



Do higher value firms voluntarily disclose more information? Evidence from China



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A B S T R A C T

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This paper examines the effect of *guanxi* on the relation between firm value and voluntary disclosure of information about new investment projects in China's institutional setting. We find a negative relation between firm value and voluntary disclosure for firms that rely heavily on *guanxi* in their value creation (e.g. non-high-tech firms, and firms located in regions with underdeveloped institutions). By contrast, for firms that rely less heavily on *guanxi* and more on other sources of core competencies (e.g. high-tech firms, and firms in high-marketisation regions), we find a positive relation between firm value and voluntary disclosure. The moderating role of *guanxi* on the relation between firm value and voluntary disclosure is explained by firms conscientiously balancing the costs and benefits of voluntary disclosure relative to *guanxi*. Specifically, high *guanxi*-dependence firms refrain from detailed voluntary disclosures for fear of revealing sensitive information that may harm their *guanxi*. In contrast, low *guanxi*-dependence firms rely more heavily on voluntary disclosures to reduce information asymmetry and financing cost, with such incentives being particularly strong for high value firms. Our evidence has implications for research on motives for disclosure and regulation of financial reporting.

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1. Introduction

Voluntary disclosure is a hotly debated research topic with important managerial and policy implications. Early studies of motives for voluntary disclosure (Grossman, 1981; Milgrom, 1981) argue that management has the incentive to voluntarily disclose private information in order to lower information asymmetry, mitigate adverse selection risk, and reduce financing cost. This line of thinking suggests that high value firms should have greater incentives to engage in voluntary disclosure because doing so helps to lower their cost of capital and avoid a price discount in a market for “lemons” (Akerlof, 1970). However, recent research (e.g. Bamber & Cheon, 1998; Li, 2010; Nagar, Nanda, & Wysocki, 2003) has not supported a positive association between firm value and voluntary disclosure. At least two reasons may be cited as to why higher value firms may not disclose more information. First, firms may choose not to disclose information if the benefits of disclosure are outweighed by the associated costs, such as proprietary cost (Armitage & Marston, 2008; Dye, 1986; Healy & Palepu, 2001; Jovanovic, 1982; Verrecchia, 1983; Wagenhofer, 1990). Second, firms may not disclose information because there is no private information to disclose in the first place (Dye, 1985; Hribar, 2004; Jung & Kwon, 1988; Verrecchia, 1983). So far, there is little consensus on firms' motives for voluntary disclosure, even in developed economies.

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Despite the fact that China has become one of the largest economies in the world and is unique in many dimensions and may not easily fit into existing western economic theories (Chow, 1997; Ke, Rui, & Yu, 2012), there is scant research on factors influencing corporate voluntary disclosures in China. Our paper aims to fill this gap in the literature. We focus on China primarily because its institutional features make it an ideal setting in which to examine the motives of voluntary disclosure and how it relates to firm value. A distinctive feature of business dealings in Chinese society is a generally high level of dependence on *guanxi* (interpersonal ties, relationships or connections). *Guanxi* network includes not only relationships with other companies, but also relationships with government agencies and bureaucrats. As a form of human capital (Chow, 1997), *guanxi* opens dialogues, builds trust, and facilitates exchanges of favours for organisational purposes (Hoskisson, Eden, Lau, & Wright, 2000). It is believed that *guanxi* can be a substitute for formal institutional support and is used to access resources (Peng & Heath, 1996; Xin & Pearce, 1996). It also enables companies to overcome institutional barriers and instability in the face of regulatory changes (Luo, 2003; Park & Luo, 2001), and even helps enforce legal contracts (Chow, 1997). Therefore, a good *guanxi* network becomes a company's distinctive competitive advantage in terms of accessing scarce resources and lowering financing cost, which in turn can lead to high value (Hoskisson et al., 2000; Khwaja & Mian, 2005; Park & Luo, 2001).

We argue that firms that rely heavily on *guanxi* in their value creation are more inclined to use *guanxi* to lower information asymmetry and the cost of capital. Therefore, voluntary disclosure in China is generally associated with low marginal benefit, and there is little urgent need for many Chinese firms to use voluntary disclosure to access outside resources. From the viewpoint of costs, *guanxi* has dark sides and represents potential pitfalls for firms (Gu, Hung, & Tse, 2008). Specifically, *guanxi* is characterised by its uniqueness and secrecy, and thus high *guanxi*-dependence firms are generally reluctant to disclose sensitive information, as the more information disclosed, the more likely and easily a competitor may see through the network of relationships and consequently exploit or imitate such relationships (Lu, 2003). Furthermore, because *guanxi* is sometimes linked to nepotism, cronyism and even corruption (Day, 2003), detailed disclosures pertinent to *guanxi* networks may cause dissatisfaction to connected parties. All these dark sides of *guanxi* may aptly be regarded as a type of proprietary cost. Our institutional analysis and the generally positive association between firm value and *guanxi* (Luo & Chen, 1997; Peng & Luo, 2000) thus suggest that on average high value Chinese firms are less likely to voluntarily disclose firm-specific information.

Rather than investigating disclosure of general information, we focus on firms' decisions on whether to disclose details of their planned investment projects, for the following reasons. First, Chinese regulations require firms to disclose their plans to launch new investment projects, but leave to firms' discretion whether to disclose details of such projects. Thus, we can observe that the information in question (details about new investment projects) does exist, whereas much of the previous literature examines disclosure contexts in which firms' non-disclosures may reflect managerial choices or merely the fact that firms do not have the information to disclose (Ellis, Fee, & Thomas, 2012). Therefore, the results of our analysis of disclosures regarding new investment projects are not subject to the ambiguities inherent in interpreting results in the contexts examined in prior literature. Second, firms that plan to launch new investment projects are more likely to seek external financing, and hence have stronger incentives to engage in voluntary disclosure.¹ By contrast, firms without new investment projects are likely to have lower demand for outside capital and thus have fewer incentives for voluntary disclosure. For the latter type of firms, non-disclosure of detailed information may not be due to their ability to access resources through *guanxi*. Instead, non-disclosure is likely due to their lower financing needs, as well as concerns over disclosure-related costs. Therefore, by focussing on firms that plan to launch new investment projects, we may increase the power of our tests.

In addition, given that information about firms' new investments is highly relevant to investors (e.g. Chung, Wright, & Charaenwong, 1998; McConnell & Muscarella, 1985), examining how firms' dependence on *guanxi* affects their disclosures regarding new investment projects represents an important contribution to the literature on disclosure choice and regulation of financial reporting. To our knowledge we are among the first to investigate this important issue, which has implications beyond China's market setting.

Using non-financial Chinese listed firms during 2007–2010, we find that, on average, there is a negative relation between firm value and voluntary disclosure. We also find a negative relation between firm value and voluntary disclosure for those firms which rely heavily on *guanxi* in their value-creation process or new investment projects (e.g. non-high-tech firms, and firms located in provinces with underdeveloped institutions). However, for high-tech companies that depend less on *guanxi* and more on technological innovations, we find a positive relation between firm value and voluntary disclosure. Furthermore, we find that in the coastal regions of Southeast China where formal institutions are better developed and marketisation has taken hold, the influence of *guanxi* is weaker such that higher value firms in these regions are more willing to disclose detailed information about their new projects.

We contribute to the literature in the following ways. First, we show that the relation between voluntary disclosure and firm value is moderated by factors that reflect firms' business economics and institutional reality. The mixed results in prior studies may thus be attributable to the failure to account for key moderating factors. Second, we find that heavy dependence on *guanxi* may create or exacerbate information asymmetry and results in lower levels of voluntary disclosure. The evidence is consistent with the proprietary cost hypothesis.

¹ Beyer et al. (2010) note that the demand for additional funds increases when firms have new investment opportunities. Lang and Lundholm (2000) find that firms dramatically increase the disclosure activities six months prior to seasoned equity offerings.

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