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Ownership balance, supervisory efficiency of independent directors and the quality of management earnings forecasts

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ABSTRACT

In the Chinese securities market, with its characteristics of influence through personal relationships (*Guanxi*) and underdeveloped standards of law and enforcement, can independent directors play the supervisory role expected by securities regulators? In this study we use the degree of precision and accuracy in corporate earnings forecasts as proxies for the quality of information disclosure by listed companies and examine the supervisory efficiency of independent directors with respect to information disclosure. Using data from 2007 to 2009, we find that in the absence of ownership balance, independent directors have a significant positive effect on the accuracy of management forecasts. In addition, the personal backgrounds of independent directors have specific effects on management earnings forecasts. Directors with certified public accountant (CPA) expertise significantly improve the precision of management forecasts. However, directors with industrial expertise significantly reduce the precision of management forecasts. In other words, having directors with CPA expertise improves the independence of boards, but having independent directors with industrial expertise has the opposite effect.

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1. Introduction

The absence of ownership balance and the popularity of a single large shareholder are the most commonly mentioned causes of malpractice in Chinese share markets. Therefore, investors have for many years been calling for boards of directors with greater independence. In 2002, the Chinese Securities Regulatory Commission (CSRC) moved to improve the corporate governance structures of Chinese listed companies by issuing *The Guiding Opinions on the Establishment of Systems of Independent Directors* (hereafter referred to as the *Guiding Opinions*). Thereafter, the efficiency of independent directors became one of the most widely studied fields in the Chinese capital market. There are many extant studies on the relationship between independent directors and firm performance, which generally agree that supervision is the most important responsibility of independent directors (Ye et al., 2007; Wang, 2007a; Zhao et al., 2008). Recently, Wang et al. (2008) argue that the improvement in listed companies' levels of disclosure and transparency serves both to curb the dominance of large shareholders and to provide a basis for the appraisal of independent directors' supervisory efficiency.

In testing this theory, the main question that previous studies confront is how to measure the level of information disclosure in listed companies. The easiest and most accepted way is to use the rating scores given by independent institutions.¹ In China, however, only companies listed on the Shenzhen Securities Exchange (hereafter referred to as the SZE) are rated annually and those on the Shanghai Securities Exchange are not. The sample of rated companies is therefore limited, which raises difficulties for using rating scores as a proxy for the level of information disclosure. Because of this difficulty, previous studies have usually used variables such as earnings quality to proxy for the level of information disclosure. The measurement of earnings quality requires the use of statistical models and the derived variables may not be significantly related to the quality of information disclosure. For example, among the three variables used by Hu and Tang (2008), only the degree of earnings aggressiveness is significantly related to the rating scores given by the SZE and the degree of earnings management or earnings smoothness are not.

Another way to measure the level of information disclosure is to study the quality of one specific aspect of corporate reporting. The assumption here is that a measure of disclosure quality produced by examining any one aspect of corporate reporting could proxy for the general level of disclosure provided by a firm (Botosan, 1997). This assumption was tested and confirmed by Lang and Lundholm (1996), who document a significant rank-order correlation between annual report and other publication disclosure rankings, compared with the correlation between annual report and investor relations disclosure rankings. Building on this approach, Botosan (1997) used the degree of voluntary information disclosure found in a firm's annual report alone to serve as a proxy for the degree of disclosure provided by a firm across all avenues and created a transparency scoring system called the *DScore*. Li (2008) scored companies based on the readability of annual reports. Other studies (Graham et al., 2005; Wang, 2007b) have used the attributes of management earnings forecasts to proxy for the general level of disclosure. For Chinese listed companies, Bai (2009) find that the precision and the accuracy of management forecasts are significantly related to the transparency rating scores given by the SZE. In line with this approach, we choose the precision and accuracy of management forecasts to proxy for the general level of disclosure and use this measure to study the supervisory efficiency of independent directors.

We choose the quality of management forecasts to proxy for the general level of corporate disclosure for three reasons. First, management forecasting is an important aspect of corporate disclosure that has a significant influence on investors and financial analysts (Bai, 2009; Healy and Palepu, 2001). Numerous studies have used the quality of management forecasts to proxy for the level of information disclosure, such as Graham et al. (2005) and Wang (2007b).² Second, there is considerable scope for manipulation in management forecasting. Studies on voluntary management forecasts have found that management can manipulate the timing, precision and accuracy of management forecasts (Karamanou and Vafeas, 2005; Rogers and Stocken, 2005).

¹ For example, studies on American firms (Sengupta, 1998; Lang and Lundholm, 1996, etc.) usually use the rating scores provided by FAF (the Report of the Financial Analysts Federation Corporate Information Committee) and its successor AIMR (The Association for Investment Management and Research, which changed its name to The CFA Institute in 2004).

² Beyer et al. (2010) find that for the average firm, 28.37% of the variance in quarterly stock returns occurred on days when accounting disclosures (including earnings announcements, earnings pre-announcements, management forecasts, analyst forecasts or other SEC-form filings) are made. Surprisingly, management forecasts provided, on average, approximately 55% of accounting-based information (pp. 299–300).

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