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A Tale of Two Segmented Markets in China: The Informative Value of Corporate Environmental Information Disclosure for Foreign Investors☆

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ABSTRACT

Focusing on the unique setting of two segmented stock markets in China and using a sample of Chinese listed firms issuing both A-shares and B-shares during the period of 2007–2014, this study examines the influence of corporate environmental information disclosure on foreign share discount, and further investigates the moderating effect of globalizing the board. The findings show that environmental information disclosure is significantly negatively related to foreign share discount, suggesting that environmental information disclosure provides valuable and incremental information to mitigate information asymmetry between domestic and foreign investors, and thus reduces foreign share discount. Moreover, globalizing the board reinforces the negative relation between environmental information disclosure and foreign share discount. These findings are robust to alternative measures of environmental information disclosure and foreign share discount, and further, these conclusions are still valid after controlling for the endogeneity problem.

1. Introduction

In China, there are two segmented stock markets: A-share and B-share markets, which are mainly open to domestic and foreign investors, respectively (Sun and Tong, 2000). In the Chinese stock market, B-shares (foreign shares) are traded at a significant magnitude of discount relative to A-shares (domestic shares) (Bailey et al., 1999; Sun and Tong, 2000), known as the "foreign share discount puzzle" (Fernald and Rogers, 2002). Focusing on the "foreign share discount puzzle" in China, this study aims at examining the influence of environmental information disclosure on foreign share discount (i.e.,the price disparity between A-share and B-share). A thin body of literature has addressed whether corporate social responsibility (CSR) helps local (domestic) investors obtain incremental information to value a firm (Berthelot, Cormier, and Magnan, 2003). Nevertheless, so far, extant studies have provided little evidence on whether CSR information can mitigate information asymmetry between foreign investors and local investors, facilitate foreign investors to value local firms, and reduce foreign share discount. To fill this gap, this study focuses on environmental information disclosure (a specific CSR dimension) to examine its effect on the cross-sectional variations in the magnitude of foreign share discount. In addition, this study further addresses the moderating effect of the globalizing board.

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Prior studies found that corporate governance (Tong and Yu, 2012), disclosure disparity (Tang, 2011), illiquid B-share markets (Chen, Lee, and Rui, 2001), information asymmetry between foreign and domestic investors (Bergström and Tang, 2001; Fernald and Rogers, 2002), clientele biases, diversification effects, risk-free return differentials, and foreign exchange risks (Bergström and Tang, 2001; Hou & Lee, 2014) affect foreign share discount. However, prior literature has not provided much evidence on whether environmental information disclosure can reduce foreign share discount through mitigating the information disadvantage of foreign investors compared to local investors. In response, this study examines the relation between environmental information disclosure and foreign share discount.

Domestic investors can obtain local knowledge and have full access to a variety of information sources, and thus have an information advantage over foreign investors (Leuz, Lins, and Warnock, 2010; Mian, 2006). Information asymmetry between local investors and foreign investors may lead to foreign share discount in the Chinese stock market (Bergström and Tang, 2001; Fernald and Rogers, 2002). Therefore, the disclosure that can mitigate foreign share discount needs to be incrementally more informative for foreign investors than for local investors. Given that foreign investors value CSR more than domestic investors (Grażyna, 2012), foreign investors may be more dependent on environmental information disclosure than domestic investors. Serious environmental pollution in China is another reason for foreign investors to pay additional attention to the environmental information disclosure. Environmental pollution tends to cause negative contingent events in the future (e.g.,a hefty fine or even operation discontinuity)—which are less likely to be directly known by foreign investors (due to information asymmetry) and result in reputation losses and negative image (Du, Chang, Zeng, Du, and Pei, 2016). In this regard, information asymmetry between foreign and local investors can be mitigated to some extent through environmental disclosure, which is incrementally more informative for foreign investors than for domestic investors (Bondy and Starkey, 2014). Therefore, this study predicts that environmental information disclosure is negatively related with foreign share discount.

This study also examines how globalizing the board of directors (i.e. having at least one foreign director) moderates the relation between corporate environmental information disclosure and foreign share discount. Globalizing the board is found to be related with higher independence of corporate boards (Du, Jian, and Lai, 2017; Masulis, Wang, and Xie, 2012), and thus it can be expected to strengthen the trust of foreign investors in a firm's financial information and other information sources. Extant studies find that globalizing the board can improve financial reporting at an earlier stage (Financial Reporting Council, 2010) and ensure the credibility of environmental information by improving the board's decisions and monitoring ability (Du et al., 2017). As a result, globalizing the board can increase the relative informativeness of environmental information disclosure. Based on this premise, I predict that globalizing the board reinforces the mitigating effect of environmental information disclosure on foreign share discount.

Using a sample of Chinese listed firms issuing both A-shares and B-shares during the period of 2007–2014, first, I find that environmental information disclosure is negatively associated with foreign share discount, and a standard deviation increase in environmental information disclosure leads to a 1.89% reduction in foreign share discount. Second, globalizing the board is negatively related to foreign share discount and strengthens the mitigating effect of environmental disclosure on foreign share discount. Third, these findings are robust to alternative measures of environmental information disclosure and foreign share discount and are still valid after addressing the issue of endogeneity. Fourth, additional tests of the channels by which environmental information disclosure mitigates foreign share discount reveal that: (1) environmental information disclosure (ENV) predicts financial performance in the subsequent period; (2) ENV mitigates bid-ask spread in B-shares (but not for A-shares)[1]; (3) ENV mitigates foreign share discount regardless of whether it is in accordance with Global Reporting Initiative (GRI, 2006); (4) ENV in separate CSR reports reduces foreign share discount (but ENV in bundled reports cannot); (5) foreign investors from far countries (regions) value ENV more than those from near countries (regions); (6) statutory requirements on ENV in polluting industries is negatively related to foreign share discount to a greater extent; and (7) seven components of ENV mitigate foreign share discount by various degrees.

This study makes two contributions to the existing literature: First, this study is one of very few studies that focus on the two segmented markets in China to explore the impact of environmental information disclosure on foreign share discount. This study extends the literature based upon the liquidity hypothesis and the information asymmetry hypothesis (Abdel-Khalik, Wong, and Wu, 1999; Fernald and Rogers, 2002). While Bergström and Tang (2001), Domowitz, Glen, and Madhavan (1997), and Sun and Tong (2000) have examined the effects of specific determinants (e.g.,corporate governance mechanisms, disclosure disparity) on foreign share discount (Chen et al., 2001; Ma, 1996; Tang, 2011), these studies do not discuss whether the CSR disclosure (or specific CSR dimensions) affects foreign share discount. My study finds that environmental information disclosure reduces foreign share discount by mitigating information asymmetry between foreign and domestic investors. In this regard, my study adds to the existing literature by probing into the effect of environmental information disclosure on foreign share discount. Second, this study finds that globalizing the board reduces foreign share discount and reinforces the mitigating effect of environmental information disclosure on foreign share discount, contributing to prior literature on the relation between governance mechanisms and foreign share discount (Hou and Lee, 2014; Tong and Yu, 2012).

The remainder of this paper is organized as follows. The second section introduces institutional background and develops research hypotheses. The third section reports research design, including sample and data, empirical models, and variables. The fourth section reports descriptive statistics and main findings, and then conducts sensitivity tests and endogeneity tests.The final section summarizes conclusions, including managerial implications, limitation discussions, and future research directions.

[1] Specific to stock markets, the bid-ask spread of a firm's stock refers to the amount by which the ask price exceeds the bid price. In other words, the bid-ask spread is the difference between the maximum price that buyers pay for a firm's stock and the minimum price that sellers sell it. Thus, in essence, a bid-ask spread can be viewed as the index to reflect the supply and demand for a firm's stock.