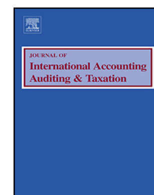
Journal of International Accounting, Auditing and Taxation 24 (2015) 29–45

Contents lists available at ScienceDirect

Journal of International Accounting, Auditing and Taxation



Corporate governance and financial reporting quality in China: A survey of recent evidence☆

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ARTICLE INFO

Article history:
Received 29 September 2013
Received in revised form
25 December 2014
Accepted 27 December 2014
Available online 6 March 2015

Keywords:
Corporate governance
Financial reporting quality
Regulations
China

ABSTRACT

We provide a survey of the empirical archival literature on the effect of different facets of corporate governance on financial reporting and audit quality in China. Our survey is motivated by the burgeoning literature on the effects of some unique Chinese governance factors on the properties of accounting information. Although surveys of Chinese governance abound, we observe a lack of any comprehensive review of the governance-reporting quality literature. One of the desirable properties of good corporate governance is to improve financial reporting quality for facilitating efficient resource allocation decisions by corporate managers. However, institutional differences among countries mean that governance needs to be flexible and responsive to local demands. China offers an interesting case for evaluating the role of corporate governance because of the dominance of state-control over listed companies, the mandatory responsibility for independent boards of directors to disclose their opinions on important board decisions publicly, and a very different audit market compared to Western counterparts. The shortcomings of the surveyed research is identified along with some suggestions for future research.

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1. Introduction

This paper provides a survey of empirical archival literature on the effects of corporate governance on financial reporting quality in China. Chinese corporate governance differs substantially from that of its Western counterparts. Although surveys on Chinese corporate governance abound, we observe a lack of any comprehensive survey of the corporate governance and financial reporting quality literature and, thus, are motivated to conduct a systematic review of this strand of the literature.

Corporate governance is a set of mechanisms through which outside investors protect themselves against expropriation by insiders (Shleifer & Vishny, 1997). A variety of firm-level mechanisms are associated with the governance of public corporations. These mechanisms can be classified into two broad categories—internal and external. Blockholders and the board of directors are often seen as the primary internal monitoring mechanism, while external auditing, market for corporate control, product market competition, and managerial labor market are some of the external governance mechanisms. One of the desirable properties of an effective corporate governance system is to ensure a high quality financial reporting regime for efficient resource allocation and economic growth. Financial reporting provides the primary source of independently verified information to capital providers about the performance of managers (Sloan, 2001).

☆ We thank two anonymous reviewers for helpful comments.
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http://dx.doi.org/10.1016/j.intaccaudtax.2014.12.002
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The significance of corporate governance mechanisms for ensuring high quality financial reporting arises from agency theory. This perspective has brought managerial decision making and various external and internal monitoring and bonding mechanisms to the forefront of theoretical discussions and empirical research. According to the Anglo-American version of agency theory, agency conflicts occur between dispersed shareholders and professional managers, because of the separation of ownership and control (Jensen & Meckling, 1976). The use of agency theory to explain the demand for corporate governance is questionable in emerging countries like China, where the nature of conflict shifts from principal-agent (P/A) to principal-principal (P/P). Despite this fundamental difference, many studies use Western agency theory to develop research questions examining the impacts of corporate governance on financial reporting quality (e.g., Chen, Firth, Gao, & Rui, 2006; Firth, Fung, & Rui, 2007).

China offers an interesting case for evaluating the role of corporate governance in financial reporting quality because of its unique cultural and historical background. Like many other countries, China is characterized by the dominance of state-control over listed companies[1]. In order to maintain state control over privatized corporations in China, the Chinese government requires a split share structure, consisting of non-tradable shares (NTS) and tradable shares (TS). This split share structure, established in the early 1990s, was intended to help finance state-owned enterprises, while retaining state control over their operation. The split share structure has caused severe agency problems between non-tradable share holders and tradable shareholders, prompting the China Securities Regulatory Commission (CSRC, 2007) to require the conversion of non-tradable shares into tradable shares. This regulatory change provides researchers an interesting context for assessing the efficacy of this reform for financial reporting quality (Hou, Kuo, & Lee, 2012; Jiang & Habib, 2012a, 2012b).

Corporate governance in China also differs with respect to the functioning of the independent board of directors. The CSRC issued ‘Guidelines for Introducing Independent Directors to the Board of Directors in Listed Companies’ in August 2001, imposing a mandatory requirement to include independent directors in corporate boards. Interestingly, CSRC also mandated that independent directors publicly disclose their opinions on important board decisions, a very different practice from that of other countries. Researchers could thus examine the antecedents for independent directors’ saying ‘no’ to important board decisions, such as the appointment of top executives, managerial compensation, financial reporting, material related party transactions, and important investment decisions. It is also possible to investigate the stock market reaction to such opinions, and the consequences for firms with dissenting independent directors with respect to inter-corporate lending, CEO turnover, and audit opinions.

A large body of accounting and auditing research has evolved over the years to address some of the above-mentioned research questions. Piotroski and Wong (2012) provide an excellent overview of the financial reporting environment in China from the perspective of the institutional influence on demand for, and supply of, credible accounting information. This review complements Piotroski and Wong (2012), by providing a systematic literature review of the effect of corporate governance on financial reporting and audit quality in China. Our findings should inform Chinese regulators on the efficacy of governance and recent governance reforms in producing accounting information useful for efficient resource allocation and contracting decisions. For example, one of the driving forces behind the government’s initiative for a transparent reporting regime is to attract more foreign institutional investment in China’s domestic capital markets (Ministry of Finance (MOF), 2006). Empirical research can provide insights about the success or failure of such initiatives. Investors should also benefit from this synthesis. Minority shareholders are vulnerable to expropriation by dominant or controlling shareholders in emerging economies, including China, and require stronger protection in terms of corporate governance. Evidence from academic research can be used for assessing the effectiveness of corporate governance mechanisms.

The present literature review synthesizes archival research published in a variety of accounting and auditing journals from 2000 onwards that examine the association between corporate governance (both internal and external) and financial reporting quality in China. Ownership structure and board of directors are the primary internal governance mechanisms examined, while research on external auditing encompasses the primary external governance mechanism. Although some Chinese accounting research was published in English language academic journals pre-2000, very few investigated the association between corporate governance mechanisms and financial reporting quality using archival data[2]. However, this scenario changed beginning in 2000 and provided the impetus for including more recent evidence[3].

We initially searched accounting journals with a heavy international focus including The International Journal of Accounting, International Journal of Auditing, Journal of International Accounting, Auditing & Taxation, Journal of Business Finance & Accounting, Asian Review of Accounting, Journal of Accounting and Public Policy, Advances in International Accounting and Journal of International Accounting Research. We also survey relevant papers published in China Journal of Accounting Research given its primary emphasis on the publication of archival empirical research on financial reporting and auditing. The review also includes relevant studies published in non-accounting journals following Bisman and Liao’s (2009) findings

[1] State ownership of listed companies is pervasive and growing elsewhere in the world. State-owned enterprises are now responsible for approximately one-fifth of global stock market value, which is more than two times the level observed just one decade ago (Pargendler, 2012)

[2] For example, Simunic and Wu (2009), in their review of China-related audit research, list only four publications in accounting journals over the period 1996–1999, none of which used empirical archival research paradigm.

[3] This is evident from Table 1.1 which lists major governance-related regulations in China. Most of these regulations came into effect in the period after 2000 (e.g. split-share reform, promulgation of a new set of accounting standards, SASAC rules on audit quality). Although regulations like ‘auditor disaffiliation program’ ‘Regulations for IPO and right issues’ were introduced in the 1990s, empirical research on the effect of these regulations began to appear in the post 2000 period [e.g., Gul, Sami, & Zhou, 2009 on auditor disaffiliation program].

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