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Accounting information quality, governance efficiency and capital investment choice

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ABSTRACT

This paper examines the relationship between accounting information quality and capital investment choice from the perspective of accounting information's governance function. Measuring capital investment choice as the correlation of growth of operating income between company and industry, this paper investigates whether and to what extent companies focus on their core business. The results show that the higher the quality of publicly listed firms' accounting information, the stronger that correlation, particularly when the corporate governance of the listed company is poor. The findings imply that accounting information quality can thus optimize the capital investment choice, which complements and strengthens the functioning of corporate governance. Hence, regulators should pay more attention to the market's power to supervise the behavior of listed firms, improve the governance functions of accounting information and increase the efficiency of capital allocation.

1. Introduction

China's stock market has developed rapidly since 1990, when the capital market was set up. The number of listed companies increased from 10 in 1990 to 2063 in 2010. In the 1990–2010 period, about 5253.7 billion yuan in outside capital flowed into listed companies by initial public offerings, seasoned equity offerings or corporate bonds (China Statistical Yearbook, 2011). Whether companies allocated the capital into their own core businesses has become a very important issue, which more and more market participants are focusing on.

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However, this paper finds that in the 2000–2011 period, about 63.7% of capital was allocated to non-core operating activities, against their original investment plans. There are an average of 53 million yuan for each change, the average 6.7 months of change frequency, and the average 3.6 times change for every firm. Moreover, almost 69.6% of all the changes are inefficient. The frequent changes of the capital investment directions have become a notable problem in China, which severely harms capital allocation efficiency. Many scholars pay attention to this issue and research on it from the views of implementing laws and regulations or improving corporate governance, but the effect of these suggestions is not good to date. Based on this important issue, this paper examines the governance function of accounting information and whether high accounting information quality can form an enforcement mechanism to push management to make capital investment more efficiently.

Since China's Accounting Law was implemented in 1985, the Chinese government has devoted effort to complete the accounting principles system and related rules to improve accounting information quality. In 2006, the Chinese Ministry of Finance issued new accounting principles comprising one basic accounting standard, 38 specific standards and application guides that have been applied to publicly listed companies since 2007. The goal of these standards is to ensure the firms to provide useful accounting information and to help investors make good investment decisions. These accounting standards are created to reduce the information asymmetry between investors and listed companies, helping investors better understand those companies' risks and thus make more rational investment decisions. However, in China's current special institutional background, can accounting information also serve a governance function to influence managements' capital investment choice?

There are several objective external forces that enhance the governance function of accounting information in China's capital market. By the end of 2010, the country's number of securities investment funds had reached 704, with 2.4228 trillion yuan in total assets (China Statistical Yearbook, 2011). Institutional investors also play an important role in China to dig up and transfer the information disclosed by listed firms, compared with other investors. More importantly, institutional investors can also respond more quickly to abnormal accounting information, "vote by foot", and finally improve the market efficiency. We believe that in the long term, high-quality accounting information can help these investors to identify inefficient investments, and in turn incur the pressure on stock price by investors' voting by foot. In an efficient market, the potential decrease in stock prices will further push management to make good investments. Meanwhile, other market forces, such as individual investors and the media, have also begun to pay more attention to interpreting accounting information, and thus finally constrain and supervise the managements' investment behavior. Hence, accounting information has become increasingly important in China to optimize corporate capital investments.

This paper examines whether and how accounting information quality has an effect on corporate investment choices, based on the governance function of accounting information. This issue is very important to government, market participants, current and latent investors, and listed firms. Addressing this issue will help them (such as market participants) better understand the governance function of accounting formations, so as to help them make good decisions.

2. Literature review

Many researchers, both Chinese and foreign, have explored the role played by accounting information quality and information transparency in market efficiency. For example, Zhou and Chen (2008) investigate the influence of the transparency of industry accounting information on industry-level capital allocation based on data from all A-share listed companies on the Shanghai and Shenzhen exchanges from 1999 to 2004. They measured capital allocation efficiency as the allotment of shares and amount of newly raised funds, focusing on whether external capital flows to the best industries. Zhou and Chen (2008) find industry accounting information transparency to exert a significant effect on resource allocation, such that the more transparent that information is, the higher the efficiency of resource allocation.

Based on 3600 firm-year observations of A-share listed companies on the Shanghai and Shenzhen exchanges from 2004 to 2006, Li (2009) examines the influence of accounting information quality on the under- and over-investment of listed companies. His results show that high-quality accounting information