STANFORD
GRADUATE SCHOOL OF BUSINESS

Session 4: Corporate Transparency and Financial Reporting in China

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Panelists:

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Financial Reporting in China: An Overview

On the basis of regulations and standards alone, the information environment of Chinese firms should be strong.

- The goal of the CSRC is to maintain an “open, fair and just” market.

Periodic Disclosure Requirements (CSRC and Exchange Rules)

- “Annual Report” (Audited; released within four months of fiscal year end)
- “Interim Report” (Audited under certain conditions; released within two months of end of the first half of fiscal year).
- “Quarterly Report” (No audit required; released within one month of end of third and ninth month)
- “Ad hoc” reports when a “major event” occurs.

- Senior officers and directors are required to sign their opinion of consent or dissent to each periodic report.
- Directors required to provide a specific explanation and express opinion on modified audit reports.
- All reports / announcements are required to be published in the media(s) specified by the relevant department of the State

Disclosure and Financial Reporting Requirements of Chinese Listed Firms (continued)

Additionally, the CSRC has implemented regulations designed to improve financial reporting practices.

Convergence with high quality, globally-accepted standards.

- Harmonization of Chinese Accounting Standards with IFRS (2006)
  - Regulations mandating that all listed firms comply with IFRS (effective 1/2007)

- Adoption of International Auditing Standards
  - New standards and stricter auditor guidelines (effective 1/2007).

Regulations designed to increase financial reporting penalties

- Directors, supervisors and managers “shall be jointly and severally liable for losses” arising from “falsehoods, misleading statements or major omissions.”

Regulations designed to improve corporate governance, reduce the benefits arising from opacity and/or increase the gains to private information acquisition activities.

- Limitations on insider trading activity.
- Independent director requirements (1/3 requirement).

Anecdotal Evidence:
Information Environment of Chinese Listed Firms is Poor

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

“Even in China that is more capitalist than ever, the instinctual 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 indicate, the information environment in China can best be characterized as opaque.

- Settings for opacity span a wide range of topics in China
  - Environmental and health issues (e.g., SARS, Bird Flu).
  - Economic Data (data on growth during the Asian Financial Crisis)
  - Internet (“Great Firewall of China”; Domain name registration)
  - Firm performance (Earnings management at IPO)

China's Financial Reporting, Disclosure and Auditing Practices: Survey Evidence

	Opacity Index (Score)			Global Competitive Report (Rank)	
	2001	2004	2008	2008	2013
China	86	56	41	86	80
United States	25	20	20	20	36
United Kingdom	45	33	10	17	16
Germany	-	17	10	14	23
Japan	81	22	21	44	25
Brazil	63	40	37	60	31
India	79	30	29	30	52
Russia	81	40	26	108	107
Hong Kong	53	33	1	1	6
Taiwan	56	40	30	53	20
South Korea	90	30	30	36	91
Singapore	38	50	14	7	4

Two key conclusions from surveys on financial reporting, disclosure and auditing in China:

- Financial reporting and disclosure practices have been improving over time.
- China systematically lags key developed economies, most other large developing economies and other developed Asian economies.

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Stock Return Synchronicity:
Evidence from Morck, Yeung and Yu (2000)

R. Morck et al. / Journal of Financial Economics 58 (2000) 215–260 227

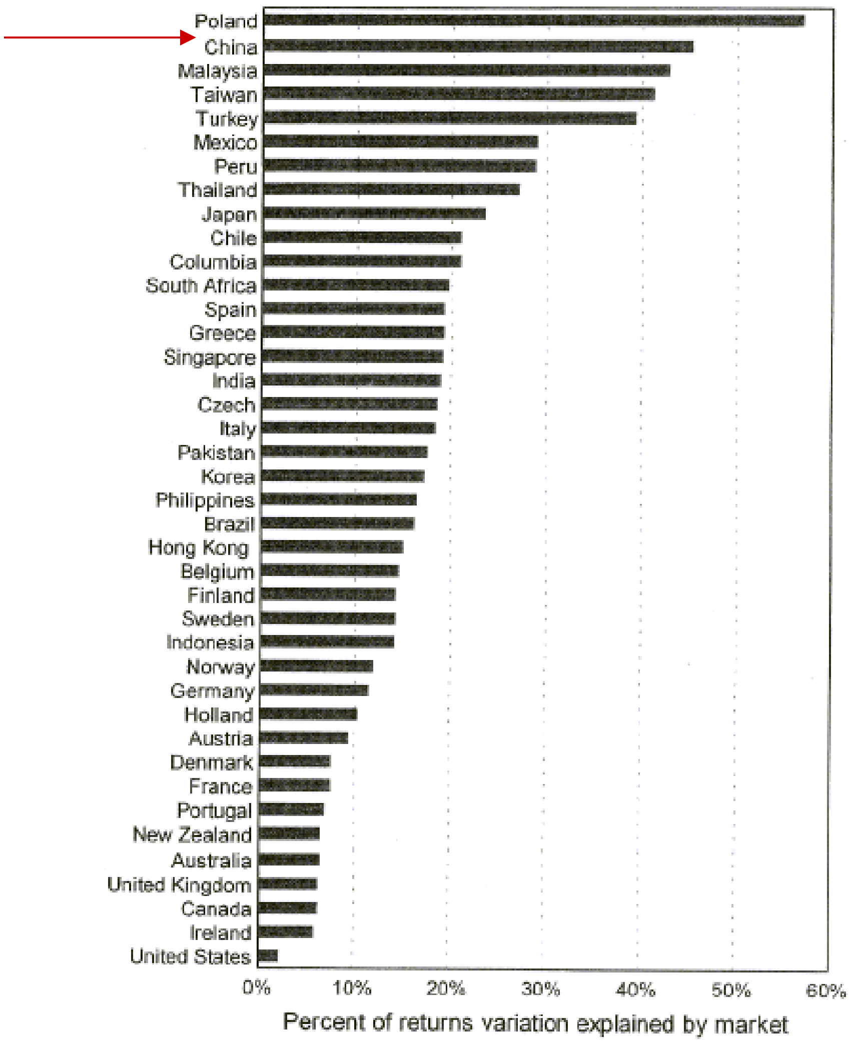


Fig. 4 (continued).

Strong co-movement with market returns is indicative of limited flow of firm-specific information.

- Market returns explain 45.3% of variation in weekly returns.
- Nearly 80% of stocks move together in average week.

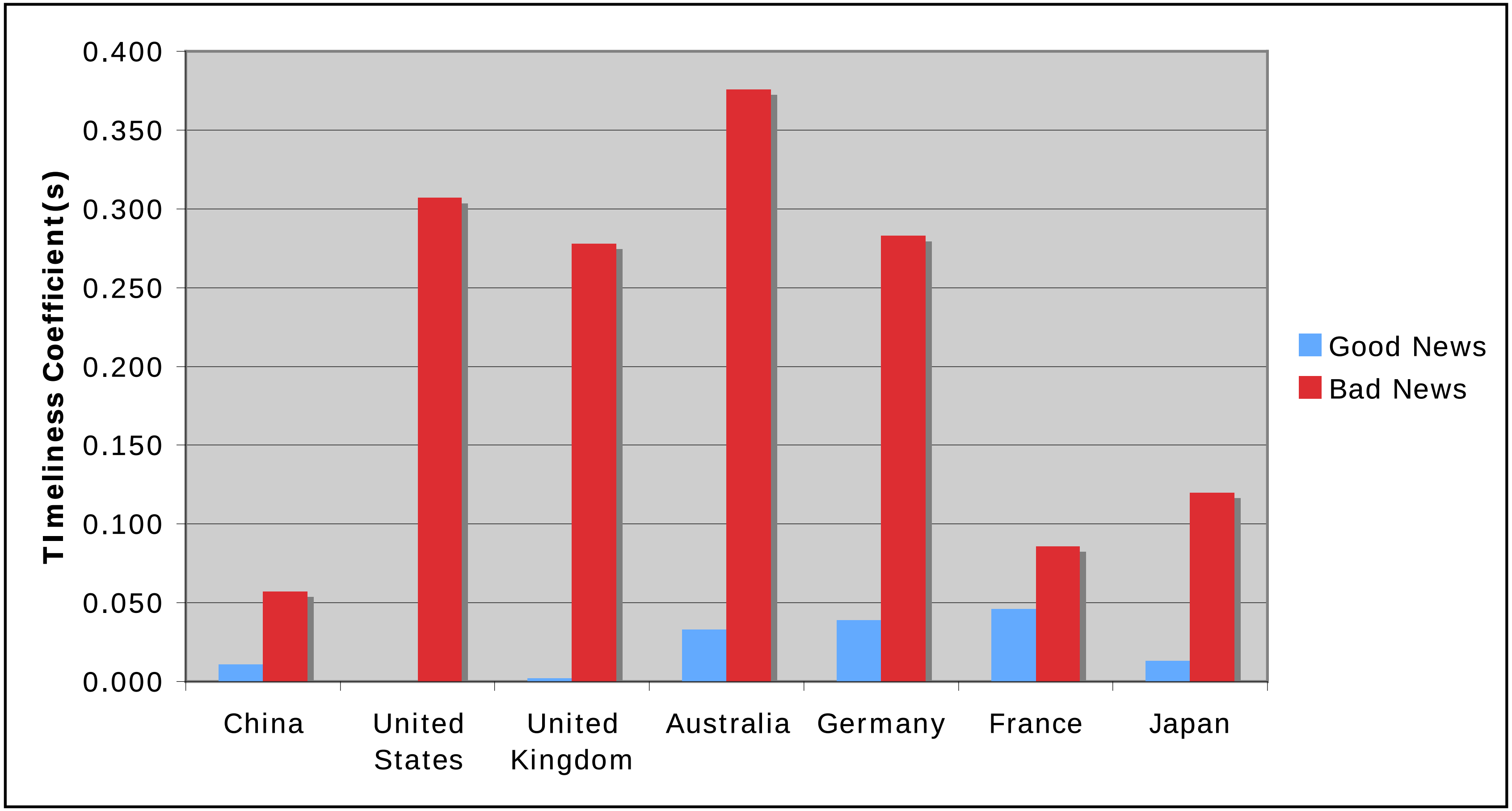
Results confirmed over longer periods by Jin and Myers (2006) and Gul, Kim and Qiu (2009)

Higher levels of synchronicity among firms with:
- State as controlling shareholder,
- Limited foreign investment
- Low quality auditor

(Gul et al., 2009)

Source: Morck et al. (2000)

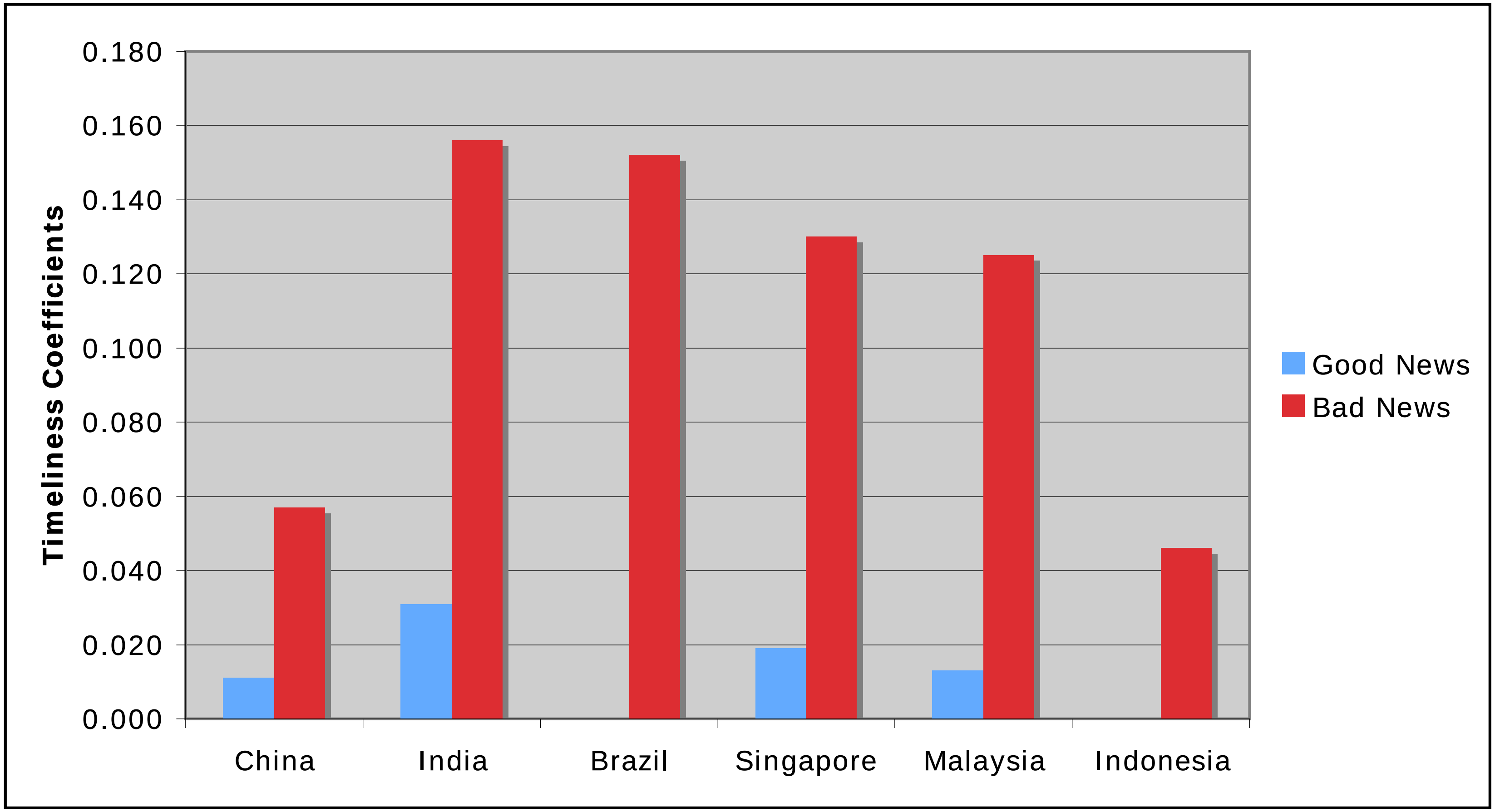
Financial Reporting Practices: Timely loss recognition practices of Chinese Firms versus Developed Economies



Timely loss recognition is an accounting practice that facilitates monitoring and performance evaluation, facilitates the transfer of decision rights from shareholders to creditors, and creates incentives to divest underperforming assets and limit inefficient investment behavior.

- Investment sensitivity to a decrease of growth opportunities are larger with strong TLR practices.

Financial Reporting Practices: Timely loss recognition practices of Chinese Firms versus Other Developing Economies



Source: Bushman and Piotroski (2006)

Distribution of earnings realizations for US Listed Firms

Earnings management: capital market incentives for loss avoidance

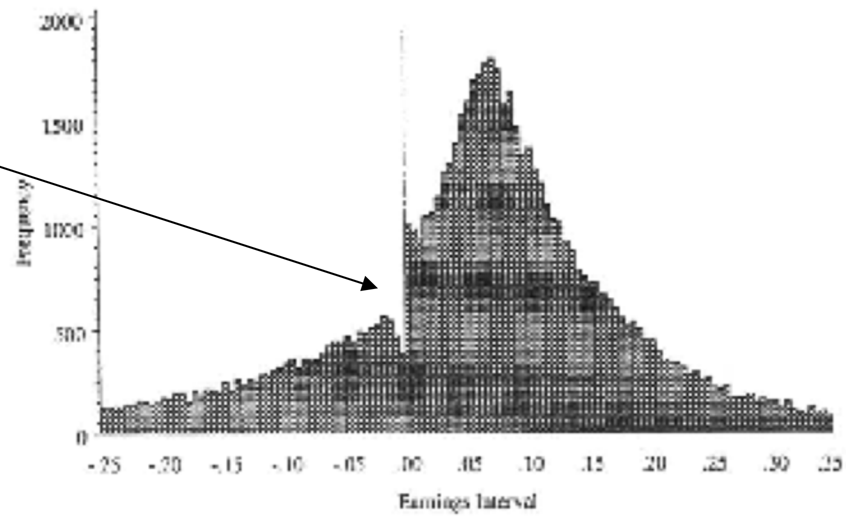
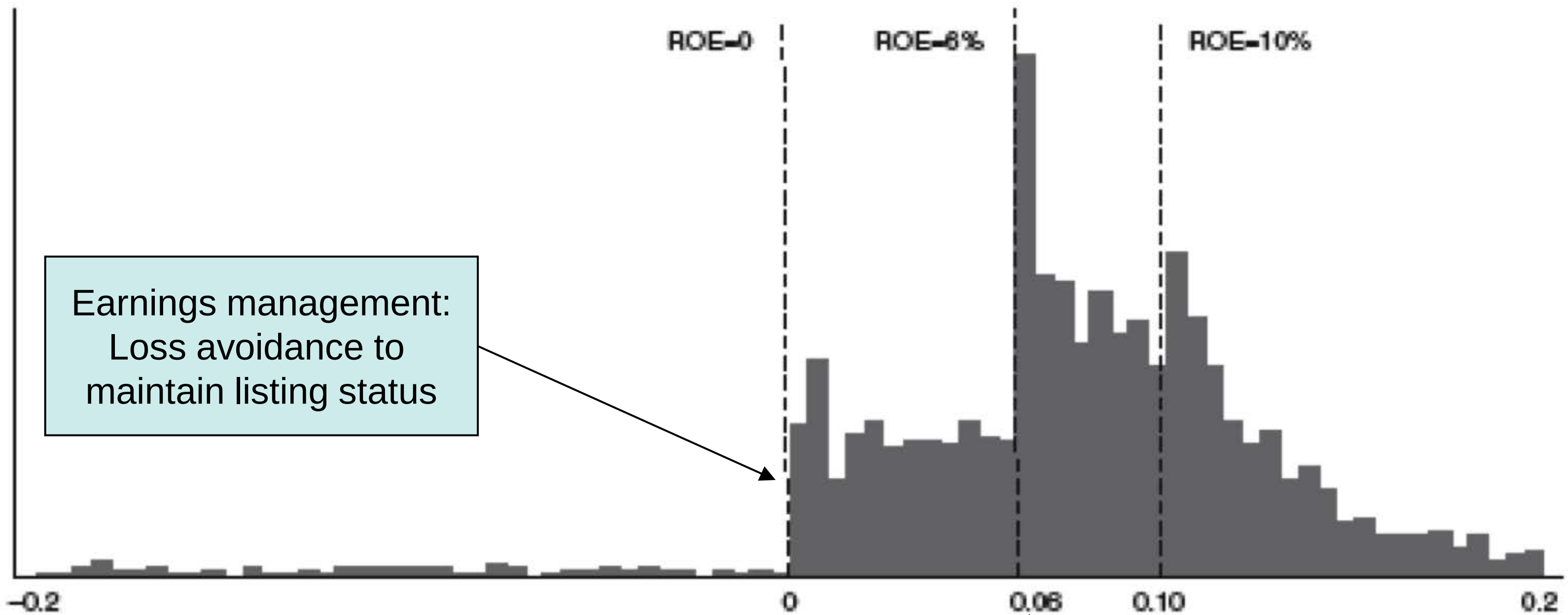


Fig. 3. The distribution of annual net income (Compustat item #172) scaled by beginning of the year market value (Compustat item #[illegible] × Compustat item #[illegible]). The distribution interval widths are 0.005 and the location of zero on the horizontal axis is marked by the dashed line. When the 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.

Distribution of Return on Equity Realizations of Chinese Listed Firms: Earnings Management around Regulatory Benchmarks

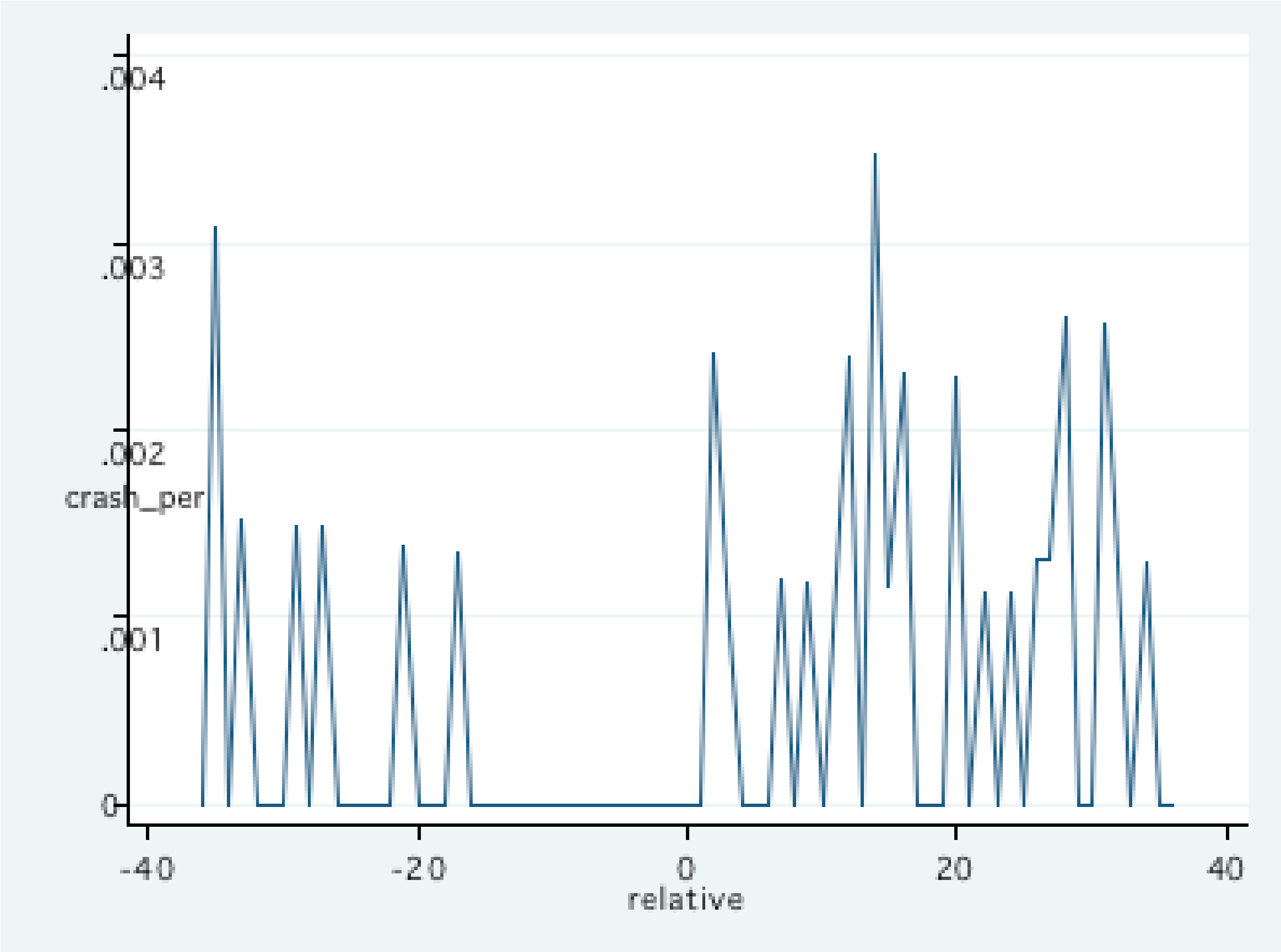


Earnings management: Loss avoidance to maintain listing status

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

Effective July 2002, firms seeking a seasoned equity offering must have a three year average ROE greater than or equal to 10% and have an ROE greater than or equal to 10% in the year preceding the offering. Firms seeking permission for a rights issuance must have three year average ROE of at least 6%. Similar rules have existed since the mid-1990s. (Chen and Wang, 2007)

Suppression of Negative Information:
Frequency of Significant Negative Stock Price Movements for State-Controlled Entities
Announcement of Political Promotions



Today’s Session

To better understand the dynamic information environment of China’s listed firms, our panelists will discuss …

- The influence of institutions, politics and cultural norms on transparency and governance in China
- Recent regulatory reforms and initiatives in China
- Recent government attempts to encourage Chinese firms listed in HK to switch to domestic (PRC) auditors.