

Institutions and Information Environment of Chinese Listed Firms

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This objective of this paper / chapter is to describe the financial reporting practices and information environment of Chinese listed firms, to document the influence that local and national institutions have on reporting incentives and the resultant information environment in China, and to outline prescriptive actions that can be taken at the firm and country level to improve China's information environment.

Following the framework outlined in Bushman et al. (2004), we define corporate transparency as the wide-spread availability of firm-specific information to those market participants outside the publicly-traded firm. At the country-level, we recognize that corporate transparency is the output of a multi-faceted system whose components collectively produce, gather, validate and disseminate information to market participants outside the firm. This output is generated by country, regional and firm-level information mechanisms that fall under three broad headings: (1) the corporate reporting regime, which includes the quality of the firm's financial reports and the underlying audit function, (2) the intensity of private information acquisition activities, which includes the depth and breadth of analyst and institutional investor activity, and (3) the strength of dissemination mechanisms, including the role of media and freedom of the press. This framework allows us to systematically document China's information environment and forms the basis for future prescriptive actions. Given our background as accountants, specific attention is paid to the impact of the financial reporting system and audit function on the information environment in China.

It is well-established that the widespread availability of information is a key determinant of the efficiency of resource allocation decisions and growth in an economy. For example, at the heart of most theories about financial development is the key role that financial markets play in the reduction of information and transaction costs in an economy. Similarly, greater transparency and stricter disclosure standards have the capability of strengthening corporate governance by improving monitoring and limiting the consumption of private benefits by controlling shareholders, resulting in better asset management and

investment decisions (e.g., Rajan and Zingales, 2003; Stulz, 1999; Doidge, 2004; Doidge, Karolyi and Stulz, 2004). Consistent with these arguments, countries with strong information environments have been shown to garner significant benefits in terms of greater economic development, lower costs of capital, better functioning capital markets, greater foreign investor interest and higher valuations. As such, it is in the long-term interest of developing economies such as China to promote corporate transparency.

In spite of the developmental benefits arising from transparency, financial reporting practices and the resultant information environment are not exogenously determined; instead, reporting practices are the outcome of competing incentives for and against transparency. Given concentrated ownership structures and the highly politicized institutional arrangements that characterize most developing economies, the market and contracting-based benefits are frequently outweighed by the benefits from opacity. As a result, many emerging economies, including China, suffer from opaque information environments and weak corporate transparency.

In the case of China, great strides have been taken to improve corporate governance, accountability and transparency at both the state and firm level in the last decade. Recent regulations mandating the use of IFRS reporting standards, IAAS auditing standards, the presence of outside directors and limits on insider trading activity, along with broad government disclosure reforms and significant anti-corruption programs, have been implemented with the goal of improving the investing environment in China. However, despite these recent institutional and regulatory improvements, China's financial markets continue to be plagued by weak information systems and, as a result, low quality financial information.

The goal of this chapter is to provide a deeper understanding of China's information environment and the impact that the underlying institutional structure has on the financial reporting practices and information environment of publicly listed firms in China. Section 1 provides an overview of the information environment in China vis-à-vis other developed and developing economies. Section 2 describes the influence of China's legal, political, financial and regulatory institutions on financial reporting incentives and the resultant information

environment. Section provides prescriptive suggestions on how China can improve its information environment with respect to publicly listed firms.

Section 1: Information Environment in China

“The suppression of bad news remains an unedifying habit that dies hard on the Mainland.”
(South China Morning Post, June 2007)

“Even in a China that is more capitalist than ever, the instinctive official response to bad news is to suppress it with all the force available to the nominally communist state.”
(Financial Times, July 2007)

“Local politicians suppressed a company report about tainted milk powder until the completion of the Olympic Games to avoid ‘creating a negative influence on society’.”
(The People’s Daily, October 2008).

As the preceding quotes highlight, the influence of the State and local politicians on China’s information environment is a well-documented, publicized and vigorously discussed topic both within and outside China. Although much has changed since the start of Deng Xiaopeng’s economic reforms and his famous “southern excursion,” information (or a lack thereof) remains a powerful tool in the hands of China’s local politicians and leaders. Currently, political and cultural incentives still exist in China that prevent the widespread dissemination of unbiased information in a timely basis. The settings / incentives for opacity span a wide-range of topics in China, from environmental and health issues (e.g., SARS and Bird Flu outbreaks) to government policy to demographic and economic data (e.g., economic growth data during the Asian Financial crisis of 1998).

Given the prevailing incentives for opacity, the natural question is whether this trend extends to the financial markets and the reporting practices of Chinese listed firms. Investors (and especially foreign investors) create a demand for timely, unbiased financial information, and reporting firms have an incentive to supply this information in order to minimize the adverse pricing consequences arising from information asymmetry and illiquidity. Moreover, credible financial reporting facilitates monitoring, potentially resulting in better corporate governance and improved decision making at the firm level. Yet, in spite of the prevailing

contracting and market-based incentives for transparency, there exist countervailing political and cultural incentives for opacity in China, resulting in an information environment that is weaker than that which would exist absent these factors. As a result, China is frequently ranked as one of the least transparent of the world's large economies.

Using evidence from recent surveys and cross-country empirical research, the following sections presents basic descriptive evidence on the relative strength of China's information environment and the reporting practices of publicly-traded firms.

1.1 China's information environment: Evidence from stock prices

In an efficient market, stock prices react instantaneously and completely to new information; firm-level residual returns would be expected to display minimal cross-sectional correlation, no serial correlation and approximate a log normal distribution. However, in markets with limited information or significant trading frictions, stock returns will not take on these characteristics. Specifically, it has been argued that a limited supply of firm-specific information is expected to produce firm-level stock returns that are highly synchronized with general market movements (e.g., Roll, 1988; Morck, Yeung and Yu, 2000), while the systematic suppression of bad news would produce a stock return distribution that is significantly left skewed and subject to a greater frequency of stock return crashes (Jin and Myers, 2006; Chen Hong and Stein, 2001). In both cases, heightened stock return synchronicity and greater negative skewness (increased frequency of stock price crashes) would be symptomatic of limited amounts of firm-specific information being impounded into prices in a timely manner. Stock prices on China's exchanges exhibit these characteristics.

First, China's stock prices exhibit high levels of co-movement. In their seminal study on stock return synchronicity, Morck Yeung and Yu (2000) measure the average co-movement of weekly returns for securities traded on the local exchanges of 40 countries during 1995. Measured as both (1) the fraction of security prices moving together in an average week and (2) as the average R^2 of firm-level regressions of firm-level returns on local and US market indices, stock return synchronicity is designed to inversely measure the amount of firm-specific information being impounded into firm-level stock prices (see Roll,

1998). Essentially, the synchronization of stock returns in a given market are expected to increase (decrease) in the absence (presence) of new firm-specific information.

Morck Young and Yu (2000) find that, on average, 57.9% of US stock prices move together in a given week, and market returns can explain for approximately 2.1% of variation in firm-level returns. These percentages are the lowest of all surveyed countries, consistent with strong information and regulatory environment that characterizes US markets. In contrast, Morck et al. (2000) find that nearly 80% of Chinese stocks move together in an average week, and market returns explain approximately 45.3% of the variation weekly firm-level returns. These statistics highlight the significant differences that exist in both the information and regulatory environments of the mature US market versus the developing Chinese market.

More striking, however, is the behavior of stock prices in China relative to the complete sample of developed and developing countries. Out of 40 countries examined, China ranked 2nd in terms of stock return synchronicity using both measures. This compares very unfavorably to the fraction of co-movement in weekly returns documented in other large economies (e.g., UK = 63.1%; Germany = 61.1%; Japan = 66.6 %), in other large emerging economies (e.g., Brazil = 64.7%; India = 69.5%) and in Hong Kong (67.8%). Of the countries included in the study, only Poland exhibited greater stock return synchronicity during the sample period (82.9% and 56.9%, respectively). Similarly, over the longer period 1991 to 2000, Jin and Myers (2006) find that Chinese firms displayed the highest level of stock return synchronicity out of the 40 countries included in their study. Thus, one of the defining characteristics of the Chinese stock market – highly synchronized stock price movements – is a likely artifact of the country's weak information environment.

Second, current research suggests that Chinese stocks are more crash prone than the global average. As discussed in Chen, Hong and Stein (2001), a failure to release negative information in a timely manner will ultimately produce a larger subsequent price reaction when the information reaches the market. Consistent with large stock price crashes being driven by previously suppressed news, Jin and Myers (2006) show that the skewness of negative returns is inversely related to the level of disclosure in an economy. More

importantly, in terms of relative susceptibility to stock price crashes, Piotroski, Wong and Zhang (2008) show that the negative skewness in daily excess returns in China is significantly greater than the global average documented in Jin and Myers (2006). Thus, a second key attribute of China's stock markets – a heightened risk of large negative stock price crashes -- also relates to China's weak information environment. Together, these studies provided strong market-based evidence on the relative weakness of the information environment in China.

1.2 China's information environment: Survey evidence

Each year, numerous reports are published that assess the various legal, financial and political risks associated with investing in foreign (and especially emerging) markets. These annual reports include the World Bank's "Doing Business Guide," the Heritage Foundation's "Economic Freedom of the World" country reports, and Transparency International's "Corruption Perception Index." As a part of these assessments, the underlying surveys frequently evaluate the country's financial reporting regime, the openness of government about financial policies and budgets, the country's record of protecting investor rights and enforcing contracts, and other aspects of the institutional environment that can affect the supply of and demand for timely and unbiased information. As a principle destination for foreign direct investment, China tends to be prominently featured in these surveys.

In a seminal survey on global transparency, PricewaterhouseCoopers (2001) assessed five country-level factors that contribute to or diminish the transparency of capital markets and the country's overall economic environment: level of perceived corruption, the legal system, economic policy at the government level, accounting and reporting standards, and the regulatory regime. Out of the original thirty five countries surveyed by Pricewaterhouse Coopers (PwC), China ranked last in overall transparency (an opacity score of 87 out of 100), and was ahead of only North Korea in terms of the transparency of its accounting and financial reporting standards (accounting opacity score of 86 out of 100).

Since the original PwC survey, the Opacity Index has been produced by both the Kurtzman Group (2004) and the Milken Institute (2006 and 2008). These later versions of

the survey have been expanded to include a larger set of developing countries and re-measured to capture fundamental changes in these economies. These recent surveys document two important facts about overall transparency in China. First, there has been a gradual improvement in the overall information environment; the Opacity Index fell from a score of 50 to 45 (out of 100) over the period 2004 to 2008. This improvement is principally driven by improvements to China's regulatory and legal environment and the implementation of specific exchange-level reporting and auditing requirements. Second, in spite of this improvement in China's overall score, the country continues to rank as one of the least transparent economies surveyed, ranking 41st out of 48 countries in the 2008 survey.

Focusing strictly on accounting and financial reporting transparency, similar conclusions are reached. First, China has experienced a significant improvement in its opacity score for "accounting and financial disclosure," improving from 56 to 41 (out of 100) over the period 2004 to 2008. This improvement mimics the general global trend towards transparency over the last decade. Second, despite this improvement on an absolute basis, China's accounting opacity score of 41 continues to be the fourth worst among the 48 countries surveyed in 2008; only Colombia, Saudi Arabia and Nigeria fare worse. By contrast, other large emerging economies received accounting opacity scores of 26 (Russia), 29 (India) and 37 (Brazil), while China's Special Administrative Region of Hong Kong received an opacity score of 1.

Other reports offer similar conclusions about the opacity of China's financial reporting environment. For example, the World Economic Forum's Global Competitiveness Report (2008) specifically assessed the strength of auditing and financial disclosures in 134 countries. Similar to the conclusions drawn from the Opacity index, China ranked 86th out of the 134 countries surveyed in the 2008 report. By contrast, the other large developing economies were ranked 30th (India), 60th (Brazil), and 108th (Russian Federation), while local Asian economies South Korea, Taiwan and Hong Kong were ranked 36th, 53rd and 1st, respectively.

These surveys highlight three important characteristics about China's information environment. First, overall transparency has been improving over the last decade in response

to better regulation, improved enforcement and strong demand from foreign investors. Second, despite these improving trends, overall transparency in China continues to lag the levels observed in both developed economies, such as the U.S., U.K. and Japan, the world's largest developing economies, especially India and Brazil, and China's own SAR of Hong Kong. Lastly, and for our purposes, most importantly, these overall characteristics apply to the realm of the financial reporting environment of China's listed firms, resulting in the weak information environment that produces the highly synchronized stock returns documented in prior research.

1.3 China's information environment: Financial reporting standards and practices.

It is clear from survey and market-based evidence that China's listed firms are associated with a poor information environment. At the heart of these perceived deficiencies are weaknesses with respect to the financial reporting and audit practices of China's listed firms. To better understand the source and nature of China's weak corporate reporting environment, the following section presents basic evidence on the financial reporting environment of listed Chinese firms.

1.3.1 Standards and regulations

On the basis of regulations and standards alone, the information environment for China's listed firms should be strong. Starting in 2001, the China Securities Regulatory Commission (CSRC) implemented a series of regulations specifically designed to improve the accounting practices of publicly-traded Chinese firms. The most noteworthy action in this area was the harmonization of Chinese accounting standards with International Financial Reporting Standards (2006), and, ultimately, the issuance regulations mandating that all listed firms comply with IFRS (effective 1 January, 2007). Additionally, the CSRC recently implemented new auditing standards and stricter auditor guidelines in an effort to increase the credibility of the financial reports (effective 1 January 2007).

Outside the direct realm of financial reporting, the CSRC issued new regulations designed to improve corporate governance through limitations on insider trading activity and

requirements for independent board membership (2003); these regulations are expected to increase investor protections and reduce the incentives for firms to withhold information from the capital markets. Similarly, the Chinese government has introduced numerous ordinances and reforms designed to promote greater government accountability, counter corruption, and improve government transparency and openness. These actions are expected to improve the investing environment in China, and should have a spill-over effect on the information environment of listed firms by removing, or at least attenuating, some of the institutional frictions and costs that impeded information acquisition and dissemination activities in China's markets.

1.3.2 Observed financial reporting practices

In spite of the CSRC's regulations and overall trends in market development, surveys continue to rank the quality of China's financial reporting practices as low. The natural question is: how do accounting practices in China differ from the rest of the world? Unfortunately, there exists minimal empirical evidence that directly compares the broad financial reporting and disclosure practices of Chinese firms against the reporting practices of other countries *within the same study*. For example, Bhattacharya, Daouk and Welker's (2003) examination of the link between accounting opacity and cost of capital, Leuz, Nanda and Wysocki's (2003) study of earnings management around the world and Bushman, Piotroski and Smith's (2004) study of corporate transparency around world include Hong Kong firms, but do not include PRC-listed firms. Similarly, seminal studies on the informativeness of earnings (e.g., Alford, Jones, Leftwich and Zmijewski, 1993) and the properties of accounting numbers around the world (e.g., Ball, Kothari and Robin, 2000) only focus on large, developed economies.¹

Despite these cross-country data limitations, some key evidence exists on the overall quality of accounting practices in China. The most striking observation about the reported

¹ One constraint is that numerous cross-country studies exclude communist and former-communist countries from their research design. Additionally early cross-country studies of corporate reporting and accounting practices excluded China from their databases because of limited data availability during the early 1990's.

earnings of Chinese firms is the clustering of firm-level ROE realizations around zero, six and ten percent annually (see figure 1). Because the CSRC uses bright-line regulatory benchmarks to initiate a performance-related delisting or to grant an approval for a rights offering, Chinese firms have an incentive to manage reported earnings to meet these specific performance benchmarks. As a result, a disproportionate number of Chinese firms report ROE realizations around the CSRC's three regulatory performance benchmarks of zero, six and ten percent. Moreover, there is almost a complete absence of loss-making firms in the China. These distributional characteristics are especially striking when compared against a similar distribution of earnings realizations for US listed firms that do not face bright-line regulatory benchmarks (see figure 2). Thus, by comparison, it is fairly clear that the CSRC's benchmarks are influencing reported accounting realizations in China.

To achieve ROE targets and avoid losses, Chinese firms engage in both accruals-based earnings management and real transactions designed to prop the performance of the listed firm. The result is accounting numbers that fail to capture the real economic condition of the listed firms. For example, Ball, Robin and Wu (2001) and Bushman and Piotroski (2006) demonstrate that the loss recognition practices of Chinese firms are less timely than for firms domiciles in other countries. The limited application of conditionally conservative accounting practices among Chinese firms is striking when compared against the extent of timely loss recognition among the firms domiciled in key developed economies (see figure 2) and in large and local developing economies (see figure 3). The basic conclusion from these studies is that the accounting numbers of Chinese firms fail to capture deterioration in firm performance in a timely manner, severely limiting the usefulness of these reports for contracting and monitoring purposes. Similar results have been documented in studies examining the quality of discretionary accruals among China's state-controlled firms (e.g., Chen, Lee and Li, 2003; Liu and Xiao, 2005). Thus, Chinese firms appear to use discretion in the accounting process to manage reported earnings.

The other means by which Chinese firms meet earnings targets and avoid losses involves the use of related party transactions. For example, Jian and Wong (2008) document the prevalence of propping activities through related party transactions among China's state-

controlled firms to manipulate the firm's earnings. Although the form of these transactions are real (e.g., product sales, raw material purchases, intercompany loans, etc.), the substance of the transactions are designed to facilitate earnings management and, in many cases, tunneling activities. Moreover, Jian and Wong (2008) find that these earnings management effects were most pronounced in those provinces characterized by weak legal institutions and less deregulation of the marketplace, where the likelihood of detection and resultant penalties are expected to be lowest.

Together, these papers illustrate alternative mechanisms by which China's publicly traded entities manipulate their reported performance to either meet the aforementioned regulatory requirements, to overstate the value of the firm to potential shareholders or to facilitate the tunneling of resources out of the publicly-listed firm. Thus, in spite of recent regulatory actions designed to foster transparency, the financial reporting environment of Chinese listed firms is opaque. The discrepancy between the strength of China's standards and regulations and the relative weakness of China's actual financial reporting environment is ultimately the result of local institutions that create adverse financial reporting incentives. The next section explores in greater detail the impact that China's unique institutional environment has on the financial reporting practices of its publicly listed firms.

Section 2. Institutions and China's information environment

It is well documented that legal, political, financial and regulatory institutions exert strong pressures on economic agents and their behavior. In finance and economics, a vast literature discusses and documents how primitive institutions influence the form of the economy and the resultant impact the equilibrium set of institutions have on investor protections, financial development, investment behavior and, ultimately, economic growth and wealth. As a key institution that aids in the allocation of capital within an economy, financial reporting practices, and the resultant information environment, are shaped by these same primitive forces.

In general, institutions associated with strong investor protections and economic outcomes are associated with more favorable financial reporting practices and better

information environments. Cross-country studies, for example, show that corporate transparency is positively associated with stronger legal protections and inversely related to state involvement in the economy (Bushman, Piotroski and Smith, 2004), earnings management is found to be less prevalent in economies with greater investor protection of minority shareholders and less concentrated ownership (Leuz, Nanda and Wysocki, 2003), timely loss recognition practices are stronger in countries with greater investor protections and institutions supporting contract usage (Ball, Robin and Kothari, 2000; Ball, Robin and Wu, 2003; Bushman and Piotroski, 2006), earnings informativeness is higher in the presence of less concentrated ownership (Fan and Wong, 2002) and stronger investor protections (DeFond, Hung and Trezevant, 2007), and the use of high quality auditor is more likely in the presence of strong institutions (Francis, Khurana and Pereira, 2003).

This section discusses how the institutional settings of an emerging economy like China shape its information environment. Special emphasis is placed on the role of political forces and the trend towards greater market institutions in certain regions affect the ways Chinese listed firms release information to the market and demand for external auditors. We also discuss how regulatory requirements create an incentive for earnings management and how the unique ownership structure among state-controlled entities facilitates propping activities via related party transactions.

2.1 Contracting role of accounting in the US setting

In the US environment, accounting plays an important contracting role in the governance of listed firms (Watts and Zimmerman, 1986). The use of accounting numbers in firms' managerial and debt contracts creates a demand for disciplinary mechanisms, such as the appointment of audit committee and external auditors, to ensure the reporting of high quality information to all contractual parties, including existing and potential investors in the capital markets (Watts, 2006). The stronger the contracting demand for credible information, the higher is the accounting quality must be to fulfill this monitoring role.

The contracting role of accounting is first discussed in Jensen and Meckling (1976), who posit that there exists a contractual cost between owner-manager and outside

shareholders; this contracting cost is termed agency cost. Accounting is an integral part of the organizational architecture in reducing this contracting cost. In a typical US listed firm, ownership is not concentrated in the hands of an owner-manager or family; instead, ownership is highly diffuse. This diffuse ownership structure creates a serious agency problem because of the separation of ownership and control in the organization. Essentially, the diffuse investors have delegated the control of the firm to professional managers whose interests are not aligned with theirs. This misalignment of interests is less problematic when managers are also part owners of the firm, because their stake in the company creates an incentive to maximize shareholder value. As a result, Fama and Jensen (1983) argue that firms characterized by diffuse ownership have a much stronger need to set up a governance structure that reduces the agency conflicts between professional managers and owners than firms with concentration in ownership. Specifically, firms with diffuse ownership need to appoint independent board members that are given the decision control rights to monitor managers on behalf of the owners. One frequently used monitoring device is an arm's length contract that links the managerial compensation to the firm's accounting performance. In order to validate the credibility of the accounting information, the board also hires external auditors to examine the managers' accounting reports on behalf of the owners.

Debt contracts also create a demand for high quality financial reports in the US environment. Because creditors in the US (especially bond holders) typically lack board representation and do not have privileged access to firm information, creditors frequently employ debt covenants based on accounting information to monitor the firm. Essentially, these debt covenants are used to trigger the transfer of decision rights from shareholders to creditors in the event of a decline in the financial condition of the firm. The efficacy of these contractual arrangements hinge upon the presence of credible financial accounting information and a judicial system that will enforce the underlying contract. The US strong legal environment, combined with the prevalent use of public debt, leads to a heightened demand for high quality financial reports by debt contracting parties. Thus, both the form of the US credit markets and the form of US equity ownership arrangements create a strong contracting-based demand for high quality financial reports.

2.2 China's institutions and the role of accounting

As discussed in section one, the information environment in China is significantly weaker than the US environment. A principle reason for this difference relates to the fact that the financial reporting practices of Chinese firms are very different than those of their US counterparts. These differences in accounting and financial reporting practices are likely the result of differences in key legal, political, financial and regulatory institutions between these two countries.

There are a number of institutional factors that shape the ownership and regulatory environments of the Chinese listed firms. These institutions, in turn, affect the contracting relationships of the key players in the capital market and the role and properties of accounting in the Chinese firms. The key institutional arrangements that ultimately shape the financial reporting practices of publicly-listed firms in China are: State ownership of listed firms; government control of capital markets; weak market institutions; weak protection of property rights; lack of independent auditors. The impact of these institutional arrangements on the reporting practices of China's listed firms is discussed below.

Majority of the Chinese firms remain state-controlled after listing

China set up two stock exchanges in the early 1990s, one in Shenzhen and the other Shanghai, as a way to partially privatize its state enterprises and reform their governance structure to match international standards. However, the central or local government is required to maintain control of these state firms after listing. At present, the state owns on average 53% of the outstanding shares of listed state firms, while the remaining 47% of outstanding shares are in the hands of individuals, institutional investors, investment trusts and private firms. In addition, the government has historically given listing preference to state firms; as a result, state-controlled firms making up the majority of the equity market in the two stock exchanges (65% of firms with 89% of market capitalization).

The contracting role of accounting in a Chinese listed state firm is different from that of a US firm with diffuse ownership for a number of reasons. First, concentrated control

gives the State (i.e., owner) both the incentive and the ability to directly monitor the performance of the firms' managers. For example, the Chinese government retains the rights to appoint key officers such as the chairman and CEO of these state firms (Qian, 1997); as a result of this control, Fan, Wong, and Zhang (2008) document that 27% of the CEOs of listed state-controlled firms have government background. Moreover, as argued by Ball, Kothari, and Robin (2000), the government owners of listed state firms can use private channels and their political networks, instead of public accounting and information reported to the markets, to measure and assess managerial performance, thereby bypassing the need for high quality external reports.

Second, bankruptcy is rare among listed state firms in China. As a consequence, most domestic investors expect the government to bail out state firms that are financially distressed. This implicit insurance against creditor and shareholder losses further reduces outside investors' demand for public information about the listed state firms. Instead, investors focus on buying into firms that have strong political support.

Third, profit maximization is not the sole objective of most Chinese publicly-listed state-controlled firms; instead, these firms are also obligated to achieve of certain social objectives, such as infrastructure development and full employment targets in the region. Because of these multiple and frequently conflicting objectives, local governments do not solely use firm-level profit information to monitor and assess the performance of the firms' managers, again reducing the demand for high quality external reports.

In summary, because of the state's controlling ownership in the vast majority of listed firms, the contracting role of accounting numbers in China is very different from that of US firms. This difference reduces the demand for high quality external financial reports in China relative to the US market.

Government control of capital markets

A unique feature of the Chinese environment is the State's strong control of the capital markets, especially as it pertains to state controlled entities. Since the creation of the two stock markets in China, the listing process and subsequent share issuances are highly

controlled by CSRC. Furthermore, rather than leaving listing decisions to the market or the firm's managers, the government retains the ultimate power in selecting firms for IPOs and subsequent share offerings. Additionally, the central government has control over the credit market for most listed firms; this control arises because publicly-traded state firms typically obtain the majority of their debt financing from the four largest state banks in China.

The government's control of China's capital markets has two effects on firms' accounting practices. First, due to high information costs, the CSRC uses bright line rules to screen firms for rights offerings and delisting. For example, three consecutive years of losses will lead to delisting for Chinese firms, while return on equity realizations of ten percent are required for a firm to engage in a rights issuance. Without a strong market infrastructure to guard against manipulation, and with the CSRC's heavy reliance on simple accounting targets to regulate the marketplace, listed firms have strong incentives to manage accounting. These incentives result in firms using accounting discretion when measuring firm-level performance, as discussed previously in section 1.3.2.

Second, the Chinese government frequently turns to non-financial channels, such as political networks, to obtain information to make capital raising, financing and listing decisions. For example, Fan, Rui, and Zhang (2008) document that politics influence the decisions of state banks to lend capital to state-owned enterprises. The extensive use of non-financial data for capital-related transactions again limits the demand for high quality external reports in China.

Lastly, the prevalence of debt financing from state-controlled banks minimizes the need for accounting to fulfill a debt contracting role. Instead, the government owners of the bank can directly monitor and assess the financial condition of the state-controlled borrower.

Weak market institutions and protection of property rights

China was a planned economy prior to the reforms in the late 1970s. Despite the fast economic growth in the past thirty years, the government has retained control in many sectors of the market. For example, the government has the power to appoint key personnel in state firms, grant license for operations in a particular location, control and regular the labor

market and influence the supply of input materials and inventory. Thus, it is essential for all Chinese firms to develop and maintain good relations with the government. These political connections, when combined with China's weak legal system and a long tradition of relationship-based transactions in business, mean that the use of accounting numbers to enforce arms-length contracts is much less likely in this transitional economy; instead, these alternative political channels are used to seek enforcement and remedies for non-performance.

More broadly, the legal and financial institutions needed to foster the activities of information intermediaries still need to be developed further. Because of the State's control over the markets and economy, Chinese investors are less likely to rely upon legal protections or information supplied by the firms or financial intermediaries when making their investment decisions. Instead, local investors focus on the firms' political background when choosing investment opportunities, and expect the government to bailout the firm if it experiences financial distress. As such, local investors do not create a demand for high quality reports. Furthermore, the weak protection of investor and property rights limits foreign investment activity and the resultant demand for high quality financial reports created by foreign investors.

Independence of local auditors

In the US environment, external auditors ensure that the managers accurately report the financial condition of the firm to outside investors. In that governance role, it is essential that the auditors represent the interests of the outside investors and remain independent of the managers; as such, the US has instituted regulations designed to promote the independence of the audit function (e.g., the Sarbanes-Oxley Act). In China, however, the ownership structure of the state-controlled firms, combined with the market for audit activities, adversely affects the governance role of external auditors.

First, as controlling shareholder of a listed state firm, the government can directly communicate with and monitor its managers via internal channels; as such, the demand for

external auditors to attest to the quality of public accounting reports is significantly lower in China.

Second, prior to the reform in 1998, almost all the audit firms across China were state audit bureaus. Even today, these audit firms are supervised by their local government and retain many of their old political connections. For example, local finance bureaus, audit bureaus, and CPA institutes are in charge of the licensing of audit firms, the administration of qualifying examinations, and the regulation of audit firms' day-to-day operations (Zhong, 1998; Tang, 1999). These connections are likely to create conflicts of interest between the managers who are ex-bureaucrats and/or have strong political ties with the local governments and the auditors located in that same local region (local auditors). Moreover, this lack of independence can induce collusion between the local state firms and local auditors to expropriate minority shareholders, resulting in a reduced supply of high quality financial reports.

2.3 Some recent research findings

2.3.1 Politics and suppression of bad news

One dimension of a strong corporate governance regime is the board's ability and willingness to take corrective actions when the firm experiences a deterioration in its performance. Additionally, the board is expected to be forthcoming with bad news to outside investors, whether through press releases, through communication with analysts or, from a financial reporting perspective, through the recognition of economic losses into earnings in a timely manner. In most common law countries, firms generally recognize economic losses into accounting earnings in more timely manner than economic gains; this conditionally conservative accounting practice thus provides a mechanism that allows board members to closely monitor and discipline managers and to take corrective actions earlier. Unfortunately, Chinese firms recognize losses into earnings in a less timely manner than firms domiciled in traditional common law countries (Ball, Kothar and Robin, 2000; Bushman and Piotroski, 2006).

So why are Chinese firms less likely to report bad outcomes in a timely manner? One explanation, put forth by Piotroski, Wong, and Zhang (2008), is that Chinese firms have strong political incentives to suppress bad news. On the demand side, the Chinese listed firms are under less pressure to report bad news promptly. As discussed earlier, the government ownership of the listed state firms and its control over the capital market weakens the contracting role of accounting, and thus the demand for timely reporting of bad news. On the supply side, the controlling owners of state firms also have political incentives to suppress bad news. Due to the heavy government control in the listed state firms, a large portion of politicians and ex-bureaucrats serve as senior executives and board members. They often pursue political goals or private benefit objectives at the expense of the firms' financial health. Thus, managers and local politicians incur a personal cost by reporting poor performance. Suppression of bad news allows politicians and politically astute managers to hide inefficiencies, expropriation-related activities and mask the inefficient allocation of resources to achieve political objectives.

Using the crash statistics of share prices in Jin and Myers (2006) and Chen, Hong, and Stein (2001), Piotroski, Wong, and Zhang (2008) document that Chinese state firms control the release of bad news to the markets around three political events: The National Congress of the Chinese Communist Party, provincial-level promotions, and the revelation of provincial-level corruption investigations. The promotion event involves turnover of local governors when they move to a more senior position. The measure of corruption events reflects the exposure of corruption cases involving provincial politicians at or above the bureau level. The results show that state-controlled firms are significantly less likely to experience negative stock price crashes in the years of the National Congress of the CCP, in advance of political promotion decisions and during the course of corruption investigations relative to non-event years. This suggests that in China, due to government's control over the capital markets and its ownership of the listed state firms, politics plays a significant role in shaping the information environment of these firms.

2.3.2 Penalties for accounting scandals and relationship-based contracting

Another recent study by Hung, Wong, and Zhang (2009) uses penalties associated with accounting scandals to show that accounting has a significantly less of a contracting role in China than the US. In a series of papers by Karpoff et al. (Karpoff et al., 2004; Karpoff, Lee and Martin, 2008a,b), they find that the reputation penalty is huge. There is on average a 41% decline in share prices for firms caught in accounting scandals sanctioned by the US Securities and Exchange Commission. They argue that a significant portion of the share price decline is to associated with the loss in reputation, which leads to loss of potential new contracts or increase in future contracting costs. In addition, they document that almost all senior officers such as the CEOs and CFOs are dismissed and would have a hard times finding comparable positions in the future.

In contrast to the US experience, the reputational penalty against earnings management is significantly smaller in China. Using a sample of 217 accounting scandals sanctioned by CSRC, Hung, Wong, and Zhang (2008) find that the share price decline of the associated firms is only about 10%. When Sun, Wong, and Zhang (2008) trace the career paths of the senior executives who are involved in the accounting scandals, they find that 40% of the chairman and 20% of the CEOs are promoted to a much higher position in the corporate groups or government organizations.

The major reasons for such a difference in reputational penalties associated with accounting scandals lie in China's institutional environment. With heavy government influence in the markets, and its weak development in market institutions and legal protection, Chinese firms tend to contract based on social and political networks rather than public accounting information and legal documents; in contrast, US firms rely mainly on arm's length contracts. As such, accounting quality and corporate transparency are essential for various parties to enforce the firms' contracts in the US environment, and an accounting scandal damages the very credibility of the firm's underlying contracting environment. Chinese firms, on the other hand, focus more on their social and political networks in contracting; thus, an accounting scandal has minimal impact on the stability of the firm's underlying contractual relations.

In support of these arguments, Hung, Wong, and Zhang (2009) document that among firms with senior officers that are caught in corruption charges and accounting scandals, the share prices of the firms dropped by 35%, which is significantly more than those that were only involved in accounting scandals. Since these corruption charges will likely lead to a disruption in political networks within the firms, they have a much bigger reputational effect on firms than pure accounting scandals. They find that immediately after the corruption charges, these firms have a much harder time getting bank loans, their accounting and stock performance suffers and there is significant change in board membership, possibly due to change in political appointees that help to realign the firms' political ties.

2.3.3 Earnings management and related party transactions

A common way of measuring the information environment of a market is the level of earnings management among listed firms. Past research has found that Chinese firms have strong incentives to manage earnings. As discussed in the section on China's institutions, the government's bright-line rules for rights offering and delisting, and the weak reputational penalties and legal sanctions against accounting scandals, results in earnings management being prevalent among listed firms in China. There is extant evidence of earnings management in China, ranging from inflating earnings in years leading up to IPOs (Aharony, Lee, and Wong, 1999) and rights offering (Chen and Yuan, 2004).

Besides having strong incentives to manage earnings, the group structure of these listed Chinese firms also facilitates earnings management. Typically, a state firm will only carve out a portion of its assets for listing, leaving the rest in the unlisted parent firm. After the listing, the unlisted parent and the listed subsidiary often continue to trade with each other via related party transactions. The corporate structure of the group that the listed firm belongs often has multiple layers and many firms in each layer. This complex structure is a result of diversification and vertical integration arising from the lack of developed input and output markets in China.

In a recent study, Jian and Wong (2008) document that the Chinese listed firms use related party sales to their unlisted parents to boost earnings to avoid delisting or qualify for

rights offering. This research raises a new set of questions on whether and how we should value listed firms in China. Should they be considered separate entities from their unlisted parent firms? Since almost all the parents of the listed firms are unlisted, it is difficult for investors to know about the true financial conditions of the listed firms in the market. This is one aspect of the information environment of Chinese listed firms that need further research and analysis.

2.3.4 Weak demand for external auditing

In this subsection, we discuss the market for external auditors in China because past US research shows that auditor quality can affect the information environment of client firms. Specifically, Teoh and Wong (1993) and Becker et al. (1998) have established a positive link between firms' audit quality and earnings quality.

In a move designed to improve both auditing and accounting quality in the Chinese equity markets, the government adopted the international Generally Accepted Auditing Standards (GAAS) for the fiscal year of 1995. DeFond, Wong, and Li (1999) find that the immediate effect of such adoption is that the modified audit opinions go up by 9 fold, from 1% to 9%. This significant increase suggests that Chinese auditors became more stringent when issuing opinions on the quality of their clients' financial statements following GAAS adoption. During this same time period, the Chinese government was attempting to develop a list of Top-10 auditors (based on number of clients or clients' total assets) with superior audit quality. Consistent with the government's desire, DeFond, Wong, and Li (1999) also find that everything else equal, these Top-10 auditors are indeed more stringent, issuing more modified opinions in sample period of 1993-1996. However, after the adoption of the new GAAS in 1995, the market share of Top-10 auditors drops significantly and has remained such for the last decade². So, the obvious question is: why did the demand for Top-10, higher quality auditors in China fall after the adoption of the new GAAS?

² Wang, Wong, and Xia (2008) document that only 25% of the listed firms in China hire Top-10 auditors in 2003.

The reason for such a low concentration of Top-10 auditors again relates to China's institutional environment. As highlighted earlier, block ownership and the likelihood of a government bailout in times of financial distress reduces the demand for the governance role of external auditors. Additionally, the reliance on political networks rather than arm's length contracts further weakens the contracting role of accounting and the demand for high quality external auditing. Thus, it is unnecessary for state firms to hire Top-10 auditors.

Wang, Wong, and Xia (2008) also propose an alternative explanation for their result that local state firms tend to hire non-Top-10 auditors from the same region (local auditors). Wang et al. (2008) argue that local governments retain substantial political influence over these small local auditors; by hiring local auditors, local state firms can collude with the auditors in managing earnings to meet government targets and/or suppressing bad news for political goals. Wang, Wong, and Xia (2008) report that compared with non-state firms, local state firms are more likely to hire small local auditors. Moreover, the relative difference in the propensity to hire small local auditors is greater in provinces with more government influence and weaker legal institutions, consistent with political forces shaping the audit choice decision.

Section 3. Recommendations

The preceding sections outline the current information environment in China and highlight the influence that local institutions have on financial reporting incentives. The final section of this paper discusses how a shift to China's institutional and regulatory environment will likely impact the country's information environment.

3.1 Potential benefits to China from an improvement in corporate transparency

Prior research outlines the potential economic benefits that can arise from strong corporate reporting and disclosure practices at both the firm and country level. First, using US data, prior research has shown that firms with better disclosure practices are positively associated with lower levels of information asymmetry and less uncertainty about future performance, as measured by smaller absolute analyst forecast errors and narrower dispersion

of analyst forecasts. This reduction in information asymmetry and estimation risk translates into smaller bid-ask spreads, greater liquidity and, ultimately, lower costs of equity and debt capital (e.g., Barry and Brown, 1985; Botosan, 1997).

Additionally, US data shows that firms with more transparent disclosure practices are associated with greater levels of analyst coverage (Lang and Lundholm, 1996) and institutional ownership. To the extent that greater analyst coverage improves overall information gathering, processing and dissemination activities, the increase in analyst coverage should improve the efficiency of stock prices, reduce information asymmetry, and ultimately lower trading costs and decrease the country's cost of capital. Additionally, to the extent that greater analyst coverage is positively related to the overall level of investor interest in the firm, greater demand for the securities can also raise valuations and lower the firm's cost of equity capital (Merton, 1987).

Similar relations exist between the quality of reported earnings, information asymmetry and the firm's cost of capital using both US data (e.g., Francis, LaFond, Olsson and Schipper, 2004) and cross-country data (Bhattacharya, Daouk and Welker, 2003). As such, the credible adoption of transparent reporting and disclosure practices by Chinese firms should result in a reduction in the firm's cost of capital. However, the magnitudes of these benefit ultimately depends upon the credibility of the firm's commitment for transparency, as well as the extent that capital is being raised by the firm in a market setting. To the extent that state firms continue to raise the majority of their funding from state banks or via politically-influenced channels, the expected magnitude of benefits from increased transparency would be small. More broadly, however, greater corporate transparency has the capability of reducing market frictions arising from information asymmetry and adverse selection concerns, potentially lowering trading costs, increasing liquidity for the firm's shares, increasing the efficiency of market prices and raising firm valuations.

Second, in the context of an emerging economy like China, where ownership is concentrated in the hands of the state or a few non-state owners, greater transparency and stricter disclosure standards have the potential to strengthen corporate governance by improving monitoring and limiting consumption of private benefits by controlling

shareholders (e.g., Rajan and Zingales, 2003; Stulz, 1999; Doidge, 2004; Doidge, Karolyi and Stulz, 2004). These governance improvements should result in better asset management and investment decisions for the firm and lower the risk of expropriation by the controlling shareholders. These improvements should produce stronger firm performance, lower costs of capital, higher market valuations, and from the perspective of minority shareholders, larger dividends and greater free cash flows. Consistent with these corporate governance arguments, Bushman, Piotroski and Smith (2008) show that firms operating in economies with timely accounting loss recognition practices respond to a decrease in growth opportunities more strongly than firms operating in economies with limited loss recognition practices.

Third, strong information systems lower the information gathering costs investors, increase investor protections through the use of enforceable contracts, allow for improved monitoring, and lower the uncertainty faced by foreign investors. Consistent with these arguments, Gelos and Wei (2004) show (using cross-country data) that stronger disclosure practices are associated with greater levels of foreign investment.

Finally, all of these outcomes are expected to improve the price setting process in China's markets, ultimately resulting in market prices that will better aid in the allocation of the country's capital towards the most promising investment opportunities.

In summary, a credible commitment for strong disclosure practices will aid in China's economic development through greater levels of foreign investment, lower costs of capital and higher market valuations, as well as an improvement in the allocation of capital through the more accurate identification of positive NPV investment projects and better asset management. Moreover, as foreign capital flows into the economy, foreign and minority shareholders will demand higher quality information and audit function to monitor both managers and controlling shareholders, reinforcing the aforementioned benefits. It is for these reasons that Rajan and Zingales (1998) are able to document a positive relation between the level of financial development of an economy, the strength of the country's accounting standards (as measured by CIFAR) and economic growth.

3.2 Improving corporate transparency and China's information environment

In terms of economic and financial development, China would benefit from an improved information environment and stronger financial reporting systems. However, transparency is not costless; the current political and legal environment in China does not create incentives for strong information systems, and in many cases, actually promotes opacity. As such, how can China improve the information environment of listed firms given the prevailing incentives for opacity?

China's economy has undergone an incredible transformation over the last several decades, including the introduction of public equity markets and the embracing of many western-style market arrangements. This market development, along with the arrival of foreign capital, has created a demand for better information about China's listed firms. However, many attributes of the Chinese environment – the State's ownership of listed firms, concentrated ownership structures, a cultural preference for relationship-based transactions, and the role of political connections and incentives – have remained fairly unchanged over this same time period. It is these institutional attributes that create the wedge between market demand for corporate transparency and the firms' and country's willingness to supply that information.

First, the adoption of IFRS is a good first step for China to benchmark their accounting standards to global standards. However, due to the organization and incentive structure of Chinese listed firms, standard setters and regulators should focus more on the disclosure of related party transactions and the complex pyramidal and ownership structure of the firms. Moreover, it needs to be recognized that accounting standards and regulations alone are not sufficient to improve the information environment; there must also exist credible mechanisms to enforce the rules. Thus, although convergence towards IFRS is important, the costs of non-compliance must be sufficiently strong to create an incentive for managers, politicians and firms to follow these rules. In this regard, a strong central regulator such as the CSRC is in the position to act as the public enforcer, similar to the Securities and Exchange Commission in the U.S.

Prior research shows that the enactment of laws and regulation may be insufficient to derive economic benefits.. For example, Bhattachary and Daouk (2002) show that it is the initial enforcement of a country's insider trading law, not the law's enactment, which results in a decrease in country-level costs of capital. Similarly, Bushman, Piotroski and Smith (2005) show that it is the initial enforcement, not enactment, of those same insider trading laws that results in an increase in the depth and breadth of analyst coverage in an economy.

Second, China needs to develop a legal / judicial system that is free from political influence. This legal system needs to promote the private enforcement of contract, and decisions need to be made in a fair and transparent manner, independent of political policy objective and local connections. Such a shift in the legal regime will serve to strengthen investor protections in China, creating a climate for foreign investment and related information gathering activities. As shown in prior research, strong legal systems create an institutional and market environment that promotes and creates a demand for strong financial reporting practices (e.g., Ball, Kothari and Robin, 2000; Leuz, Nanda and Wysocki, 2003; Bushman, Piotroski and Smith, 2004) and attracts foreign investment.

Third, and most fundamentally, China needs to alter the incentives of managers and local politicians to promote transparency. In this regard, China has taken significant steps in the last several years to increase the accountability of local politicians; however, as the evidence suggests, additional work needs to be done to align the reporting and disclosure incentives of these parties. The government's efforts to fight corruption and make use of media coverage as a way to promote accountability are steps in the right direction.

Lastly, as shown in our research, one key institutional constraint that leads to the appointment of low quality auditors is government ownership of listed firms in China. Three recent trends in China have helped to reduce government's influence on the listed firms. First, there has been an increase in the number of privately controlled firms listed in the stock exchanges in China. Second, the government has recently been granted permission to freely transfer their state shares to private investors. Third, the increase of foreign ownership through New York, London and Hong Kong listing of Chinese firms will also help reduce the

government influence, which in turn will help to improve the corporate transparency of the Chinese listed firms.

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Figure 1
Distribution of Return on Equity Realizations of Chinese Listed Firms

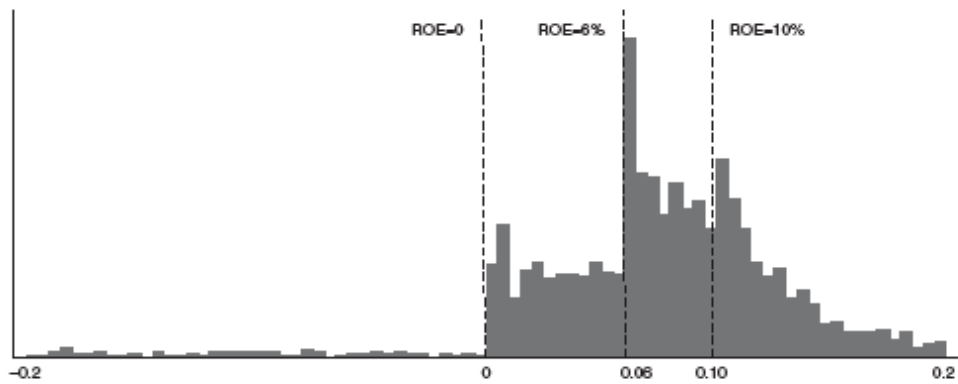


Figure 2 Histogram of ROE for China's listed companies from 1999 to 2001

Source: Liu (2006)

Distribution of return on equity realizations for US listed firms

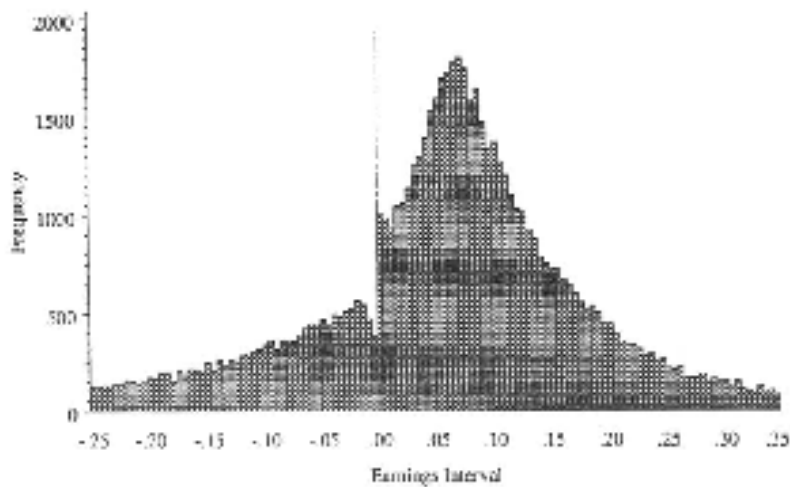


Fig. 3. The distribution of annual net income (Compustat item NI) scaled by beginning of the year market value (Compustat item BV) for US listed firms. The distribution interval width is 0.005 and the location of zero on the horizontal axis is marked by the dashed line. When the interval width is 0.005, the first interval to the right of zero contains all observations in the interval (0.000, 0.005), the second interval contains (0.005, 0.010), and so on. 'Frequency' is the number of observations in a given earnings interval.

Source: Burgstahler and Dichev (1997)

Figure 2
Timely loss recognition practices of Chinese Firms versus Developed Economies

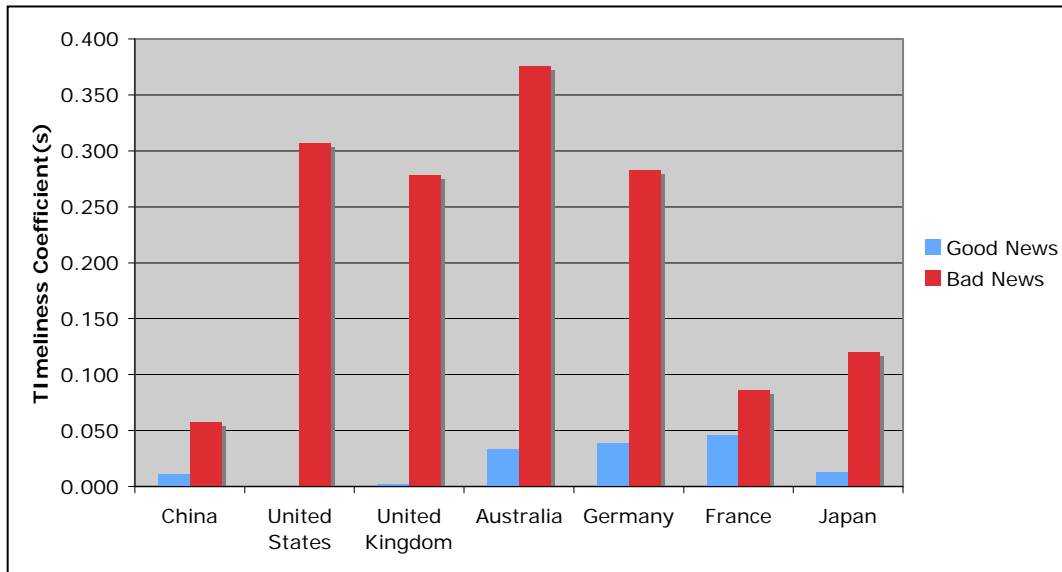


Figure 3
Timely loss recognition practices of Chinese Firms versus other Emerging Economies

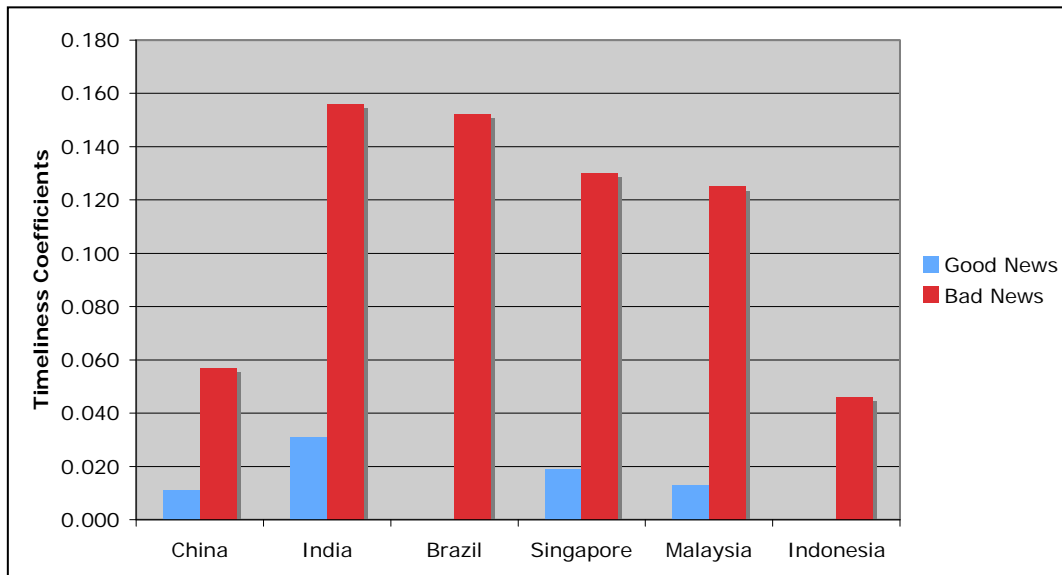


Table 1
Descriptive Statistics on China's Accounting and Disclosure Standards:
Survey Evidence

2001 Opacity Index (score)	2004 Opacity Index (score)	2008 Opacity Index (score)	Global Competitiveness Report 2008 (rank)
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Brazil

63

40

37

60