of earnings management by the firms in the given study period. Due poor corporate governance, political instability, economic distress and terrorist threats to Pakistani economy i assume that Pakistani firms will exhibit more earnings management in term of location and magnitude as compared to the Chinese firms. Further, the differences of culture, socio economic and institutional factors, I assume that there will be significant difference in the behavior of earnings management practices in both study economies

Inconsistent with our assumption, the findings interestingly provide evidences that Chinese firms show more positive earnings management location as compared to Pakistani sample firms. This suggests that upward earnings manipulation is more apparent in Chinese firms than that of Pakistani firms. The primary reason of such finding may be the state ownership of most of the Chinese firms. While as for as negative earnings management is concerned, Pakistani firms show more than Chinese firms which is in accordance with our assumption. This reveals that downward earnings manipulation is more important for Pakistani firms as compared to Chinese firms. The main rationale behind this result may be that most of the Pakistani firms are privately held. The findings further reveal that overall the magnitude of earnings management is much higher in Pakistani firms as compared to Chinese firms. The Mann-Whitney test results show that there is significant difference of the earnings management practices in the two countries. Which suggests that cultural and institutional differences of countries influence earnings management practices. Thus, financial reporting process may be affected by some of the socio-cultural distinctiveness of those countries.

On the basis of findings in this study, we can conclude that the incentives of managing reported earnings for the firms of the two countries are totally different. The use of more positive discretionary accruals by the Chinese firms may be due to incentives of managing earnings to avoid the debt agreement violations and increase managerial compensations etc. while the use of more negative discretionary accruals by Pakistani firms clearly demonstrate the earnings management incentive of tax reduction. Future research can be done to explore the association between the earnings management and various incentives in these two economies.

5.2. Practical implications

In this study, an effort has been made to attract the attention of regulators, policy makers and academia on the issue of aggressive accrual management behavior of firms in two different economies. The findings of this study recognize the existence of earnings discretions, which provides a better understanding about the quality of accounting earnings in both countries. Such studies provide interesting insights regarding to the reliability and truthfulness of financial reports prepared by firms. This study helps international investors and financial analysts to make effective and efficient decisions and shows that earnings as they are recorded in financial reports in Pakistan and China may have different rationalization.

5.2. Contribution of study

Earnings management is a hot raging issue for both developed as well as developing economies. In Pakistan, research studies on this issue have been extremely limited. So, this paper contributes to extend the literature on earnings management in the context of Pakistan. The main contribution of this study is to compare earnings discretion practices in Pakistan and China, having different socio-economic and institutional system. This study emphasizes that standard setters and policy maker should be conscious of socio-economic differences across the countries.

5.3. Limitations of the study

The basic limitation of the study is the limited size of sample and time period. Due to unavailability of financial reports we have restricted our sample size to only 100 companies from each country and only three years data have been used. By increasing the sample size and time span the validity of study can be improved. However, this is a preliminary effort to detecting earnings management in Pakistan which will open new doors for researchers to investigate the earnings management issues in this region.

Another limitation of the study is the use of Cross Sectional Modified Jones Model in order to decompose total accruals into normal and abnormal accruals. Majority of the studies in earning management literature have used this model to determine earnings management in different contexts. Numerous studies have analyzed the ability of different methods in calculating the abnormal accruals, showed that the cross-sectional modified Jones model offers on average more perfect findings (Bartov et al., 2001). However, some studies have criticized on the use of Modified Jones Model in estimating the abnormal accruals and emphasized that the use of current and performance-adjusted abnormal accruals is more suitable (Ashbaugh et al., 2003 and Klein, 2002). So, the estimation of earnings management from different models leads to different conclusions.

5.4. Directions for future studies

No doubt, earnings management has been studied widely in prior literature in the context of western countries. But in developing countries particularly in Pakistan, research on this issue is very limited. This study will open new doors for researchers to explore the issues of earnings management related to Pakistani firms. It would be of interest to find out if earnings management practices exist in Pakistan then what are the incentives which attract these firms to do so. Further, the quality of corporate governance in Pakistan can be improved by exploring the relationship of different corporate governance attribute with earnings management practices prevailing in this region.

CHAPTER 6

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Appendix A:

Company Name	Sectors
Artini china company Limited	Textile
Addchance Holdings Ltd.	Textiles and garment
Air china Limited	Transportation
Alco holdings Ltd	Electronics
Alltronics Holdings Ltd.	Electronics
AMVIG Holdings Ltd.	Manufacturing
Asia Coal Ltd.	Energy / Mining
BEL Global Resources Holdings Limited	Apparel & Textiles
brightoil petroleum	Oil and gas
Broad Intelligence Int. Pharmaceutical Holdings Ltd.	Drugs, Cosmetics & Health Care
C C Land Holdings Limited	Manufacturing
Chaoyue Group Limited	Textile
China Agrotech Holdings Limited	Agriculture
China Best Group Holding Limited	Transportation
China Energy Development Holdings Limited	Oil and Gas
China Oriental Group Company Limited	Manufacturing
China Everbright International Limited	Construction
China Mengniu Dairy Company Limited (02319)	Food and Beverage
China Motion Telecom International Ltd. (00989)	Telecommunication
China Ocean Shipbuilding Industry Group Limited	Metal Product Manufacturing
China Petroleum & Chemical Corporation (00386)	Oil and Gas
China Pharmaceutical Group Limited	Pharmaceutical
China Sci-Tech Holdings Limited	Technology
China State Construction International Holdings Limited	Construction
China Strategic Holdings Limited	Drugs, Cosmetics & Health Care
China Wireless Technologies Ltd.	Communications / Telecommunications / Technology
China Yurun Food Group Limited (01068)	Food & Beverages
China ZenithChemical Group Ltd.	Oil, Gas, Coal & Related Services
chu kong shipping dev compny limited	Transportation
CITIC Resources holdings Ltd.	Construction
Daido Group Ltd.	Manufacturing and Trading
Daisho Microline Holdings Ltd	Manufacturing / Electronics

Deteam Company Ltd.	Mining / Manufacturing / Trading
DVN Holdings Ltd.	Communications / Electronics
Ec Founder Holdings Company Ltd	Distribution of Information Products
EVA Precision Industrial Holdings Limited	Metal Product Manufacturers
Founder Holdings Limited	Technology
Fujikon Industrial Holdings Ltd.	Electrical Appliances / Electronics / Industrial / Manufacturing
G Resources Group Ltd.	Investment / Mining
Global Biochem Technology Group Company	Bio-chemistry / Chemical / Food / Technology
Grandtop International Holdings Limited	Garment / Trading / Investment / Sports
Greater China Holdings Ltd.	Apparel & Textiles
GZI Transport Ltd.	Transportation
Hembly International Holdings Ltd.	Retailers
Heng Tai Consumable Group Ltd.	Food & Beverages
Hengan International Group Compnay Ltd.	Drugs, Cosmetics & Health Care
Herald Holdings Ltd.	Recreation
Hi Sun Technology (China) Ltd.	Technology
Hong kong Aircraft Engineering Company Ltd.	Aerospace
Hop Fung Group Holdings Ltd.	Miscellaneous
Hutchison Telecommunication International Ltd	Technology
Hutchison Whampoa Ltd.	Services
IDT International Ltd.	Consumer Retail / Electronics / Retail
Jackin International Holdings Limited	Electrical
Ju Teng international Holdings Ltd	Miscellaneous
Kee Shing (Holdings) Limited	Metal Producers & Products Manufacturers
Kenford Group Holdings Limited	Electrical
Leeport (Holdings) Limited	Miscellaneous
Lerado Group (Holding) Company Limited	Apparel & Textiles
Li and Fung Ltd.	Services
Lung Kee (Bermuda) Holdings Limited	Manufacturing
Ming Kei Holdings Limited	Mining, sale and distribution of coal
National Electronic Ltd.	Telecommunications
New Times Energy Corporation Limited (00166)	Oil and gas
Ngai Lik Industrial Holdings Limited	Electronics
OPES Asia Development Ltd.	Miscellaneous
Pacific Andes International Holdings Limited (01174)	Food & Beverages

Playmates Toys Ltd.	Retailers
Prosten Technology Holdings Limited	Technology
Quality Healthcare Asia Ltd.	Miscellaneous
Safety Godown Company Ltd.	Warehousing
See Corporation Ltd.	Entertainment and media business
SEEC Media Group Ltd.	Electronics
Shanghai Allied Cement Ltd.	Cement
Shougang Concord Century Holdings Limited	Metal Producers & Products Manufacturers
SIM Technology Group Limited (02000)	Telecommunications
Sino Gas Group Ltd.	Utilities
Sino hotels holdings Ltd.	Hotels
Sino-Tech International Holdings Ltd.	Miscellaneous
smart turn Telecommunication Holdings Ltd.	Telecommunication
Starlite Holdings Ltd.	Paper
Styland Holdings Ltd.	Oil, Gas, Coal & Related Services
Sun East Technology (Holdings) Limited	Manufacturing
SUNeVision Holdings Limited	Electronics
TC Interconnect Holdings Ltd.	Electronics
Techtronic Industries Company Ltd.	Machinery & Equipment
Texwina Holdings Ltd.	Apparel & Textiles
The sincere Compnay Ltd.	Retailers
The United Laboratries Holdings Ltd.	Drugs, Cosmetics & Health Care
Tidetime Sun (Group) Ltd.	Media / Electronics
Tonic Industries Holdings Ltd.	Electronics / Industrial
Trasy Gold Ex Ltd.	Miscellaneous
Tungtex (Holdings) Company Limited	Textiles
UDL Holdings Limited	Construction
Vital Pharmaceutical Holdings Ltd.	Drugs, Cosmetics & Health Care
Vodatel Network Holdings Ltd.	Electronics
Wah Nam International Holdings Ldt.	Mining
Weiqiao textile company Limited	Textile
Winteam Pharmaceutical Group Limited	Pharmaceutical
Xian Yeng Titanium Resource Holdings Ltd.	Miscellaneous

Appendix B:

Companies	Sectors
Al-Abbas Cement Industries Ltd. (Essa Cement Industries Ltd.	Cement
Al-Khair Gadoon Ltd.	Miscellaneous
Atlas Honda Ltd.	Engineering
Baluchistan Glass Ltd.	Miscellaneous
Bata Pakistan Ltd.	Miscellaneous
Bolan Castings Ltd.	Engineering
Cherat Cement Company Ltd.	Cement
Crescent Steel And Allied Products Ltd.	Engineering
D.G. Khan Cement Company Ltd.	Cement
Dadabhoy Cement Industries Ltd.	Cement
Dewan Farooque Motors Ltd.	Engineering
Exide Pakistan Ltd.	Engineering
Fateh Textile Mills Ltd.	Textile
Fatima Enterprises Ltd.	Textile
Fauji Cement Company Ltd.	Cement
Fawad Textile Mills Ltd.	Textile
Fazal Cloth Mills Ltd.	Textile
Fazal Textile Mills Ltd.	Textile
Fecto Cement Ltd.	Cement
Gadoon Textile Mills Ltd.	Textile
Gharibwal Cement Ltd.	Cement
Ghazi Fabrics International Ltd.	Textile
Gul Ahmed Textile Mills Ltd.	Textile
Gulistan Spinning Mills Ltd.	Textile
Gulistan Textile Mills Ltd.	Textile
Gulshan Spinning Mills Ltd.	Textile
Haji Mohammad Ismail Mills Ltd.	Textile
Hajra Textile Mills Ltd.	Textile
Hala Enterprises Ltd.	Textile
Hinopak Motors Ltd.	Engineering
Honda Atlas Cars (Pakistan) Ltd.	Engineering
Huffaz Seamless Pipe Industries Ltd.	Engineering
Husein Industries Ltd.	Textile
Indus Motor Company Ltd.	Engineering
International Industries Ltd.	Engineering
Ismail Industries Ltd.	Miscellaneous
Javedan Cement Ltd.	Cement
Karam Ceramics Ltd.	Miscellaneous
Kohat Cement Ltd.	Cement
KSB Pumps Company Ltd.	Engineering
Lakson Tobacco Company Ltd.	Tobacco

Leather Up Ltd.	Miscellaneous
Millat Tractors Ltd.	Engineering
Mitchell'S Fruit Farms Ltd.	Miscellaneous
Murree Brewery Company Ltd.	Miscellaneous
National Foods Ltd.	Miscellaneous
Nestle Milkpak Ltd	Miscellaneous
Noon Pakistan Ltd.	Miscellaneous
Noon Sugar Mills Ltd.	Sugar
Pak Datacom Ltd.	Transport and Communication
Pak Elektron Ltd.	Engineering
Pak Leather Crafts Ltd.	Miscellaneous
Pak Suzuki Motor Company Ltd.	Engineering
Pakistan Cables Ltd.	Engineering
Pakistan Engineering Company Ltd.	Engineering
Pakistan Hotels Developers Ltd.	Miscellaneous
Pakistan House International Ltd.	Miscellaneous
Pakistan International Airlines Corporation Ltd.	Transport and Communication
Pakistan National Shipping Corporation.	Transport and Communication
Pakistan Services Ltd.	Sugar
Pakistan Telephone Cables Ltd.	Engineering
Pakistan Tobacco Company Ltd.	Tobacco
Premium Textile Mills Ltd.	Textile
Prosperity Weaving Mills Ltd.	Textile
Quality Textile Mills Ltd.	Textile
Quetta Textile Mills Ltd.	Textile
Ravi Textile Mills Ltd.	Textile
Regent Textile Industries Ltd.	Textile
Reliance Cotton Spinning Mills Ltd.	Textile
Reliance Weaving Mills Ltd.	Textile
Resham Textile Industries Ltd.	Textile
Ruby Textile Mills Ltd.	Textile
Saif Textile Mills Ltd.	Textile
Sajjad Textile Mills Ltd.	Textile
Salfi Textile Mills Ltd.	Textile
Salman Noman Enterprises Ltd.	Textile
Samin Textiles Ltd.	Textile
Sana Industries Ltd.	Textile
Sanghar Sugar Mills Ltd.	Sugar
Sapphire Fibres Ltd.	Textile
Sapphire Textile Mills Ltd.	Textile
Sarhad Cigarette Industries Ltd.	Tobacco
Saritow Spinning Mills Ltd.	Textile

Service Industries Textiles Ltd.	Textile
Shadab Textile Mills Ltd.	Textile
Shahmurad Sugar Mills Ltd.	Sugar
Shahtaj Sugar Mills Ltd.	Sugar
Shakarganj Mills Ltd.	Sugar
Siemens (Pakistan) Engineering Co.Ltd.	Engineering
Sindh Abadgar'S Sugar Mills Ltd.	Sugar
Singer Pakistan Ltd.	Engineering
Southern Electric Power Co. Ltd.	Fuel and Energy
Sui Northern Gas Pipelines Ltd.	Fuel and Energy
Sui Southern Gas Co. Ltd.	Fuel and Energy
Tandlianwala Sugar Mills Ltd.	Sugar
The Frontier Sugar Mills & Distillery Ltd.	Sugar
The General Tyre & Rubber Co. Of Pakistan Ltd.	Engineering
The Hub Power Company Ltd.	Fuel and Energy
The Premier Sugar Mills & Distillery Co. Ltd.	Sugar
The Thal Industries Corporation Ltd.	Sugar