



Corporate governance and forward-looking disclosure: Evidence from China



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ABSTRACT

This paper investigates the association between a range of corporate governance mechanisms and forward-looking disclosure (FLD) in a low information environment: the Chinese stock markets. It finds that the implementation of certain monitoring and control mechanisms, such as financial expertise on audit committees and independent directors on the board of directors, can improve the extent of FLD. However, the size of the supervisory board and separating the roles of the CEO and the chairman of the board of directors is of little help in explaining any improvement in FLD. In contrast, ownership structure appears to play an essential role in determining FLD policies. Indeed, listed firms with high levels of foreign ownership and fewer pyramidal layers in their ownership structure tend to disclose more forward-looking information. Of particular interest, the association between state ownership and FLD is likely to be non-linear (an inverted U-shape), and the inflection point at which the association becomes negative occurs at a state ownership over 33 percent. In summary, this study provides new evidence on the impact of corporate governance mechanisms on FLD in China's unique institutional environment.

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1. Introduction

Under the principal agent model, information asymmetry can considerably influence the contractual relationship, as agents who benefit from their private information lack incentives to reveal their insights. As such, there is a demand for corporate information disclosure by the principal and other information users (Beyer, Cohen, Lys, & Walther, 2010; Machio-Stadler, Pérez-Castrillo, & Watt, 2001). As a vital source of corporate information, forward-looking disclosure (FLD) can be an essential factor to assist information users to better understand what a firm's previous and present performance may be in the future (Bozzolan, Trombetta, & Beretta, 2009; Robert, 2010). In recent years, the research on forward-looking narratives in financial reports has been gaining increasing prominence. However, most studies focus on the usefulness, predictive value, and value relevance of FLD in developed markets (Athanasakou & Hussainey, 2014; Beyer & Dye, 2012; Hussainey & Walker, 2009; Rogers & Stocken, 2005; Wang & Hussainey, 2013). The research on FLD in emerging markets is sparse.

China is an interesting case because of its unique institutional environment. For example, listed Chinese firms typically have a more complex ownership structure than those in the West, and a considerable proportion of listed companies' shares are held by the government. Concentrated state ownership can impede corporate information transparency and trigger conflicts of interest between the state and minority shareholders (Su, Xu, & Phan, 2008). Consequently, the Chinese

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government has recently imported a stream of advanced corporate governance mechanisms from developed nations, with the aim of strengthening the internal monitoring and control of listed firms and improving the information environment of Chinese stock markets. In the meantime, Chinese accounting standards (CAS) have been gradually harmonized with international accounting standards (IAS/IFRS). Moreover, the China Securities Regulatory Commission (CSRC) issued the *Principles of Contents and Formats for Financial Disclosure by Listed Chinese Firms* in 2002, requiring a forward-looking statement to be provided in financial reports. The convergence of CAS with IAS/IFRS and the development of financial disclosure regulations obviously aim to facilitate listed firms' mandatory disclosure by providing more value-relevant information to investors. Additionally, the government has recently issued a series of policies on equity incentive plans for listed firms to mitigate the interest conflicts of the agent and the principal and to facilitate corporate information transparency. However, reforms in the legal and political systems have largely lagged behind, as a result of the government's concerns regarding losing control of large listed firms and the safety of state assets. Therefore, while the economic system is largely market-oriented, the legal and political systems are still strongly influenced by the communist ideology (Allen, Qian, & Qian, 2005). The unique features of China's institutional environment, along with the development of FLD regulations by the CSRC, provides an opportunity to investigate the impact of improved corporate governance and FLD by listed Chinese firms.

The following observations have been made from an analysis of a sample of SHSE (Shanghai Stock Exchange, 2008) listed firms' forward-looking statements and financial data over the period 2008–2012. First, although the majority of listed firms have complied with the CSRC's disclosure regulations by providing a forward-looking statement in their financial reports, these statements contain far more qualitative (soft) information than quantitative (hard) terms. Second, consistent with early studies, this investigation finds that the extent of FLD is positively associated with foreign ownership (Owusu-Ansah, 1998; Wang, Sewon, & Claiborne, 2008), independent directors (Beeks & Brown, 2006; Donaldson & Davis, 1994; Tam, 1999, 2000), and financial expertise on the audit committee (Badolato, Donelson, & Ege, 2014), and negatively related to complex pyramidal ownership structure (Chang & Wong, 2004; Fan & Wong, 2002). Interestingly, the impact of state ownership on FLD is likely to be non-linear (an inverted U-shape). Initially, the impact is positive when the level of state ownership is lower than 33 percent (the inflection point). However, the impact becomes negative when the state owns more than one-third of listed firms' equity. In contrast to the study by Ding, Zhang, and Zhang (2007), this study does not find any non-linear association between managerial ownership on FLD for SHSE-listed firms. Also, it finds that the size of the supervisory board and separating the roles of the CEO and chairman of the board of directors is of little help in explaining any improvement in FLD.

The contribution of this study to corporate governance and disclosure research lies in the following areas. First, it reconciles and extends the ongoing research on the determinants of corporate disclosure in developing markets (Bai, Liu, Song, & Zhang, 2004; Beeks & Brown, 2006; Chen, Cheng, Gong, & Tan, 2014; Eng & Mak, 2003; Gul & Leung, 2004; Owusu-Ansah, 1998; Wang et al., 2008). To the best of the author's knowledge, this is the first research paper that investigates the impact of corporate governance on FLD in a large emerging market. In particular, this study provides new evidence of a non-linear association between state ownership and FLD. Second, it examines the success of the Chinese government's importation of a wider range of corporate governance mechanisms than prior studies have done (Chen et al., 2014; Ding, Zhang, & Zhang, 2007; Wang et al., 2008; Yeh, Shu, Lee, & Su, 2009). For example, this research demonstrates that more financial expertise on an audit committee can improve its role in facilitating the extent of FLD, while the use of a complex pyramidal ownership structure by the government to mask its continued control over listed firms can exacerbate agency problems and make FLD less transparent. Also, it examines the combined effect (incentive-alignment vs. management entrenchment) of managerial stockholding on managers' willingness to provide more value-relevant information, such as forward-looking narratives, in listed firms' financial reports. This study therefore increases our understanding of the determinants of corporate disclosure in an institutional environment that is characterized by concentrated state ownership and complex ownership structures.

The remainder of this study is organized as follows: The next section reviews developments in China's accounting and corporate governance regulations, previous corporate governance and disclosure research, and develops the study's hypothesis. The sample selection and research methodology are presented in Sections 3 and 4 reports the empirical findings and analysis. The final section summarizes and concludes the study.

2. Background and hypothesis

2.1. China's stock market, accounting and corporate governance systems

In accordance with the economic liberalization and reform policy introduced by the Chinese government in the late 1970s, the SHSE and Shenzhen Stock Exchange (SZSE) were re-established in the early 1990s, aiming to modernize ailing state-owned enterprises (SOEs). However, they remain relatively underdeveloped and many listed companies are still directly or indirectly owned or controlled by the state, raising the possibility of conflict of interest between the controlling shareholders (the state and its agencies) and outside investors (Su et al., 2008). Moreover, while La Porta, Lopez-de-Silanes, and Shleifer (2008) classify China's legal system as being of German civil law origin, a unique feature of China's legal tradition is that the judicial system is not independent from the government's administrative system, and politics and adjudication are often mixed (Chen, 2003). Indeed, private property rights were recognized by China's legislative system for the first time in March 2004 during the second session of the Tenth National People's Congress Meeting. However, the definition and

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