
Corporate Transparency and Financial Reporting in China

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Outline

- ❖ Corporate governance matters when making investment decisions in China firms listed in the US and the mainland
- ❖ Low transparency is a result of China's economic, political and social institutions - price effects of accounting scandals and auditor choice
- ❖ Where do we go from here?

Governance and Investment Decisions

Governance matters when investing in China

- ❖ Many Chinese RTOs in the US are bad firms. They weren't even qualified to be listed in China or HK
- ❖ We find that governance predicted poor earnings quality but US market failed to distinguish good and bad Chinese (RTO) firms before and after the market crash (287 RTO firms)
 - ❖ Ownership concentration, professionalism of the board, management's overseas experience, founder staying as CEO or Chairman, market environment in which the firms operate
- ❖ The market also punished Chinese firms that went through regular IPO, regardless of their corporate governance
- ❖ Those Chinese firms delisting from the US recently are firms with better governance (32 firms between May 2010 to Sept 2012)
- ❖ Some are planning to list in HK

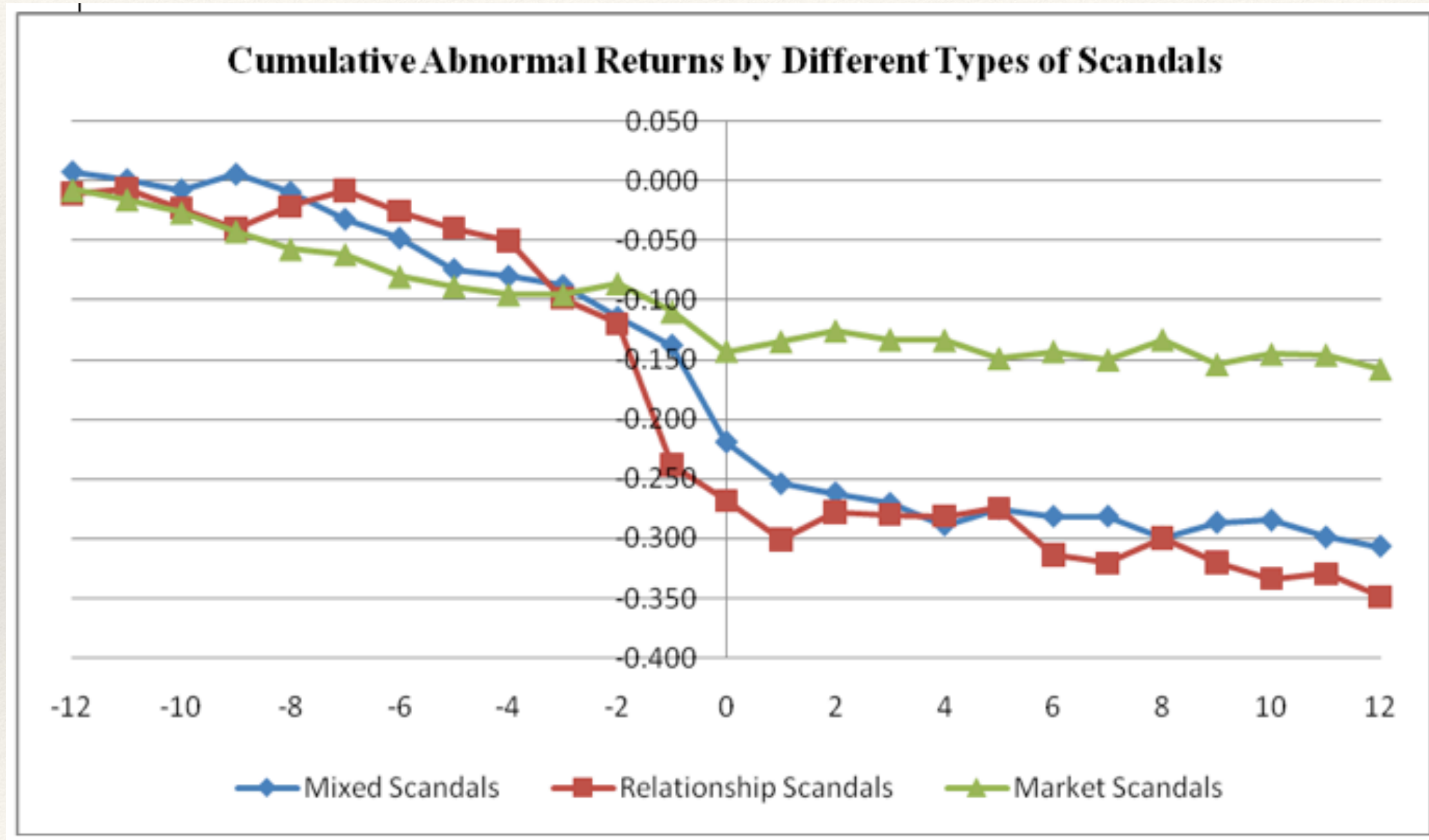
Investing with G-scores in A-shares

- ❖ Price = firms' discounted cash flows or earnings
- ❖ In China, future cash flows or earnings are noisy
- ❖ Price = (DCF|governance)
- ❖ G-score is based on OR, change in OR, subsidies, change in RPT, change in non-operating CF for SOEs
- ❖ F-score + G-score hedge portfolio with annual returns of 21% between 2000 to 2009
- ❖ Work better for firms in developed regions, followed by analysts and audited by top 10 auditors



Corporate Scandals

Value of transparency vs. political ties

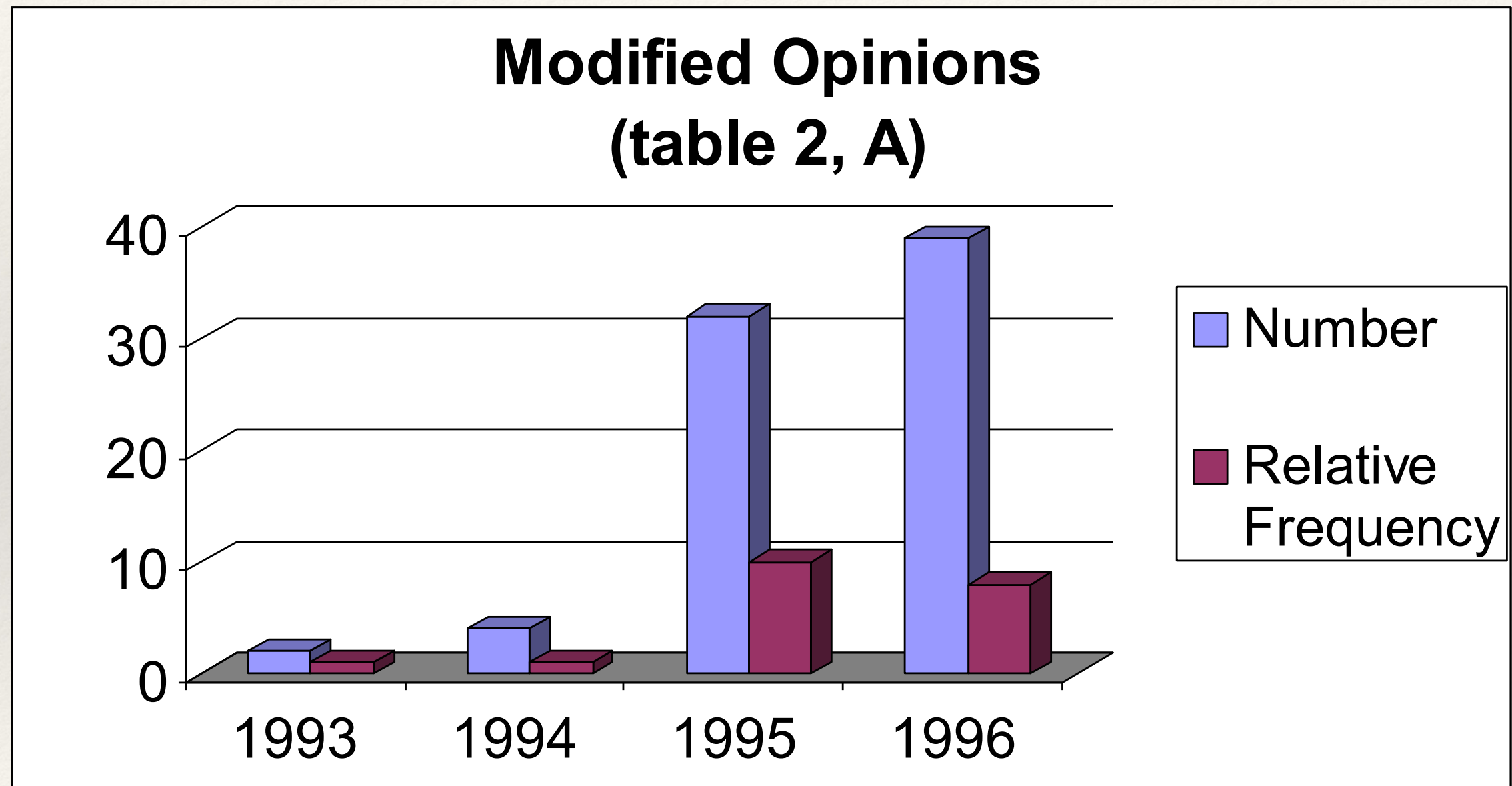


Corporate transparency vs. political networks

- ❖ Pure accounting scandals do not depress share prices as much as scandals that damage the ties with government
- ❖ Relationship-based contracting (social or political) is more important than market-based contracting
- ❖ Future research: how do we quantify firms' social and political networks and measure their effects on firm value?

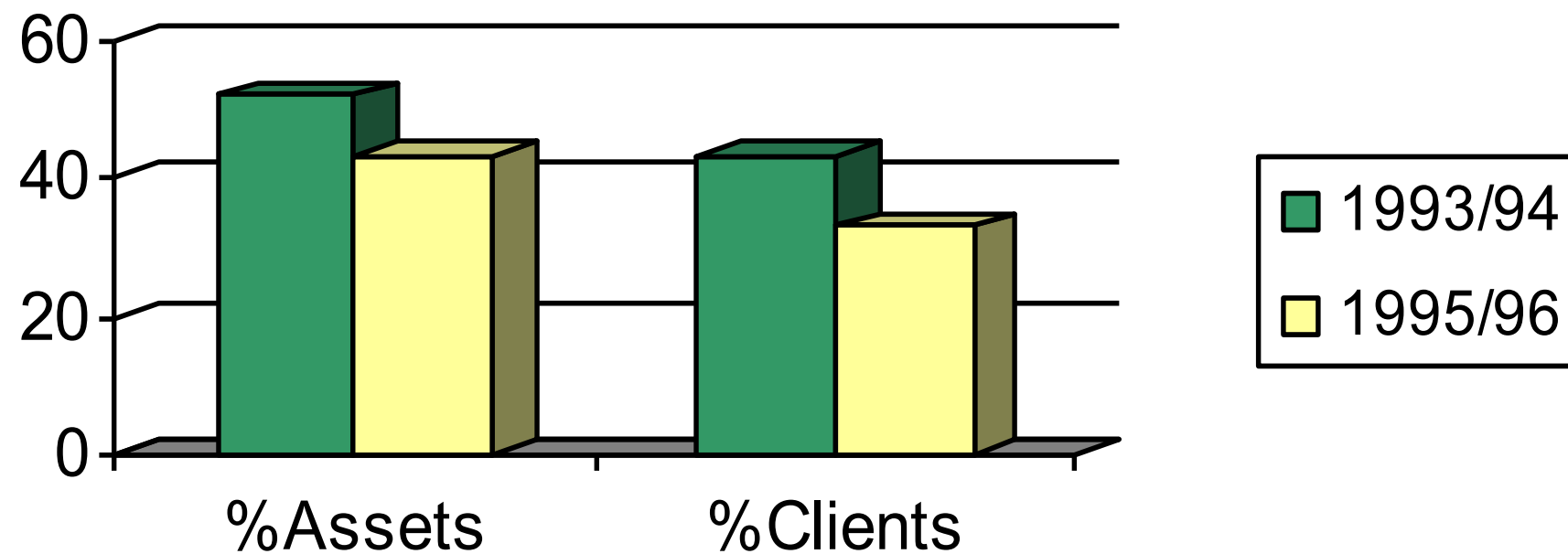
Auditing

Adoption of International Auditing Standards in 1995



Top 10 auditors losing market share

**Market Share of Top 10 Auditors,
excluding clients with foreign owners
(table 5, A)**



Local SOEs vs. Entrepreneurial Firms

- ❖ Local SOEs more likely to hire non-top 10 auditors
- ❖ This difference is more significant in regions with weaker market development
- ❖ When SOEs are privatised, the firms are more likely to hire top-10 auditors
- ❖ Local SOEs are not necessarily opportunistic. Simply lack of demand



Is low transparency and weak corporate governance of these SOEs optimal in such institutional environment?

Where do we go from here?

Helping Hand View

- ❖ China firms don't need high corporate transparency, especially these large SOEs. You have the government's backing. Investors price protect themselves.
- ❖ State capitalism is working. Look at the GDP growth in the past 10 years.
- ❖ Helping hand view - efficient building of infrastructure; tackling market failures; and pursuing social goals and perhaps long-term share values.

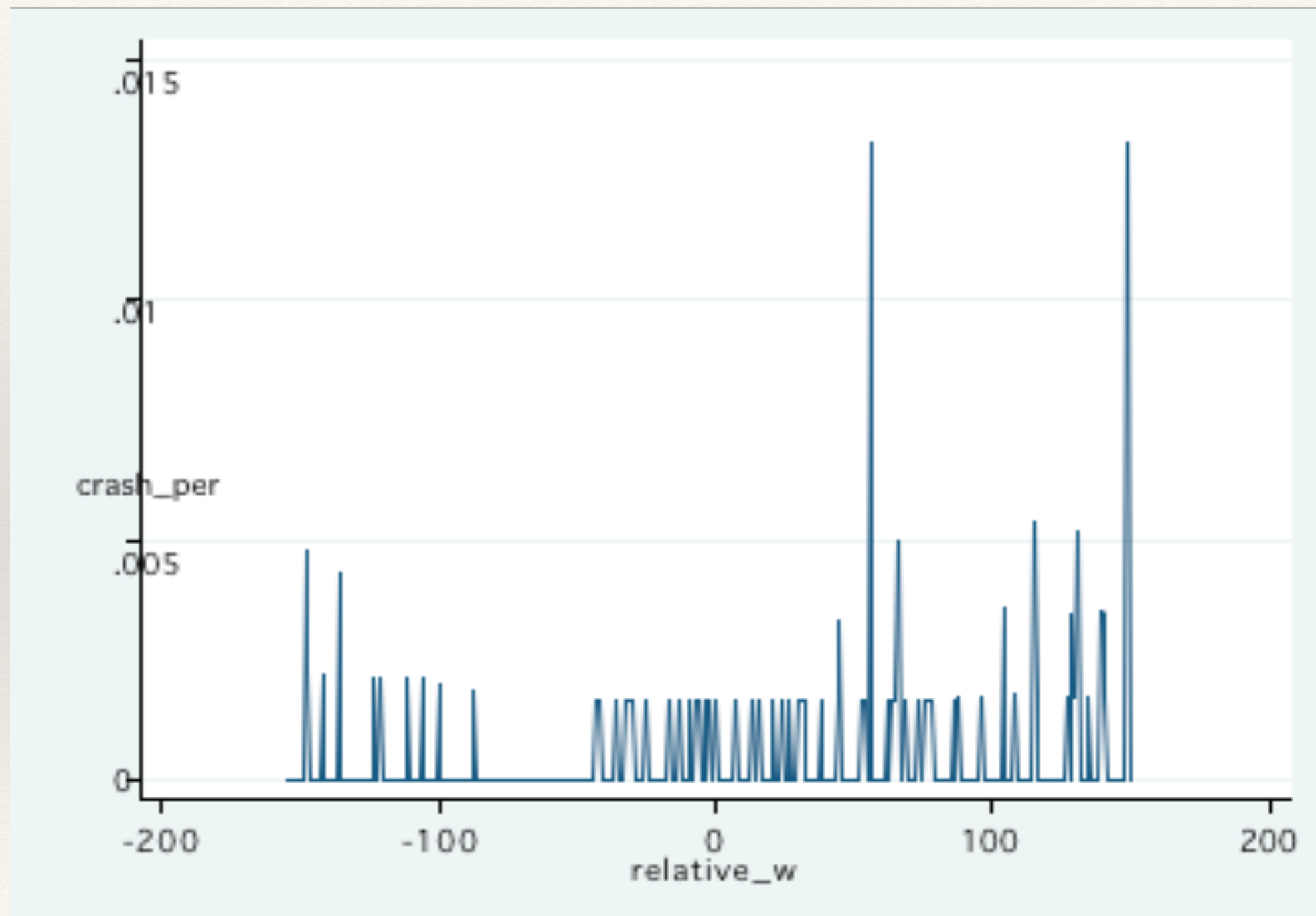
Grabbing Hand View

- ❖ Although the private sector generated 70% of the output (and 80% of the employment) in 2013, they received only 47% of the total fixed asset investment in 2012 (new book by Yasheng Huang at MIT).
- ❖ Not worry about whether the state has the ability (technology and know how) to allocate resources properly.
- ❖ More worry about crony capitalism - politicians pursuing private objectives and political goals at the expense of shareholders
- ❖ Excessive government control and low transparency will lead to:
 - ❖ Failure to invest in private sector, build markets and promote competitions that benefit investors and the economy
 - ❖ Discourage innovation and creative destruction that create consumer surplus but reduce politicians' and their cronies' economic rents.

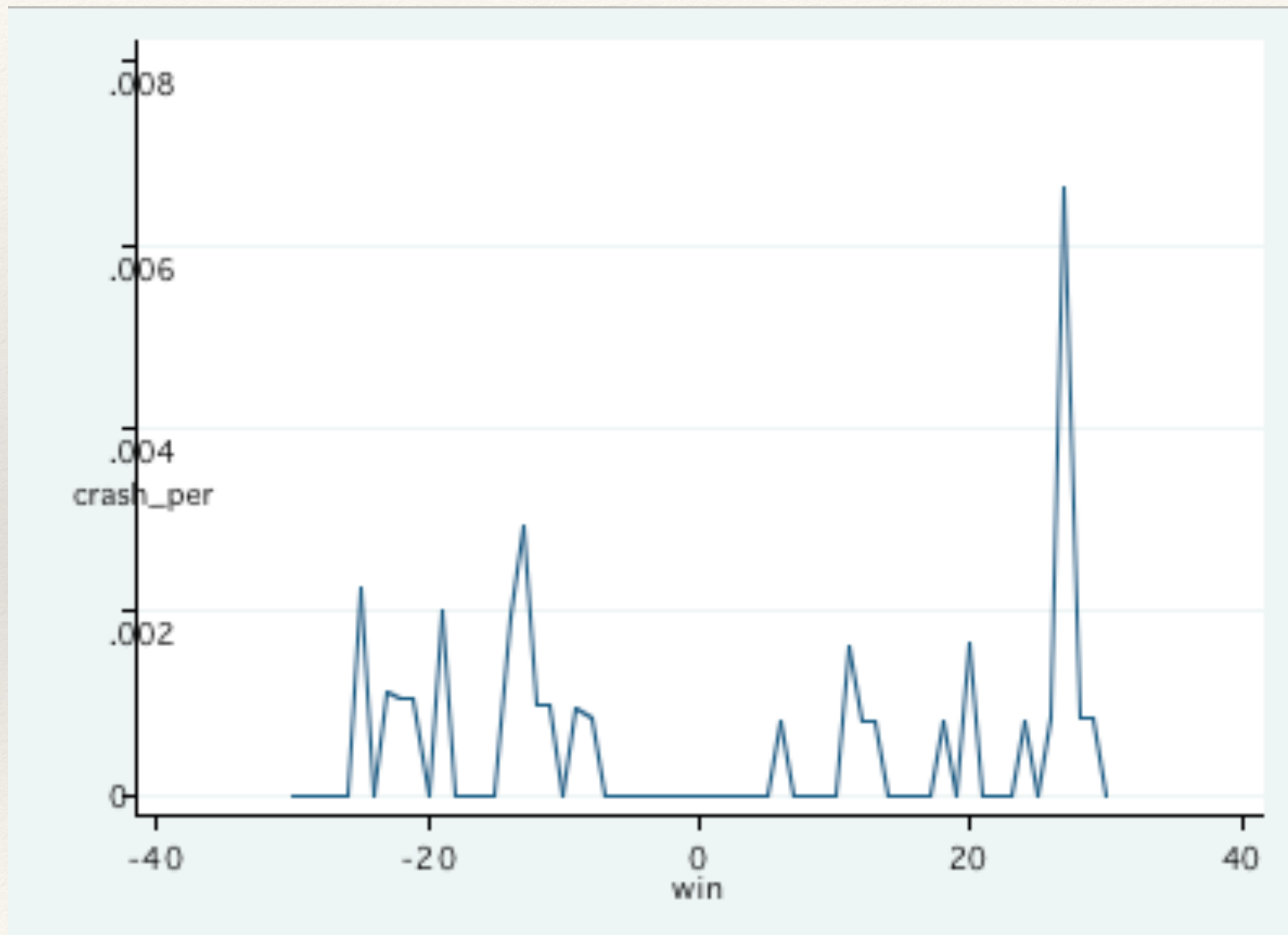
Political incentives and Transparency

- ❖ Good governance promotes reporting bad news early
 - conservatism
- ❖ Political incentives induce suppression of bad news around political events e.g. National Congress of the CCP and promotion of provincial leaders

Political promotion of provincial leaders



National Congress of CCP



Many CEOs are promoted to political jobs

- ❖ Many CEOs of the central government SOEs and large local SOEs are promoted to senior government positions
- ❖ Do they have incentives to suppress bad news and lower transparency?
- ❖ Do they sacrifice minority shareholders' benefits for political objectives e.g. promotion?



Where do we go from here?

- ❖ No denying that the state has done a lot in the past 10-20 years - consistently high GDP growth, amazing urban development and world-class infrastructure such as the high speed train
- ❖ But in the next phase of development, we need software (not just hardware), innovation and world class management for global competition
- ❖ We have to improve governance and transparency to make our firms more competitive
- ❖ Not just adopt IFRS but increase enforcement.
 - ❖ Establish independent judiciary court system that takes on civil lawsuits against cheaters. Not just relying on administrative governance.
- ❖ Level the playing field between state and private sectors to allow for more creative destruction and innovation.
- ❖ Limit the excessive intervention of the state. Let the SOEs operate like real companies.
- ❖ Can China do that?