A Study of Voluntary Disclosure by Listed Firms in China

by

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ABSTRACT

The Chinese corporate disclosure environment has changed dramatically during the past two decades as a result of political, economic and social changes in China. The establishment of the regulatory framework for corporate disclosure and the emergence of new stakeholder groups have created a challenging disclosure environment for listed firms in China. The purpose of this study is to investigate the response of Chinese listed firms to the changed corporate reporting environment in respect to their disclosure behavior. The investigation is conducted by examining the voluntary disclosure of strategic, financial and non-financial information in 297 listed firms’ annual reports in the 1995 to 2006 reporting periods. The empirical findings aim to explain 1) to what extent the level of voluntary disclosure of listed firms in the Chinese stock market has changed over the period 1995-2006, and 2) what factors have contributed to the changes in the level of voluntary disclosure in the Chinese stock market. The established theoretical framework based on legitimacy theory and stakeholder theory predicts that listed firms would assess stakeholder attributes and identify powerful stakeholders in the Chinese stock market. Voluntary disclosure is one of the strategies adopted by firms to manage the firm-stakeholder relationship.

The findings of this study show that voluntary disclosure made by listed firms in the Chinese stock market increased over the testing period, meaning firms have positively reacted to the changed corporate disclosure environment in China. Firms’ ownership structure, corporate governance-related factors and economic attributes are used to represent either stakeholder’s political or financial stake in listed firms. The findings show that state ownership has a significant negative impact on firms’ disclosure decisions, whereas foreign investment has a significant positive influence on firms’ voluntary disclosure. The corporate governance
régime in the Chinese stock market has exerted pressure on listed firms in respect of information disclosure and investor protection. International audit firms were found to play a positive and significant role in improving disclosure transparency among listed firms.

This study extends the literature by using a legitimacy and stakeholder theoretical framework to explain corporate disclosure changes in the Chinese context. China has displayed significant political, economic and social changes in the past three decades. This thesis, therefore, contributes to the literature by using a system-oriented view to explore disclosure behavior changes in an emerging capital market. More specifically, this longitudinal study enriches the corporate disclosure literature by investigating the implications and impact of the changing disclosure environment on the level of voluntary corporate disclosure made by listed Chinese firms in the context of a rapidly developing Chinese stock market.
LIST OF ABBREVIATIONS

AMC: Asset Management Company  
ASCT: Australian Society of Corporate Treasurers  
CASB: China Auditing Standards Board  
CASC: China Accounting Standards Committee  
CBRC: China Banking Regulatory Commission  
CCP: Chinese Communist Party  
CICA: Canadian Institute of Chartered Accountants  
CICPA: Chinese Institute of Certified Public Accountant  
CPA: Certified Practice Accountancy  
CSR: Corporate Social Responsibility  
CSRC: China Security Regulatory Commission  
EPS: Earnings per Share  
GAAP: Generally Accepted Accounting Principles  
IAASB: International Auditing and Assurance Standards Board  
IFRS: International Financial Reporting Standard  
IPO: Initial Public Offer  
ISA: International Standards on Auditing  
ISO: International Organization for Standardization  
MBE: Market to Book Equity Ratio  
MOF: Ministry of Finance (in China)  
NPL: Non-Performing Loan
<table>
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<tr>
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<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>PBOC</td>
<td>People’s Bank of China</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities Exchange Commission (in US)</td>
</tr>
<tr>
<td>SEHK</td>
<td>Stock Exchange Hong Kong</td>
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<tr>
<td>SEPA</td>
<td>State Environmental Protection Agency (in China)</td>
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<td>SOE</td>
<td>State-Owned Enterprise</td>
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<td>VDS</td>
<td>Voluntary Disclosure Score</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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CHAPTER 1

INTRODUCTION

1.1 Purpose of the study

The Chinese corporate disclosure environment has changed dramatically during the past two decades. Chinese accounting standards have been harmonized with the International Financial Reporting Standards (IFRS) and the regulatory agencies of the Chinese government have gradually established a comprehensive regulatory framework for corporate information disclosures in the Chinese stock market. The economic reforms launched in China since the late 1970s have led to some significant changes to Chinese society. Increased international competition and direct foreign investment, rapid development of the Chinese stock market and stakeholders’ demands for transparent information have all created a challenging disclosure environment for publicly-listed firms in China. The purpose of this study is to investigate the impact of the changed disclosure environment on disclosure behavior of listed Chinese firms. The investigation is conducted by examining the voluntary disclosure of strategic, financial and non-financial information made by listed Chinese firms in their annual reports in the 1995-2006 reporting periods. The study investigates empirically whether listed Chinese firms have increased their voluntary disclosure due to pressure from public stakeholders over the years and whether their voluntary disclosure can be explained by
legitimacy theory and stakeholder theory. Both theories and the theoretical framework based on them are elaborated on in Chapter 2 and Chapter 5.

Section 1.2 of this chapter describes the general context of this study. Factors that have motivated this study are discussed in Section 1.3, and Section 1.4 specifies the research issues. Two key terms used in this thesis, voluntary disclosure and corporate disclosure environment, are defined in Section 1.5. Section 1.6 overviews the theoretical framework established for this study and explains the research methods employed to address the research questions. Research findings of this study are summarized in Section 1.7. Section 1.8 discusses the contributions this study makes to the financial accounting literature. Section 1.9 outlines the structure of the remainder of the thesis.

1.2 Context

The general context for this study is the fast-growing economy in China, the rapid development of the Chinese stock market and complexities associated with the Chinese stock market. In the late 1970s, the Chinese government implemented an economic reform program and an open-door policy to promote economic growth. The success of these strategic actions is evident with the growth in China’s GDP averaging 10% percent per annum over the 1990 – 2004 period, driven mainly by huge state investment in infrastructure and heavy industry, and by rapid growth of the private sectors (Wikipedia, 2010). International trade has been a major component supporting China’s economic growth. With its global trade exceeding US$2.4 trillion at the end of 2008, China has become an indispensable participant in the global economy. The Chinese government has also focused on attracting foreign investment as
another driving force for China’s economy. By 2006, China had received US$69.5 billion in foreign director investment (World Bank, 2007), making it the world’s top destination for capital inflows. To capture the competitive advantage, more than 400 of the top 500 largest companies worldwide have investments in China (People’s Daily, 2005c). A survey conducted by the Organization for Economic Co-operation and Development (OECD) in China recommends that China represents one of the most sustained and rapid economic transformations seen in the world economy in the past fifty years, and the pace of economic change is likely to be sustained for some time (OECD, 2005).

The establishment of the Chinese stock market is a direct outcome of the economic reform in China. The Shanghai and Shenzhen Stock Exchanges were officially opened in 1990 and 1991, respectively. The development of China’s stock market is pivotal to the privatization of the country’s state-owned enterprises (SOEs). Since its establishment, the Chinese stock market has been transformed from a fledgling, emerging market to the largest emerging stock market in the world. It is now the biggest stock market in Asia outside Japan, with 1879 firms listed on two stock exchanges and a total market capitalization equivalent to US$2.6 trillion at the end of 2009. There are approximately 146 million individual investors in the Chinese stock market (CSRC, 2009).

Corporations have emerged in China following the profound SOE reforms. From the beginning of the 1990s the Chinese government has transformed many SOEs into corporations with a formal legal status, business structure, expanded administration and decision-making powers to increase their operational efficiency and make them more competitive. Since then, these corporations no longer have privileges in obtaining continuous fund injections from the Chinese government; these enterprises must seek capital
resources from financial institutions and the capital market. For over a decade, publicly-listed firms have benefited most from the fast expansion of the Chinese stock market, raising more than US$96.6 billion of capital funds from public investors (CSRC, 2009).

Despite fast growth, the Chinese stock market maintains a low information environment for public investors (Lam and Du, 2004). A major problem lies in the lack of transparent corporate information available to assist investors and other market participants to effectively make informed decisions (Lin and Chen, 2005). Several high-profile corporate scandals between 1998 and 2002\(^1\) further confirm the view that Chinese corporate disclosure generally lacks transparency. This problem derives from the unique characteristics of the Chinese stock market. The difference between tradable shares and non-tradable shares, and between domestic invested class A shares and foreigner invested class B shares prior to 2005, complicated the internal control and share trading of listed firms. The diversified and conflicting interests between majority shareholders and minority shareholders have led to “one dominating state-owned share monopolization” and “insider control”\(^2\) in listed firms (Xu and Wang, 1999). To maintain the confidence of domestic and international investors, the Chinese government has demanded corporate governance and disclosure transparency from listed firms in recent years (CSRC, 2000).

In October 1992, the General Secretary of the Communist Party of China, Jiang Zemin released the government report *Speed up Reform, Achieving Victory in Building up Socialist Undertaking with Chinese Distinguishing Features* at China’s 14th National People’s

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\(^1\) Financial scandals occurring between the late 1990s and early 2000s included Hongguan Shiye (1997), Hainan Qiong min run (1999), Xingye Juzhi (2001) and Yinguanxia (2001).

\(^2\) Both terms are elaborated on further in Chapter 4 under the institutional background discussion.
The significance of this government report is to confirm that the Chinese economy is moving from a socialist economy towards a “socialist market economy” and one of the essential factors supporting the sustainable economic development in China is the development of its capital market. General Secretary Jiang stated explicitly in the government report that the standardization and prosperity of the capital market in China would serve to optimize the allocation of resources, thereby promoting the growth of the national economy.

To ensure sustainable development of the Chinese stock market, a regulatory framework on securities has been gradually established since the opening of the Shanghai and Shenzhen Stock Exchanges. The National People’s Congress issued *Company Law* in 1993 and *Security Law* in 1999. The stipulation of the *Company Law* is to meet the needs of establishing a modern enterprise system and to standardize the organization and activities of companies in the socialist market economy. The issuing of the *Security Law* represents a new stage of legislation and regulation of the Chinese capital market. Its implementation has become the cornerstone for regulating the Chinese capital market in subsequent years, with the purpose of protecting minority investors’ interests (Tomasic and Andrews, 2007). Between 1992 and 2000, the State Council promulgated a series of important regulations, particularly addressing the trading activities in the Chinese stock market and disclosure requirements for listed firms, and aimed at improving the efficiency of the Chinese stock market and attracting both domestic and international investors. The established regulatory framework of the

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3 In China, the National People’s Congress is the essential political system. According to the Chinese constitution, people are the owners of the country and all the rights of PRC belong to the people. The National People’s Congress is the supreme agency in which people exercise the state’s right and the National People’s Congress has the authorities of making country’s policies and decisions, and also exercises the country’s legislative rights (Zhang, 2005). The reports given, the proposals passed and decisions made in the National People’s Congress set the mainstream “tune” of China’s political reform, economic development and social changes. The State Council is the highest administrative authority and decision making authority.

4 The State Council of the People’s Republic of China, namely the Central People's Government, is the highest executive organ of state power, as well as the highest organ of state administration. The State Council is responsible for carrying out the principles and policies of the Communist Party of China as well as the regulations and laws adopted by the National People’s Congress, and dealing with such affairs as China's internal politics, diplomacy, national defense, finance, economy, culture and education.
Chinese stock market sends a strong signal to Chinese society and global markets that the development of a capital market is essential to China’s long-term economic prosperity.

1.3 Motivation

This investigation of voluntary disclosure made by listed Chinese firms from 1995 to 2006 is motivated by the significance of the Chinese stock market to the nation’s economy and social development. The dramatically changed disclosure environment in China during the past two decades and the impact of a changed disclosure environment on firms’ disclosure behavior in the Chinese stock market over the years is also examined.

1.3.1 Significance of the Chinese stock market

The significance of the Chinese stock market is its profound impact on China’s national economic development and social development. Since its establishment, the backbone of the Chinese stock market is constituted by large-scale and profitable enterprises such as Bao Steel, China Life, China PingAn Group and Daqin Railway. The stock markets have listed firms coming from a wide range of industries including manufacturing, telecommunications, electronics, electricity, power, petroleum, chemicals and financial sectors (CSRC, 2009). The stock market has enabled Chinese enterprises to access more financial resources. By the end of 2007, listed firms had raised a total of US$246 billion from share issues. These funds have facilitated the growth of the Chinese corporate sector, making them more competitive in terms of productivity and strengthening their corporate governance through diversified ownership structures.
In respect of its influence on China’s social development, the Chinese stock market has diversified Chinese people’s investment channels. Wealth management has become increasingly popular among Chinese investors. The number of individual investment accounts increased significantly from 8.4 million in 1992 to nearly 138 million by the end of 2007, and a total of US$74 billion was distributed as dividends to investors during that period. The Chinese stock market has facilitated the improvement of the social security system, with more insurance and social security funds being invested in the Chinese stock market. The development of the Chinese stock market has also nurtured new industries and a large number of professionals are engaging in underwriting, brokerage, asset management, legal and accounting consultation, financial analysis and financial planning (CSRC, 2009).

Evidence shows that the Chinese stock market has become a growing driving force of the Chinese economy. As one of the direct results of the Chinese economic reforms, the Chinese stock market has led the development of the corporate sector in China and demonstrated its strong influence over China’s social development.

1.3.2 The dramatically changed disclosure environment in China

A country’s disclosure environment comprises its political context, social environment and economic system (Frank, 1979; Perera, 1989; Salter, 1998). In China, during the past three decades, the economic reform has led to fundamental changes in almost every aspect of the social life of the Chinese people. Politically, Premier Deng Xiaoping (1977-1989) and General Secretary Jiang Zemin (1989-2002), two of the leaders of the Chinese Communist Party (CCP) in the post-Mao Zedong era (1949-1976), abandoned Mao’s political class struggles and fights as the main theme of Chinese society. They gave priority to economic
reform and development. As a result, the Chinese people have benefitted with reduced poverty, higher incomes and improved living standards under Deng and Jiang’s leadership. The “Open Door” policy not only brings China capital investment, advanced technology and global markets, but also exposes Chinese people to the social environment of other Asian and western countries. Some traditional social values and social norms have gradually been transformed by the interactions between the Chinese value and Western value systems. As Kunkel (1970) suggested, economic development would lead to the changing of those selected aspects of man’s social environment which were relevant to the learning of new behavior patterns. Chinese society has changed some of its value system, for example, from a collectivist and feminist society to one exhibiting characteristics of individualism and masculinity\(^5\) (Ralston et al., 1999). These value changes are reflected in Chinese people’s new material focus and their worship of wealth.

Rapid development of the Chinese economy requires new accounting, reporting and disclosure systems to meet its needs. The financial accounting conceptual framework for Chinese enterprises was established by a comprehensive accounting system reform launched by the Chinese government in the early 1980s. The Chinese government’s “Open Door” policy and China’s accession to the World Trade Organization (WTO) in 2001 have motivated huge foreign investment inflows into the Chinese economy. These economic measures give the government more impetus to align Chinese financial accounting systems and standards with internationally accepted accounting standards and practices.

The establishment of the Chinese stock market leads to the separation of ownership and management in listed firms. There has been fundamental change in financial reporting and

\(^5\) Hofstede (1984) identifies these four value dimensions as large versus small power distance, strong versus weak uncertainty avoidance, individualism versus collectivism and masculinity versus femininity. These value dimensions will be explained in detail in Chapter 3.
disclosure. The fundamental change is that the objective of corporate disclosure has changed from satisfying the information needs of internal management and relevant government departments, to satisfying the information needs of public investors. The Ministry of Finance (MOF) and the China Security Regulatory Commission (CSRC) are the two main government regulatory agencies managing and regulating the stock market. Since the mid-1990s, they have issued a series of regulations to govern corporations’ information disclosure and corporate governance practices. The roles played by the MOF and the CSRC suggest that the Chinese government is willing to improve the information transparency of corporate disclosure and protect the interests of public investors in the stock market. In addition to the state government, new stakeholder groups for listed firms have emerged. Investors, creditors and accounting professional associations are interested in firms’ performance and external disclosure as they possess either economic or political stakes in those firms. The stakeholder groups exert different degrees of pressure on listed firms to disclose more transparent information.

1.3.3 The impact of changed disclosure environment on firms’ disclosure behavior

A firm’s information disclosure includes its disclosure mandatorily required by regulations and its voluntary disclosure. Compared to mandatory disclosure, voluntary disclosure can reflect firms’ disclosure behavior changes better, as voluntary disclosure is the excess information voluntarily disclosed by firms for economic or social consideration and benefit (Lang and Lundholm, 1993; Healy and Palepu, 1995; Deegan, 2002; O’Donovan, 2002). Voluntary disclosure practices vary from country to country as they can be driven by the different information needs of stakeholders such as government, regulators, investors, environmentalists or other interested parties in society. The content of firms’ voluntary
disclosure has been investigated worldwide. The Steering Committee under the Financial Accounting Standard Board (FASB) in the US reports that American firms voluntarily disclose business data (for example, operating data), management’s analysis of business data (for example, the identity and past effect of key trends), forward-looking information (for example, management plans), information about management and shareholders (for example, management compensation and major shareholders), background about the company (for example, broad objectives and strategies) and information about intangible assets (FASB, 2001). Key recommendations given by the Steering Committee are that firms in the US should increase their voluntary disclosure of intangible assets, forward-looking information and disappointing news. Among European countries, Brennan (2001) reports low voluntary disclosure of intellectual capital in Irish firms’ annual reports. Bozzolan et al. (2003) find a high level of voluntary disclosure about firms’ customers, distribution channels and business collaborations. Vandemaele et al. (2005) compare voluntary disclosure made by firms from Sweden, UK and Holland and conclude that Swedish firms’ voluntary disclosure of intellectual capital is higher than in the other two countries.

The development of the Chinese stock market during the past twenty years provides a good research opportunity to explore voluntary disclosure practices thoroughly in the Chinese context through a longitudinal study. The longitudinal approach enables researchers to ascertain the main information content listed firms prefer to voluntarily disclose, and the information which listed firms avoid disclosing. A long-term trend of voluntary disclosure since the early days of the Chinese stock market and any changes related to it can also be traced by repeating observation of the same sample firms.
Factors motivating corporate voluntary disclosure have been broadly studied in western countries (Chow and Wong-Boren, 1987; Cooke, 1991; Skinner, 1994; Zarzeski, 1996; Healy and Palepu, 2001). Most of these studies have investigated the relationship between the level of voluntary disclosure and stock prices, and firms’ costs of raising capital. Firms’ specific characteristics such as firm size, industry classification, leverage and profitability have been identified as determinants of firms’ disclosure decisions. The Chinese stock market has attracted some research attention in recent years due to its rapid development and distinctive institutional setting. Two studies have particularly concentrated on voluntary disclosure made by Chinese listed firms. Researchers use some variables closely associated with the unique characteristics of the Chinese stock market. Xiao et al. (2004) investigate voluntary internet-based disclosure made by the largest 300 listed firms in 2001 and find that factors including type of auditor, foreign listing, and legal-person ownership are positively related to firms’ voluntary disclosure, while state ownership is negatively related to voluntary disclosure. The findings of Xiao and Yuan (2007) show the positive association between foreign ownership and firms’ voluntary disclosure. Their study is based on a sample comprised of 559 firms listed on the Shanghai Stock Exchange in 2002. The single test periods in both empirical studies are not able to generate a trend of changes in voluntary disclosure among listed firms in the Chinese stock market. These studies also haven’t identified the key influential factors behind firms’ disclosure decisions over a sufficiently long period of time.

Although it has frequently been discussed that factors such as firms’ efforts to gain reputation and pressures from corporate regulatory bodies may also be driving the voluntary disclosure practices, not enough empirical research has been done to provide evidence supporting these assertions in the literature (Boesso and Kumar, 2007). Given the dramatic changes in the corporate disclosure environment in China, this study intends to argue that environmental
factors have played a major role in improving disclosure transparency in the Chinese stock market. Empirical research on voluntary disclosure in the Chinese stock market over a long period of time would provide evidence to test Boesso and Kumar’s assertion.

1.4 Basic research questions

The aim of this study is to investigate and explain the response of listed firms to the changing corporate reporting environment in respect of their disclosure behavior in China. The improved disclosure behavior could be measured by the increased extent of corporate disclosure to the Chinese stock market. This thesis adopts this measurement method. Transparent information disclosure in corporate annual reports can be partly achieved by following mandatory disclosure requirements. Corporate disclosure promulgation is aimed at improving the relevance, reliability and comparability of corporate information. This goal could be achieved by standardizing accounting rules determining the recognition and measurement of figures presented in the financial statements, or by prescribing the nature, quality and quantity of both financial and non-financial information to be presented and disclosed in corporate annual reports (Chalmers, 2001). In the Chinese stock market, listed firms must follow mandatory disclosure requirements. Xiao (1999) reveals that there is a high level of compliance of mandatory disclosure requirements among listed firms in the Chinese stock market.

The other way to improve disclosure transparency is through voluntary disclosure. The issue of voluntary disclosure is of significance to the global business community. Its importance can be evidenced by the voluntary disclosure frameworks developed by the Financial
Accounting Standard Board (FASB, 2001) in the US, the OECD (OECD, 2001), the Association of Chartered Certified Accountants (ACCA, 1999) and the Institute for Social and Ethical Accounting (ISEA, 1999) in UK. Voluntary disclosures are aimed at reducing the information asymmetry between firms and investors and provide clarification about long-term business sustainability that concerns various stakeholder groups.

Why is voluntary disclosure chosen to represent disclosure behavior change in China rather than mandatory disclosure? In the annual reports released in the Chinese stock market, listed firms make mandatory information disclosures. The compulsory character of disclosure is governed at national level through regulatory agencies in China. External reporting emerged in China after the establishment of the Chinese stock market at the beginning of the 1990s. It has taken the Chinese government nearly two decades to establish and complete corporate reporting and disclosure regulatory frameworks in China. The implication of this development process is that, even in the presence of mandatory disclosure regulations, full information disclosure is not guaranteed. Initially, the mandatory disclosure requirements of the Chinese stock market, compared with the mandatory disclosure requirements in a developed stock market, could not typically ensure that investors had all the information they needed for making efficient investment decisions. The Chinese government and its agencies have learned how to embrace internationally-accepted accounting standards themselves over the years. This situation supports why regulatory agencies in China encourage listed firms to voluntarily disclose information which, in their view, is useful for investors’ decision-making.

Academic literature shows that voluntary disclosure behavior is influenced by social and economic factors that are specific to firms, aggregately and individually. Listed firms’
voluntary disclosures could be the result of the changed social, economic and political environment, regulations put in place by government agencies, or the pressures of public investors and other stakeholder groups. Therefore, to investigate the disclosure behavior changes of listed firms since the establishment of the Chinese stock market, an examination of voluntary disclosure made by listed firms will achieve more effective results than examining firms’ mandatory disclosure.

This study argues that the corporate disclosure environment has changed dramatically in China over the past twenty years and it is expected that these changes would have impacted on corporate disclosure behavior. To investigate how the changed disclosure environment has impacted on listed firms’ voluntary disclosure, this study addresses these two specific questions:

RQ1: To what extent the level of voluntary disclosure of listed firms in the Chinese stock market has changed during the 1995-2006 period?

RQ2: What factors have contributed to the changes in the level of voluntary disclosure in the Chinese stock market?

1.5 Definitions

Two important key terms are defined in this section: voluntary disclosure and corporate disclosure environment.
1.5.1 Voluntary disclosure

Both regulatory bodies and academic researchers have defined voluntary disclosure. The FASB defines voluntary disclosure as the information primarily outside the financial statements that is not explicitly required by accounting rules or standards (FASB, 2001). Meek et al. (1995) define voluntary disclosures as the disclosures made in excess of requirements. They represent free choices on the part of company management to provide information deemed relevant to the decision needs of users of their annual reports. Al-Razeen and Karbhari (2004) divides annual corporate disclosure into three categories: (1) compliance with mandatory disclosure, (2) depth of disclosing mandatory disclosures, and (3) the extent of other voluntary disclosures. Without the distinction between the voluntary disclosures that are closely related to mandatory disclosure requirements and other types of disclosures, it is difficult to differentiate the information mandatorily required, the information exceeding the mandatory requirement and the information that has no direct relationship to mandatory requirements.

For the purpose of this study, voluntary disclosures are the additional disclosures made by listed firms in their annual reports in addition to the statutory required information. These disclosures include:

- Information closely related to mandatory disclosure requirements where the depth of disclosing exceeds the minimum mandatory disclosure requirements.

- Information that has no direct relationship to the mandatory disclosure requirements.

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6 The depth of disclosing mandatory disclosures is explained by Al-Razeen and Karbhari (2004) as the extra information that exceeds the minimum requirement of mandatory disclosure regulations.
Voluntary disclosures are also classified by academic researchers into three types, namely, strategic, financial and non-financial information disclosure (Meek et al., 1995; Eng and Mak, 2003). Following prior academic studies, this thesis adopts the following perspectives on voluntary disclosure:

- Strategic information includes general corporate information, corporate strategy, acquisition and disposals, research and development, and future prospects.
- Financial information includes sections such as segmental information, financial review, foreign currency information and stock price information.
- Non-financial information includes information about directors, employee information and social policy.

1.5.2 Corporate disclosure environment

A number of international accounting studies have documented variations in financial accounting, reporting and disclosure practices across different countries. Diverse environmental factors have been suggested to explain differences in disclosure levels between countries (Frank, 1979; Belkaoui, 1983; Adhikari and Tondkar, 1992; Salter, 1998; Archambault and Archambault, 2003; Hope, 2003). Belkaoui (1983) examines international differences in reporting and disclosure adequacy and relates these differences to the economic and political environment of each country. In his study, political rights, civil liberties and the political system constitute a country’s political environment, while the economic system, growth rate of income, government expenditure, gross national product and exports are components of the economic environment. Adhikari and Tondkar (1992) and Salter (1998) focus on the impact of a country’s economic factors and equity market factors on its corporate financial disclosure practices. The type of economy, degree of economic
development, level of foreign investment, development and size of the stock market, and activities on the stock market are employed as the elements of the disclosure environment. Another branch of international accounting studies looks at the roles of a country’s social environment in explaining variations in annual report disclosures (Jaggi, 1975; Violet, 1983; Perera, 1989; Eddie, 1990; Gray and Vint, 1995; Salter and Niswander, 1995; Chanchani and Willett, 2004). These studies either develop their own theoretical frameworks to explore the relationship between a country’s social environment and its accounting practices or empirically test Gray’s (1988) accounting model, which links the social dimension of Hofstede (1980) and accounting values. The empirical results of these studies indicate that it is impossible to dismiss culture as an explanatory variable for firms’ disclosure choices.

A comprehensive multinational test of determinants of corporate disclosure was conducted by Archambault and Archambault (2003). This study develops a model which combines political, economic and social factors that influence the financial disclosure of corporations. It extends the literature on disclosure by considering a larger number of variables that represent determinants of disclosure, and by empirically testing the model using a large number of countries. Political factors include the freedom people have in a society, the legal system and the role of the media. A country’s economic system includes the development of its economy and its capital market, and its corporate system includes the ownership structures, auditors, leverage, size, industries and foreign sales. Social factors include education and religion, in addition to Hofstede’s (1980) four social dimensions.

For the purpose of this study, the corporate disclosure environment in China consists mainly of three environmental categories: the political environment in China, its economic system

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7 The four accounting values are professionalism versus statutory control, uniformity versus flexibility, conservatism versus optimism, and secrecy versus transparency.
and the social environment in Chinese society. Each category includes components developed by prior studies and some specific variables related to the Chinese context. The components of each category are as follows:

**Political environment**

The political environment in this study includes the political system of the Chinese Communist Party (CCP) before the late 1970s, and the CCP’s political reform since the early 1980s.

**Economic system**

The economic system includes the stage of economic development, the objectives of financial reporting, the source of, and authority for, accounting standards and disclosure regulations, the establishment of corporate governance, the education, professional training and licensing system, and the enforcement of standards and regulations.

**Social environment**

The social environment includes the traditional Chinese norms and values, and changes in those norms and values in modern Chinese society.

### 1.6 Overview of the study

The theoretical framework developed for this study is based on legitimacy theory and stakeholder theory. Findings of prior studies based on information perspective and contracting research paradigm suggest that a firm’s characteristics, including firm size, leverage, profitability and industry classification, are determinants of a firm’s voluntary disclosures (Chow and Wong-Boren, 1987; DeAngelo, 1988; Ng and Koh, 1994; Zarzeski, 1996; Leventis and Weetman, 2004). These economics-based views, however, limit their

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8 These three environmental categories are elaborated on in detail in Chapter 3 when the political, economic and social changes in China over the years are discussed.
investigation of firms’ voluntary disclosure to the relationship between investors and the firms’ management, without considering the broader social impact on corporations’ behavior. In recent years, academic studies have used legitimacy theory and stakeholder theory to explain the voluntary disclosure of social and environmental performance made by corporations in western countries (Deegan, 2002; Deegan et al., 2002; O’Donovan, 2002). These two theories consider corporations operate in a society where various stakeholder groups exist. Corporations’ performance and achievements are affected by these stakeholder groups and, meanwhile, are affecting the quality of stakeholders’ lives. To legitimize their social status and improve their social image, corporations need to comply with the ‘social contract’ between society and corporations. Corporations need to satisfy powerful stakeholders’ demands in terms of information disclosure. Social and environmental disclosure is a means adopted by corporations to achieve those objectives. Although legitimacy theory and stakeholder theory are more frequently used to explain corporate social responsibilities in western countries, it doesn’t prevent other studies from using them as ‘lenses’ to look at voluntary disclosure behavior other than social and environmental disclosure. Chalmers and Godfrey (2004) adopt legitimacy theory to explain that managers of Australian reporting entities voluntarily disclose financial derivative information prior to its standard implementation, in order to gain a good reputation in respect of information disclosure.

The changes that have occurred in the political, social and economic environment in China during the past three decades have led to some specific changes to the corporate disclosure environment in the Chinese stock market. The establishment of the regulatory framework for corporate disclosure and the emergence of new stakeholder groups have created a challenging disclosure environment for listed firms. It is expected that these changes would have
impacted on the disclosure behavior of listed firms. This study investigates empirically the predictive ability of legitimacy theory and stakeholder theory in the Chinese settings.

Adopting legitimacy theory and stakeholder theory, this study identifies main stakeholder groups of listed firms in the Chinese stock market. They are regulatory agencies, investors, creditors and professional associations. Stakeholder attributes including power, legitimacy and urgency of these stakeholder groups are then assessed and the most powerful stakeholder group is identified. A set of hypotheses are developed based on the following five propositions:

1. Listed firms in the Chinese stock market need to legitimate their social status to respond to a changed disclosure environment and voluntary disclosure is a result of stakeholder salience;
2. Ownership structures reflect shareholders’ financial stakes in listed firms and influence firms’ disclosure behavior;
3. Corporate governance variables reflect political stakes of regulatory agencies and they influence firms’ disclosure behavior;
4. Firms’ economic attributes are closely related to creditors’ and shareholders’ financial stakes and are associated with firms’ disclosure behavior;
5. Listed firms use auditing firms with a good reputation to legitimate their social status.

In this study, voluntary disclosures made by listed firms in their annual reports are chosen as the area of interest. A longitudinal research approach is adopted to examine the voluntary disclosure made by 297 listed firms in their annual reports to the Chinese stock market during the 1995 to 2006 financial reporting periods. Listed firms are selected because they are more likely to attract the attention of investors who are interested and rely upon corporate
disclosure to make investment decisions in China (Liu, 2005). The annual report released by
listed firms is a significant element in the disclosure process (Todd and Sherman, 1991).
Furthermore, the level of voluntary disclosure in annual reports is positively linked to the
voluntary disclosure of quarterly and other published information (Gray et al., 1995). Also,
companies would like to incorporate the information disclosed voluntarily beforehand
through other sources into audited annual reports to increase the report’s credibility (Lang
and Lundholm, 1993). Therefore, to a certain degree, the level of voluntary disclosure made
in annual reports mirrors a company’s overall attitude towards information disclosure to the
public investors.

A weighted voluntary disclosure checklist was developed for this study based on mandatory
disclosure requirements stipulated by the Chinese regulatory agencies, a survey of prior
voluntary disclosure studies and reference to FASB’s voluntary disclosure framework. The
checklist captures firms’ voluntary disclosure for financial reporting periods from 1995 to
20069. Items voluntarily disclosed by the listed sample firms in their annual report are
assigned different scores according to the extent of information disclosed and based on the
consideration given to the significance of an item to investors’ decision-making. A firm’s
disclosure score is the sum of the scores assigned to each of the information items. The total
disclosure score assigned to each sample firm is used as the dependent variable for testing the
hypotheses. The independent variables are the corporate governance attributes including state
ownership, legal-person ownership, foreign ownership, proportion of independent directors,
the existence of an audit committee and the quality of the external auditor. An ordinary least
squares (OLS) regression model is employed to test hypotheses which establish the

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9 With the increasing comprehensiveness of the Chinese accounting standards over the years, the voluntary
disclosure items identified for 1995-1998, 1999-2002, and 2003-2006 are different. However, the author has
verified that the differences are marginal. The development of the voluntary disclosure checklist used for this
study is elaborated on in Chapter 6.
relationship between firms’ voluntary disclosure and their corporate governance attributes. The whole testing periods, 1995-2006, are further divided into three testing phases. They are Phase I, Developing phase (1995-1998); Phase II, Corporate governance regime phase (1999-2002); and Phase III, Convergence phase (2003-2006). The three testing phases reflect different development stages of the Chinese stock market. It is expected that different factors will affect firms’ voluntary disclosure during the different testing phases.

1.7 Research findings

The results indicate that the levels of voluntary disclosure made by listed firms in the Chinese stock market gradually increased during the 1995-2006 reporting periods. The level of voluntary disclosure is represented by both the increased number of disclosing firms and the increased extent of voluntary disclosure over the years. Among three testing phases, significant increments are found during Phase II (1999-2002 reporting periods). This result suggests that when the most powerful stakeholder of listed firms, the regulatory agency group, strengthens its regulation and exerts pressure on listed firms to disclose more information to the stock market, firms act responsively to satisfy the stakeholders’ demands. The pressure from the investor group and creditor group also has motivated listed firms to increase their voluntary disclosure.

Univariate statistical results show, however, that listed firms are selective when they voluntarily disclose information. Firms are found to be more likely to disclose information related to their business operations and strategic plans. More sensitive information such as CEO duality, CEO commercial experience, stock price performance and trends of market
capitalization, however, have low levels of voluntary disclosure. Listed firms are also found to be more likely to disclose forward-looking information. High voluntary disclosures are found in relation to earnings forecasts, planned sale targets and future growth opportunity. Excess forward-looking information disclosure in the Chinese stock market reflects firms’ responses to a regulatory agency’s call in terms of improving information disclosure transparency. Low litigation costs may also contribute to the high volume of forward-looking information disclosure.

Multivariate statistical test results show different factors influencing firms’ decision-making in respect of voluntarily disclosing information during different stages of the development of the Chinese stock market. They support all five propositions established for this study. State ownership is negatively related to voluntary disclosure, while foreign ownership contributes positively to information disclosure transparency throughout the entire testing period. Corporate governance related factors, independent directors and the existence of an audit committee all play a positive role in improving firms’ voluntary disclosure since the corporate governance regime was established in the Chinese stock market. A quality external auditor is another factor contributing positively to voluntary disclosure.

1.8 Contribution of the study

As corporate disclosure takes on a more important role in investors’ decision-making in the Chinese stock market, researchers have highlighted the need for further investigation into the significant change process that has occurred in Chinese corporate disclosure practices. Some studies conducted during recent years have addressed different aspects of Chinese corporate disclosure, including the level of mandatory disclosure compliance among listed companies
(Xiao, 1999); the extent that listed companies would like to disclose sensitive information such as related-party transactions and new share subscriptions (Lu, 2002); the relations between reported earnings and return on investment (Lee and Cao, 2002); and value relevance of accounting information prepared under the Chinese Generally Accepted Accounting Principles (GAAP) (Sami and Zhou, 2004). In addition, Xiao et al. (2004), Liu (2005) and Leung et al. (2005) try to use company characteristics such as size and the structure of ownership as determinants of the transparency of corporate disclosure. However, the impact of changed corporate disclosure during the past twenty years has not been well addressed, and the question of how listed Chinese firms have responded to the external disclosure environment still represents a significant gap in the Chinese corporate disclosure literature.

This study extends the literature by using a legitimacy and stakeholder theoretical framework to explain corporate disclosure changes in the Chinese context. China has undergone significant social and economic changes in the past three decades. This thesis, therefore, contributes to the literature by using a system-oriented view to explore disclosure behavior changes in an emerging capital market. More specifically, this longitudinal study enriches the corporate disclosure literature by investigating the implications and impact of the changed disclosure environment on the level of voluntary corporate disclosure, as made by listed Chinese firms in the context of the rapidly developing Chinese stock market. Understanding why listed Chinese firms voluntarily disclose information is potentially useful for the information preparers, users of such information and policy-making bodies, both in China and western countries. As the information preparers, listed firms will gain knowledge of what extent, what type and the amount of information that should be disclosed in order to be successful in competing for funds on the stock market. Knowledge of the influences on
voluntary disclosure will also assist users, such as public investors and financial analysts, to form reasonable expectations about the type and amount of information being made available. Understanding why listed Chinese firms voluntarily disclose information will enable the policy-makers in China to gauge the effectiveness of the corporate governance regime, compare the harmonization between Chinese accounting standards with internationally accepted accounting standards, and assess the ownership reforms implemented during the past twenty years. A thorough understanding of the corporate disclosure environment in China is also particularly useful for the policy-makers in western countries and western corporations, in order to make the best use of opportunities to develop business in China. Furthermore, the impact of a changed corporate disclosure environment on disclosure behavior in China will provide insights into the ability of Chinese enterprises to harmonize their corporate reporting with international corporate governance principles and practices.

1.9 Organization of the thesis

Chapter 2 contains the literature review. Studies conducted on voluntary disclosure are critically reviewed, and a review of two main views used to explain why firms voluntarily disclose information to the capital market is included. The information perspective and contract perspective are discussed under the economics-based view. Legitimacy theory, stakeholder theory and institutional theory are reviewed under the system-oriented view. Disclosure studies focusing on the Chinese stock market are also considered, and the gap that exists in the literature is identified, particularly in this area.
Chapter 3 considers the changes in the disclosure environment in China during the past three decades. It examines the political system, economic situation and social values of Chinese society before and after the economic reforms launched by the Chinese government in the late 1970s.

Chapter 4 reviews the accounting reforms and the establishment of a regulatory framework for corporate reporting and disclosure during the past twenty years in China. The primary purposes of Chapters 3 and 4 are to set up the institutional background for Chapter 5, which applies legitimacy theory and stakeholder theory as theoretical foundations for the conceptual framework used in this study.

Chapter 5 builds up a theoretical framework for this study. This chapter justifies why legitimacy theory and stakeholder theory are more appropriate than economic-based theories in explaining the disclosure behavior changes of listed firms in the Chinese setting. The stakeholder attributes of various stakeholder groups are assessed in this chapter. Five propositions are formed and a set of hypotheses is derived from those propositions to establish the relationships between firms’ corporate governance attributes and their voluntary disclosures. The entire testing period is further divided into three distinct testing phases, Phase I (1995-1998), Phase II (1999-2002) and Phase III (2003-2006).

Chapter 6 contains the research design. It includes the research methodology and the specific research methods adopted. The quantitative longitudinal approach employed in this study requires repeated observations of the same sample over a long period of time. The sample selection, development of a voluntary disclosure checklist, disclosure item weighting and data collection are detailed in this chapter. The last section of Chapter 6 discusses the
regression model used to explore the relationship between levels of voluntary disclosure and the independent variables identified in Chapter 5’s hypotheses, and how to construct independent variables.

The results of this study are reported in Chapter 7. Univariate results are presented based on three information sections, namely, the strategic, financial and non-financial information disclosures during the different testing phases defined in Chapter 6. The trends of firms’ disclosure behavior changes, and the preference firms have when voluntarily disclosing information, are identified. Multivariate results are also presented in different testing phases. In this way, factors significantly influencing firms’ voluntary disclosure during the different development stages of the Chinese stock market can be exhibited clearly.

Chapter 8 summarizes the arguments developed in this thesis, provides a discussion of the findings, discusses limitations of the study and describes future research implications emanating from this study.
CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

As defined in Chapter 1, the aim of this study is to investigate and explain the response of listed firms to the changed corporate reporting environment in respect of their disclosure behavior in the Chinese stock market. The Chinese firms’ voluntary disclosure in their annual reports is chosen to represent firms’ disclosure behavior. This chapter reviews the theories used to explain voluntary disclosure behavior, factors motivating firms to voluntarily disclose information and firm-specific determinants of voluntary disclosures. The primary purpose of this literature review is to lay the foundation for the theoretical framework for this study. The literature review in this chapter demonstrates that voluntary disclosure has been extensively explained by two economic consequence theories, namely, information perspective and contract perspective (Chalmers and Godfrey, 2004). Firms’ profitability, leverage, size, industry, quality of auditor and various elements of corporate governance including ownership structure, proportion of independent directors on the board and the internal audit committee, have been tested as influential determinants of voluntary disclosure. In addition to these two economics-based perspectives, some disclosure studies conducted in recent years have also invoked legitimacy theory, stakeholder theory and institutional theory to explain voluntary disclosure behavior. These system-oriented theories try to embrace the social
impact on corporations’ disclosure behavior. The variables used to measure a firm’s legitimacy concerns, stakeholder relationship management and institutional pressure are, however, more tailored to specific studies.

This chapter proceeds as follows. Section 2.2 reviews the information perspective by looking at information asymmetry, the role that information disclosure could play in the stock market, information signaling and the proprietary nature of information. Section 2.3 examines the contract perspective, exploring how agency theory and corporate governance attributes explain firms’ voluntary disclosure behavior. Section 2.4 surveys the determinants of voluntary disclosure under two economics-based perspectives. Section 2.5 explores three system-oriented theories, legitimacy theory, stakeholder theory and institutional theory and why researchers have adopted them to explain firms’ voluntary disclosure in recent years. Disclosure studies of listed firms in the Chinese stock market are reviewed in Section 2.6. Section 2.7 summarizes the chapter.

2.2 Information perspective

2.2.1 Information disclosure and the stock market

This section examines the role of corporate disclosure played in capital markets. As Bushman and Smith (2004) point out, financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning the financial position and performance of publicly held firms. Audited balance sheets, income statements and cash-flow statements, along with supporting
note disclosures, form the foundation of the firm-specific information set available to investors and regulators. The availability of information is believed to be a key determinant of the efficiency of resource-allocation decisions and growth in an economy. However, information asymmetry and agency problems impede the efficient allocation of resources in a capital market economy (Healy and Palepu, 2001). Information asymmetry occurs when management has access to information about a firm, while the information is not equally available to public investors. The consequence of information asymmetry is the breakdown of the functioning of the capital market. An efficient capital market is a market in which investors have access to transparent information on the value of business investment opportunities (Palepu et al., 2004). Agency problems arise when investors do not intend to play an active role in the firms’ management and delegate the responsibility to the management of the firm. The self-interested managers have an incentive to make decisions that expropriate investors’ interests by over-consuming perquisites, paying directors excessive compensation or making investment decisions that are harmful to the interests of outside investor (Jensen and Meckling, 1976).

Corporate disclosure is critical for the functioning of an efficient capital market and, in turn, in the long run, an efficient capital market contributes positively to a country’s sustainable economic development. A growing body of literature in economics and finance has investigated the effects of domestic financial development on economic growth and efficiency (Levine, 1997). Bushman and Smith (2004) suggest that a country’s economic performance can be improved through three channels, which all involve using financial information: (1) to help managers or potential entrants to identify promising investment opportunities, acquisition candidates or strategic innovations on the basis of the profit margins reported by other firms, (2) to enhance firms’ governance role by disciplining
managers to direct resources toward projects which can benefit owners of capital, by encouraging managers to pursue value-maximizing investment policies, by facilitating shareholder monitoring and the effective exercise of shareholder rights, and (3) to reduce information asymmetries among investors. Financial accounting information can enhance economic performance by reducing adverse selection and liquidity risk. Firms’ timely disclosure of high-quality financial accounting information reduces investors’ risk of loss from trading with more informed investors, thereby attracting more funds into the capital markets and lowering investors’ liquidity risk. Well-developed and liquid capital markets are expected to enhance economic growth by facilitating corporate investments that are high-risk, high-return and long-term and high quality financial accounting regimes provide important support for this capital market function. The three channels illustrated by Bushman and Smith (2004) are presented in Figure 2.1.

With the emergence of the Chinese stock market and the separation of ownership and management in the Chinese listed firms, the importance of information disclosure has become obvious in respect of investor protection, long-term prosperity of the Chinese stock market and the sustainable development of the Chinese economy. The significant role played by information disclosure in project identification, improving corporate governance and reducing information asymmetry has been highlighted by disclosure studies focusing on the Chinese market (Xiao, 1999; Xiao et al., 2004; Qu and Leung, 2006; Xiao and Yuan, 2007).
Figure 2.1 Three channels through which financial accounting information affects economic performance

- **Channel 1**
  Better identification of good versus bad projects by managers (project identification)

- **Channel 2**
  Discipline on project selection and expropriation by managers (governance role of financial accounting information)

- **Channel 3**
  Reduction in information asymmetries among investors

Financial accounting information

- Unaudited disclosures by firms
- Stock price
- Information collection by private investors and intermediaries

Information environment

(Source: Bushman and Smith, 2004, p. 67)
2.2.2 Signaling theory

Signaling theory was initially developed by Spence (1973) to explain the behavior in the labor markets. Morris (1987) suggests that signaling was a general phenomenon applicable in any market with information asymmetry. The theory shows information asymmetry can be reduced by the party with more information signaling to others. In stock markets, signaling theory predicts that higher quality firms will choose disclosure policies which allow their superior quality to be revealed, while lower quality firms will choose accounting methods which attempt to hide their poor quality. Managers of higher quality firms will wish to distinguish themselves from lower quality firms through voluntary disclosure (Watson et al., 2002). Higher profitability, better investment opportunity and reputable external auditors are used by researchers to represent higher quality firms (Clarkson et al., 1994; Jog and McConomy, 2003). However, Skinner (1994) also looks at why firms voluntarily disclose bad news. He suggests that less-profitable firms might disclose more information to explain the reasons for negative performance, in order to prevent potential litigation costs and reputational costs, to reassure the market about future growth, and to avoid severe devaluation of share capital and loss of reputation in the stock market as the result of disclosing “bad news”.

2.2.3 Cost and benefit considerations

Firms voluntarily disclose information only when the perceived economic benefits out-weigh the proprietary costs (Verrecchia, 1983). Proprietary cost is defined as “the costs associated with strategic decision–making by a competitor using all available information” (Luo et al., 2006, p. 506). Proprietary cost is incurred when the private information conveyed through
voluntary disclosure is utilized by a competitor to the detriment of the income-producing activities of the firm. Private information, such as future earnings forecasts, is valuable to both the capital market and the firm’s strategic opponents, potentially limiting the level of voluntary disclosure. Verrecchia (1983) analyses the significance of the existence of a proprietary cost. If a proprietary cost exists and information is withheld by firms, investors are unsure whether it is withheld because the information represents ‘bad news’, or the information represents ‘good news’, but not sufficiently good news to warrant incurring the proprietary cost. Empirical studies suggest that disclosure levels decrease in relation to proprietary cost; the proprietary cost associated with voluntary disclosure can affect disclosure policy and firms need to balance the desire to convey private information against their need to protect proprietary information from potential competitors (Darrough and Stoughton, 1990; Luo et al., 2006).

Agency theory predicts that voluntary disclosures are likely to be influenced by managerial expectations of positive share price effects (Gray and Roberts, 1989). Diamond and Verrecchia (1991) conclude that revealing public information to reduce information asymmetry can reduce a firm’s cost of capital by attracting increased demand from large investors due to increased liquidity of its securities. Increased security liquidity could drive current prices up and result in lower cost of equity capital. The association between lower cost of equity capital and greater voluntary disclosure is also supported by Botosan (1997; 2000). The findings of Eng et al. (2001) suggest that the level of disclosure and the number of analysts work hand-in-hand to lower the cost of equity capital in the Singapore stock market. The explanation offered is that in a low mandatory disclosure market, the increased voluntary disclosure may not be credible to the extent of having an impact on the cost of equity capital. However, the presence of a larger number of analysts following a firm’s
performance adds credibility to the level of voluntary disclosure, thus resulting in a lower cost of equity capital.

2.3 Contract perspective

2.3.1 Agency theory

Agency theory focuses on the relationship between shareholders (principals) and corporate managers (agents). Jensen and Meckling (1976, p. 308) define the agency relationship as “a contract under which one or more (principals) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent”. This relationship assumes that the agent is driven by self-interest and undertakes self-serving activities that could be detrimental to the economic welfare of the principals (Jensen and Meckling, 1976). Principals’ monitoring of agents’ behavior and bonding agents’ interests with principals’ interests, constitute agency costs. Agency theory suggests that voluntary disclosures enable principals to monitor managers’ behavior while reducing agency costs that managers would otherwise bear. The reduction in agency costs is a product of narrowing the information gap and reducing uncertainty (Chalmers and Godfrey, 2004). Management’s incentive to engage in such activity is varied with a firm’s characteristics such as profitability, leverage, firm size and industry (Jensen and Meckling, 1976; Lang and Lundholm, 1993).

2.3.2 Corporate governance

Agency perspective suggests that the separation of corporate managers from outside investors involves an inherent conflict. This classic perspective has been widely adopted by studies that
have investigated the association between firms’ corporate governance and information disclosure since the beginning of the 1990s. Corporate governance is the system by which companies are directed and managed. Sloan (2001) suggests that financial accounting provides financiers with the primary source of independently-verified information about the performance of managers. Thus, corporate governance and financial accounting are closely linked. Corporate control mechanisms, as defined by Bushman and Smith (2001, p. 1), are “the means by which managers are disciplined to act in the investors’ interest”.

The practice of corporate governance has evolved significantly during the last several decades as a result of the rapid growth of the capitalist system, the investment in public companies and the development of the global economy (OECD, 2004). Because of its importance for the economic health of corporations and the welfare of society in general, corporate governance has attracted a great deal of public attention. During the 1980s, a series of high-profile business failures in the US and UK shook investors’ and banks’ confidence in large corporations. Several committees 10 were established to address the corporate governance problems. The Cadbury Report (1992), the Greenbury Report (1995) and the Hampel Report (1998) 11 established baselines for legislation on corporate governance that was subsequently enacted in the US, Australia and elsewhere (O’Callaghan, 2003).

10 The Treadway Commission was formed in 1987 in the United States. Its primary role was to identify the main causes of misrepresentation in financial reports and to recommend ways of reducing the incidence. Financial Reporting Council, the London Stock Exchange and the UK accountancy profession set up the Cadbury Committee in 1991 to inquire into financial aspects of corporate governance. The committee was given the task of investigating how large public companies adopt corporate governance guidelines, with a focus on the procedures of financial report production and the role of the accounting profession. Later on, the Greenbury Committee and the Hampel Committee were formed in the UK.

Acknowledging the significant transformation in the role of private corporations in economic
development, job creation and the welfare of individuals, the Organization for Economic Co-
operation and Development (OECD), in conjunction with national governments and the
private sector, developed the *OECD Principles of Corporate Governance* between 1998 and
1999. More specifically, experts of the OECD have defined corporate governance as: “... one
key element in improving economic efficiency and growth as well as enhancing investor
confidence. Corporate governance involves a set of relationships between a company’s
management and also provides the structure through which the objectives of the company are
set, and the means of attaining those objectives and monitoring performance are determined.
Good corporate governance should provide proper incentives for the board and management
to pursue objectives that are in the interests of the company and its shareholders and should
facilitate effective monitoring” (OECD, 2004, p.11).

Consistent with the above definition, the OECD Principles include the rights of shareholders,
the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency
and the responsibilities of the board as the essential components of a corporate governance
framework. The OECD Principles represent the first initiative by an inter-governmental
organization to develop the core elements of a good corporate governance regime. It can be
used as a benchmark by governments when they evaluate and improve their laws and
regulations; meanwhile, it can be referred to by corporations when they develop their
corporate governance systems and best practices (OECD, 1999).

At the beginning of the 21st century, investor confidence and public trust in accounting and
reporting practices were shattered by a series of very high-profile scandals, such as Enron and
WorldCom. The *Sarbanes-Oxley Act* was passed in 2002 in the US, and introduced highly
significant legislative changes to financial practice and corporate governance regulation. It
introduced stringent new rules with the stated objective: "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws". This Act established enhanced governance and management standards for all US publicly-listed companies and public accounting firms. The Public Company Accounting Oversight Board, under the Stock Exchange Commission, was formed to oversee public accounting firms and issue accounting standards. In general, the efforts made in the UK, the US and the OECD addressed the notion that decisions made by the directors and executives of a public company should be consistent with the interests of investors. Adequate and accurate information concerning the operations and the value of the firm needs to be disclosed in a timely and reliable manner.

Disclosure is part of the corporate governance framework and, meanwhile, plays an important role in improving corporate governance practices. As noted previously, the separation of management and ownership in modern corporations creates opportunities for self-interest driven managers to increase their own wealth at the expense of shareholders (Jensen and Meckling, 1976). Therefore, it is common to find that disclosure and transparency are emphatically addressed by all corporate governance principles, codes and best practice recommendations promoted by numerous organizations and countries worldwide. According to the OECD principles, corporate disclosure, as one way of corporations communicating their performance with public investors, can be a powerful tool for monitoring and influencing the behavior of companies and for protecting investors. Accessing regular, reliable and comparable information in sufficient detail enables shareholders and potential investors to assess the stewardship of management and make informed decisions about their investment.
Corporate disclosure comprises both the content of disclosure and the means of disclosure, which include the timeliness of disclosure, disclosure intensity and media releases (Bushman et al., 2004). The transparency of disclosure is measured by the quantity and quality of the publicly available information on the governance structure and financial position. The desirable practices of corporate governance should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. Disclosure should include, but not be limited to, material information on: the financial and operating results of the company; company objectives; major share ownership and voting rights; members of the board and key executives, and their remuneration; material foreseeable risk factors; material issues regarding employees and other stakeholders; and governance structures and policies (OECD, 2004).

On one hand, good corporate governance should exist prior to establishing transparent disclosure. On the other hand, transparent information will enable investors to participate more actively in the construction of good corporate governance mechanisms. As one of the external control mechanisms, the critical role of corporate disclosure played in capital markets is to reduce the information asymmetry and to solve the agency problem (Healy and Palepu, 2001). Transparency and disclosure give investors opportunities to exercise their rights by assessing how and in what manner the corporation is being managed. They should go hand-in-hand with a social norm of corporate governance, namely, accountability. The question formulated under the notion of accountability is “to whom are corporate managers accountable?” Licht (2002) argues that corporations, in the position of “accountables” owe shareholders, who are in the position of “accountees”, the accountability duties of promoting
the accountees’ interests, transparent reporting and liability to make amends. Without transparency and disclosure, accountability will not exist in any meaningful way.

A high level of disclosure transparency contributes to the establishment of confidence in capital markets and encourages a better flow of foreign direct investment into a country (Bushman and Smith, 2001). Arthur Levitt, the former chairman of the US Securities and Exchange Commission (SEC), states, “If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company’s practices may be, suffer the consequences” (cited by Chris, 2002).

2.4 Voluntary disclosure and economic determinants

2.4.1 Information perspective and agency theory

There are several determinants of voluntary disclosure jointly used by signaling theory and agency theory. After examining the logical relationship between signaling and agency theories, Morris (1987) concluded that these two theories are consistent theories rather than competing theories. Considerable overlap exists between the two theories: rational behavior is common to both; information asymmetry in signaling theory is implied by monitoring costs in agency theory; ‘quality’ in signaling theory can be defined in terms of agency theory variables; and signaling costs are implicit in some bonding devices of agency theory. This section reviews the determinants used by signaling theory and agency theory in explaining
firms’ voluntary information disclosure. The determinants include firms’ profitability, auditor quality, leverage, firm size and industry classification.

Agency theory predicts a positive association between a firm’s profitability and its information disclosure. Profitable firms are subject to greater public scrutiny and will, therefore, apply self-regulation mechanisms, including voluntary disclosures to avoid any external regulation (Ng and Koh, 1994) and to support the continuance of profitable firms’ positions and compensation arrangements (Inchausti, 1997). Signaling theory predicts that profitable firms will disclose more in order to signal their strong financial position to investors (Watson et al., 2002).

Both signaling theory and agency theory suggest a good quality auditing firm is positively associated with a firm’s greater information disclosure. Wallace et al. (1994) suggested quality auditing firms try to improve the perceived quality of disclosure by having clients disclose more information. The effectiveness of auditing and the auditor’s ability to influence disclosures is expected to vary with auditor quality. Auditor reputation is used to differentiate audit quality (Chalmers and Godfrey, 2004). As a result, quality audit firms have a stronger incentive to maintain their independence and to impose more stringent and extensive disclosure standards (DeAngelo, 1988). Therefore, agency theory holds a view that quality auditing firms assist in alleviating the conflicts of interest between management and investors. Signaling theory predicts that managers are cognizant of quality auditors’ incentives to demand higher quality disclosure. Engaging with quality auditors is a signal of their acceptance of such demands (Healy and Palepu, 2001).
Leverage describes a firm’s financial structure and measures the long-term risk implied by that structure. It reveals the balance between two sources of long-term finance: funds invested by shareholders and funds invested by debt-holders (Watson et al., 2002). Debt increases financial risk, as the presence of interest payments causes the shareholders’ earnings stream to become more volatile as potential wealth transfers from debt-holders to shareholders and managers. Debt contracts are employed to align the interest of firms with those of debt claimants. Agency theory predicts a positive relationship between leverage and disclosure (Jensen and Meckling, 1976). When a firm borrows, the divergence in the interest between creditors and management behavior increases the agency cost in the form of increased monitoring costs. Reducing monitoring cost may motivate firms to disclose more information voluntarily, which enables both shareholders and debt-holders to evaluate whether firms have managed the financial resources in the interests of external owners (Healy and Palepu, 2001). Signaling theory also predicts a possible association between disclosure and leverage; however, the direction of the relationship is not clear (Watson et al., 2002). While Ross (1977) suggests that managers who had confidence in a firm’s future would use an increase in financial leverage as a positive signal to the market, Myers and Majluf (1984) argue that increased leverage would only send negative signals to shareholders. The empirical research also shows inconclusive results. Chow and Wong-Boren (1987) and Leventis and Weetman (2004) find that leverage offered no explanation of voluntary disclosure for their sample of Mexican firms and firms listed in the Athens stock exchange, respectively. Hossain et al. (1995) and Archambault and Archambault (2003) confirm the prediction of agency theory, finding that there is a positive relationship between leverage and disclosure.

Firm size has been identified as a significant explanatory factor among disclosure studies (Wallace et al., 1994; Zarzeski, 1996; Watson et al., 2002; Archambault and Archambault,
The positive association between voluntary disclosure and firm size has been explained by large firms’ international resource dependence (Zarzeski, 1996), motivation to reduce political costs (Watts and Zimmerman, 1986) and agency costs (Jensen and Meckling, 1976). Confronted with greater information demands from the public, large firms are more likely to disclose more information to the market.

Industry classification is another significant explanatory factor for voluntary disclosure (Leventis and Weetman, 2004). Higher political costs in regulated industries are likely to result in higher voluntary disclosure, while highly competitive industries may hinder disclosure to avoid proprietary costs (Watts and Zimmerman, 1986). In addition, Cooke (1991) reports the “follow the leader effect”, meaning that the existence of a dominant company in an industry with high levels of voluntary disclosure may have bandwagon effects for all firms within the same industry.

2.4.2 Voluntary disclosure and corporate governance attributes

Control mechanisms include both internal mechanisms, such as managerial incentive plans, director monitoring and the internal labor market, and external mechanisms. These include outside shareholder or debt-holder monitoring, the market for corporate control, competition in the product market, the external managerial labor market, and securities laws that protect outside investor against expropriation by corporate insiders. This section reviews the literature on the association between the level of voluntary disclosure and firms’ corporate governance attributes, which include ownership structure (managerial ownership, blockholder ownership, institutional investors and government ownership), board composition
(proportion of independent directors, CEO duality and the existence of an internal audit committee) and management compensation.

Managerial ownership is the percentage of ordinary shares held by the CEO and executive directors. When managerial ownership is low, there is a greater agency cost as the manager has greater incentives to consume perks and reduced incentives to maximize firm value. Hence, outside shareholders will increase monitoring of the manager’s behavior to reduce the agency cost (Jensen and Meckling, 1976). Monitoring costs increase the costs of the firm. However, monitoring by outside shareholders may be reduced if managers can provide voluntary disclosure. Thus, voluntary disclosure becomes a substitute for monitoring (Eng and Mak, 2003). Empirical evidence provided by Ruland et al. (1990) and Eng and Mak (2003) shows that managerial ownership is negatively related to firms’ information disclosure. Luo et al. (2006) further confirm that the level of voluntary disclosure of the information about future performance of firms is weakened by a higher proportion of managerial share ownership, while Warfield et al. (1995) find that the extent of shareholding by management is positively associated with the amount of information disclosed about earnings.

Block-holder ownership is the percentage of ordinary shares held by substantial shareholders. Jensen and Meckling (1976) argue that substantial shareholders are expected to have both greater power and incentives to monitor management, as their wealth is tied to the firm’s financial performance. When share ownership is diffused, the potential conflicts between the principal and the agent are raised (Fama and Jensen, 1983). Thus, agency costs are increased by involving substantial shareholders in monitoring or controlling activities that potentially cause agency problems and more monitoring is required (Noe, 2002). Empirical evidence
shows a negative relationship between block-holder ownership and disclosure (McKinnon and Dalimunthe, 1993; Hossain et al. 1995; Mitchell et al., 1995; Schadewitz and Blevins, 1998; Chau and Gray, 2002; Luo et al., 2006).

Institutional investors have strong incentives to search for private pre-disclosure information about companies in their portfolios because of their fiduciary responsibilities and large resource bases. In addition, large institutional ownership induces a high level of voluntary disclosure prior to earnings announcements (El-Gazzar, 1998). However, Schadewitz and Blevins (1998) report an inverse relationship between institutional ownership concentration and disclosure, based on a study of interim disclosures by Finnish firms.

The relationship between government ownership and voluntary disclosure is examined by Eng and Mak (2003) in Singapore. Eng and Mak (2003) indicate that government ownership may have to look beyond pure profit goals and consider goals related to the interests of the whole nation, which may conflict with the commercial objectives of the enterprise. Enhancing investor value may not be the primary objective of government ownership. Government-linked firms in Singapore receive government funding and are also likely to have easier access to different sources of finance compared to non-government-linked firms. Managers of government-linked firms are also likely to face less discipline from the market for corporate control, because the government is expected to be a long-term investor in the firms and is unlikely to support unsolicited takeover offers for government-linked firms. Because of the government’s vested interest in the government-linked firms and the conflicting objectives faced by these firms, there may be a greater need for communication with other investors in the firms. Eng and Mak’s (2003) empirical results show that significant government ownership is associated with increased voluntary disclosure. Focused
on the same capital market, Luo et al. (2006), however, showed that the existence of government ownership has weakened the positive relationship between higher voluntary disclosure levels and information disclosure related to firms’ future performance.

The corporate governance of firms, represented by board composition, has also been examined by prior studies. Independent directors are measured by the proportion of outside directors to the number of directors on the board. The larger the proportion of independent directors who are less aligned to management on the board, the more effective it will be in monitoring managerial opportunism, and firms can be expected to have more voluntary disclosure (Eng and Mak, 2003). Meanwhile, independent directors benefit from establishing a reputation as monitoring experts; thus, they have incentives to increase the quantity and quality of disclosure (Fama and Jensen, 1983). Forker (1992) finds that a higher percentage of independent directors on boards enhances the monitoring of the financial disclosure quality and reduces the benefits of withholding information. Findings by Leftwich et al. (1981), Chen and Jaggi (2000), Ho and Wang (2001) also confirm a positive relationship between the proportion of independent directors and disclosure.

CEO duality has been used as the proxy for the existence of dominant personalities in firms (Forker, 1992; Hong and Wang, 2001). Firms that have one individual who serves as chairman and chief executive officer/managing director are considered to be more managerially dominated (Molz, 1988) and CEO duality signals the absence of separation of decision control and decision management (Fama and Jensen, 1983). Finkelstein and D’Aveni (1994) and Gul and Leung (2004) suggest that the concentration of decision-making power could constrain board independence and reduce its ability to execute its oversight and governance roles. In respect of information disclosure, the person who occupies both roles
would tend to withhold unfavorable information to outsiders (Molz, 1988). Although Fama and Jensen (1983) suggest that any adverse consequence caused by CEO duality could be eliminated by market discipline, Forker (1992) and Hong and Wong (2001) assert that a dominant personality is detrimental to the quality of disclosure and level of voluntary disclosure.

The existence of a voluntary internal audit committee is regarded as an important component of internal control mechanisms. One of the functions of an internal audit committee is to ensure the quality of financial accounting (Collier, 1993). Since an audit committee is supposed to consist mainly of non-executive directors, it is influential in reducing the amount of information withheld (Hong and Wong, 2001). Agency theory predicts that the establishment of audit committees is a means of accentuating agency costs. Forker (1992) argues that the existence of audit committees may improve internal control and, thus, regards them as an effective monitoring device for improving disclosure quality. His research findings show a positive, although weak association between the disclosure of share-options and the audit committee among UK firms, while Hong and Wong (2001) find the existence of an audit committee is significantly and positively related to the extent of voluntary disclosure.

Several studies have considered the relation between corporate disclosure level and stock price-based incentives (Verrecchia, 1983; Healy and Palepu, 2001; Nagar et al., 2003). Healy and Palepu (2001) suggest that management compensation schemes provide incentives for managers to engage in voluntary disclosure to meet restrictions imposed by insider-trading rules and to reduce the risk of misvaluation. Nagar et al. (2003) provide evidence that stock price-based incentives elicit both good news and bad news disclosures from managers. Managers have incentives to release good news because it boosts the stock price, whereas,
investors’ potentially negative interpretations of silence (Verrecchia, 1983) and litigation costs (Skinner, 1994) are incentives to release bad news.

2.5 A system-oriented view

Information perspective and contract perspective have provided us with valuable insights into the determinants of firms’ disclosure choices. However, those perspectives fail to consider a more embracing social impact (Chalmers and Godfrey, 2004). In recent years, a number of researchers have adopted ‘system-oriented theories’ to explain voluntary corporate disclosure (Deegan 2002; O’Donovan, 2002). A system-oriented view sees the organizations as being part of a broader social system. An entity is assumed to be influenced by, and in turn to have influence upon, the society in which it operates. A system-oriented view of the organization and of society permits us to focus on the role of disclosure in the relationships between organizations, the State, individual and group stakeholders (Gray et al., 1996).

Legitimacy theory, stakeholder theory and institutional theory are the three theories under the system-oriented view that explain why firms voluntarily make particular disclosures, as indicated below. Three theories are all well-linked to political economy theory. Gray et al. (1996, p. 47) define the ‘political economy’ as ‘the social, political and economic framework within which human life takes place’. Deegan’s (2006) interpretation of this perspective is that society, politics and economics are inseparable, therefore, economic issues cannot be investigated meaningfully in the absence of considerations about the political, social and institutional framework in which the economic activity takes place. Researchers are able to consider broader social issues that impact on how an organization operates and what information it elects to disclose by considering the political economy. Guthrie and Parker
(1990, quoted in Deegan, 2006, p. 252) state “the political economy perspective perceives accounting reports as social, political and economic documents. They serve as a tool for constructing, sustaining and legitimizing economic and political arrangements, institutions, and ideological themes which contribute to the corporation’s private interests. Disclosures have the capacity to transmit social, political and economic meanings for a pluralistic set of report recipients”.

2.5.1 Legitimacy theory

Legitimacy theory asserts that organizations continually seek to ensure that they operate within the bounds and norms of their respective societies (Deegan, 2006). Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within a socially-constructed system of norms, values, beliefs and definitions (Suchman, 1995). Legitimacy theory relies upon the notion of a ‘social contract’ between organizations and the society in which they operate. Deegan (2006) suggests that the requirements imposed by the law reflect the explicit terms of the social contract, while un-codified community expectations (which will be perceived to be different by different people) constitute the implicit terms of the social contract. The ‘social contract’ represents the multitude of implicit and explicit expectations that society has about how the organization should conduct its operations. It is assumed that society allows the organization to continue operations to the extent that it generally meets their expectations. Failure to comply with social expectations may lead to sanctions being imposed by society in the form of legal restrictions imposed on its operations, limited resources being provided and reduced demand for its products.
Dowling and Pfeffer (1975, p. 122) claim that “organizations will take various actions to ensure that their operations are perceived to be legitimate”. To be designated as legitimate, a firm needs to determine community expectations, identify important stakeholders and manage the potential legitimacy gap (Chalmers and Godfrey, 2004). When a disparity, actual or potential, exists between the two value systems, there is a threat to the entity’s legitimacy (O’Donovan, 2002). Legitimacy-threatening issues can be created by the media, regulatory or institutional pressures, evolving social awareness and/or corporate/industry crises. Management must be cognizant of legitimacy-threatening issues and manage legitimacy (Suchman, 1995).

Corporate disclosures are considered to represent one way in which an entity can legitimate its ongoing operations. The studies by Deegan (2002), Deegan et al. (2002), O’Donovan (2002) and O’Dwyer (2003) show that voluntary disclosure of social and environmental performance and contribution is one of the means utilized by corporations to gain, maintain and repair legitimacy, and legitimate their ongoing existence. The research setting of these studies is that community expectations change from time to time. In the 1960s, an organization’s sole responsibility was to maximize profits for investors in order to be viewed as legitimated (Friedman, 1962). Since the mid-1980s, social expectations have embraced economic, environmental and social factor-relationships (Elkington, 1997). Organizations must adapt and change accordingly to meet changed social expectations. Failure to do so may lead to a revocation of the ‘social contract’ (Deegan and Rankin, 1996).
2.5.2 Stakeholder theory

While legitimacy theory discusses society’s expectations in general, stakeholder theory considers the different stakeholder groups within society and how they should be managed if the entity is to survive and be successful in the long run (Deegan, 2006). Gray et al. (1995) suggest that stakeholder and legitimacy theory are two overlapping perspectives as both of them are set within a framework of assumptions about political economy. Their suggestion implies that the differences are in the levels of resolution of perception rather than arguments for and against competing theories.

Freeman and Reed (1983) propose two definitions of a stakeholder. The wider sense of a stakeholder is any identifiable group or individual who can affect the achievement of an organization’s objectives or who is affected by the achievement of an organization’s objectives. Public interest groups, protest groups, government agencies, trade associations, competitors, unions as well as employees, customer segments and investors are included in this definition. The narrow sense of a stakeholder is any identifiable group or individual on which the organization is dependent for its continued survival. This definition includes employees, customer segments, certain suppliers, key government agencies, shareholders and certain financial institutions. The narrow definition indicates that stakeholders are the groups of constituents who have a legitimate claim on the firm. Each group supplies the firm with critical resources or makes a contribution to the firm. In exchange, each expects its interests to be satisfied by inducements (March and Simon, 1958). As Hill and Jones (1992) described, investors provide the firm with financial capital. In exchange, they expect the firm to maximize the risk-adjusted return on their investment. Creditors provide the firm with finance and, in exchange, expect their loans to be repaid on schedule. Management and employees provide firms with time, skills and human capital commitments. In exchange, they
expect fair income and fair and adequate working conditions. Customers supply the firm with revenues and expect value for money in exchange. Suppliers provide the firm with inputs and seek fair prices and dependable buyers in exchange. Local communities provide the firm with locations, a local infrastructure and perhaps favorable tax treatment. In exchange, they expect corporate citizens who enhance and/or do not damage their quality of life. The general public, as tax payers, provide the firm with a national infrastructure. In exchange, they expect corporate citizens who enhance and/or do not damage their quality of life and do not violate the rules of the game established by the public through their legislative agents.

Despite the existence of different stakeholder groups, Scott and Lane (2000) believe that managers give their attention to certain stakeholders more than others because of time and cognitive constraints. Good stakeholder-firm relationship management has clear instrumental value for firms, as the ultimate goal of corporation decisions is market place success (Pfeifer and Salancik, 1978). Firms view their stakeholders as part of an environment that must be managed in order to assure revenues, profits and, ultimately, returns to shareholders (Berman et al., 1999). Bailey et al. (2000) and Nasi et al. (1997) suggest that entities respond to those stakeholders that are deemed to be “powerful”. A stakeholder’s power to influence corporate management is viewed as a function of the stakeholder’s degree of control over resources required by the organization, especially financial resources (Ullmann, 1985). For example, Neu, Warsame and Pedwell (1998) found that companies were more responsive to the demands or concerns of financial stakeholders including shareholders, creditors and government regulators than the concerns of environmentalists, because financial stakeholders possess power over a firm’s financial resources. Thus, Roberts (1992) suggests that one of the major roles of corporate management is to assess the importance of meeting stakeholder demands in order to achieve the strategic objectives of the firm. As the level of stakeholder
power increases, the importance of meeting stakeholders’ demands increases accordingly. Friedman and Miles (2002) believe the expectation and power relativities of the various stakeholder groups change over time. Unerman and Bennett (2004) support this argument, suggesting that organizations must continually adapt their operating and reporting behaviors accordingly as the expectations and power relativities of stakeholder groups’ change.

Mitchell et al. (1997) suggest that firms should assess the power of their stakeholders by applying sorting criteria and propose that classes of stakeholders should be identified by their possession of one, two or all three relationships attributes: power, legitimacy and urgency. The power attribute refers to a stakeholder’s power to influence the firm, and power is defined by Pfeifer (1981, p.3) as “a relationship among social actors in which one social actor, A, can get another social actor, B, to do something that B would not otherwise have done”. The legitimacy attribute refers to the legitimacy of the stakeholder’s relationship with the firm and, legitimacy in this context, is defined as a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially-constructed system of norms, values, beliefs and definitions. Legitimacy of a claim on a firm is based on contract, exchange, legal title, moral right, at-risk status or moral interest in the harms and benefits generated by company actions (Agle et al., 1999). Power and legitimacy are defined as core stakeholder attributes. The urgency attribute refers to the urgency of the stakeholder’s claim on the firm, and urgency is defined as the degree to which stakeholder claims call for immediate attention. Agle et al. (1999) further explain that stakeholder agency is a multidimensional notion that includes both criticality and temporality, with a stakeholder claim considered to be urgent both when it is important and when delay in paying attention to it is unacceptable.
Mitchell et al. (1997) classify stakeholders into latent stakeholders, expectant stakeholders and definitive stakeholders (Figure 2.2). Latent stakeholders are those possessing only one of the three attributes and include dominant (power), discretionary (legitimacy) and demanding (urgency) stakeholders. Expectant stakeholders are those possessing two attributes, and include dominant (power and legitimacy), dependent (legitimacy and urgency) and dangerous (power and urgency) stakeholders. Definitive stakeholders are those possessing all three attributes. Individuals or entities possessing none of the attributes are non-stakeholders or potential stakeholders.

The theory of stakeholder salience predicts that firms do not respond to all stakeholders equally, rather, managers prioritize stakeholder relationships. Mitchell et al. (1997) define stakeholder salience as the degree to which managers give priority to competing stakeholder claims. For example, shareholders and creditors place emphasis on firms’ profitability and wealth creation, while public interest groups, including environmentalists, focus on the impact of firms’ operations on the environment. Stakeholder salience is positively associated with the cumulative number of the three stakeholder attributes (Mitchell et al., 1997). Stakeholder salience will be high where all three of the stakeholder attributes - power, legitimacy and urgency - are perceived by managers to be present. Stakeholder salience will be low where only one of the stakeholder attributes is perceived by managers to be present. The Mitchell et al. (1997) theoretical model of stakeholder salience is tested and confirmed by Agle et al. (1999). The empirical results of Agle et al. (1999) confirm that, in the minds of CEOs, the stakeholder attributes of power, legitimacy and urgency are individually and cumulatively related to stakeholder salience. Their findings suggest that these stakeholder attributes affect the degree to which top managers give priority to competing stakeholders. Under stakeholder theory, corporate information disclosure is seen as a major element that
can be employed by an entity to manage or to manipulate the stakeholder, in order to gain their support and approval, or to distract their opposition and disapproval (Gray et al., 1996).

Figure 2.2 Stakeholder typology: one, two or three attributes present

2.5.3 Institutional theory

In recent years, some studies have adopted institutional theory to explain voluntary corporate disclosure (Carpenter and Feroz, 1992; Deephouse, 1996; Chalmers and Godfrey, 2004). According to institutional theory, interacting organizations are linked by symbiotic relationships that can create institutional pressures limiting the set of rational choices organizations can use in demonstrating legitimacy to the public (Carpenter and Feroz, 1992). Institutional theory implies that the interests, objectives and actions of those external to any given organization may also be critically important in understanding an entity’s accounting and disclosure choices.

DiMaggio and Powell (1983) propose three classifications that relate to the motivation to adopt institutional practices – coercive isomorphism, mimetic isomorphism and normative isomorphism. Isomorphism refers to the adoption of an institutional practice by an organization. Coercive isomorphism results from both formal and informal pressures exerted on organizations by other organizations upon which they are dependent, and by social expectations in the society within which they operate. Deegan (2006) relates this form of isomorphism to stakeholder theory and observes that an entity will use voluntary corporate reporting disclosures to address the economic, social, environmental and ethical values and concerns of those stakeholders who have the most power over the entity. The entity is, therefore, coerced by its influential or powerful stakeholders into adopting particular voluntary disclosure practices. Mimetic isomorphism is a process that takes place when an organization attempts to imitate a more successful referent organization, a process that is often due to the uncertainty and lack of guidance in its own environment. Normative isomorphism stems from professionalization, that is, the collective struggle of members of an
occupation to define their conditions and methods of work. Applying normative isomorphism in the context of corporate disclosure, Deegan (2006) suggests that the professional expectation that accountants will comply with accounting standards acts as a form of normative isomorphism for the organizations in which accountants work to produce accounting reports (an institutional practice), which are shaped by accounting standards. In terms of voluntary disclosure, normative isomorphic pressures could arise through less formal group influences from a range of both formal and informal groups to which managers belong – such as the culture and working practices developed within their workplace.

The above discussion shows that rather than being a competing theory to legitimacy theory and stakeholder theory, institutional theory provides a complementary perspective in explaining corporations’ disclosure behavior and in understanding how corporations respond to changing social and institutional pressures and expectations. Carpenter and Feroz (1992) draw on institutional theory to explain the state of New York’s decision to adopt GAAP. The evidence indicates that the role of professional élites was an important factor in accelerating the mimetic and coercive isomorphic processes that were creating institutional pressures for New York to adopt GAAP. Various elements of the institutional environment (the nation/state, the professions, resource providers and the public) used powerful representatives to create institutional pressure for adopting GAAP. In conclusion, they suggest that the state’s decision to adopt GAAP was an attempt to regain legitimacy for the state’s financial management practices. Deephouse (1996) operationalizes institutional theory by empirically investigating the relationship between organizational isomorphism and organizational legitimacy in the context of commercial banks. This study suggests that the key step of organizational legitimacy is to identify social actors. A legitimate organization is one whose values and actions are congruent with those social actors’ values and expectations of action.
The social actor accepts or endorses the organization’s means and ends as valid, reasonable and rational. Deephouse (1996) identifies government regulators and public opinion as two key social actors for commercial banks. He classifies two types of legitimacy, namely, regulatory endorsement which is the acceptance of an organization by the state agencies that formally regulate it, and public endorsement which is the acceptance of an organization by the general public. Regulatory endorsement is measured by a bank’s financial capital, and public endorsement is measured by public media exposure. Firms’ age, size and performance are also employed as explanatory variables.

The Chalmers and Godfrey (2004) study empirically investigated managers’ responses to derivative financial instrument disclosure requirements proposed by the Australian accounting standard setting bodies and the Australian Society of Corporate Treasurers (ASCT). Confronted with social pressures to make derivative activities more transparent, managers responded in a manner that can be explained by both legitimacy theory, institutional theory and the maintenance of the managers’ and their firms’ financial reporting reputations. While the desire for legitimacy was unobservable, financial reporting reputation was proxied by attributes such as ASCT, the auditor and Group of 100 (G100) affiliations. ASCT members are expected to exercise personal influence to try and ensure the derivative financial instrument disclosures in their employers’ financial statements conform to the ‘best practice benchmark’ initiated by their professional body (normative isomorphism). Relative to lower reputation audit firms, high reputation audit firms are more likely to suffer reputation damage associated with auditing non-disclosing firms. To maintain or enhance their reputation status and avoid reputation costs, high reputation audit firms are more likely than low reputation audit firms to persuade (or demand) their clients to adhere to the recommended disclosure régime. G100 affiliated firms are large firms and their reporting
practices are more closely monitored than those of smaller firms. The visibility (both politically and communally) of G100 firms creates a necessity for such firms to respond and conform to institutional and community demands for derivative financial instrument disclosures, more so than firms less-publicly scrutinized. With the exception of auditor affiliation, results from the analysis were consistent with expectations. Chalmers and Godfrey (2004) suggest that the consistency and significance of the results implies that legitimacy and institutional theories provide a plausible explanation as to what impulses prompted managers’ responses.

2.6 Disclosure studies in the Chinese stock market

The extant literature of voluntary disclosure worldwide has been surveyed in the preceding section, as applicable to this thesis. This section focuses on the literature examining disclosure of listed firms in the Chinese stock market and identifies the literature gap in the Chinese stock market research.

In respect of corporate disclosure research, the Chinese stock market attracted little attention until the mid-1980s owing to political, socio-economic, social and linguistic reasons (Zhou, 1988). The Chinese economy had experienced a long period of stagnation from the 1960s until the early 1980s due to political and social turbulence; Chinese society had isolated itself from the world, hence, its economy was not integrated into the global economy. Prior to 1978, there was no market-orientated competition among enterprises in China. Under the centrally-planned economy, the price of commodities and the volume of production were all under the tight control of the Chinese government. Financial accounting, reporting and disclosure were internally focused, undertaking the function of serving the administrative
purpose of the Chinese government and its regulatory agencies such as the Ministry of Finance. External disclosure has emerged in China since the early 1990s, when stock exchanges were opened in Shanghai and Shenzhen.

Following the economic reforms and consequent economic development in China, a growing body of literature on listed firms’ disclosure in China examines the characteristics of corporate disclosure and investigates the role played by disclosure in the Chinese stock market. Applying the Chinese social dimensions defined by Hofstede and Bond (1988), and the Gray (1988) accounting sub-culture model, Chow et al. (1995) explored the social constraints on the implementation and development of accounting reforms in China. Chinese society, according to the survey conducted by Hofstede and Bond (1988), features large power distance, strong uncertainty avoidance, long-term orientation, collectivism and femininity. Based upon the examination of several important phases of China’s accounting regulation development, some conventions, doctrines adopted by enterprises and the role played by accountants, Chow et al. (1995) suggest that China’s accounting practices and disclosure can be classified as statutory control, uniform practices, a conservative measurement approach and secrecy in disclosure. Disclosure requirement was reliant on the government’s prescription; accessing accounting information, particularly in the public ownership sector, was almost impossible. The implication is that transparency of corporate disclosure is difficult to achieve under the traditional Chinese social and economic environments. The Chow et al. (1995) viewpoint was further supported by the studies by Graham and Li (1997) and Bloom and Solotko (2003).

As external disclosure began to play a more significant role in Chinese investors’ decision-making and in the development of corporate governance in Chinese corporations, researchers
have highlighted the need for further investigation into the significant change process that has occurred in Chinese corporate disclosure practices. Studies conducted in recent years have addressed different aspects of Chinese corporate disclosure. Xiao (1999) indicated that there is a high level of mandatory disclosure requirement compliance among listed firms. However, firms are reluctant to disclose sensitive information such as related-party transactions and new share subscriptions (Liu, 2005). In respect of voluntary disclosure, Xiao et al. (2004), Liu and Eddie (2007) and Xiao and Yuan (2007) used firms’ characteristics such as size, the structure of ownership, the board composition and auditors as determinants of voluntary disclosure made by listed firms on the Chinese stock market. The Chinese government-owned enterprises listed on the Stock Exchange of Hong Kong (SEHK) voluntarily disclose more strategic and financial information than other companies listed there (Ferguson et al., 2002).

### 2.7 Summary

This chapter highlights the importance of information disclosure to the development of a stock market. The chapter captures the significance of agency theory, signaling theory, legitimacy theory, stakeholder theory and institutional theory. The theoretical framework and empirical research of each theory contribute to the understanding of firms’ voluntary information disclosure. The discussion in Chapter 2 forms the basis for Chapter 5, in which the theoretical framework applicable to China is developed.

In summary, voluntary disclosure has been widely explained and tested by agency theory and signaling theory. Empirical results show that voluntary disclosure is related to firms’ profitability, size, industry classification and auditors. Investigating the relationship between
firms’ corporate governance attributes and information disclosure has been an important component of the economics-based perspectives research. A firm’s ownership structure, board composition, internal audit committee and management compensation are the determinants of voluntary disclosure. In recent years, researchers have embraced legitimacy theory, stakeholder theory and institutional theory to explain firms’ voluntary disclosure, aiming to explore the impact of social influence on firms’ disclosure behavior. Their findings suggest that factors such as firms’ social image and reputation in society, and stakeholder pressure, have an impact on firms’ disclosure decisions.

The survey of disclosure literature focusing on the Chinese stock market highlights the fact that there is a significant gap in the extant literature that needs to be addressed. The impact of the changed corporate disclosure environment during the past twenty years on the level of corporate voluntary disclosure in the Chinese stock market has not previously been systematically examined. The next two chapters, Chapters 3 and 4, illustrate the political, economic and social changes in China over the past three decades, the establishment of the regulatory framework, and the growing group of stakeholders of listed firms in the Chinese stock market. These two chapters will identify the main stakeholder groups for listed firms, so a theoretical framework for this study can be developed in Chapter 5.
CHAPTER 3

POLITICAL, ECONOMIC AND SOCIAL CHANGES

IN CHINA

3.1 Introduction

As described in Chapter 1, this study examines voluntary disclosure made by publicly-listed firms in the Chinese stock market in the context of the changed corporate disclosure environment. Chapter 2 reviews the theoretical underpinnings of firms’ voluntary disclosure behavior. Chapters 3 and 4 are devoted to a discussion of the changes to the corporate disclosure environment in China in the past thirty years. Chapter 3 focuses on the political, economical and social changes in China since the late 1970s. The extensive changes that occurred in these three areas facilitated the establishment of the Chinese stock market, the emergence of various stakeholder groups for listed firms, and the development of the regulatory framework of corporate accounting, reporting and disclosure in China. Chapter 4 elaborates on several important aspects of the regulatory framework of corporate disclosure in China. The primary purpose of these two chapters is the identification of the main stakeholders of listed firms in the Chinese stock market.

Over the past three decades, China has experienced many significant political, economic and social changes. These changes include political reforms, economic reforms and shifts in
social values in Chinese society. The political changes in China during the past thirty years have influenced and facilitated its economic growth. The Chinese government's ambition to build “a socialist market economy with Chinese characteristics” was a new concept. China is the first communist régime to open up its economy to the world (Moutinola et al., 1995). The political changes have led to a remarkable upsurge in China’s economy. Since the inception of economic reforms in 1979, China has one of the world’s fastest-growing economies. The economic reforms have allowed market prices and private investors to play a significant role in production and trade, and enabled the Chinese economy to become substantially integrated into the world economy (OECD, 2005).

The above changes have contributed to a diminishing level of poverty and to higher personal incomes for the Chinese people. Along with the increase in wealth has been the increased exposure of Chinese society to innovative ideas, and a more interactive social environment between China and other societies. The traditional Chinese society has undergone significant changes as a result of the relatively more relaxed political environment and rapid economic development. The corporate disclosure environment, which has evolved in the context of the above changes in China during the past twenty years, reflects some of the characteristics of those changes.

This chapter proceeds as follows. Section 3.2 discusses the political system prior to 1978 and political reform post-1978. The economic reforms and current corporate structure and operating environment are addressed in Section 3.3. Section 3.4 illustrates some of the social changes in China during the past three decades. Section 3.5 summarizes the chapter.
3.2 Political changes in China

3.2.1 The political system prior to 1978

The Chinese Communist Party (CCP) established the People’s Republic of China (PRC) in 1949, taking socialism as its basic political system and applying Marxism-Leninism in China. During the Mao Zedong era (1949-1976), the major political developments were the centralization of party and government administration. The CCP undertook the leading role in China’s political, economic and social life. It set policies and controlled their execution through government officials and, effectively, made the government an element of the party. The CCP’s political leadership permeated in various levels of the government and institutions including the National People’s Congress (NPC), State Council and related Ministries and Bureaux. Important government policies were required to be submitted to the central party committee first for examination and approval before implementation (Zhang, 2005). During the early stages of the communist administration, the highly-disciplined new leadership gained the cooperation of all classes of people including the workers, peasants, petite bourgeoisie and the national capitalists in Chinese society. Social stability was achieved by implementing moderate social and economic policies with skill and effectiveness. However, several major political campaigns initiated by Mao, including “The Great Proletarian Cultural Revolution (1966–1976)”, put the nation in a state of serious political uncertainty. The

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12 Mao initiated several political campaigns against the “enemies of the state”, actual and potential, during his era. In the early 1950s, these enemies consisted of "war criminals, traitors, bureaucratic capitalists, and counterrevolutionaries". The major targets in this drive were foreigners and Christian missionaries who were branded as United States’ agents at mass trials. The 1951-52 drive against political enemies was accompanied by land reform. The redistribution of land was accelerated, and a class struggle between landlords and wealthy peasants was launched. An ideological reform campaign requiring self-criticisms and public confessions by university faculty members, scientists, and other professional workers was given wide publicity. Artists and writers were soon the objects of similar treatment for failing to heed Mao's dictum that culture and literature must reflect the class interest of the working people, led by the CCP. These campaigns were accompanied in 1951 and 1952 by the “three anti” and “five anti” movements. The former was directed ostensibly against the evils of "corruption, waste, and bureaucratism"; its real aim was to eliminate incompetent and politically
disorder in Chinese society caused the stagnation of the national economy during the 1960s and 1970s.

3.2.2 Political reform

The year 1978 proved a crucial one for the reformers in China. The new leader of the CCP, Deng Xiaoping, who sought genuine party reform, took the initiative to reorganize the bureaucracy and re-direct policy. The CCP then underwent a series of political reforms under Deng’s guidance after 1979 (Zhang, 2005).

The political reform in China focused on democratization which consists of three factors. First was the separation between the CCP and the state government. The Thirteenth Plenum of the Party’s Congress in 1987 clearly pointed out that the CCP’s function was to exercise leadership on political principles and directions, while the state government had more control over specific economic policies and strategies (Goldman, 2006). Local governments gained more power to formulate public policy, which took the needs of the local private economy into account (Fewsmith, 2006). Second, research establishes that a major shift in ideology underpinned the reforms, with the CCP moving from a dogmatic emphasis on the Maoist version of Marxism-Leninism to a pragmatic, market-oriented approach. Although the

unreliable public officials and to bring about an efficient, disciplined, and responsive bureaucratic system. The later movement was aimed at eliminating recalcitrant and corrupt businessmen and industrialists, who were, in effect, the targets of the CCP's condemnation of "tax evasion, bribery, cheating in government contracts, theft of economic intelligence, and stealing of state assets". In the course of this campaign, the Party claimed to have uncovered a well-organized attempt by businessmen and industrialists to corrupt party and government officials. This charge was enlarged into an assault on the bourgeoisie as a whole. The number of people affected by the various punitive or reform campaigns was estimated to be in the millions. In mid-1966 Mao's campaign against a wide variety of public figures, including State Chairman Liu Shaoqi and other Party and state leaders, had erupted into what came to be known as the Great Proletarian Social Revolution, the first mass action to have emerged against the CCP apparatus itself.
rhetoric of socialism has been retained (the so-called ‘socialist market economy’), the staunch anti-market, anti-private gain focus has been removed (Moutinola et al., 1995). Third, China has, for the first time under the communists, opened up its economy. In 1979, China established four special economic zones to facilitate foreign investment projects. In 1984, the central government declared fourteen coastal cities as “coastal open cities” and, in early 1990, several “development zones” were established among inland cities along the Yangtze River and cities bordering Russia, in order to further develop international trade and attract foreign investment (Moutinola et al., 1995).

Although there has been no significant improvement in respect of giving people individual rights of free speech and political participation, or establishing a viable system of competition for political office, or a set of constitutional limits on the state, during the past three decades, the political reforms in China have gradually introduced at least some limited democratic principles and some controlled political participation (Goldman, 2006). The system of the People’s Congress was resumed and direct election of the People’s representatives has been expanded to the country level. It has become a system where people from all levels can listen to reports from the government, the Court of Justice and Court of Procuratorate (Zhang, 2005). In addition, there has been a promotion of “public recommendation and public election”. From the late 1980s, villagers began holding multi-candidate elections for village heads and councils. During the early years of the 21st century, public elections had spread to 90 percent of China’s villages in rural areas, and to local government and neighborhood committees in the cities (Fewsmith, 2006). Meanwhile, the political reforms also led to the decentralization of decision-making and to an empowering of the lower-level officials in much of China. The system’s decentralization has made the central level less relevant. “It
3.3 Economic reforms in China

3.3.1 China’s economy prior to 1978

China’s political system determines its economic system (Zhang, 2005). The economic system in China has undergone some dramatic changes during the past six decades since the CCP established the PRC in 1949. Chiapello and Ding (2005) divided the Chinese economy into three major periods: introduction and application of the communist economic system (1949-1978), economic reform and the open door policy (1978-1992), and the development of a “socialist market economy” since 1992. The legitimacy characteristic of a communist economy is community well-being rather than economic efficiency. The communist economic system emphasizes equal wealth distribution, public property responsibility, wages and price controls, currency and trade regulations (Dillard et al., 2004).

Prior to 1978, the CCP maintained a centrally-planned communist economy and adopted a socialist heavy-industry-development strategy. As a result, household consumption was reduced while rapid industrialization was given high priority. By 1978, nearly three-quarters of industrial production was produced by centrally-controlled SOEs (Morrison, 2006). Perceived demand was converted into specific production targets for each enterprise. Capital, labor, equipment and materials were all allocated to enterprises on the basis of production targets set by state or local government through national ministries or departments (Li, W.,

used to be that when the CCP centre spoke, the people all listened and obeyed. That day is gone.” (Lewis and Litai, 2003)
The aim of the management in SOEs was to achieve the quantitative production quotas assigned by the government rather than good financial performance.

Between the early 1950s and the late 1970s, the goal of the Chinese government was to make the Chinese economy relatively “self-reliant,” which resulted in foreign trade being limited accordingly. Private enterprise and foreign-invested firms were non-existent under the public-property rights system advocated by the CCP (Morrison, 2006). The above policies kept the Chinese economy stagnant and inefficient, mainly due to the lack of profit incentives for enterprises and farmers. As prices and production were controlled by the central government, the lack of competition caused widespread distortions in the economy. The living standards of the Chinese people as a whole were significantly lower than those of many other developing countries.

3.3.2 The economic reforms and achievements

From the late 1970s, with the aim of increasing the productivity of SOEs and raising living standards, the Deng Xiaoping government began restructuring the economy from centrally-planned to more market-oriented, while remaining within the political framework provided by the CCP. This so-called “Socialism with Chinese Characteristics System” is in contrast to the “big-bang” reform adopted by post-communist Eastern Europe and the former Soviet Union. The economic reform in China is regarded as a reform with a “controlled but progressive manner” (Li, W., 1997). Although it still exerts strong control and influence over the business environment, the Chinese government has strengthened the function of macro-management while reducing micro-management intervention. It has switched its role from
administrative examination and approval in the economic field, to economic regulation, market supervision and public service (Zhang, 2005).

Under the socialist market economy, the dominant political and economic context faced by organizations has changed from communitarianism to market capitalism. The legitimacy characteristic within the socialist market economy is economic efficiency. Any institutional feature characterized as organizationally relevant is, ultimately, motivated and legitimated by the criteria of economic efficiency. Codified laws and regulations are to facilitate wealth accumulation, private property rights, free trade policies and commercial activities (Dillard et al., 2004).

One of the most fundamental changes that have occurred in China is the transformation from a public ownership system. Guo (2003) suggests that the ownership structure of the Chinese economy has transformed from a system of complete public ownership to the mixed ownership structure, with predominant public ownership coexistent with other economic elements such as cooperative, individual, private, foreign and joint venture organizational structures. The change of ownership structure indicates that the Chinese economy has departed from the pure socialism which featured predominantly public ownership.

The re-orientation of the economy involved a dramatic reduction in heavy industrial investment and a shift of resources toward the household sector by permitting a wide variety of small-scale private service enterprises and light manufacturing entities. As of 2005, the private sector contributed 70% of China’s GDP (Wikipedia, 2010). The industrial reform was characterized by decentralizing the economic control of SOEs from central government to provincial and local governments, increasing the authority of plant managers and liberalizing
commodity prices in order to create a competitive environment (Li, J., 1997). The productivity of SOEs between 1980 and 1989 significantly improved (Li, J., 1997). As a result of implementation of the ‘Open Door’ policy, foreign direct investment (FDI) became one of the major resources of China’s capital growth. Annual utilized FDI grew from US$636 million in 1983 to US$58 billion in 2005 (Morrison, 2006). Along with the increase in FDI was a rapid growth in international trade. Chinese exports rose from US$14 billion in 1979 to $762 billion in 2005, while imports over this period grew from US$16 billion to US$660 billion, producing a large trade surplus (Morrison, 2006). China’s demand for energy and raw material has become an increasingly important factor in determining world prices for such commodities (Morrison, 2006). In 2001, after nearly fifteen years’ negotiation, China joined the World Trade Organization (WTO) and, in doing so, became an indispensable participant in the global economy.

3.3.3 New capital resources for SOEs

Prior to 1978, state-owned enterprises (SOEs) in China were rigidly controlled by the Chinese government which attached great importance to heavy industry. The equipment and raw materials used by SOEs were all supplied by the government. The prices of material, products, the suppliers and customers of SOEs, were all determined by the government as part of the central planning system. The control of China’s enterprises rested primarily with the inside nominated managers who, in turn, were often controlled and supported in various forms by the Party and ministerial associates (Tam, 2002). The function of managers, who served as the Party’s agents, was solely to supervise the production process and ensure the actualization of government plans (Lin and Tan, 1999). In terms of capital resources of SOEs, state funds were collected through fiscal and other means of revenue collection and siphoned
off to SOEs. The government, therefore, placed little weight on commercial banking and the capital market as active players in financial intermediation (Suzuki et al., 2008). Due to the government being the sole stakeholder of the SOEs, the Chinese economy had stagnated for a long period of time. The government gained the profits but also bore the losses as the ultimate owner of the SOEs, and managers and employees had no incentives to maximize the profitability of the SOEs (Xu and Wang, 1999). The distinctive characteristic of SOEs was a culture of low productivity.

As part of the economic reform in China, the SOE reforms were launched in 1978. The essence of SOE reforms was a gradual relaxation of state central planning, implementation of various kinds of profit sharing schemes and increased autonomy over decision-making conferred to SOEs, and especially to the managers of SOEs (Qiang, 2003; Ren et al., 2005). In respect of financing the SOEs’ operations, the Chinese government in 1983 transformed the state budget allocations into loans, which were funded by four state-owned commercial banks13. The state-owned bank loans, therefore, replaced the government budget allocation and the major stakeholder of SOEs was changed from the Chinese government to state-owned banks. Although banks were the main financial resource provider of SOEs, banks did not have any power over SOEs in terms of whether to lend funds to them. In fact, the government prevented banks from operating on purely commercial terms with revenue generating activities, by forcing banks to provide subsidized lending to SOEs. Since the emergence of the capital market in China in the early 1990s, some SOEs have been transformed into shareholding companies, obtaining funds for further development and expansion from public investors. However, the majority of poorly-managed and inefficient

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13 China Industrial and Commercial Bank, China Agrisocial Bank, Bank of China, and China Construction Bank are the four state-owned commercial banks. In China, they are well known as “The Big Four”. The main functions of these four banks are to attract inexpensive, long-term capital to ensure credit for SOE and large state projects mainly in the areas of trade, agriculture, heavy industry and construction-related companies.
SOEs in China still relied upon bank loans. To avoid the potential social unrest caused by a high unemployment rate, the government felt obligated to support unprofitable SOEs by requesting state-owned commercial banks to extend loans or even provide the SOEs with more funds, with little consideration given to the borrowers’ repayment capacity (Xu, 2005). The formation of the Non-Performing Loan (NPL) problem was caused by the government’s intervention and the inefficiency of the SOEs. The China Banking Regulatory Commission (CBRC) reported that there was the equivalent US$340 billion in NPLs in the financial system by the end of 2004. PricewaterhouseCooper’s China NPL Investor Survey 2004, however, reveals a figure as high as US$500 billion (Xu, 2005).

The commitment to opening the banking and financial service market to foreign financial rivals under the World Trade Organization (WTO) agreement has pushed the banking and financial institution industry in China to be more independent, transparent and profit-driven. Public listing is one of the strategies to achieve these goals. Prior to public listing, the Chinese government assisted state-owned commercial banks to “unload” huge non-performing loans from their books. In 1999, as a solution for tackling the NPL problem, the government established four financial asset management companies (AMCs) and transferred the equivalent of US$55 billion of non-performing loans to those companies (Xinhua Press, 2005). The function of AMCs is to focus exclusively on debt collection. In addition, the four AMCs are allowed to negotiate with the borrowing state-owned enterprises and conduct a series of debt-to-equity swaps. In this way, the debts are transferred into equities and the AMCs have gained control over some enterprises (China Daily, 2005). The massive disposal of NPLs to AMCs has dramatically reduced the NPL ratio of banks and financial institutions. There were fourteen national and regional commercial banks listed in the Chinese stock market by the end of 2008. The two most publicized public listings are the China
Construction Bank and the Bank of China. The former was listed on the Hong Kong Stock Exchange in 2005 and the latter on the Shanghai Stock Exchange in 2006. The other two state-owned commercial banks, China Industrial and Commercial Bank and China Agrisocial Bank, were listed in 2007 and 2008, respectively.

The listing of commercial banks and the further opening up of the banking market to foreign financial institutions has led to some positive changes in the Chinese banking industry. Petkova (2008) discusses several strategies adopted by the Chinese banking system in order to strengthen the banks’ balance sheets. First, the Chinese banks began to adopt international practices regarding balance sheet criteria in which the capital ratios are based on the risk involved. Secondly, banks started to apply commercial lending criteria. In their lending activities, banks have been disconnected from the government-based policy and have shifted to lending based on generally accepted commercial banking techniques. To reduce NPLs, banks have strengthened the finances and management of SOEs. In 2007, the National People’s Congress passed the new Bankruptcy Law, aiming to reduce the NPLs by ensuring better respect for creditors’ rights. In the same year, some steps were taken to build national standards and networks for credit assessment. The central bank of China, the People’s Bank of China (PBOC), has sought to develop a national credit information database and has urged banks to unify regulations. The CSRC has issued the *Tentative Procedures for the Administration of Credit Ratings in the Securities Market* (Petkova, 2008).
3.4 Social changes in China

3.4.1 Traditional Chinese society

China is a country with a history of more than five thousand years of civilization. The traditional moral standards, social norms and values of the Chinese people are heavily influenced by Confucianism. The essential components of Confucianism are the doctrine of the means, rite of harmony, the group or country’s interest over the individual’s and morality over utility (Creel, 1953). Achieving harmonization is in the best interest of each member to enable them to live in a good society. Consequently, it emphasizes individual duties to family and society. Individuals must be ready to compromise and willing to sacrifice their rights and freedom for the sake of the harmonious order of the family or society. Moral cultivation is much more important than material wealth.

It is argued that Confucianism has played a positive role in maintaining peace and stability in ancient Chinese society, despite China being a country with a large geographical area and vast population, and the government being a huge, complex and layered bureaucratic structure (Ding, 1997). Influenced by the doctrine of means and the importance of harmony, people tended to avoid confrontation and extremes. Forbearance was considered a good virtue. In respect of people’s attitude to government and authority, forbearance means people only need to obey whatever orders are given, without understanding and questioning them. The power of feudal China was further strengthened by blind loyalty and a lack of democratic ideals.

There is a view that the traditions and customs in Chinese society, while assisting in maintaining social stability, gradually turned into conservative forces that slowed down and
even stifled the growth of innovative ideas and new systems. The enduring stability of China’s feudal society brought with it one serious effect – lasting stagnation. Social development was extremely slow. There was no revolutionary change in the social, economic or political system for two thousand years (Ames, 2003).

In summary, Confucian values had a double influence over society. Positively, they ensured the nation’s independence and unity, produced harmonious human relations, and cultivated the responsibility of individuals to society. Negatively, despising scientific rationality, they denied individual interests and self-development, causing one to be conservative and to seek peace, stability and safety (Deng, 2000). Hofstede and Bond (1988) examined the social characteristics of Chinese people. They identified the value dimensions of Chinese as: large power distance; strong uncertainty avoidance; collectivism; femininity; and long-term orientation. In general, Hofstede’s identification of the value dimensions of the Chinese people is consistent with the traditional Chinese culture.

### 3.4.2 Forces leading to social changes

Hofstede (1980) defines “culture” as a collective programming process by a society, which distinguishes the belief systems of its members from other societies. Can the culture of a society be changed? The extant literature provides some explanations in relation to a country’s culture change. Hofstede (1980) observes that the stability of culture patterns over a long period of time is the product of the dominant value systems, which are reinforced by the institutions in the society. Meanwhile, he points out that the value system is in a self-regulating quasi-equilibrium: it does change, but generally at a slow pace. The forces toward change come from the outside, in the form of forces of nature or forces of man including
trade, conquest, or scientific discovery (Hofstede, 1980). Other social scientists believe that there are four major factors that cause social changes in a nation. They are changes in the environment; contact with other cultures; invention; and the future development of the culture itself. Of these forces, Hofstede (1980) acknowledges that the economic factor which leads to the changes in the environment is the most important one.

Historical experience shows that economic development leads to a transformation in ideology, modes of thinking and sense of values (Fu, 2003). Hofstede (1980) also suggests that a society’s degree of economic evolution or modernity is a major determinant of social norms. His research shows that among the four dimensions of national culture, established empirically and based on his survey data, it is the individualism-versus-collectivism dimension which relates most closely to a country’s level of economic development and the femininity-versus-masculinity dimension the second. The cases of Egypt and Russia have also demonstrated that the transformation from a centrally-planned economy to a market-based economy is a long process involving changes in the philosophy of a society (Samadian, 1996; HassabElnaby and Mosebach, 2005).

3.4.3 Social changes in China during the past two decades

In traditional Chinese culture, “individualism” possesses the meaning of egoism and selfishness (Deng, 2000). The main stream of traditional Chinese culture upholds collectivism by educating people to ignore the existence of individuals or sacrifice the good of an individual if it is necessary, just in order to achieve the goal of the group or to protect the benefit of the family; organization or community the individual belongs to. The harmonization and stability of Chinese society and its political system are at the expense of
individual values and personal rights. This philosophy was inherited and further strengthened by Mao Zedong, the leader of the CCP and the President of PRC from 1949 (Shi, 2000). He extended collectivism to an extreme level, treating individualism as an evil threatening the development of the socialist society. Hofstede explains Mao’s idea as: “The selfish behavior which Mao condemns is not necessarily behavior at the expense of others. It is sufficient to place personal interests above those of the group or simply to devote too much attention to one’s own things. Collectivism does not mean a negation of the individual’s well-being or interest; it is implicitly assumed that maintaining the group’s well-being is the best guarantee for the individual” (Hofstede, 1980, p. 151).

The opening up of Chinese society since the beginning of the 1980s has led to the re-interpretation of the meaning of individualism. Individualism has been re-interpreted as people’s self-realization, self-determination and self-struggling. Human creativity, freedom and innovation have become the ingredients of individualism replacing selfishness (Deng, 2000). Along with the revival of individualism has been the growth of awareness of rights consciousness, particularly of political rights, as various individuals and groups have attempted to assert their right to speak out on a variety of issues without the CCP’s permission (Goldman, 2006). The 1978 Democracy Wall Movement and 1989 Tiananmen Demonstrations represent intellectuals’ challenges to the party’s political policies. In the beginning of the 21st century, increasing consciousness and articulation of political rights was spreading to the population as a whole.

The increase in individualism is also being reflected by the behavior observed in the workplace. The social background of employees is very evident in the work environment: workers do not abandon their social values and attitudes upon entering a working place (Hofstede, 1980). As part of Chinese society, the mindset of senior executives of Chinese
enterprises would be impacted by the social culture as well. Hofstede’s opinion on the role

generations can play in the process of culture change is: “Generation effects occur for values
that were absorbed by the young people of a certain period and accompanied their age
cohort over its lifetime. If conditions of life have changed, subsequent generations may carry
forward different values that they absorbed in their youth” (Hofstede, 2001, p. 35).

Ralston et al. (1999) lend support to Hofstede’s statement. Ralston et al. (1999) compared
values held by the old generation of managers in China who experienced the communist
consolidation (1949-1965) and the current generation of managers, whose adolescence
occurred during the Great Cultural Revolution (1966-1976), to the new generation of
managers who grew up mostly during the era of economic reform (1977-present). The
research findings suggest that the new generation of managers scored much higher on values
that are consistent with individualism, while scoring lower on traditional Chinese values such
as collectivism and Confucianism. One implication of the increased individualistic tendencies
of these younger Chinese managers is that they are more likely to act independently and
openly, and take risks in the pursuit of profit, even when those actions are in conflict with
traditional ways. The values of the new generation managers appear to reflect the
consequence of the government’s “open door” policy, the relative freedom the Chinese
people can now have and the greater exposure to western culture.

Closely related to the increase in individualism is the change from femininity to masculinity.
Under the planned economy, there was lifelong employment which not only included salary
payment to workers, but also accommodation, child care and medical benefits. In order to
maintain social stability, excessive government intervention and subsidies have saved the
inefficient state-owned enterprises from bankruptcy. People did not have a sense of risk and
competition; egalitarianism was predominant in society. Despite the losses made by the SOEs, workers and managers could still receive a low, but steady income to maintain their day-to-day life (Lewis and Litai, 2003).

The transformation to a market economy has brought both benefits and pain to Chinese society. Security of employment, which is highly valued by feminine cultures, has not been predominant in China since the mid-1990s (Deng, 2000). The development of a competitive business environment has resulted in some workers losing their permanent jobs due to lack of educational background, professional qualifications or desired skills. University graduates nowadays have the freedom to choose the job they are interested in but, meanwhile, they need to compete with others rather than relying upon the government to provide them with a guaranteed workplace position. Social security and welfare have been transferred from business enterprises to society. The Chinese business community is now being driven by profitability and productivity. Rewards for loyalty and conformity as well as group performance have been replaced by performance-based rewards for personal contributions in many Chinese corporations. Chief executive officers in large corporations have to confront enormous pressures, coming from the board of directors, the employees, shareholders and competitors (Deng, 2000). Individually, worship of money, wealth, achievement and individual success has gradually become acceptable values among the Chinese people.

3.4.4 Emergence of domestic investors in China

Since the economic reforms launched at the beginning of the 1980s, the level of income of urban and rural residents in China has continuously improved; China’s middle-class has expanded rapidly. Rising personal income has stimulated household consumption on the one
hand and resulted in a high saving rate in China on the other. With a population exceeding one billion, China’s saving rate has been as high as an average 40% of national GDP. Since the mid 1990s, the high saving rate has been correlated to factors including traditional Chinese culture and family concepts. The social structure changes caused by the economic reforms also contribute to the high saving rates. Many people prefer to have a bank deposit to fund their future retirement pension, education fees for children and the expenses of medical services and housing (China News, 2006).

Individual investors have emerged in Chinese society since the beginning of the 1990s, when stock exchanges were opened in Shanghai and Shenzhen. As part of the fiscal policy of the Chinese government, the interest rates in China have remained low. Some investors have started to seek higher rates outside of traditional savings accounts. The prosperity of the Chinese stock market has attracted increasingly more residents to invest their savings in relatively high-risk income stocks, funds and other investment devices. As a result, many have withdrawn money from banks and given it to security companies in the form of cash deposits (People’s Daily, 2005b).

Investors are investing capital resources in listed firms and, in return, they expect firms to maximize the return on their investment. The CSRC (2000) reports the Chinese stock market is primarily made up of individual investors. These individual investors are segmented, segregated and shareholding ratios are relatively low. As minority shareholders of listed firms, individual shareholders have, on average, no more than 0.3% of the seats on the board of directors or supervisory board, even though they are a group possessing approximately one-third of the shares (Xu and Wang, 1999). Various factors have restricted individual

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14 Regulators typically required that Tradable A shares accounted for no more than 25% of total outstanding shares when a company went public. Until July 1999, individuals were prohibited from holding more than 0.5% of total shares outstanding for any listed company; subsequently, the legal maximum for individual shareholders was increased to 5.0% (Berkman, 2008).
shareholders’ participation in the management and significant decision-making of listed firms. These include low shareholdings by individual shareholders, geography and the time zone differences (CSRC, 2000). Thus, the absence of cumulative voting procedures has significantly enhanced the control rights of a firm’s largest shareholder.

Chinese domestic investors have a reputation for seeking short-term trading profit rather than long-term dividend income and investment growth, which is evidenced by the short shareholding periods of 1-2 months in 1995, and 5.8 months in 2002, compared to the average 18 months shareholding period in the US (Deng and Wang, 2006). Such short investment horizons indicate that small individual shareholders neither have the willingness nor the capacity to monitor the management of listed firms closely. After more than a decade of development in the Chinese stock market, the number of individual investor accounts has increased from 8.35 million in 1992 to nearly 138 million by the end of 2007. The individual Chinese investors are also increasingly interested in the performance of listed firms and macroeconomic development when investing in the Chinese stock market. The value-oriented investment ideology is becoming more acceptable; and traders have been reported as becoming more rational and mature. The increasing number of institutional investors has changed the structure of investors in the Chinese capital market (People’s Daily, 2004).

The Chinese public investors have also progressively become aware that they can protect their interests through legal mechanisms. This change can be related to the social changes in Chinese society since the late 1970s. While the Confucius school dominated other philosophical schools, including the legalist school\textsuperscript{15}, civil action did not develop as an

\textsuperscript{15} Another influential philosophy in Chinese history is Legalism. Legalism is a political philosophy that does not address higher questions pertaining to the nature and purposes of existence; instead, it is concerned with ways of governing society (Wong, 2003). The essential view taken by Legalists is that the most effective way to control human behavior and maintain social order is through ritual, custom or ethics. Han Feizi is the prominent
independent body of law in China; rather, it has been subservient to the administrative and criminal law for the overall purpose of the empire’s stability. In traditional Chinese society, administrative courts and judicial courts were the same body and the head of each administrative court functioned as executive, judge and legislator. Private lawsuits were frowned on by the public and discouraged by the government. The administrative court regarded parties to the lawsuit as people who did not follow socially-accepted norms and had a nerve challenging the authority above them (Shao, 2003). Improved living standards and a more open society have contributed to change in some social norms and values. As discussed in previous sections of this chapter, the revival of individualism in Chinese society has led to a growing sense of rights consciousness. People living in a more masculine society pursue material wealth and individual success. The combination of these two social changes contributes to investor concerns about market abuse.

In 2001, nearly 900 compensation cases in relation to fraudulent financial statements, insider trading and market manipulation were lodged in the lower courts (People’s Daily, 2001). In early 2002, two reputable law firms filed plaints in the court on behalf of 363 investors and 700 investors who suffered from financial losses caused by fraudulent financial information disclosed by two listed firms. In November 2002, eleven individual investors obtained compensation of RMB 224,096 Yuan (US$28,012) from Hongguan Shiye and a related security underwriting company after a lawsuit lasting nearly four years. This marks the success of the first civil compensation case in China over fraudulent financial information.

advocator of Legalism. He used to be Xunzi’s student and accepted his opinion on human nature. As all human beings were born fundamentally depraved, selfish, greedy and lustful, Xunzi believed that humans could be made good through education, while Han Feizi suggested that humans could be made good only through laws. In his work, which was named after his name, Han Feizi contended that the laws should be written well enough and enforced aggressively; there was no need for individual leadership, for the laws alone were sufficient to govern a state. Whoever was ruler was powerful because the position held power, not because the person possessed any special qualities. Benevolence and humanity are not attitudes adopted by rulers because unless people are ruled by a strong, strict government, they grow lazy and disrespectful of authority (Deng, 2000).
The case reflects the attitude of government authorities and regulatory agencies towards further legal enforcement of various regulations in respect of listed companies (Shao, 2003). These high-profile civil compensation cases indicate that as major stakeholders of listed firms, shareholders’ actions can exert pressure on listed firms in the Chinese stock market in relation to corporate disclosure. The investment community, therefore, has created a demand for transparency in corporate disclosure.

3.5 Summary

Since the late 1950s, the shift of political emphasis in the Chinese Communist Party has enabled Chinese society to focus on the economic development of the nation rather than political campaigns. A series of economic reform measures implemented by the Chinese government has abandoned the pure public property system, allowing the co-existence of both public and private ownership. A market-oriented economy has replaced a centrally-planned economy in China. As a result, the operating environment of state-owned enterprises has fundamentally changed. In respect of capital resources, rather than relying solely upon funds budgeted by the Chinese government, enterprises now need to seek alternative capital resource providers. State-owned commercial banks and investors in the Chinese stock market have replaced the government’s role, providing enterprises with financial capital for their operations and for further expansion. Improved living standards and a more open society have led to changes in social norms and values. It can be observed that the Chinese people, especially the younger generation, worship power and desire wealth and individual success. Investors have emerged in Chinese society as a social group. The pressure they have exerted on listed firms to disclose transparent information reflects the changed social norms and
values. The changed social environment now enables Chinese investors to protect their interests through legal mechanisms, if necessary.

The significance of Chapter 3 is that it defines the political, economic and social changes in Chinese society in the past three decades. These changes have created an environment for new stakeholders of listed firms, such as investors and creditors, to emerge in the Chinese stock market. Chapter 4 will consider the unique characteristics of the Chinese stock market and the development of the regulatory framework of corporate disclosure.
CHAPTER 4

REGULATORY FRAMEWORK OF

CORPORATE DISCLOSURE IN CHINA

4.1 Introduction

Chapter 3 examined the political, economic and social changes that have occurred in China during the past three decades. This chapter explores another important component of the changed corporate disclosure environment, the accounting, reporting and disclosure system that has been established in China. The Chinese stock market has its own unique institutional setting. The overwhelming influence of state-owned shares creates two main problems for listed firms, namely, “one dominant state shareholder” and “insider control”. Poor corporate governance practices in the early stages of development of the Chinese stock market have become the main driving forces of the corporate disclosure regulatory framework.

The Chinese government continues to maintain its important influence on the development of the Chinese stock market. Its two regulatory agencies, the Ministry of Finance (MOF) and the Chinese Securities Regulatory Commission (CSRC) have been actively engaged in the regulation, administration and operation of listed firms in the stock market. The MOF has significantly reformed the accounting system in China and harmonized Chinese accounting standards with the International Financial Reporting Standards (IFRS). The CSRC devotes
itself to minority investor protection through building up the regulatory framework of corporate disclosure in China and the corporate governance régime in the Chinese stock market.

This chapter proceeds as follows. Section 4.2 discusses unique characteristics of the Chinese stock market, including its ownership structure, related agency problems and poor corporate governance practices in the early period of the Chinese stock market. The establishment of the regulatory framework of corporate disclosure is illustrated in Section 4.3. Section 4.4 assesses the CSRC’s efforts in minority investor protection among listed firms. The development of a professional accountancy association is detailed in Section 4.5. Section 4.6 summarizes this chapter.

4.2 Unique characteristics of the Chinese stock market

Being part of China’s economic reforms, the SOE reforms, as previously discussed, have been launched since 1978. The essence of SOE reforms has been a gradual relaxation of state central planning, the implementation of various kinds of profit-sharing schemes and increased autonomy over decision-making conferred on the SOEs, and especially managers of SOEs (Xu and Wang, 1999). The establishment of the Chinese stock market is the consequence of continuous economic restructuring, including SOE reform, in China. Aiming to raise capital funds for the Chinese enterprises from the public and to facilitate the modernization of the operation and management of Chinese enterprises, from the early 1990s, some of the SOEs were transformed into listed companies via corporatization, raising capital funds from the Shanghai and Shenzhen Stock Exchanges through their initial public offerings (IPO) (Wang,
Along with the development of the Chinese stock market, the problems associated with agency relationships and the conflicting interests between majority shareholders and minority shareholders, emerged in the Chinese business structures. The main reasons contributing to these problems were the unique ownership structures of listed firms in China and the poor corporate governance practices among the listed firms.

4.2.1 Ownership structure of listed firms

To analyze the ownership structure of Chinese listed firms, consideration needs to be given to the classification of shares and the trading restrictions imposed on different classes of shares in China. Shares issued are classified as either A-shares, B shares, H shares or N shares. A-shares could only be sold to Chinese investors, traded on Chinese stock exchanges in Chinese currency and financial reporting is under the Chinese GAAP. B shares could only be sold to foreign investors prior to April 2001\(^\text{16}\). These types of shares are tradable on Chinese stock exchanges, but in US dollars, and financial reporting is subject to IFRS. Companies that issue H shares are listed on the Stock Exchange of Hong Kong and this type of share could only be traded in HK dollars. N shares are listed on the New York Stock Exchange through an IPO.

The A-shares could be further classified into state shares, legal-person shares and tradable A-shares. State shares are owned by the central government and local government, but the ultimate owner, in fact, is the State Council of China. State shares are not tradable on stock exchanges, but are permitted to be transferred between domestic institutions, with the approval of the CSRC up until April 2005. Legal-person\(^\text{17}\) shares are held by domestic institutions including stock firms, state-private mixed enterprises and non-bank financial institutions.

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\(^{16}\) Since April 2001, domestic Chinese investors can also subscribe to B shares if they have a US dollar account.

\(^{17}\) A legal-person is defined in the \textit{PRC Company Law} as a non-individual legal entity or institution.
institutions and SOEs that have at least one non-state owner. Non-financial institutions include securities firms, trust and investment companies, finance companies and mutual funds. Legal-person owned shares are not tradable on the stock exchange; they were only allowed to be transferred between institutions until April 2005. The rationale behind the trading restriction of state-owned shares and legal-person shares was to ensure the “control” of the company remains with the state-owned or state-controlled shareholders. Tradable A-shares, representing only one-third of total shares issued, are owned by Chinese individual investors and they could be traded relatively freely among domestic investors. Figure 4.1 describes the ownership structure of listed firms in the Chinese stock market.

The status of share ownership could be described as concentrated share ownership during the early stage of the Chinese stock market. After more than a decade of operation, some changes have occurred to ownership structures. The official statistics published by the Chinese Securities Express show that although non-tradable shares still occupy a significant proportion of total shareholdings of listed firms, the average proportion of non-tradable shares has decreased from 72.58% in 1992 to 64.28% in 2000. The average proportion of state-owned shares has decreased from 51.3% to 38.90% (CSRC, 2009). In April 2005, the government initiated a program, aiming to eliminate various share ownership types and make all shares legally tradable A-shares. By mid-2006, this conversion process had been completed by 94% of listed firms (Jiang et al., 2008).
4.2.2 Agency problem in the Chinese stock market

The concentration of ownership among listed firms in the Chinese stock market caused an agency problem. Xu and Wang (1999) suggest that the agency problem in the Chinese context is not in the diverged interests between management of firms and their shareholders. It is in the form of conflicting interests between majority shareholders (state-owned shareholding) and minority shareholders (public shareholding). The illustration of two interrelated issues below is helpful in understanding how majority shareholders exploit minority shareholders in listed firms.

4.2.2.1 One dominating state-owned share monopolizes

The first issue is the close relationship between listed firms and their parent entities. The closeness is the direct result of the “privatization procedure” of SOEs in China. Briefly mentioned before, the Chinese government’s original purpose of transforming state-owned
enterprises (SOEs) into listed firms was to raise funds for SOEs and improve their performance, hoping that their operation could be more efficient and responsive to market competition. However, while the government has tried to give corporatized SOEs more autonomy, it is also concerned about the loss of controlling ownership rights. As indicated by Firth et al. (2006), many listed firms are “carve-outs” from SOEs, in which some or all of the profitable operations of an SOE are transferred to a new firm, new shares are sold to the public, and these shares are listed on the stock exchange. The SOE often, however, retains a controlling stake in the listed firm and becomes the parent entity. Since the establishment of the Chinese stock market, state ownership has been the largest shareholder stake in many listed firms.

As majority shareholders of listed firms, state shareholders are the organizations with authority to invest on behalf of the Chinese government, such as the state asset management bureaux and local finance bureaux. The equity stake of state shareholders in listed firms is normally converted from the properties previously allocated to SOEs prior to the SOEs being transformed into listed firms. Although the Chinese government declared in the mid-1990s that the ultimate owner of state shares is the State Council of China, there is no true owner.

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18 The transformation from an SOE to a listed firm is a result of considerations given to the socio-political environment and involved a series of procedures. The CSRC set a quota for the number of listings each year and gave the listing priority to enterprises engaging in agriculture, resources, transportation, telecommunication and high-technology prior to 1998. Local government and state ministries are encouraged to recommend leading enterprises with a good record of profitability and greater prospects to be listed on stock exchanges (CSRC, 1996). To become a listed firm, an SOE’s profitable operation is firstly registered as a new firm. The net assets of the SOE are re-valued and converted into state ownership. The shareholder of the state ownership is the original SOE, having controlling voting rights. This is called a “carve-outs” procedure by Firth et al. (2006). After this “carve-outs” procedure, the SOE becomes the parent entity of the new firm. Secondly, the firm needs to submit an application to the CSRC and obtain its approval. To be qualified for listing, a firm must pass the profitability requirements of the CSRC, having at least 3 consecutive years of profitable operations prior to the IPO process. Once the CSRC’s approval is obtained, the firm is examined by the Listing Committee of the stock exchange and is assigned with a numerical listing code. The IPO Prospectus can be released to the public after the above administrative procedures. This document must disclose the primary purpose of capital raising, the IPO offer price, number of different types of shares offered, the ownership structure prior and post IPO offering, composition of the Board of Directors, balance sheet and income statement for the past three years and earnings forecast (until March 2001). On average, six months after issuing the IPO Prospectus, the firm is officially listed on the stock exchange.
representing these properties in a practical sense, as the State Council of China represents all of the citizens of the PRC. Firth et al. (2006) found that the majority of the ownership of the listed SOEs belongs to the state, as people in the state are supposed to be the master of the country and owner of public properties in a socialist society. However, the public in general in China do not have direct control over public properties nor do they participate in the management of enterprises. Therefore, there is no true owner of state shares. Thus, this “lack of proper owner” of the state’s stake is commonly regarded as the most important reason that has led to corruption and poor corporate governance among listed firms (Xu and Wang, 1999; Shi and Weisert, 2002).

Although holding a majority of shares in listed firms, state investors in China do not have cash flow rights from the shares they hold; dividends and other payouts by firms are remitted directly to the Ministry of Finance or local governments (Deng and Wang, 2006). They are also prohibited from direct involvement in running listed firms. As a result, state investors must appoint representatives to work in the senior management positions in listed firms. The selection and evaluation of senior management are often determined by the CCP organizations. The senior management personnel must be members of the CCP and do not necessarily have skills to manage a commercial business. The consequence of such a political process is that representatives of state investors cannot play a significant role in terms of performance improvement and profit maximization. Research findings of Xu and Wang (1999), Hovey et al. (2003) and Leung (2007) all show a negative relationship between state ownership and firms’ performance.

The phenomenon of “one dominating state-owned share monopoly” is very common among listed firms in China. The consequence is the lack of restriction on “big” shareholders, who
can take opportunities to manipulate listed companies or invade minority shareholders’ interests by utilizing their priority position (DeFond et al., 1999). A typical example is the dominant shareholders’ control of the funds of listed firms. Dominant shareholders divert capital resources to purposes other than business operations, in contrast to listed firms which promise not to in their communications with public investors in their IPO prospectuses. Statistics compiled by the CSRC show that, by 2004, the dominant shareholders of 350 listed firms had improper control of funds and about US$7 billion of funds had been used for non-operating purposes. Among the listed companies which retreated from the stock exchange19, the most important reason for their failure was the dominant shareholders’ control and the use of capital funds in listed firms (Tong, 2004).

4.2.2.2 Insider control

The second issue derives from the first issue, it is the “insider control problem”. State ownership (where there is no true owner) means there is a lack of effective external monitoring of the management of listed firms. The controlling power of listed SOEs is concentrated in the hands of the directors and senior management, who share no material interests or risks in the company, but exercise dominant power, free from the checks of market discipline. Rubber-stamped shareholders’ meetings and dual roles undertaken by managing directors constitute the problem of insider control, enabling the controlling insiders to serve their own interests to the potential detriment of minority shareholders and even the whole firm. Deng and Wang (2006) list five typical insider controlling behaviors: (1) pursuing private benefits, such as embezzling companies’ resources for perquisite consumption; (2) conducting market manipulation through misleading the public investors or being engaged in insider trading; (3) seeking and retaining relationship advantages for

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19 A listed firm could be delisted from the Chinese stock market if the firm makes a loss for two consecutive years or has a negative return on equity (ROE) for three consecutive years.
themselves by using company resources, for example, state-owned companies may appoint persons who are helpful for them to keep good connections with the government officials; (4) appropriating company funds to develop their own political background; and (5) dealing with creative accounting and releasing fraudulent financial information and over-investing or excessively consuming the assets.

4.2.3 Poor corporate governance practices in listed firms

There was no notion of corporate governance in China until the mid-1990s. The enactment of the PRC Company Law in 1994 is regarded as a big step forward in improving corporate governance in China. According to the PRC Company Law, the basic corporate structure of a limited liability company consists of three tiers of control: the shareholders’ meeting, the board of directors, and the board of supervisors.

The board of directors is responsible to the general meeting of the shareholders: to convene and report to the general meeting; to fulfill the resolutions of the general meeting; to determine the operating plan and investment plan of the company; to prepare the annual financial budget and financial statements; to determine how profits should be distributed; to determine increases or decreases in the registered capital of the company; to determine the combination, separation, change or liquidation of the company; to determine the design of the company’s internal management organization and its establishment; and to appoint or dismiss the management team and supervise their remuneration.

The function of the board of supervisors is to supervise directors and senior officers, in order to ensure that they fulfill their responsibilities. The board of supervisors should consist of not
less than three supervisors and be comprised of representatives of shareholders and a reasonable proportion of representatives of employees (Articles 52 & 53, *PRC Company Law*). Directors, general managers and financial controllers should not hold a position concurrently as a supervisor. The duties of the supervisory board include supervising the directors and managers for any violation of laws, regulations or the articles of association of the company during their performance of company duties. They also have the right to examine the company’s financial affairs, instruct a director or manager to rectify his/her actions if such an act is harmful to the interests of the company, and propose the holding of special shareholders’ meetings.

There are several studies investigating corporate governance practices among listed firms in the early stages of the Chinese stock market. Xu and Wang (1999) suggest that due to the “one dominating state-owned share monopoly and insider control”, the three tiers of control did not function very effectively and efficiently. By studying the *PRC Company Law*, shareholders in China appear to have more managerial power than their counterparts in many Anglo-American countries, as shareholders in China have the power to call for meetings, elect and replace directors and supervisors, and approve the reports provided. In addition, they also have the right to examine the corporate final accounts, decide whether to issue additional shares and make decisions regarding corporate mergers, dissolution and liquidation. However, research findings show that shareholders’ meetings are often merely “rubber stamped”.

The dominance of state ownership enables the original state-owned enterprises to exert control over managerial appointments and incentives. A survey conducted in 2000 by the CSRC reveals that the majority of directors of boards were appointed via the state ownership.
Meanwhile, the independence of the board has been seriously weakened as the board is controlled by an “insider person” as a result of the duality of a board member also acting as chairman. The supervisory board is also incapable of identifying and addressing managerial corruption, due to its lack of real authority and power. It can be concluded that the “one dominating state-owned share monopoly under internal control” has been a major problem in blocking the way for Chinese listed firms to improve their corporate governance practices.

4.3 Regulatory framework of corporate reporting and disclosure

China’s economic development during the past twenty years has been facilitated by significant changes in the political attitudes and priorities of the CCP. However, a political tradition that originated in the era of central planning means the government still has a strong influence over the market-oriented economy in China (Xiao et al., 2004). In order to create a more attractive business environment and improve the efficiency of the Chinese stock market, the Chinese government has been heavily and actively involved in the establishment of a regulatory framework for listed firms. Since the mid-1980s, various governmental agents have released important regulations, including the Accounting Law, the Company Law, the Securities Law and the Code of Corporate Governance for Listed Companies, to regulate the accounting practices, external financial reporting, the corporate affairs and the trading behavior of the listed firms in the Chinese stock market. As a result, a comprehensive regulatory framework of corporate accounting, reporting and disclosure has been gradually built up. This section looks at three main components of the regulatory framework: the accounting reform, corporate disclosure régime and development of corporate governance.
4.3.1 The accounting reform in China

The transformation from a centrally-planned economy to a market-oriented economy demands a changed accounting system. The “fund accounting” adopted under the planned economy was unable to adequately serve and support economic reforms, as it lacked the capacity to handle diversified ownership and more complex business transactions (Tang and Lau, 2000). In response to the rapidly changing business environment, the MOF started to formulate a series of new accounting systems and standards based on western accounting concepts and practices. Without Deng Xiaoping’s bold call for rapid change towards a market economy in 1992, it would have been impossible for accounting standards containing principles previously perceived to be capitalist tools to be issued in China (Xiao et al., 2004).

4.3.1.1 The accounting and reporting system between 1949 and 1978

The objective of the accounting function in China between 1949 and 1978 was to serve the centrally-planned economy, as featured by the public-ownership model. Specifically, the accounting system in China was to reflect, analyze and assess the implementation of the state plan and to reflect the source of funds obtained by enterprises and the way funds are applied (Zhou, 1988). In the 1950s, isolated from western countries in areas of politics and economics, China allied with the Union of Soviet Socialist Republics (The Soviet Union) because of the shared social system and belief in communism (Chiapello and Ding, 2005). Under the socialist system, enterprises were owned by the state government on behalf of the Chinese people and, therefore, played a dominant role in the Chinese economy (Zhou, 1988).

20 The “Fund Accounting System” includes two main accounts, “Fund applications” refers to employment and utilization of funds in the acquisition of property, goods and materials for production, while “Fund sources” represents the channel for obtaining and generating funds.
The accounting system in China followed the pattern used by the Soviet Union, namely “fund accounting”. The role of “fund accounting” was to service the information needs of the government, the central planner and to assist the government in planning and controlling economic activities.

Prior to 1978, the managers of SOEs had little or no managerial autonomy. The state provided all the financing to factories and controlled virtually all the investment and operating decisions. Inputs were provided by the state and outputs were sold to the state at the price determined by the government. The government also specified the salaries and wages of the workers and managers of the SOEs. All profits were remitted to the state and all losses were covered by the government. The factories simply served the purpose of fulfilling the production quota stipulated by the government. Consequently, the managers of these factories had neither the incentive nor the managerial authority to reduce costs and generate profits (Xiang, 1998).

4.3.1.2 The accounting reform between 1980 and 1990

The period from 1980 to 1990 was a transition period when the Chinese economy was transformed from a centrally-planned economy to a socialist market economy. The accounting system reform during the transition period was driven by the forces of the economic and enterprise reform, and the “Open Door” policy. Since 1978, the economic role of the Chinese government has changed from the planner and manager of the economy at a macro and micro level, to the macro level only. The government significantly reduced its intervention in the affairs of individual SOEs and began to use indirect monetary and fiscal policy to achieve economic goals. SOEs were given autonomy in their operational and
financing activities: they were free to produce, set prices and compete with other suppliers for consumer market share in most areas of the economy. Meanwhile, the Open Door policy enabled foreign investment enterprises from Hong Kong, USA and Japan to operate and compete with SOEs in the Chinese domestic market. The emergence of private enterprises and foreign investment dramatically changed the capital structure of business enterprises in China. Foreign trading partners and investors required accounting reports that were based on accounting concepts and conventions with which they were familiar, and the reform to enterprise management also highlighted the need for reports suitable for decision-making at the enterprise level. Groom et al. (2005) suggest the reforms exposed the need for accounting standards on consolidation and equity accounting, as well as clarification of accounting treatments for paid-up capital, fixed assets and depreciation, intangible assets and goodwill, tax and profit appropriation. The “fund system” adopted from the former Soviet Union during the 1950s could not facilitate and support economic reform, as it lacked the capacity to handle diversified ownership and more complex business transactions, such as leasing of assets, real estate valuation, business mergers and foreign exchange transactions (Davidson et al., 1996; Tang and Lau, 2000).

In response to the rapidly changing business environment and to create a more attractive business environment for foreign investments, the MOF began to reconstruct its accounting rules, theories, practices, education and the profession (Chiapello and Ding, 2005). Since 1982, the main responsibility of the MOF has been to form and implement accounting laws and regulations at national level and also to examine the accounting systems and methods drafted by districts. The most remarkable achievement in terms of establishing accounting regulations was the issuing and enacting of the PRC Accounting Law in 1985. These regulations were widely regarded as a milestone in the legalization of accounting work
(Davidson et al., 1996). Zhou (1988) indicates that the purposes of the promulgation of the Accounting Law are, first of all, to prevent illegal financial activities such as corruption, embezzlement and speculation that had caused significant losses of state properties; and secondly, to improve the qualifications of practitioners, so they can possess the capacity to execute adequate accounting supervision and managerial control; and last, to protect accountants when they need to exercise their duties in fighting illegal and criminal activities. The main contents of the Accounting Law include the defining of the functions and sphere of responsibility of accounting officers and staff of enterprise units; identification of legal liability of accounting officers and staff; and specification of the legal liability and obligations of hierarchical administrative executives.

Since the beginning of the 1980s, the MOF has issued several accounting systems applicable to different industries. The uniform accounting system remained, but it was revised and improved by simplifying the chart of accounts, introducing reference numbers and permitting the financial bureau and agencies of local government to formulate certain supplementary regulations, in order to ensure the stability and consistency of the accounting information (Zhou, 1988). In addition to the above industry-emphasized regulations, the MOF also issued the Accounting System for Sino-Foreign Joint Ventures in 1984. The formulation of this regulation was widely regarded as the first attempt made by the Chinese government to harmonize Chinese accounting practice with international practice (Chow et al., 1995; Zhang, 2007). Giving consideration to the financial accounting and reporting needs of foreign invested enterprises, the new system, for the first time in China, adopted the accounting elements and financial statements widely used in western countries. Therefore, foreign investments were pivotal in pushing Chinese accounting practice towards IFRS during the
transition period. However, convergence of accounting standards was limited and application of accounting regulations was narrow in scope (Zhang, 2007).

Despite the above changes occurring in the economic context and accounting area, prior to the emergence of the stock exchanges in China at the beginning of the 1990s, accounting information was still used in national planning and macro-economic control. The state government was the ultimate user of financial information. There was no sense of external reporting and disclosure.

4.3.1.3 The capital market and accounting reform between 1990 and 2000

At the beginning of the 1990s, the Chinese government defined the destination of the economic reform as building up the socialist market economy system with Chinese characteristics. The accounting, reporting and disclosure system reform in China between 1990 and 2000 was driven by the emergence and rapid development of the Chinese stock market. Compared to the accounting reforms between 1980 and 1990, the accounting regulations promulgated during the 1990s had considerable impact on the financial accounting practice of listed firms. A principal component of this phase of accounting system reform was the development of financial reporting standards to fairly present the financial position and performance of enterprises participating in the share system (Winkle et al., 1994).

In 1992, the MOF issued the first national regulation, the Accounting System for Experimental Shareholding Companies, to specifically address the financial accounting for listed firms. The system stipulated in detail the general principles of accounting as well as the
accounting of assets and liabilities, shareholders’ equities, costs and expenses, operating incomes, profits and profit distribution. Accounting items and accounting statements were standardized, as were procedures and tasks for the audit of accounts. In addition, it also stipulated the formats and contents of accounting statements that listed companies must disclose to the public.

Effective from July 1993, the *Accounting Standards for Business Enterprises* (ASBE) were seen as a landmark development in the Chinese accounting system, reflecting the socialist market economy. The ASBE was regarded as a conceptual framework for financial reporting in China, guiding the production of accounting information and formalization of accounting standards (Davidson *et al.*, 1996). A big step forward made by the ASBE was the financial information user identification. In addition to the information needs of the main user, the state government, ASBE also acknowledged that the information needs of investors, creditors and other relevant parties must be satisfied. The ASBE represented a dramatic breakthrough and went a considerable way to bringing Chinese accounting systems into harmony with IFRS. Many features were incorporated which made the financial statements more understandable to foreign investors. Its theoretical underpinnings were congruent with that of accounting concepts adopted by the IASB, FASB and other national standard setters (Tang and Lau, 2000). These included the basic accounting principles of the accounting entity, accounting period, going concern and monetary measurement. To ensure the effective application and compliance of the ASBE standards, thirteen industrial accounting regulations were implemented in 1993 as a transitional arrangement to provide technical guidelines. These thirteen regulations integrated the industrial characteristics and requirements of the ASBE standards and provided listed firms with detailed rules for the recording of transactions, a chart of accounts and the formats of financial statements. The empirical results show that the
application of ASBE, in conjunction with the thirteen industry-specific accounting regulations, substantially improved the understandability and comparability of accounting information provided by Chinese enterprises (Chen et al., 1999).

The formulation and release of specific Chinese Accounting Standards started from mid 1997. On 22nd May 1997, the MOF released the Accounting Standards for Business Enterprises: Related Party Relationships and Transactions, to tackle the lack of transparency of related party transactions and improve associated disclosure. Listed firms in China were reported to be using related-party transactions to “enhance” their performance and manipulate earnings (Ma, 2005). For example, a listed firm can purchase raw material from its related parties at a price far below the market price and, meanwhile, sell the products to other related parties at a price far above the market price, in order to artificially improve profitability (Groom et al., 2005). The deal was motivated by either attracting more capital from the stock market or avoiding delisting by the CRSC. Whether the standard has effectively improved the creditability of financial statements could be questioned. Despite the fact that majority-listed firms disclose related-party transactions according to the requirements of the standard, corporate financial scandals involving related-party transactions have never stopped (Ma, 2005).

Nevertheless, related-party standards were the first Chinese Accounting Standards and since their release, between 1998 and 2003, the Chinese Accounting Standards Committee (CASC), under the instruction of the MOF, has issued another fifteen accounting standards. These address the accounting and reporting requirements for the cash flow statement, events after the balance sheet date, debt restructuring, revenue, investment, construction contracts, changes of accounting policy, estimates and corrections of accounting errors, non-monetary
transactions, contingencies, intangible assets, borrowing costs, leases, interim reporting, inventories and fixed assets. These standards were all developed with reference to IFRS.

Efforts were continuously made to shorten the distance between Chinese accounting practices and internationally accepted practices. In early 1998, the MOF promulgated the *Accounting Regulation for Listed Companies*, aiming to eliminate discrepancies between the ASBE and the IFRS. The new regulation made some significant changes in terms of bad debt allowances, inventory valuation, investment valuation, equity/cost method, organization costs, revenue recognition and consolidation. The Chinese government claimed that the 1998 regulation was in harmony with IFRS in all major aspects and the accounting practices of listed firms in China (Chen *et al.*, 2002). However, the empirical results cannot lend strong support to this claim. There was no evidence available showing that the 1998 regulation had significantly reduced the gap between Chinese GAAP earnings and IFRS earnings.

### 4.3.1.4 Completion of the accounting framework between 2000 and 2007

At the beginning of the 21st century, WTO accession became the main impetus for the Chinese government to speed up its international accounting standard harmonization process. Simultaneous to the issue of Chinese accounting standards more closely aligned with IAS GAAP, was the promulgation of the *Accounting System for Business Enterprises (System)* in 2001 by the MOF. The *System* functioned as a comprehensive financial reporting framework, emphasizing principles such as substance over form, consistency, timeliness, understandability, accrual basis, prudence, materiality and transparency. A significant development in terms of asset measurement was the requirement to recognise impairment losses on all assets. Listed firms were required to follow one unified financial accounting
system rather than industry-specific regulations. Supposedly, the increased comparability would enhance users’ decision-making. However, financial scandals that occurred between the late 1990s and early 2000s damaged the credibility of the Chinese stock market and weakened public investors’ confidence in the financial information being provided to the market.

The need to attract foreign investment and further develop the Chinese stock market motivated the Chinese government to enhance the reputation of the Chinese stock market amongst the international investment community. The new System was viewed as the Chinese government’s response to the “accounting information crisis” caused by misleading financial reporting (Xiao et al., 2004). The harmonization process was ongoing, with the MOF directing that the CASC’s work program, including the development of new standards and reissue of existing standards, aligned with IFRS. During 2005, the CASC issued 21 Exposure Drafts and also reviewed its 16 existing standards. As a result, China’s Accounting Standards System for Business Enterprises was further developed with a view to achieving convergence of those standards with the equivalent IFRSs.

On 16th February 2006, the MOF announced the new Accounting Standard for Business Enterprises (ASBE). The ASBE consists of the Basic ASBE and 38 specific ASBEs that are substantially in line with international standards. The Basic ASBE replaces the 2001 System and functions as a new conceptual framework; specific ASBEs replace existing standards and address nearly all areas covered by IFRSs. The new ASBE changes the primary basis of financial accounting in China as it moves toward emphasizing the new philosophy of providing decision-useful accounting information to investors and the public (MOF, 2006). It is not simply an expansion of the disclosure requirement, but is expected to have a significant
effect on how an entity’s financial position and performance are presented in the financial statements. Changes to some areas are notable, such as the share-based payment transactions for employee services, business combinations, accounting treatment for goodwill, discount on acquisition of a business, presentation of minority interest and development costs, derivatives recognition, measurement of finance leases and the recognition of the tax effect of temporary differences between the tax basis and the carrying amount of assets and liabilities (Deloitte, 2006). The new ASBE, effective from 1st January 2007, is mandatory for all listed firms in the Chinese stock market. By the end of 2006, the MOF had issued implementation guidance on 32 of the 38 ASBEs, aiming to assist listed firms to cope with the new financial accounting standards.

Concurrent with the IFRS convergence of financial accounting standards, is the movement toward adoption of International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB). The issuance of a series of exposure drafts by the China Auditing Standards Board (CASB) and the Chinese Institute of Certified Practicing Accountants (CICPA) resulted in the adoption of 48 new Chinese Auditing Standards based on ISAs in February 2006, effective for listed firms from 1 January 2007.

The fundamental change, as a result of accounting reform and international accounting standard convergence, is the change of the objective of financial reporting in China. Under the centrally-planned economy, the Chinese government was the main and sole user of enterprise reporting. The only role of financial reporting was to provide information to the government for planning purposes, for resource allocation decisions and for monitoring of the plan. The SOEs prepared financial statements to report their production levels and cost data according to a uniform style; there was no real system of external financial reporting (Tang
and Lau, 2000). In contrast, the objective of financial reporting under the market-oriented economy is, according to the MOF, “to meet the needs of national macro-economic administration, the needs of all concerned parties to understand the financial position and operating results of an enterprise” and “to strengthen accounting work of share enterprise, to protect the legitimate interest of investors and creditors” (MOF, 1992). Users of financial reporting include non-government bodies such as non-state investors, creditors and other users of financial information (Tang and Lau, 2000).

4.3.2 Establishment of a corporate disclosure regulatory framework

The primary purpose of a corporate disclosure regulatory framework in China is to improve the efficiency of the Chinese stock market and protect investors’ interests (CSRC, 1996). The regulatory framework of corporate information disclosure in China is comprised of four tiers. The corporate disclosure régime is built of regulations stipulated by the National People’s Congress, the State Council, the CSRC and the stock exchanges in Shanghai and Shenzhen.

On top are the basic laws released by the National People’s Congress, the PRC Company Law and the PRC Securities Law promulgated in 1993 and 1999, respectively. The Company Law imposes legal responsibilities on public issuing companies to disclose their financial reports to public shareholders, not to provide fraudulent financial information and that non-disclosure will lead to fines. The Security Law aims to regulate share issuing and trading of shares. The law requires listed firms’ continuous disclosure, forbids fraud, insider trading and market manipulation in issuing and trading securities. Article 69 states that if the share prospectus, measures for offer of corporate bonds, financial or accounting report, listing report document, annual report, interim report or ad hoc report announced by an issuer or a securities
underwriting firm contains any falsehood, misleading statement or major omission, thus causing losses to investors in the course of securities trading, the issuer or the firm shall be liable for the losses, and responsible director(s), supervisor(s) and/or the manager of the issuer or the firm shall be jointly and severally liable for such losses.

The second layer is the administrative regulations released by the State Council. In April 1993, after three years of stock exchange operation in China, the *Temporary Regulation of Share Public Issuing and Trading* became the first regulation to standardize the information disclosure of listed firms. However, for the listed firms, it is still a regulation at the principle level rather than a practical guide. This regulation determines the direction and emphasis for the stock market regulator – the CSRC\(^{21}\). It is the CSRC’s responsibility to produce detailed guidance to assist listed firms to implement the administrative regulations.

The third layer is *Detailed Rules for Implementation of Information Disclosure of Publicly Listed Firms* released by the CSRC in June 1993. This regulation marks the beginning of a series of specific disclosure rules and requirements stipulated by the CSRC in order to strengthen the transparency of information disclosure made by listed firms. The regulations issued by the CSRC from 1993 to 2003 can be classified into four categories: Standards of Contents and Formats of Information Disclosure by Public Issuing Firms (14 documents);

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\(^{21}\) To regulate trading activities and information disclosure of listed firms in the Chinese stock market, two government regulatory agencies, the State Council Securities Commission (SCSC) and China Securities Regulatory Commission (CSRC) were established in October 1992. The SCSC was the state authority responsible for exercising centralized market regulation, while the CSRC operated as SCSC’s executive branch, responsible for conducting supervision and regulation of the securities markets. In August 1997, The State Council decided to put the securities markets in Shanghai and Shenzhen under the supervision of the CSRC. Meanwhile, offices of the CSRC commissioners were set up in the two municipalities. In April 1998, pursuant to the State Council Reform Plan, the SCSC and the CSRC were merged to form one ministry directly under the State Council. Both the power and the functions of the CSRC have been strengthened after the reform. In December 1998, The Security Law clearly stipulates that the CSRC is the main supervisory organization of the Chinese securities markets. The two stock exchanges are under the ultimate authority of the CSRC and they are delegated powers to regulate firms under their jurisdiction. Thus, a centralized securities supervisory system was established.
Preparing Rules of Information Disclosure by Public Issuing Firms (17 documents); The Answers to the Queries of Information Disclosure Regulations of Public Issuing Firms (6 documents); and Other Regulations (6 documents) (Ma, 2005).

Of these standards, Number 2, *Contents and Formats of Listed Firms’ Annual Reports* was first released in January 1994. It is the first regulation for the content and format of annual reports in the Chinese stock market. In 1997, the CSRC established the formal draft and later amended it in 1998, 1999, 2001 and 2002, respectively. A series of revisions have significantly increased the information that listed firms are mandatorily required to disclose to the market. In addition to financial information, listed firms are required to disclose information related to corporate governance, such as ownership structure and working experience and education background of directors and management personnel. Hu (2002) indicates that there have been several steps taken by the CSRC in improving the information usefulness of the annual report. First, this regulation explicitly requires firms to disclose the information related to earning distribution. When companies make a profit but decide not to distribute dividends to investors, listed firms are required to disclose reasons and a plan of how the retained profit will be used. This requirement reflects the CSRC’s concern for public investors’ interest protection. Second, listed firms are required to disclose whether there is a complete separation of management personnel, assets and the financial system between listed firms and their parent entities. Listed firms are supposed to be the pioneer of modern enterprises in China; it is the CSRC’s expectation that listed firms should undertake a leadership role in corporate governance. Third, this regulation addresses specifically the independent role of accounting and auditing firms. An annual report must be accompanied by an auditor’s report.
Since 1993, listed firms have been required to lodge their interim financial report, annual report, acquisition announcements and significant events announcements with the CSRC. In terms of the means of information disclosure, the full text of the annual report must be published on the CSRC’s official website within four months after the reporting date. A summary of these reports must be published in at least one of the national newspapers appointed by the CSRC. The CSRC also takes into account the fact that a large number of individual investors in China reside in diverse locations and requires listed companies to make information available not only at the firm’s premises, the stock exchange, the relevant licensed brokers and their branches, but also to publish their annual report using specified publication requirements and the internet concurrently (CSRC, 2000).

The fourth layer is the listing rules and specific guidance released by the two stock exchanges. These rules and guidance are subject to the approval of the CSRC. In 1998, the Shanghai and Shenzhen stock exchanges released the Rules Governing the Listing of Securities, further defining the stock exchange’s forefront surveillance responsibility of information disclosure.

4.3.3 Corporate governance régime

As one of the important participants in the global economy, China has responded to the emphasis on corporate governance worldwide by establishing its own corporate governance principles for publicly-listed firms. The two most important regulations stipulated by the CSRC are the Guidelines for Establishing Independent Directors System for Listed Companies in 2001 and Code of Corporate Governance for Listed Firms in China in 2002. The former tries to overhaul the insider-controlled board structure problem by promulgating a
requirement that the board of each listed firm is to have at least one-third independent directors by June 2003. The latter addresses the rights of shareholders and stakeholders, the responsibilities the directors and management of listed firms should undertake, and the importance of information disclosure.

4.3.3.1 China’s Code of Corporate Governance

In January 2001, the CSRC issued its *Code of Corporate Governance for Listed Companies in China*, based on the *OECD Principles of Corporate Governance*, 1999. This code signals a new direction in the development of China’s corporate sector and has been used as an important tool for raising the standard of corporate governance in China (Tomasic and Andrews, 2007). The CSRC’s 2001 Code addresses several aspects of corporate governance, including shareholders and shareholders’ meetings; listed firms and their controlling shareholders; directors and boards of directors; the supervisors and the supervisory board; performance assessment and incentives; and disciplinary systems and stakeholders. Chapter 7 of the Code gives special attention to information disclosure and transparency, by addressing detailed disclosure requirements for listed companies. In addition to financial information, companies must disclose information regarding corporate governance and controlling shareholders’ interests. It is recorded that it is the responsibility of listed companies to provide shareholders with truthful, accurate, complete and timely information, as required by laws and regulations. The code itself does not give a definition of transparency but listed firms are encouraged to voluntarily disclose all other information that may have a material effect on important decisions to ensure equal access to information for all investors.
4.3.3.2 Independent director system

One way of seeking to improve Chinese corporate governance and to solve the problems caused by “insider” control among listed firms is to seek the appointment of independent directors (Tomasic and Andrews, 2007). A survey of listed firms in Shanghai, conducted by Tam (1995) in 1992, reveals the following board composition: independent directors, 30.6%; representatives of legal-person ownership, 10.6%; government department, 10.6%; and representatives of foreign investors, 5.7%. Compared to an average of 75% independent directors on the board of publicly-listed firms in the United States, the proportion of independent directors in firms listed on the Shanghai Stock Exchange is relatively low. Several high profile corporate scandals in 2000 and 2001 highlighted the poor corporate governance practices among listed firms in the Chinese stock market. The existence of both a board of directors and a supervisory board did not prevent the disclosure of false information.

To protect public investors’ rights and interests, in August 2001, the CSRC released the *Guide Opinion on Establishing Independent Director System by Listed Companies*, hoping that independent directors taking on more of the monitoring responsibilities would result in greater transparency in listed firms. The independent directors system required the managing board to be comprised of at least one-third independent directors by 30th June 2003. The CSRC defines “independence” as being independent from controlling shareholder, management and major business relations. Candidates’ qualifications as independent directors must be checked and approved by the CSRC before they can be elected at a shareholders’ meeting. Candidates for independent directorships are required to make a public declaration on their independence qualifications and their information needs to be published in the newspapers. The CSRC reports that by June 30, 2002, more than 2,300 independent directors had been elected and appointed at shareholder meetings of listed
companies. 80% of the 1,084 firms appointed 2 independent directors on their board of directors, and 70% of companies have at least one accounting professional as an independent director (Zhang, 2002). In the new regulations, the main responsibility of independent directors is to protect investors’ rights, especially public minority investors. Independent directors are authorized to submit proposals to call shareholders’ meetings, recruit or dismiss accounting firms, invite in independent auditors and offer independent financial reports, apart from their normal duties as board members. Major related-party transactions have to be approved by independent directors and independent directors can serve as chairs of the auditing, compensation, and nomination committees and they must be in the majority on those committees. The independent director system has contributed positively to the credibility of corporate information disclosure and increasing minority investors’ wealth (Tomasic and Andrews, 2007).

The CSRC recognizes that rules and regulations will not necessarily bring about investor protection in the Chinese stock market unless proper training of the main participants of the Chinese stock exchange and strong enforcement are implemented. To promote corporate governance practice among listed firms, the CSRC conducts workshops and training courses. The requirement for independent directors has created a huge demand for qualified directors. By offering training courses on the roles and responsibilities of directors, CSRC is able to develop a pool of candidates from which the listed companies can choose independent directors (Zhang, 2001). Monthly training classes for independent director candidates were run in big cities including Beijing, Shanghai and Shenzhen. There were five thousand candidates trained between 2001 and 2002. The CSRC believes strongly that the educational process will enhance understanding of the importance of corporate governance by both firms and investors.
4.4 Enforcement of investor protection

One of the most important measures necessary to maintain the sustainable development of the Chinese stock market is minority investor protection, given the problem of “one dominating state-owned share monopoly under insider control”. Minority or public investors’ interest has been expropriated by majority shareholders since the establishment of the stock market in China (Xu and Wang, 1999). Over the years, investor protection has been acknowledged by the MOF, the CSRC and both stock exchanges as one of the most important measures to support the steady growth of the Chinese stock market. In the speech given at a Chinese Business Summit in 2001, Laura Cha, the Vice Chairman of the CSRC, pointed out that given the overwhelming proportion of state ownership and the inferior position of minority shareholders in listed firms, minority investors need to be given priority protection due to information asymmetry. Minority investors, if well-protected, will establish confidence in the Chinese stock market, leading to more funds being invested in the market and greater investor participation. Thus, the better protected the investors are, the better role the capital market will play in the allocation of resources, leading therefore to the sound and efficient development of the entire national economy.

“Investor protection” is a relatively new concept in Chinese society and there are two ideological issues affecting the implementation of investor protection in the Chinese stock market (CSRC, 2007). First, prior to economic reform, China’s centrally-planned economy was based on material production. It was widely held that only tangible productions such as wheat, steel and automobiles could make contributions to society, the economy and wealth creation. Service industries, banking, finance, tourism and storage were thought of as not
creating or increasing real wealth for the nation because they did not manufacture or produce any material products. Secondly, the income distribution principle is derived from the material production concept. The income distribution principle under the planned economy stresses that only labor-producing material wealth is entitled to eventual distribution. This narrow understanding of the economy and wealth creation has cast doubts on whether securities investment can create value in the way that material production does. This doubt unavoidably gives rise to the question of why securities investors’ interests need to be protected. Therefore, the CSRC recommends that it is necessary to promote a deeper awareness and understanding of the concept of investor protection. Without a real understanding of the significance of developing the securities market, and a full affirmation of the role of stock investment, the protection of investor interests would not be able to be implemented in a real sense (CSRC, 2007).

4.4.1 Justification of regulatory agencies’ role in investor protection

La Porta et al. (2000) argue a legal approach is a more fruitful way to understand corporate governance and to protect minority investors. In China, although the Chinese government has enacted the Company Law and the Security Law in recent years, the overall legal system is still relatively primitive by the standards of capitalist countries (Berkman, 2008). China’s first civil compensation suit regarding a securities case, illustrated in the previous section, reflects on one hand, the activism of the investment community in China. On the other hand, as Chen et al. (2005) suggest, one successful civil suit in the first 12 years of the Chinese stock market is a testament to the lack of legal redress in securities cases. Under the Security Law, a civil case against a listed firm can only be brought to the court after the CSRC has made an investigation. Class action lawsuits are not possible in China and so a lawsuit brought by an individual investor is very costly and has a low probability of success (Chen et al., 2005).
Given the weak legal mechanism in China in respect of investor protection, the question needs to be raised, who is in the best position to play this role in the Chinese stock market? Glaeser et al. (2001) suggest that in emerging markets with relatively weak legal systems, regulators can provide an effective substitute for ineffective judicial enforcement. This proposition is particularly relevant to the Chinese stock market. Research has shown that in China the government’s regulatory agency group including the MOF, the CSRC and stock exchanges, can jointly provide an investor protection role (Chen et al., 2005; Berkman, 2008).

4.4.2 CSRC enforcement

Aiming to promote and protect investor interest, the CSRC introduces, on average, twenty major policies each year to address the stock issue system, trading and supervision of listed firms (People’s Daily, 2005d). Since the establishment of the CSRC in 1992, more than 300 regulations, rules, standards and guidelines concerning the securities market have been stipulated by the MOF and the CSRC. In respect of its enforcement, the CSRC declares that its major responsibilities are supervising security markets and exercising vertical power of authority over the regional and provincial supervisory institutions of the market, and investigating and penalizing activities violating securities and futures laws and regulations. The CSRC acknowledges that investors are expecting stronger supervision of listed firms’ information. Firms that fail to provide the capital market with timely, adequate and transparent information will face severe penalties from the CSRC (People’s Daily, 2005a). In the early and mid-1990s, the CSRC enforcement actions were weak and punishment was lax. Thus, in the earlier days, the CSRC was viewed as being ineffective (Chen et al., 2005).
From 1998, the CSRC gained overall regulatory power and has over-riding control over the securities industry.

The CSRC initiates investigations based on a number of leads. According to Chen et al. (2005), leads include complaints from investors, information from insiders or former employees of firms, newspaper articles, analyses of annual reports and other corporate disclosures, referrals from the stock exchanges, legal disputes and police investigations. In addition to formal investigations, the CSRC also conducts on-going surveillance of listed firms and has a practice of regular reviews and random investigations. The process is similar to that of the Securities and Exchange Commission (SEC) in the US. The results of the CSRC’s investigations are made public if wrong-doing is found. If an infraction is deemed to be very minor, the CSRC will give an internal warning to the firm and there will be no public disclosure of either the investigation or its outcome. Public admonishments take four main forms. They are public criticism, public condemnation, official warning and monetary fines. These four categories of admonishment are stipulated in the Security Law. For individuals, the sanctions can include criminal prosecution and carry severe penalties. An example of the possible severity of the penalties occurred in 1999, when the chairman and general manager of Dongfang Boile were sentenced to death for fabricating financial statements. Table 4.1 summarizes the number and category of firms which received CSRC’s public condemnation for providing misleading information to the Chinese stock market between 1996 and 2006.
To enforce the Chinese accounting standards, the MOF, jointly with the CSRC, supervise financial accounting information disclosures made by listed firms on the Chinese stock market. The CSRC has the power to punish listed firms and their auditors if non-compliance with accounting standards and audit criteria or false financial information is found. Penalties for the CPA firms that do not apply appropriate standards can include cancellation of licenses, temporarily or permanently. By the end of 2004, the CSRC had completed the investigation of 851 cases and 953 related persons had been punished, most for disobeying the accounting standards and showing false information in their reports (CSRC, 2005).

The CSRC has also publicly pledged to improve the transparency of its own work to ensure the efficiency of capital market reforms and to curb corruption. In 2005, the CSRC further implemented the stock market reform plans mapped out by the State Council and steadily opened up the market. According to Shang Fulin, the former chairman of the CSRC, strong protection of the interests of public investors is the priority for the reforms, and an accountability culture needs to be developed (CSRC, 2000). The CSRC has also increased its

### Table 4.1 Public condemnation of inappropriate behavior of listed firms

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(Source: the CSRC website http://www.csrc.gov.cn)
interaction with the media and the public investors, such as offering more detailed introductions of the new policies to investors and conducting more interviews with the media.

The “transparency” principle of the CSRC can be reflected by the composition and work of its listing approval committee. The Committee, which reviews and approves the listing applications of domestic companies, was established by the CSRC in 2003. The members are made up of representatives from other government departments, securities businesses, lawyers, accountants, fund managers and academic scholars who can represent some interest groups and present professional opinion on listing. Since 2003, the names of the members that review each stock or bond issue application have been released on the CSRC’s website to ensure transparency. In fighting against corruption in the process of listing approval, the CSRC has also pledged to create legal access for normal communications between listing committee members and the listing applicants, such as giving the latter more opportunities to introduce their enterprises and respond to problems raised during the reviews (CSRC, 2005).

4.4.3 The stock exchanges’ role in investor protection

Under the close supervision of the CSRC, Shanghai and Shenzhen stock exchanges established their own listing rules in 1998 and strengthened their roles in supervising information disclosure. While endeavoring to provide facilities for the securities trading and monitoring thereof, the two stock exchanges also participated in championing the improvement of corporate governance, especially in respect of protecting investors’ interests and the transparency of information disclosure. In 2003, the Shenzhen Stock Exchange issued the Guidelines on Protection of Investor Rights and Interests for Small and Medium Enterprises Board. Article 12 of this guideline stresses that listed companies should “truthfully, accurately, completely and timely disclose the information that may significantly
impact the price of stocks and derivatives or the decision-making of investors, and such information must not contain falsehoods, misleading statements or material omissions. The person with disclosure obligation shall, based on the principle of good faith, voluntarily disclose other information that is not required by laws, administrative regulations and rules, as well as the rules of the Exchange. Listed firms shall ensure that investors have equal access to the information disclosed and shall not make selective disclosure”. Article 13 emphasizes that “when making voluntary disclosure of forward-looking financial information, listed companies shall follow the internal audit procedures, issue risk warnings to investors stating the assumption basis for such forward-looking information and any uncertainty involved and, in accordance with actual conditions and in a timely manner, modify the information previously disclosed”.

In addition to releasing and implementing rules to regulate information disclosure by listed firms and safeguard the interest of public shareholders, these two stock exchanges also take some action to maintain the sustained development of the stock market. They monitor the dominant shareholders’ illegal use of funds of listed companies; in conjunction with the assistance of local governments, they enforce state shareholders to return funds to listed companies to ensure the capital resources raised from the stock exchange are used for legitimized purposes. The regulatory department within the Shanghai Stock Exchange has also released reports to expose the bad behavior of some security investment companies in the stock market. It is complementary to Chinese accounting standards that disclosure is reasonable and systematically and efficiently enforced. It also helps to ensure that the Chinese accounting standards are properly implemented. Taking a similar attitude as the
CSRC in respect of investor protection, the two stock exchanges also undertake strong enforcement to promote transparent disclosure in the stock market22.

### 4.4.4 Market reaction to regulatory agencies’ actions

Market reactions to the CSRC’s actions are investigated by Chen et al. (2005) and Berkman (2008). Chen et al. (2005) provide empirical evidence on the impact of the regulatory agencies’ enforcement actions on the valuation of listed firms. In their study, the authors identify 169 enforcement actions carried out by the CSRC in the period 1999-2003. Using event study research methodology, Chen et al. (2005) find that enforcement actions implemented by the CSRC have a negative impact on stock prices, with most firms suffering wealth losses of around 1-2% in the 5 days surrounding the event. Moreover, they find that firms have a greater rate of auditor change; a much higher incidence of qualified audit opinions; increased CEO turnover; and wider bid-ask spreads. The negative stock returns and the costly economic consequences for listed firms suggest that the regulatory agencies in the Chinese stock market have credibility and their actions have “teeth”.

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22 In his research report, Ruyin Hu (2002), Director of Shanghai Stock Exchange Research Centre, reports on the stronger enforcement and frontline regulations in 2002 and 2003 in Shanghai Stock Exchange – SSE publicly reprimanded listed companies for violations of their listing rules: in the year of 2002, SSE strengthened supervision on listing companies: made format guidelines for listing companies temporary bulletin, regulated disclosure, and further implemented the questioning supervision. SSE sent listing firms over 500 post-auditing advices and 105 supervision letters. Publicly reprimanded 19 companies, sent inside notice of criticism to 49 companies or high-level managers, had CSRC specially audit or check 21 firms. Established inside information knower database. Checked the share-holding situation and illegal close-out among high-level managers. Advocated 37 companies to announce a proposal letter on perfecting corporate governance, actively advanced listed firms for regulating disclosure of governance structure, and strengthened the legal system training and trust education of directors and auditors. In 2003, SSE made further implementation of questioning supervision and strictly managed listing companies which have violation activities: 33 companies received a notice of criticism. 11 companies were publicly reprimanded, 10 listing companies were subjected to a CSRC special investigation. In the period after the periodical report, SSE issued 480 post-auditing advice reports and 142 regulatory letters and urged listing companies to publish 169 Complementary to Periodical Reports or Correct Announcements.
Berkman (2008) adopts an event study methodology to examine the stock market reactions to three newly-released regulations by the CSRC aimed at reducing expropriation from public investors by controlling shareholders. The three regulations were all introduced in the second quarter of 2000 and were partly motivated by China’s successful attempt to gain entrance into the World Trade Organization (WTO). The first new regulation (released on May 18, 2000) substantially increased the rights of public investors at a firm’s annual shareholders’ meeting. The second regulation (released on June 6, 2000) prohibited the issuance of loan guarantees by a firm to its controlling shareholder, and the third regulation (released on June 26, 2000) improved the transparency and regulation of asset transfers to related parties. Berkman (2008) finds significant positive abnormal returns accrue to firms with weak governance, as proxied by the value of related-party transactions and a variety of less direct measures. These results are interpreted as evidence that securities market regulation can be effective in protecting public investors from expropriation in a country like China with weak judicial enforcement.

4.5 Development of a professional association – CICPA

The accounting profession had not been a strong, well-organized and well-paid professional group in China until the late 1970s. Traditional Chinese culture and its under-developed economy contributed to the low status of accountants. Traditional Chinese culture considers merchants and people related to industry as inferior to other professions. Confucian philosophy suggests that “the mind of the superior man is conversant with righteousness; the mind of the mean man is conversant with gain” (Gao and Handley-Schachler, 2003). In ancient China, in an economy which was dominated by small scale family businesses, the role of accountants in respect of strategic management and decision-making in Chinese
society was not well regarded. However, the function of accountants has changed since the
economic and enterprise reforms in China. The rapid growth of accounting firms during the
past fifteen years is the consequence of the introduction of massive new accounting
regulations, standards and the trend of international accounting harmonization. The important
role that accountants can play in improving business management and corporate governance
has been recognized and this recognition has led to the development of a certification process
for the accounting workforce (Groom and Sims, 2005).

The establishment of the Chinese Institute of CPAs (CICPA) was a landmark event in the
development of the CPA profession in China (Tang and Lau, 2000). The CICPA is a quasi-
government organization and reports to the MOF. The CICPA’s main responsibilities include
registering CPAs and public accounting firms and conducting the entrance examination. In
January 1994, the People’s Republic of China Registered Accountant Law (Certified Public
Accountants Act) was promulgated by the MOF. The Act defines the scope of a CPA’s role,
including external auditing as distinct from internal auditing and government auditing, and
other accounting consultancy work such as the design of accounting systems, performing
accounting projects for management and providing advice on taxation, business registration
and staff training.

A further step in the development of an independent profession has been the de-linking of
CPA firms from sponsoring agents, usually government departments and institutions, since
1998. With the growth of the market economy, the government’s tight control over CICPA
has become impractical. It is necessary for accounting firms to be formed as independent
partnerships or limited liability companies. The de-linking is a sign of the intention of the
government to abandon direct control over CPA practices. CPA professional services have been subject to professional, legal and market discipline since then.

An important role has been played by the independent accounting and auditing firms in boosting investors’ confidence in the Chinese stock market. In 1998, a survey was conducted by the CICPA among 773 listed companies as part of an “accounting and auditing market cleaning campaign” implemented between 1997 and 1999 in China. The results show that there was a significant improvement in respect of the quality of accounting and auditing work. Of the 773 companies, there were 38 companies that received qualified auditor’s opinion, 55 companies were offered an auditing opinion with the attachment of an explanation. One auditing firm released a qualified auditor report to a listed firm and one auditing firm refused to issue an audit report to a listed firm. In total, 12.29% of auditing firms expressed their disagreement to the financial information provided by the listed firms. Prior to that, the issuing of a qualified auditor report to a listed firm by an auditing firm had never previously happened. The implication of these actions is that accountants in China have improved their professionalism and sense of responsibility to public investors. A survey conducted by Chinese media in June 1998 also showed that the public’s confidence in qualified accountants had improved from 45% in 1994 to 81%. The image and creditability of independent accounting and auditing firms have gradually improved. However, the quality of services provided by domestic accounting and auditing firms is still far from satisfactory, especially in respect of professional ethics. In order to make higher profits, some accounting firms assist their clients to produce fraudulent financial information. Due to a lack of any sense of risk, these accounting firms do not seem to realize that public investors rely upon an auditor’s opinion to make decisions regarding capital investment. The majority of corporate
scandals including Hongguan Shiye and Qiongminyuan can be related to the deceptive role played by external accounting and auditing firms.

4.6 Summary

This chapter discusses the complex nature of the Chinese stock market. The unique ownership structure among listed firms has consequently caused an agency problem with distinctive characteristics in the Chinese context. The conflicting interest between majority shareholders and minority shareholders requires further transparency in terms of corporate disclosure. A regulatory environment has been gradually established by the Chinese government to facilitate a more attractive business environment. As government agencies, the MOF and the CSRC jointly oversee the administration of the Chinese stock market. Both of them promote transparency of disclosure and the protection of the interests of public investors. Established in 1992, the initial function of the CSRC was to perform administrative roles such as approving the listing and reviewing the share transfers of state shares and legal shares among institutional investors. Gradually, the CSRC has changed its function to regulate listed companies’ information disclosure and fraudulent behavior. The CSRC sees itself as a pro-active regulator in fostering corporate governance, in enforcing rules, in safeguarding the integrity of the Chinese stock market, and in championing the rights of public investors (Tomasic and Andrews, 2007). Research shows their actions are plausible as the market responds to them positively.

Both Chapter 3 and Chapter 4 have established the institutional background for Chapter 5, by illustrating the changed disclosure environment and identifying the main stakeholder groups of listed firms in the Chinese stock market. Chapter 5 will develop a theoretical framework
for this study and establish hypotheses to explain disclosure behavior changes among listed firms over the 1995 to 2006 testing period.
CHAPTER 5

THEORETICAL FRAMEWORK AND HYPOTHESES

5.1 Introduction

The objective of this chapter is to establish a theoretical framework for this study by analyzing the impact of the changed corporate disclosure environment on listed firms’ disclosure behavior over the period 1995 to 2006 in the Chinese stock market. The theoretical framework is based on the range of theories reviewed in Chapter 2. This chapter draws upon the two previous chapters in developing the hypotheses detailed later in this chapter. Chapter 2 critically reviews the extant literature on corporations’ voluntary disclosure. Previously, firms chose to disclose information based either on economic concerns or through pressure from society and powerful stakeholder groups. Chapters 3 and 4 elaborate on the changes in the disclosure environment in China during the past three decades as influenced by the political, economic and social changes which have occurred since the late 1970s. Chapter 4 explores the main roles undertaken by the MOF, the CSRC and the two stock exchanges in developing a comprehensive regulatory framework for corporate disclosure in China.

The analysis in this chapter is based upon the assumption that a changed disclosure environment in China would have impacted on the disclosure behavior of listed firms in the Chinese stock market. It is believed that the changed disclosure environment has resulted in several social groups in Chinese society becoming important stakeholders of listed firms.
Theories under the system-oriented view discussed previously, suggest listed firms will assess the power possessed by each stakeholder group and determine their strategies according to stakeholders’ power. Listed firms are expected to adopt voluntary information disclosure as a means to strategically manage the relationship between firms and their powerful stakeholder/s. Links between stakeholder power and firm-specific characteristics including ownership structure, corporate governance-related factors and economics-based variables are also established in this chapter. Several hypotheses are then developed to predict the relationship between these firm-specific characteristics and firms’ voluntary disclosure changes over the period covered by this study.

This chapter proceeds as follows. Section 5.2 justifies why a system-oriented view is more appropriate in the Chinese context than an economic-based view in explaining voluntary disclosure of listed firms. The theoretical framework used in this study is developed in this section. Section 5.3 assesses stakeholder attributes by using the Mitchell et al. (1997) stakeholder sorting criteria and identifies the most powerful stakeholder group for listed firms. Hypotheses are established in Section 5.4, and Section 5.5 summarizes the chapter.

5.2 Theoretical framework of this study

As reviewed in Chapter 2, disclosure studies use two main perspectives, an economics-based perspective and a system-oriented perspective to explain and predict factors that have contributed to firms’ voluntary disclosure behavior. The former perspective primarily concerns the relationship between management of firms and their investors specifically, while the latter considers firms’ disclosure behavior in the much broader social structure and institutional environment within which firms operate (Chalmers and Godfrey, 2004). The
agency problem in the Chinese context, as illustrated in Chapter 4, is not caused by diverged interests of managers (agents) and investors (principals). The problem is in the form of conflicting interests between majority ownership and minority ownership, due to “one dominating state-owned share monopoly” and “insider control”. Therefore, commonly used economics-based variables cannot give a full account or description of disclosure behavior changes among listed firms in the Chinese stock market. Rather, they provide supplementary explanations of the disclosure behavior changes of listed firms in the Chinese institutional setting of corporate disclosure.

Legitimacy theory asserts that firms need to consider the social environment in which firms operate. Firms legitimize their behavior in accordance with the “social contract” between the society and firms. The voluntary disclosure of corporate social and environmental responsibility in recent years in developed countries is regarded as corporations legitimizing themselves in society, due to increased demand from stakeholders (Roberts, 1992; Nasi et al., 1997; Neu et al., 1998; Deegan, 2002; Deegan et al., 2002). The institutional environment surrounding increased voluntary disclosure of CSR can be regarded as a changed “social contract” in western societies. In the 1960s, the expectation that society had of corporations was profit maximization, meaning profit was the only criterion used by society to measure whether a firm’s behavior and performance was legitimated (Friedman, 1962). The public expectations, however, have significantly changed in recent years. Rather than focusing only on investors’ economic interests, society also expects corporations to address the interests of other stakeholders including employees, suppliers, customers and the community. The content of the “social contract” has changed primarily from profit maximization to environmental protection, pollution reduction, employee welfare and safety of products (Deegan, 2006). Voluntary disclosure of CSR is regarded as one of the means by which
corporations choose to respond to changed social expectations and operating environments. Voluntary disclosure of CSR can assist corporations to reduce the “legitimacy gap” between corporations and society.

In China, given the political, economic and social changes which have occurred during the past thirty years, as discussed in Chapter 3, the changes of disclosure behavior among listed firms are considered and investigated using a changed corporate disclosure environment as a lens. The main elements of the changed disclosure environment, as discussed in Chapters 3 and 4, include:

- the transformation from a socialist, centrally-planned economy to a market-oriented economy in China;
- the anxiety of the Chinese government about opening the economy further and attracting more direct foreign investment;
- the development of the Chinese stock market;
- the change in the objectives of reporting and disclosure from solely satisfying the government’s information needs, to satisfying external investors’ information needs;
- the establishment of a regulatory framework for corporate reporting and disclosure;
- the increased pressure and demand for transparent information from the investment community;
- the growth of professional accounting associations.

These changes have formed a new “social contract” between Chinese listed firms and Chinese society. Prior to the economic reform launched in the late 1970s, the social expectation of state-owned enterprises was to operate as an integrated part of the planned economy. To legitimate their social status, enterprises were required to provide stable and
secure working conditions for Chinese workers and contribute to equal wealth distribution. Since the late 1970s, the economic reform and establishment of the Chinese stock market dramatically changed the operating environment of state-owned enterprises, especially those that had been privatized and transformed into listed firms. In a market-oriented economy, enterprises rely on investors and creditors for capital resources. Consequently, the investment community expects more transparent disclosure from listed firms, in order to make more informed economic decision-making. Legitimacy theory underpins the basic assumption that listed firms would change their disclosure behavior due to the demands of various stakeholders, including public investors, creditors and regulatory bodies. Therefore, the changed disclosure environment is expected to motivate listed firms to improve disclosure transparency and make their information disclosure more external-user oriented.

Stakeholder theory addresses the functional aspect of legitimacy theory, considering how firms legitimate their behavior and operation in order to satisfy stakeholders’ demands. Under the managerial branch of stakeholder theory, power is a crucial variable in a stakeholder-management relationship. Roberts (1992) suggests that a major role of corporate management is to assess the importance of meeting stakeholder demands, in order to achieve the strategic objectives of the firm. A stakeholder’s power to influence corporate management is viewed as a function of the stakeholder’s control over resources required by the organization (Ullmann, 1985). The stakeholders of firms possess powers that may be used to command limited financial or labor resources, legislate against firms, and influence the consumption of firms’ goods and services. However, firms will not respond to all stakeholders equally. The most powerful stakeholders’ will be attended to first (Nasi et al., 1997) and a successful corporation is considered to be one that satisfies the demands of the various powerful stakeholder groups (Ullmann, 1985).
In the Chinese context, the only stakeholder of state-owned enterprises is the Chinese government. The results of privatization of SOEs and transformation of SOEs into publicly-listed firms have made investors and creditors the main stakeholders of listed firms, as they provide the capital resources. Under a market-oriented economy, business needs to be more competitive in order to survive and succeed; customers have the freedom to choose better products and seek lower prices in an open commodity market. Employees, however, lose their job security. Professional associations in the area related to financial reporting and corporate disclosure, start to undertake some roles in implementing the accounting standards and disclosure rules among listed firms; people living in communities are concerned about the social issues such as safety of products, unemployment and environmental protection. The Chinese government has changed its role from direct intervention in the economy to actively managing it. Thus, investors, creditors, regulatory agencies, employees, customers, suppliers, professional associations and the community affect the operation and behavior of listed firms on one hand; while those parties’ political and economic stakes are also affected by the performance and behavior of listed firms on the other. Applying the definition of stakeholders proposed by Freeman (1984), all the above parties can be classified as the stakeholders of listed firms in China. To legitimate their social status, listed firms’ behaviors need to be in line with stakeholders’ expectations, especially those stakeholders that control the financial resources of listed firms.

Applying stakeholder theory in this study, the stakeholder sorting model developed by Mitchell et al. (1997) is used in this chapter to identify powerful stakeholders for listed firms in the Chinese stock market. Stakeholder salience theory is used to predict the disclosure behavior changes of listed firms as a group. Stakeholders of listed firms will be classified into
latent stakeholders, expectant stakeholders and definitive stakeholders, based on Mitchell et al.’s (1997) analysis of stakeholder attributes (power, legitimacy and urgency). The research findings of Agle et al. (1999) suggest that in the minds of management, the stakeholder attributes are individually and cumulatively related to stakeholder salience across all groups. Therefore, listed firms in the Chinese stock market are predicted to use voluntary information disclosure to respond to the demand and pressure from the most powerful stakeholders.

Several characteristics related variables of firms are also used in this study to predict firms’ disclosure behavior changes. However, this is considered under the stakeholder theory setting rather than under economics-based views. Ownership structure reflects equity stakes of majority shareholders and public shareholders in listed firms, either domestic or foreign investors. Corporate governance mechanisms are imposed on listed firms by regulatory agencies and represent the political stake of the Chinese government. Economics-based variables include leverage, profitability and growth opportunity. They are closely related to stakeholders who have economic stakes in listed firms. It is expected these variables would influence firms’ disclosure decision-making to various degrees during different periods, as China opens up its economy to the global market. Figure 5.1 summarizes the theoretical framework of listed firms’ voluntary disclosure behavior in the Chinese stock market.
Figure 5.1 Theoretical framework of voluntary disclosure in the Chinese stock market
5.3 Stakeholder attributes

This section applies Mitchell et al.’s (1997) stakeholder sorting criteria to identify the stake and assess the power possessed by various stakeholder groups of listed firms in the Chinese stock market. Stakeholder attributes of the creditor group, shareholder group, regulatory agency group and professional association group are specifically assessed in this section, as they are the stakeholder groups most relevant to disclosure transparency in the Chinese stock market. This assessment classifies these stakeholders into different types and identifies the most powerful stakeholder groups for listed firms, thus predicting firms’ disclosure behavior as a result of stakeholder salience. Table 5.1 recaps Mitchell et al.’s (1997) stakeholder sorting criteria and classifications discussed in Chapter 2.

Table 5.1 Stakeholder sorting criteria and classifications (Mitchell et al., 1997)

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Classification</th>
<th>Power</th>
<th>Legitimacy</th>
<th>Urgency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latent stakeholder</td>
<td>Dormant stakeholder</td>
<td>√</td>
<td></td>
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<tr>
<td></td>
<td>Discretionary stakeholder</td>
<td></td>
<td>√</td>
<td></td>
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<tr>
<td></td>
<td>Demanding stakeholder</td>
<td></td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>Expectant stakeholder</td>
<td>Dominant stakeholder</td>
<td>√</td>
<td>√</td>
<td></td>
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<tr>
<td></td>
<td>Dependent stakeholder</td>
<td></td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td></td>
<td>Dangerous stakeholder</td>
<td>√</td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>Definitive stakeholder</td>
<td></td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
</tbody>
</table>
5.3.1 Creditor group

As discussed in Chapter 3, banks became one of the main sources of SOEs’ capital when state-owned bank loans replaced the government’s budget allocation in the early 1980s (Xu, 2005). Banks in China then formed a stakeholder group for listed firms as a result of China’s economic reform. As creditors for listed firms, the power possessed by this stakeholder group has changed during the past two decades. In the early stage of the economic reform, banks were under pressure from the government to provide “policy loans” to SOEs (Petkova, 2008). Banks, therefore, had no power to influence SOEs’ performance and information disclosure. They also did not have an urgent claim over the actualization of their economic stake. Therefore, between the early 1980s and mid-1990s, creditors could only be classified as a discretionary stakeholder of SOEs.

Factors such as the entrance of China into the WTO, the opening up of the Chinese banking market and the listing of several large commercial banks, have all contributed to the changes in the operation of the banking system in China. Now, profit-oriented banks provide firms with loans on commercial terms. Regardless of being state-owned or private, commercial banks were expected to earn interest revenue from borrowers and have their loans repaid. Creditors now have a stronger economic stake in listed firms. The power and urgency possessed by the state-owned banks over listed firms gradually increased with the disconnection between the government’s loan policies and banks’ commercial activities. Banks can now independently determine which enterprises they want to lend funds to and how to avoid non-performing loans (NPLs).
Since the mid-1990s, the Chinese banks have developed stakeholder attributes, power and urgency. Therefore, banks can be classified as a definitive stakeholder of listed firms in the Chinese stock market.

### 5.3.2 Investor group

Investors, as a major capital resource provider of listed firms, form another stakeholder group. This group has one strong attribute, namely, urgency. Investors can buy or sell their shares freely. If they can’t have the management changed via their voting powers, they may sell their shares in the stock market and this action may lead to the devaluation of a firm’s share price. As investors have equity stakes in listed firms, they expect firms to make transparent disclosures to assist them in making efficient decisions in terms of how to allocate their financial resources. This group, however, does not have strong power over listed firms. Although investors in China have begun to use legal mechanisms to protect their interests from exploitation by majority owners, their actions are only strong enough to put external demands and pressure on listed firms to make transparent disclosures, rather than imposing sanctions on firms directly (Chen et al., 2005). With strong urgency and legitimacy but weak authoritative power, investor groups can only be classified as a dependent stakeholder of listed firms in the Chinese stock market.

### 5.3.3 Regulatory agency group

The regulatory agency group is identified as a corporations’ stakeholder by Freeman and Reed (1983). In the Chinese stock market, the regulatory agency group includes
the Ministry of Finance (MOF), the China Security Regulatory Commission (CSRC) and the Shanghai and Shenzhen stock exchanges. In respect of corporate disclosure, the way the regulatory agency group legitimizes its existence is to develop and enforce corporate disclosure rules and regulations that satisfy community information demands (Chalmers and Godfrey, 2004).

Regulatory agencies have a political stake in listed firms in the Chinese stock market. Politically, a healthy capital market serves the government to further open up China’s economy, enhance enterprise reform and attract more investments from both domestic and overseas investors. However, due to the problems of “one dominating state-owned share monopoly” and “insider control”, as discussed in Chapter 3, the minority or public investors’ interests have been expropriated by majority shareholders since the establishment of the stock market in China. Over the years, “investor protection” has been acknowledged by the regulatory agency group as one of the most important measures for supporting the steady growth of the Chinese stock market.

Regulatory agencies have political power over listed firms to ensure that the political stake of the Chinese government is actualized. The MOF has authoritative power over listed firms in terms of following accounting regulations and standards. The CSRC has power to regulate listed firms’ conduct and information disclosure. As described in Chapter 4, the CSRC and both stock exchanges have employed a series of strategies and actions to achieve “investor protection”. These actions include stipulating accounting and disclosure regulations, establishing a corporate governance régime, providing training for investors and independent directors, and imposing

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23 Political power means the ability to influence due to use of the political process (Freeman and Reed, 1983).
public sanctions against listed firms. These actions suggest an increased willingness by the Chinese leadership to subordinate the interests of controlling shareholders to the interests of other shareholders (Berkman, 2008). They have sent a clear and strong signal to listed firms over the years, that to legitimate their status in the Chinese stock market, listed firms need to devote themselves to protecting minority investors’ interests by disclosing transparent information to investors.

The evidence provided in Chapter 4 shows the regulatory agency group in the Chinese stock market has three strong stakeholder-attributes. This group legitimates its existence by establishing the regulatory framework of corporate disclosure in the Chinese stock market. The enforcement of the regulations and sanctions it has imposed show its power and urgency over listed firms in the stock market. If listed firms are de-listed by the stock exchange, not only do they lose an important source of capital, but also their reputation in society is damaged. Based on the stakeholder sorting criteria of Mitchell et al. (1997), the regulatory agency group can be identified as a definitive stakeholder for listed firms in the Chinese stock market.

5.3.4 Professional association - CICPA

Chapter 4 also illustrates the establishment and development of the Chinese Institute of CPAs (CICPA). This professional body has played a positive role in improving the quality of financial disclosure in the Chinese stock market. However, as one of the stakeholders of listed firms, CICPA only possesses one of the three stakeholder sorting criteria – legitimacy. CICPA doesn’t have power and urgency over listed firms and CPA firms. Rather, it is the CSRC and the MOF that possess authoritative power
over listed firms and CPA firms. As mentioned previously, it is the CSRC and the MOF that can impose a penalty on CPA firms that do not apply appropriate standards and such a penalty can include cancellation of a CPA firm’s license, either temporarily or permanently. Therefore, the CICPA can only be classified as a discretionary stakeholder of listed firms in the Chinese stock market, as it cannot threaten listed firms’ capital resources.

5.3.5 Environmentalists in Chinese society

Another stakeholder group of listed firms are environmentalists and the environmental authority. The State Environmental Protection Administration (SEPA) has issued several regulations and provisions related to environmental disclosure and reporting. *The Management Provision on Reporting and Registration on Pollutant Emissions* (1992) was the earliest regulation, requiring enterprises to report to the government the details of the pollutants they are responsible for and how they are managed. *The Environmental Management Provision for Construction* (1998) requires enterprises that run construction projects to produce an Environmental Impact Assessment report (EIA). The *Bulletin on Information Disclosure for Corporate Environmental Performance* (2003) stipulates that non-compliant enterprises should disclose their corporate environmental performance to the public. Local environmental protection bureaux must release corporate non-compliance lists periodically to the public through newspapers and television. This regulation requires that listed firms must disclose their environmental performance information for the previous year by March 31st every year. Another regulation released in 2003, *Regulations on the Environmental Inspection of Companies Accessing or Refinancing from the Stock
Market, aims to prevent environmental risk associated with listed firms from certain heavily polluting industries such as metal, chemicals, oil, coal, thermal power and construction materials. The CSRC requires firms wanting to be listed on the Chinese stock exchanges to include their environmental risk and how they meet environmental standards and environment-related measurements in their *Prospectus of Initial Public Offerings (IPO)*, *Application files for IPO* and *Legal Statement and Working Reports of Lawyers for IPO*.

The survey of annual reports of 1195 listed firms conducted in 2003 by Guo (2005) concludes that firms in China pay less attention to corporate environmental reporting and disclosure compared to some of their western counterparts. As most of the regulations in the Chinese stock market focus on improving corporate disclosure and reporting of firms’ financial performance rather than social and environmental issues, environmental disclosure is not popular, and annual reports of listed firms rarely include environmental issues. Environmentalists and environmental authorities in China can be classified as discretionary stakeholders of listed firms in the Chinese stock market. Although possessing legitimacy attributes, they do not have strong power and urgency over the financial resources of listed firms.

### 5.3.6 Summary of stakeholder attributes

Applying Mitchell *et al.*’s (1997) stakeholder sorting criteria, the assessment of stakeholder attributes clearly shows the regulatory agency group is the most powerful stakeholder group for listed firms in the Chinese stock market. The MOF, the CSRC and the Shanghai and Shenzhen stock exchanges can be jointly identified as definitive
stakeholders, as they possess three strong stakeholder attributes, namely, power, legitimacy and urgency over the capital resources of listed firms. To be continuously listed in the Chinese stock market and obtain financial resources from shareholders, listed firms must follow the rules and regulations enforced by those regulatory agencies. Investors are dependent stakeholders and, due to relatively weak legal mechanisms, have limited power over listed firms. However, investors strongly exhibit one of the attributes, namely, urgency. They can take immediate actions by selling their shares when they feel their legitimate interests are not being served by the management of listed firms. The changed banking environment in China has transferred the creditor group from a discretionary stakeholder to a definitive stakeholder. The creditor group now possesses three stakeholder attributes. These attributes are closely related to the economic stake creditors have in listed firms. Being profit-oriented itself, this group possesses power to control the capital resources relied upon by listed firms. The professional association, CICPA, exhibits strong legitimacy but lacks power and urgency over listed firms in the Chinese stock market, which makes it a discretionary stakeholder. Table 5.2 summarizes stakeholders and their attributes in the Chinese stock market.
Table 5.2 Stakeholders and stakeholder attributes in the Chinese stock market

<table>
<thead>
<tr>
<th>Stakeholder group</th>
<th>Stake</th>
<th>Inducement</th>
<th>Power</th>
<th>Legitimacy</th>
<th>Urgency</th>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creditor group</td>
<td>Economic stake</td>
<td>Interest</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>Definitive stakeholder</td>
</tr>
<tr>
<td>Shareholder group</td>
<td>Equity stake</td>
<td>Shareholder value</td>
<td>Low</td>
<td>High</td>
<td>High</td>
<td>Dependent stakeholder</td>
</tr>
<tr>
<td>Regulatory agency group</td>
<td>Political stake</td>
<td>Effective investor protection</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>Definitive stakeholder</td>
</tr>
<tr>
<td>Professional association group</td>
<td>Political stake</td>
<td>Quality of information disclosure</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
<td>Discretionary stakeholder</td>
</tr>
<tr>
<td>Environmental authority</td>
<td>Environment stake</td>
<td>Environment protection</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
<td>Discretionary stakeholder</td>
</tr>
</tbody>
</table>

5.3.7 Stakeholder salience

The management of listed firms needs to manage the stakeholder-management relationship. Mitchell et al. (1997) observe that an organization is an environmentally-dependent coalition of divergent interests. All interested parties try to gain the attention of management at the centre of the nexus of contracts between stakeholders and management. Thus, they propose that the perspective of managers is vital; it is the managers who determine which stakeholders are salient and, therefore, deserve management attention. So, which factor particularly influences managers’ perspectives? It is believed that it is stakeholder power. “Control over resources” can be achieved through commanding limited finance resources, influencing media and using legislation against organizations. The more critical the stakeholder’s resources are to the survival and success of the organization, the greater the expectation that the
stakeholder’s demands will be addressed (Ullmann, 1985). Mitchell et al. (1997) support this view by suggesting that managers’ perceptions of a stakeholder’s attributes are critical to the managers’ views of stakeholder salience. Stakeholder salience is high where all three of the stakeholder attributes - power, legitimacy and urgency - are perceived by managers to be present. They claim that stakeholder salience is moderate where two of the stakeholder attributes are perceived by managers to be present, and stakeholder salience is low where only one of the stakeholder attributes is perceived by managers to be present.

Applying the theory of stakeholder salience, the management of listed firms will give priority to managing their relationship with regulatory agencies in the Chinese stock market, as they are the most powerful stakeholder group. Although the investment community is a demanding stakeholder group, investors’ interests are advocated by the regulatory agency group for political reasons. Satisfying the demands of the regulatory agency group literally enables listed firms to satisfy the expectations of the investment community. The requirement of the regulatory agency group on listed firms, in terms of disclosure, is to provide transparent information which supports efficient decision-making by investors in respect of their financial resource allocations.

As discussed in Chapter 2, voluntary disclosure reduces firms’ cost of capital and improves transparency by reducing information asymmetry. Investors react to information voluntarily disclosed to the stock market, meaning voluntary disclosure is value-relevant to investors’ decision-making. The Chinese regulatory agencies have always encouraged firms to voluntarily disclose information which is relevant to
investors’ decision-making, in addition to their mandatory information disclosure. Several examples can be found from the disclosure regulations implemented by the CRSC since the early stages of the development of the stock market:

“Listed firms should report any other information related to firms’ operations which they think is necessary to disclose to investors” – Item 5, Section 3, Chapter 2, The Standards of Contents and Formats of Information Disclosure by Public Issuing Companies, the CSRC, 1993.

“This regulation represents the minimum requirement of information disclosure of listed firms. Firms should also disclose any other information which will affect investors’ economic decision-making, no matter this information is required to be disclosed by this regulation” – Item 3, Chapter 1, The Standards of Contents and Formats of Information Disclosure by Public Issuing Companies, the CSRC, 2001 (revision) and 2003 (revision).

“In addition to disclosing mandatory information, a company shall also voluntarily and timely disclose all other information that may have a material effect on the decisions of shareholders and stakeholders, and shall ensure equal access to information for all shareholders” – Item 88, Section 1, Chapter 7, Code of Corporate Governance for Listed Companies in China, the CSRC, 2002.

“One of the basic principles of establishing a good investor-firms relationship is to have transparent information disclosure. In addition to mandatory disclosure, firms should voluntarily disclose other information which the investors care about” - Item 1, Article 4, The Guidance of the Relationship between Listed Firms and Public Investors, the CSRC, 2005.

The stakeholder attributes section and the discussion of stakeholder salience above provide evidence that in the Chinese stock market, regulatory agencies’ self-
promotional behaviors legitimize their own existence in the perceptions of Chinese and international investors. The power, legitimacy and urgency possessed by the regulatory agencies enable them to exert pressure on “regulatees”, that is, the listed firms in the Chinese stock market, to legitimate their behavior. As the regulatory agencies strongly advocate that listed firms voluntarily disclose information in the Chinese stock market, it is expected that firms will adopt voluntary disclosure as a means of stakeholder salience. Listed firms would use voluntary information disclosure as part of a strategic management process to manage the relationship between firms and the most powerful stakeholders, in order to gain their support and approval or to avert their opposition and disapproval. Therefore, it is expected that the level of voluntary disclosure would have increased in the Chinese stock market throughout the 1995-2006 reporting periods.

5.4 Hypothesis development

Discussion of the application of legitimacy theory has suggested that the changed corporate disclosure environment created the pressure on listed firms to disclose more transparent information, and that listed firms in the Chinese stock market would change their disclosure behavior to legitimize their social status in Chinese society. The assessment of stakeholder attributes has identified the most powerful stakeholder group for listed firms in the Chinese stock market. This section translates those theoretical underpinnings into research hypotheses. The changes in disclosure behavior of listed firms will be empirically investigated through five propositions and a set of hypotheses developed based on the five propositions.
The propositions are formed from the theoretical framework established in Section 5.2 and stakeholder attribute analysis in Section 5.3. The first proposition is that voluntary disclosure is a result of stakeholder salience. Listed firms as a group assess each stakeholder’s attributes and identify powerful stakeholders. In the Chinese stock market, powerful stakeholders demand information disclosure from firms. One of the strategies to manage the stakeholder-firm relationship is to adopt voluntary disclosure. The second proposition is for the ownership structure among listed firms to reflect shareholders’ financial stakes in listed firms, and the various ownership types, including state ownership, legal-person ownership and foreign ownership would have an influence on firms’ disclosure behavior through their financial stakes. The third proposition is for the corporate governance variables to reflect the political stakes of the regulatory agencies in the Chinese stock market. The corporate governance régime is established by the regulatory agencies, aiming to protect investors’ interests and improve the efficiency of the stock market. Corporate governance variables such as the proportion of independent directors on the board and the existence of an audit committee would have an influence on a firm’s disclosure decisions. The fourth proposition is for firms’ economic attributes to be closely related to creditors’ and shareholders’ financial stakes. Stakeholders’ power and urgency can be reflected by firms’ economic attributes, including profitability, leverage and potential growth opportunity. Therefore, these specific firm characteristics would be associated with firms’ disclosure behavior. The fifth proposition is that listed firms use auditing firms with a good reputation to legitimate their social status. The auditing market has been gradually established in China and auditing firms are playing an important role in the Chinese stock market in ensuring relevant and reliable information disclosure.
Legitimacy theory suggests that firms employing an auditor that has a good reputation in the professional service industry are most likely to disclose more information.

5.4.1 Longitudinal disclosure levels

This study investigates listed firms’ voluntary disclosure during the period 1995 to 2006. To determine firms’ voluntary disclosure and factors affecting firms’ voluntary disclosure during different phases of the Chinese stock market, the entire testing period is further divided into three distinct testing phases: Phase I, 1995-1998; Phase II, 1999-2002; and Phase III, 2003-2006. These three phases represent three distinct phases of the history of the Chinese stock market. As explained below, each of these phases may have an impact on voluntary disclosure made by listed firms. Hypotheses are identified based on these assumptions. The level of voluntary disclosure made by listed firms in each phase is expected to be different from the other two. According to the main features of each phase, they are named as the “developing phase”; “corporate governance régime phase” and “convergence phase”, respectively.


The opening of two stock exchanges, one in Shanghai and one in Shenzhen in 1990 and 1991 respectively, marks the establishment of the Chinese stock market. Of the three testing periods, the 1995-1998 period represents the initial, developing phase of the Chinese stock market. During this testing phase, the regulatory agency, the CSRC, undertook the administration role in the stock market, rather than strategically managing its development. Banks in China were under pressure from local or state governments to make “Policy Loans” to Chinese enterprises. Also during that period,
several public investors had taken actions against listed firms for fraudulent information disclosure, and the professional association – CICPA - was in its initial establishment phase.

As discussed in Chapter 4, the accounting reform which fundamentally changed the accounting system in China was triggered by the opening of the Chinese stock market at the beginning of the 1990s. During the early phase of the Chinese stock market, a uniform accounting system and specific accounting standards were yet to be developed in China. It was not until mid-1992 that the State Council, the MOF and the CSRC started to promulgate a series of accounting and reporting regulations to regulate accounting information in the stock market. Although the Accounting Standards for Business Enterprises released by the MOF in 1993 introduced some accounting regulations with western theoretical underpinning, an investor-oriented market was still far from reality and the establishment of the accounting and reporting regulatory framework was a long way from completion. Therefore, the level of voluntary disclosure in the reporting periods 1995-1998 is expected to be lower than in the other two phases.

Phase II - Corporate governance régime phase (1999-2002)

The second testing phase covers the reporting periods 1999-2002. During this phase, the Chinese government and its regulatory agencies had further committed to development of the stock market regulatory framework. Significant accounting and reporting regulations implemented during this phase included a series of Chinese accounting standards, the Securities Law and more information disclosure rules. The
CSRC changed its emphasis from market administration to public investor protection. The *Guidelines for Establishing Independent Directors System for Listed Companies* and the *Code of Corporate Governance for Listed Companies* released by the CSRC in 2001 and 2002, respectively, highlighted the regulatory agencies’ belief that strong corporate governance among listed firms would play a positive role in improving investor interest protection. China’s accession to the WTO in December 2001 also provided impetus to motivate listed firms to improve their information transparency. Several high-profile legal actions against listed firms, caused by misleading and fraudulent information disclosure, increased demands from the investment community for improved disclosure. The pressure from stakeholders such as the regulatory agencies and shareholders increased dramatically during this phase. Therefore, the level of voluntary disclosure in this phase is expected to be higher than that in the reporting periods 1995-1998.

**Phase III - Convergence phase (2003-2006)**

The last testing phase includes the reporting periods 2003-2006. In this phase, the regulatory framework of corporate disclosure was further augmented by the MOF’s release of the new accounting system and more accounting standards based on IFRS. In 2006, the *Accounting Standard for Business Enterprises (ASBE)*, which includes the Basic ASBE system and 38 specific ASBEs promulgated by the MOF, marked substantial harmonization between China GAAP and IFRS. As required by CSRC regulation, listed firms have all implemented the independent director system, and at least one-third of the directors on their boards are independent directors. The CSRC’s aim of establishing the independent director system was to further improve corporate
governance of listed firms and protect the interests of investors in the Chinese stock market. The level of voluntary disclosure in this phase is, therefore, expected to be higher than that in both the “developing phase” and the “corporate governance phase”.

Table 5.3 lists the major activities and events of the four stakeholder groups during each testing phase. It shows major events, actions taken and progress made by the creditor group, investor group, regulatory agency group and professional association group, in exerting pressure on listed firms in respect of transparent information disclosure.

In terms of the longitudinal disclosure level, it is hypothesized that:

**H1: The level of voluntary disclosure increased in the Chinese stock market throughout the 1995-2006 reporting periods.**
Table 5.3 The three testing phases and relevant regulations/events

<table>
<thead>
<tr>
<th>Testing period</th>
<th>Creditor group</th>
<th>Shareholder group</th>
<th>Regulatory agency group</th>
<th>Professional association group</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Phase I (1995-1998)</strong></td>
<td>-Transition period for state-owned commercial banks. They changed from lending “policy loans” to enterprises only to lending funds to enterprises at normal commercial rates. -Non-performing loans are a very common problem in China.</td>
<td>-Number of individual investors is increased from 12 million in 1995 to 39 million in 1998 (there were only 2.2 million individual investors in 1992). -In 1996, investor Liu Zhongming brought the first civil action against Bohai Group for making a fraudulent statement. -In 1998, several plaintiffs sued Hongguang Shiye for civil compensation, and the trial court of Shanghai Pudong New District dismissed the case for lack of jurisdiction.</td>
<td>-The MOF implements the Accounting system for Pilot Enterprises with Shareholding System in May 1992. -The MOF releases the Accounting Standards for Business Enterprises (effective July 1, 1993). It functions as the conceptual framework. -The State Council releases the Temporary Regulation of Share Public Issuing and Trading in 1993. -The CSRC releases the Detailed Rules for Implementation of Information Disclosure of Publicly Listed Companies in 1993. -The CSRC releases the Standards of Contents and Formats of Information Disclosure by Public Issuing Companies in 1993 (revision is released in 1994). -The Company Law is implemented in 1993. -The MOF releases first Chinese Accounting Standards for Business Enterprises: Related party transactions in May 1997.</td>
<td>-In January 1994, the People’s Republic of China Registered Accountant Law (Certified Public Accountants Act) was promulgated. -CICPA became a member of the Confederation of Asian and Pacific Accountants (CAPA) and the International Federation of Accountants (IFAC) in October 1996 and May 1997, respectively. -In 1998, CPA firms were de-linked from the MOF.</td>
</tr>
<tr>
<td>Testing period</td>
<td>Creditor group</td>
<td>Shareholder group</td>
<td>Regulatory agency group</td>
<td>Professional association group</td>
</tr>
<tr>
<td>----------------</td>
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</tbody>
</table>
| **Phase II**  
(1999-2002)  | To tackle the Non-Performance Loan (NPL) problem, the Chinese government forms four financial asset management companies in 1999, and transferred RMB459 billion yuan NPL from state-owned commercial banks to the asset management companies. | -Number of individual investors increased from 45 million in 1999 to 68 million by the end of 2002.  
-By September 2001, 900 compensation cases regarding fraudulent statements, insider trading and market manipulation were brought by individual investors to the lower courts. | - The MOF releases seven Chinese accounting standards between 1998 and 1999 and another six accounting standards in 2001.  
- The Securities Law is implemented in 1999 (effective in 2000).  
- In August 2001, the CSRC introduced the ‘Guide Opinion on Establishing Independent Director System by Listed Companies’.  
- China became a formal member of the WTO in December 2001.  
- In 2002, the CSRC sanctioned 17 listed firms and investigated an additional 17 firms. The MOF sanctioned 4 listed firms. Six firms were under criminal prosecution, of which one was found guilty at trial. | - CICPA conducts “accounting and auditing market cleaning campaign” in 1999. |
<table>
<thead>
<tr>
<th>Testing period</th>
<th>Creditor group</th>
<th>Shareholder group</th>
<th>Regulatory agency group</th>
<th>Professional association group</th>
</tr>
</thead>
</table>
| **Phase III** *(2003-2006)*    | China Construction Bank is listed in 2005 and Bank of China is listed in 2006. Up to 2008, 14 national and regional commercial banks are listed in the Chinese stock market. |                   | - In 2005, the CASC (under the MOF) issued 21 Exposure Drafts and also reviewed its 16 existing CASs.  
- On 16th February 2006, the MOF announced the new *Accounting Standard for Business Enterprises (ASBE)*. The *ASBE* consists of the Basic ASBE and 38 specific ASBEs that are substantially in line with international standards. | - By May 2006, CICPA has more than 5,600 group members (accounting firms), over 140,000 individual members, of whom about 69,700 are practising members and over 70,000 are non-practising members. The total revenue of the whole profession in 2005 exceeded RMB 18 billion.  
- CICPA is a member of the IFAC Board and CAPA Executive Committee, and has developed friendly cooperation and communication with more than 50 professional accounting bodies in other jurisdictions. |
5.4.2 Ownership structure

Ownership of the share capital of listed firms on the Chinese stock market is spread over domestic public investors, foreign investors, legal persons and the state. This multi-class ownership structure represents the equity interest of various shareholder groups in listed firms and it has implications for listed firms’ disclosure behavior over the period 1995 to 2006.

5.4.2.1 State ownership

As discussed in Chapter 4, given that state ownership leads to problems of “one dominant shareholder” and “insider control” in China, firms with higher state ownership are expected to lack motivation for the voluntary disclosure of information to public shareholders. It is suggested that state shareholders are able to obtain information from internal resources (Xiao et al., 2004). It emerges from the above illustration that the different priorities between state ownership and public shareholders and the “insider control” in listed firms, should weaken the pressures for voluntary disclosure. It is, therefore, hypothesized that:

H2a. The level of voluntary disclosure is negatively related to state ownership throughout the 1995-1998 reporting periods.

H2b. The level of voluntary disclosure is negatively related to state ownership throughout the 1999-2002 reporting periods.

H2c. The level of voluntary disclosure is negatively related to state ownership throughout the 2003-2006 reporting periods.
5.4.2.2 Legal-person ownership

Although not tradable shares, shareholders of legal-person shares receive dividends from their investment. Therefore, legal-person ownership is a real stakeholder of listed firms, as it has an equity stake. Thus, compared to state shareholders, legal-person shareholders are more economically oriented and geared towards profit maximization (Tan and Wang, 2004). Legal-person shareholders have industry expertise and management skills. If legal-person ownership is a majority shareholder of a listed firm, it will put pressure on the listed firm to maximize profits in order to increase shareholders’ return on investment. In respect of corporate governance of listed firms, legal-person shareholders can monitor the management more effectively than domestic public investors through their control over the board of directors, the selection of corporate officers and the compensation of chief corporate officers (Xu and Wang, 1999). Representatives of legal-person shareholders are elected to the board of directors and the supervisory committee (Sun et al., 2002).

Research findings show that legal-person shareholders have played a positive role in improving corporate governance among listed firms and helping to strengthen the alignment of interests between managers and shareholders, as evidenced by the positive relationships between the legal-person shareholding and firm valuation (Hovey et al., 2003) and also firm profitability (Xu and Wang, 1999; Delios and Wu, 2005). Thus, it is expected that legal-person ownership would play a significant role in demanding transparent information for the purpose of their own equity stake as shareholders. Meanwhile, as controlling owners, legal-person ownership undertakes a positive role in improving firms’ corporate governance and disclosure transparency. However, due to the strong state-related roots of legal-person ownership in the early stage of the Chinese stock market (Delios and Wu, 2005), it is not
expected that legal-person ownership would have a positive association with firms’ voluntary disclosure during the 1995-1998 periods. Therefore, it is hypothesized that:

**H3a:** The level of voluntary disclosure is negatively related to the legal-person ownership throughout the 1995-1998 reporting periods.

**H3b:** The level of voluntary disclosure is positively related to the legal-person ownership throughout the 1999-2002 reporting periods.

**H3c:** The level of voluntary disclosure is positively related to the legal-person ownership throughout the 2003-2006 reporting periods.

### 5.4.2.3 Foreign ownership

B shares were held exclusively by foreign investors before 2001. Most B shareholders are international financial institutions, whereas most tradable A shareholders are individuals. As equity stakeholders of listed firms, foreign investors have behaved as effective external monitoring agents. Empirical research demonstrates that investors in the B-share market have better and more timely information than those in the A-share market (Chui and Kwok, 1998).

Listed firms issuing B shares are required to follow International Accounting Standards which require a broader scope in respect of disclosure than the domestic GAAP (Xiao et al., 2004). The research findings of a number of studies comparing the quality of financial information prepared under International Accounting Standards and China’s GAAP (Bao and Chow, 1999; Haw et al., 1999; Chen et al., 2003; Sami and Zhou, 2004; Lin and Chen, 2005) show the earnings and book value of equity under IAS-GAAP are more value-relevant than the China-GAAP-based earnings and book value of equity.
Firms with foreign ownership are more politically visible and subject to more public scrutiny in China. Improving disclosure transparency may potentially reduce political costs (Liu and Eddie, 2007). The disclosure behavior of listed Chinese firms in the Hong Kong stock market is investigated by Ferguson et al. (2002). The different political régime and legal and economic system in Hong Kong mean their stock market is arguably more mature than its counterpart in Mainland China. The Chinese firms listed on the Hong Kong Stock Exchange are, therefore, subject to a more comprehensive and rigorous disclosure environment. Chinese Mainland firms issuing H shares on the Hong Kong Stock Exchange interestingly were found to voluntarily and significantly disclose more strategic and financial information than the local Hong Kong firms. Despite Mainland Chinese firms being relatively new entrants to the competitive capital market in Hong Kong, the disclosure practices of the former SOEs appear sensitive to external investors’ information demands. Ferguson et al. (2002) suggest that the voluntary disclosure behavior of SEHK-listed Chinese firms is “showcasing” – to signal to international investment communities that Mainland Chinese firms are willing to increase transparency and act as good corporate citizens in the worldwide capital market.

Presumably, in line with the continually updated disclosure regulations being implemented in the Chinese stock market and pressure from both domestic and international investors, listed firms in the Chinese stock market will exhibit similar behavior to that in the Hong Kong stock market. It is hypothesized, therefore, that:

**H4a:** The level of voluntary disclosure is higher when the foreign ownership increases throughout the 1995-1998 reporting periods.

**H4b:** The level of voluntary disclosure is higher when the foreign ownership increases throughout the 1999-2002 reporting periods.
H4c: The level of voluntary disclosure is higher when the foreign ownership increases throughout the 2003-2006 reporting periods.

5.4.3 Corporate governance

In a stakeholder theory setting, the corporate governance mechanism is one of the key strategies to help an organization understand, respond to and relate to different stakeholder relationships. An implication of the corporatization of SOEs in China and their overwhelming state ownership is that corporate governance is very relevant to listed firms in the Chinese stock market. Tam (1995) has pointed out that as an integral part of China’s reform process, several issues must be addressed by the corporate governance mechanisms in listed firms: Who are the stakeholders of listed firms? How can their interests be represented and protected? Who is, and who should be, in charge of the firm? How is, and how should, senior management be monitored and made accountable?

5.4.3.1 Independent directors

In the literature of corporate governance, the board of directors is often thought of as an important mechanism to represent and protect shareholders’ interests, provide strategic direction and monitor the performance of corporate management. The composition of the board, as discussed in Chapter 2, has a significant impact on its role. An effective board should include both inside directors and independent directors. Although independent directors do not normally have an equity stake in listed firms, nor relationships with the management and employees, they provide firms with tangible and intangible resources, monitor senior management and should be responsive to shareholders.
As discussed in Chapter 4, having a board comprised of at least one-third independent directors in listed firms is the result of the regulatory agency, the CSRC’s commitment to investor protection. Therefore, the independent director system reflects the Chinese government’s political stake in listed firms. An increased number of independent directors are expected to play a positive role in improving listed firms’ disclosure transparency. Therefore, it is hypothesized that:

H5a: The level of voluntary disclosure is positively related to the increased number of independent directors throughout the 1995-1998 reporting periods.

H5b: The level of voluntary disclosure is positively related to the increased number of independent directors throughout the 1999-2002 reporting periods.

H5c: The level of voluntary disclosure is positively related to the increased number of independent directors throughout the 2003-2006 reporting periods.

5.4.3.2 Audit committees

The Code of Corporate Governance for Listed Companies in China issued by the CSRC in 2001 suggests that boards of directors of listed firms should establish four specialized committees including a corporate strategy committee, an audit committee, a nomination committee and a remuneration and appraisal committee. All committees shall be composed solely of directors. In particular, the audit committee should be chaired by an independent director, and independent directors shall constitute the majority of the committee. At least one independent director in the audit committee shall be an accounting professional. Item 54 of the Code states, “the main duties of the audit committee are: to recommend the engagement or replacement of the company’s external auditing institutions; to review the internal audit system and its execution; to oversee the interaction between the company’s internal and external audit institutions; to inspect the company’s financial information and
its disclosure; and to monitor the company’s internal control system”. The literature review in Chapter 2 shows that an internal audit committee plays a significant role in improving the quality of financial information, reduces agency costs and improves a firm’s internal control system (Forker, 1992; Collier, 1993; Hong and Wong, 2001). It is expected, therefore, that audit committees established in listed firms in China will contribute to the firms’ voluntary disclosure behavior. Prior to the release of the Code of Corporate Governance for Listed Companies in China in 2001, no audit committees are expected to have existed in listed firms. Therefore, the following hypotheses only cover the period after 2001. It is hypothesized that:

H6b: The level of voluntary disclosure is positively related to the existence of an audit committee throughout the 1999-2002 reporting periods.

H6c: The level of voluntary disclosure is positively related to the existence of an audit committee throughout the 2003-2006 reporting periods.

5.4.4 Firms’ economic attributes

Three firm-specific economic attributes, namely, leverage, profitability and growth opportunities, are closely related to shareholders’ and creditors’ economic benefits in listed firms. This section looks at the potential relationship between these attributes and firms’ voluntary disclosure.

24 To match the other hypotheses, there is no H6a established as no audit committee were found to be in existence during Phase I when data was collected from sample firms’ annual reports.
5.4.4.1 Leverage

Agency theory predicts a positive relationship between leverage and disclosure. Further, agency costs are increased as creditors try to restrict and monitor managerial behavior (Jensen and Meckling, 1976). Reducing monitoring costs will motivate management to voluntarily disclose more information to satisfy creditors’ information needs. Inconclusive and inconsistent research findings are noted in respect of the association between leverage and voluntary disclosure. While Zarzeski (1996) showed a negative relationship between financial leverage and disclosure, Jaggi and Low (2000), however, suggested leverage had a positive impact on the level of disclosure. In China, the banking system is an important external source of financing for enterprises. In the early stages of economic reform when banks were subject to political control rather than being market-oriented, the banks neither allocated financial resources efficiently nor monitored the enterprises adequately. With the further development of the Chinese enterprise reforms, banks have resumed their role as important intermediaries of financial resources. As the total amount and ratio of non-performing loans (NPL) in China's major commercial banks have declined considerably and banks have been geared towards profit-seeking, the banking system is expected to have established the ability to serve as an effective corporate governance mechanism in the Chinese stock market. Therefore, it is hypothesized that:

H7a: The level of voluntary disclosure is positively related to leverage throughout the 1995-1998 reporting periods.

H7b: The level of voluntary disclosure is positively related to leverage throughout the 1999-2002 reporting periods.
H7c: The level of voluntary disclosure is positively related to leverage throughout the 2003-2006 reporting periods.

5.5.4.2 Profitability

Agency theory predicts a positive association between a firm’s profitability and its information disclosure. Profitable firms are subject to greater public scrutiny and will, therefore, apply self-regulatory mechanisms, such as voluntary disclosures, to avoid external regulation (Ng and Koh, 1994), and to support the continuance of their positions and compensation arrangements (Inchausti, 1997). Signaling theory predicts that profitable firms will disclose more information in order to signal their strong financial position to investors (Watson et al., 2002). On the other hand, Skinner (1994) suggests that less-profitable firms may disclose more information to explain the reasons for negative performance, to reassure the market about future growth, and to avoid severe devaluation of share capital and loss of reputation in the stock market by disclosure of “bad news”.

In the Chinese stock market, the establishment of the Special Treatment (ST) and Particular Transfer (PT) for stocks of firms operating at a loss was an effort to remind investors of the risks involved in the trading of such stocks during the 1990s. However, the ST and PT systems, intended to avoid irrational investment, did not lead to more delistings in the Chinese stock market. Many analysts have pointed out that these systems mislead investors into falsely believing that the listed firms wouldn't go bankrupt or be delisted (People’s Daily, 2001). To improve the quality of listed firms, and to advocate rational investment and promote the sustainable development of China’s stock market, the CSRC released in 2001 The Implementation Measures for Suspending and Terminating the Listing of Loss-Incurring Listed Companies. A stock-trading suspended firm that fails to make profits in the first six
months following suspension will be delisted. If the firm begins to make profits in that period, it can apply for reinstatement with approval from the regulators. Confronted with more stringent regulations, loss-making firms will disclose more information to the market in order to maintain investors’ confidence and to avoid the risk of being delisted. In view of the mixed motivations for disclosure, as discussed above, there is no specific expectation about the direction of firms’ association with voluntary disclosure and profitability. It is hypothesized:

**H8a:** The level of voluntary disclosure is related to profitability throughout the 1995-1998 reporting periods.

**H8b:** The level of voluntary disclosure is related to profitability throughout the 1999-2002 reporting periods.

**H8c:** The level of voluntary disclosure is related to profitability throughout the 2003-2006 reporting periods.

### 5.4.4.3 Growth opportunity

Growth opportunity has rarely been used as one of the explanatory variables in studies of the Chinese stock market. A common proxy for growth opportunity is the Market-to-Book Equity Ratio (MBE ratio). The market value of equity measures the present value of all future cash flows to equity holders, while the book value of equity represents the accumulated value generated from existing assets only. Therefore, the MBE ratio measures the mix of cash flows from future investment opportunities (Adam and Goyal, 2007). The relationship between a firm’s growth opportunity and its level of voluntary disclosure has been investigated in several studies (Chalmers and Godfrey, 2004; Hossain *et al.*, 2005; Akhtaruddin and Hossain, 2008). While both Hossain *et al.* (2005) and Akhtaruddin and Hossain (2008) find a positive
relationship between voluntary disclosures and growth opportunities, Chalmers and Godfrey (2004) find no significant relationship between these two factors. In the Chinese stock market, under stakeholder theory, a higher MBE ratio is closely related to a potential increment in the existing shareholders’ equity investment and, meanwhile, attracts more investors. Thus, it is expected that growth firms would provide more frequent voluntary information to signal that they are performing well and are a good investment option. Therefore, it is hypothesized that:

**H9a:** The level of voluntary disclosure is positively related to a firm’s growth opportunity in the Chinese stock market throughout the 1995-1998 reporting periods.

**H9b:** The level of voluntary disclosure is positively related to a firm’s growth opportunity in the Chinese stock market throughout the 1999-2002 reporting periods.

**H9c:** The level of voluntary disclosure is positively related to a firm’s growth opportunity in the Chinese stock market throughout the 2003-2006 reporting periods.

### 5.4.5 Auditors

Wallace *et al.* (1994) suggest that the level of disclosure is influenced by auditors. Larger audit firms try to improve the perceived quality of disclosure by having clients disclose more information. The effectiveness of auditing and the auditor’s ability to influence disclosures is expected to vary with auditor quality. Auditor reputation is used to differentiate audit quality (Chalmers and Godfrey, 2004). As a result, firms audited by one of the Big 4 accounting firms may disclose more information than other firms. In the Chinese stock market, two forces worked together to bring the Big 4 international accounting firms into China (Zhang, 2007). First, market forces forced the Big 4 to establish firms in China to provide accounting
and auditing services to their multinational clients and, secondly, under the open-door policy, the Chinese government devised arrangements to settle the large accounting firms into their new environment. While firms issuing B and H-shares are required to have their financial reports audited by international audit firms, some listed firms issuing only A-shares voluntarily choose international firms as their auditors. Given that international audit firms have an established reputation and more experience than domestic audit firms, it is hypothesized that:

**H10a:** The level of voluntary disclosure is higher for firms with international auditors than for firms with domestic auditors throughout the 1995-1998 reporting periods.

**H10b:** The level of voluntary disclosure is higher for firms with international auditors than for firms with domestic auditors throughout the 1999-2002 reporting periods.

**H10c:** The level of voluntary disclosure is higher for firms with international auditors than for firms with domestic auditors throughout the 2003-2006 reporting periods.

### 5.4.6 Control variables

#### 5.4.6.1 Size

Firm size has been identified as a significant explanatory factor in some disclosure studies (Wallace *et al.*, 1994; Zarzeski, 1996; Watson *et al*., 2002; Archambault and Archambault, 2003). The impact of a firm’s size on increased information disclosure has been explained as a result of large firms’ dependence on international resources (Zarzeski, 1996), motivation to reduce political costs (Watts and Zimmerman, 1986), and agency costs (Jensen and Meckling, 1976). Confronted with greater information demands from the public, large firms...
are more likely to disclose extra information to the market. Firm size, therefore, is included as a control variable which is measured in this paper by the value of assets (log).

5.4.6.2 Industry

Industry classification is another significant explanatory factor for voluntary disclosure (Leventis and Weetman, 2004). Higher political costs in regulated industries are likely to result in higher voluntary disclosure, while highly competitive industries may hinder disclosure to avoid proprietary costs (Watts and Zimmerman, 1986). In addition, Cooke (1991) reported a “follow the leader effect”, meaning that the existence of a dominant company in an industry with high levels of voluntary disclosure may create a bandwagon effect for the other firms in the same industry. The industry factor is, therefore, included as another control variable.

5.5 Summary

This chapter develops hypotheses predicting changes in listed firms’ disclosure behavior during the 1995 to 2006 financial reporting periods in the Chinese stock market. The identification of stakeholders’ positions and an assessment of the power possessed by creditors, shareholders, regulatory agencies and professional associations lead to the prediction that throughout the 1995 to 2006 period, the level of voluntary disclosure will gradually increase due to the demands and pressure from the most powerful stakeholders of listed firms. The hypotheses are designed to test the association between voluntary disclosure strategies and firm attributes. The attributes examined in this chapter are related to either stakeholders’ economic stakes or political stakes. Chapter 6 describes the research and data collection methods employed to enable the hypothesis testing.
<table>
<thead>
<tr>
<th>Propositions</th>
<th>Hypotheses</th>
<th>Independent Variables</th>
<th>Disclosure Prediction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voluntary disclosure is a result of stakeholder salience</td>
<td>H1: The level of voluntary disclosures increased in the Chinese stock market throughout the 1995-2006 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ownership structure reflects shareholders’ financial stake in listed firms and influences firms’ disclosure behavior</td>
<td>H2a: The level of voluntary disclosure is negatively related to state ownership throughout the 1995-1998 reporting periods. H2b: The level of voluntary disclosure is negatively related to state ownership throughout the 1999-2002 reporting periods. H2c: The level of voluntary disclosure is negatively related to state ownership throughout the 2003-2006 reporting periods. H3a: The level of voluntary disclosure is negatively related to the legal-person ownership throughout the 1995-1998 reporting periods. H3b: The level of voluntary disclosure is positively related to the legal-person ownership throughout the 1999-2002 reporting periods. H3c: The level of voluntary disclosure is positively related to the legal-person ownership throughout the 2003-2006 reporting periods. H4a: The level of voluntary disclosure is higher when the foreign ownership increases throughout the 1995-1998 reporting periods. H4b: The level of voluntary disclosure is higher when the foreign ownership increases throughout the 1999-2002 reporting periods. H4c: The level of voluntary disclosure is higher when the foreign ownership increases throughout the 2003-2006 reporting periods.</td>
<td>State ownership</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>H5a: The level of voluntary disclosure is positively related to the increased number of independent directors throughout the 1995-1998 reporting periods. H5b: The level of voluntary disclosure is positively related to the increased number of independent directors throughout the 1999-2002 reporting periods. H5c: The level of voluntary disclosure is positively related to the increased number of independent directors throughout the 2003-2006 reporting periods.</td>
<td>Independent directors</td>
<td>+</td>
</tr>
</tbody>
</table>

Corporate governance variables reflect the political stakes of regulatory agencies and how they influence firms’ disclosure behavior
<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Description</th>
<th>Attribute</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>H6b</td>
<td>The level of voluntary disclosure is positively related to the existence of an audit committee throughout the 1999-2002 reporting periods.</td>
<td>Audit committee</td>
<td>+</td>
</tr>
<tr>
<td>H6c</td>
<td>The level of voluntary disclosure is positively related to the existence of an audit committee throughout the 2003-2006 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H7a</td>
<td>The level of voluntary disclosure is positively related to leverage throughout the 1995-1998 reporting periods.</td>
<td>Leverage</td>
<td>+</td>
</tr>
<tr>
<td>H7b</td>
<td>The level of voluntary disclosure is positively related to leverage throughout the 1999-2002 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H7c</td>
<td>The level of voluntary disclosure is positively related to leverage throughout the 2003-2006 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H8a</td>
<td>The level of voluntary disclosure is related to profitability throughout the 1995-1998 reporting periods.</td>
<td>Profitability</td>
<td>?</td>
</tr>
<tr>
<td>H8b</td>
<td>The level of voluntary disclosure is related to profitability throughout the 1999-2002 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H8c</td>
<td>The level of voluntary disclosure is related to profitability throughout the 2003-2006 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H9a</td>
<td>The level of voluntary disclosure is positively related to growth opportunity throughout the 1995-1998 reporting periods.</td>
<td>Growth opportunity</td>
<td>+</td>
</tr>
<tr>
<td>H9b</td>
<td>The level of voluntary disclosure is positively related to growth opportunity throughout the 1999-2002 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H9c</td>
<td>The level of voluntary disclosure is positively related to growth opportunity throughout the 2003-2006 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H10a</td>
<td>The level of voluntary disclosure is higher for firms with international auditors than for firms with domestic auditors throughout the 1995-1998 reporting periods.</td>
<td>International</td>
<td>+</td>
</tr>
<tr>
<td>H10b</td>
<td>The level of voluntary disclosure is higher for firms with international auditors than for firms with domestic auditors throughout the 1999-2002 reporting periods.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H10c</td>
<td>The level of voluntary disclosure is higher for firms with international auditors than for firms with domestic auditors throughout the 2003-2006 reporting periods.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Firms’ economic attributes are closely related to creditors’ and shareholders’ financial stakes and they are associated with firms’ disclosure behavior.
CHAPTER 6

RESEARCH METHODOLOGY

6.1 Introduction

The main research question addressed in this study is to what extent the changed corporate disclosure environment during the past thirty years has impacted on the level of corporate disclosure made by listed firms in China. Chapters 3 and 4 illustrate the political, economic and social changes that have occurred in China since the late 1970s, and the development of corporate reporting and the regulatory framework regarding disclosure since the opening of the Chinese stock market. Chapter 5 suggests that the changed corporate disclosure environment has led to the emergence of other stakeholder groups related to listed firms in the stock market, in addition to the government. The most powerful stakeholder for listed firms identified in Chapter 5 is the regulatory agency group, CSRC. This group established the regulatory framework for corporate reporting, and developed the corporate governance régime in the stock market. It also advocates minority investor protection in listed firms. Investors and creditors are identified as another two key stakeholder groups who have increased their demands for information disclosure by listed firms. It is expected that, when confronted with social pressures from both the government and the investment community to make disclosure more transparent, listed firms in the Chinese stock
market should have responded in a manner that can be mainly explained by stakeholder theory and legitimacy theory.

The preceding chapter develops hypotheses relating to listed firms’ decisions to voluntarily disclose their strategic, financial and non-financial information in annual reports. This chapter describes the research methodology used in this study and the specific methods employed to capture dependent and independent variables and test the voluntary disclosure model developed. A quantitative research method is adopted to provide the empirical evidence. This chapter proceeds as follows. Section 6.2, methodology, justifies the adoption of the longitudinal research method used and why annual reports are preferred to other disclosure channels for examining firms’ voluntary disclosure. Section 6.3 justifies the testing period and the further division into three testing phases. Section 6.4 discusses the sample selection criteria and process. Three steps are involved in developing the voluntary disclosure checklist for this study. Weighting of the checklist items and how to ensure the reliability of the checklist are addressed in Section 6.5. How to measure the level and extent of voluntary disclosure and the relationships between the level of voluntary disclosure and influential factors, are illustrated in Section 6.6. Section 6.7 summarizes the chapter.

6.2 Methodology

The purpose of this study is to investigate the impact of a changed disclosure environment on listed firms’ disclosure behavior. The main research questions are:
1. To what extent did the level of voluntary disclosure of listed firms in the Chinese stock market change over the 1995-2006 periods?

2. What are the factors that have contributed to the changes in the level of voluntary disclosure in the Chinese stock market?

These research questions are tested in eleven hypotheses, as fully described in Chapter 5.

The primary purpose of the first research question is to track disclosure behavior changes in listed firms in the stock market as an aggregate of effects. The primary purpose of the second research question is to gain more detailed insight into behavior changes at individual firm level and track changes in disclosure behavior as a result of individual firm attributes. The following discussion considers the methodology used to answer both research questions.

To investigate the impact of the changed disclosure environment on corporate disclosure in the stock market, this study is based on an analysis of the voluntary disclosure made through corporate annual reports, covering the period from 1995-2006. This period saw significant changes in the information disclosure environment in China. The total mandatory contents disclosure requirements increased rapidly under the impetus of the MOF, the CSRC and the stock exchanges in Shanghai and Shenzhen. Meanwhile, increasing openness in the Chinese economy, China’s admission to the WTO and increased information demands from public investors over the years have also contributed to the formation of the modern corporate disclosure environment in China. The annual reports of 297 firms listed in the stock market for
the twelve years from 1995 and 2006 are examined for detailed testing, in order to establish the main patterns and trends of disclosure behavior changes over time, and the main factors contributing to those changes.

**6.2.1 Using a longitudinal approach**

A longitudinal research method is chosen as it involves repeated observations of the same samples relating to multiple time points. The longitudinal approach provides an understanding of social change, of the trajectories of individual life histories and of the dynamic processes that underlie social and economic life, which is not possible from research based on cross-sectional data. The rationale for using a longitudinal approach is either to infer causation from temporal ordering, or to investigate the effects of events (Buck, 1990).

There are two types of longitudinal studies. Cohort longitudinal studies sample a cohort, defined as a group experiencing some events, in a selected time period and study them at intervals through time. Panel studies sample a cross-section and survey it usually at regular intervals. Observation of the same group of listed firms that have experienced dramatic changes in their disclosure environment in the Chinese stock market over a decade, can make observing changes more accurate than choosing different firms each year. The trends of changes can be developed by observing the same firms (Buck, 1990). This study looks back in time, focusing on the period from 1995-2006. Therefore, it is a retrospective and cohort longitudinal study, with firms continuously listed on the Chinese stock market from 1995-2006 used as the sample firms.
The drawbacks of a longitudinal study are discussed by Yee and Niemeier (1996). They point out the coverage problem a longitudinal study could have. Coverage refers to “the set of units constituting the target population” and includes issues associated with both selecting and tracking individual sample respondents. The coverage limitations of a longitudinal study are, first, the study is restricted to the members of the sample, although changes in the population may occur. Secondly, there is invariably a fair amount of attrition. They suggest the design of longitudinal data is particularly well-suited for stationary populations that reside in a closed system. By keeping the sample population fixed, there is a risk of making inaccurate conclusions about the true population, which may have changed as a result of a reduction or an influx of a population with different behavioral characteristics from the indigenous population.

These two drawbacks of a longitudinal study, however, will not significantly affect the findings of this study. Since the establishment of the stock market in China, the number of listed firms has gradually increased. Statistics show the numbers of listed firms increased from 10 in 1990, to 311 in 1995, 923 in 1999, 1200 in 2002 and 1408 in 2006. Therefore, changes did occur in the population of the Chinese stock market. This study tries to investigate firms’ disclosure behavior changes over a period of time. In order to establish the trend of disclosure behavior changes, the actual population of this study is the firms listed on the Chinese stock market in its early stages. This population has experienced some dramatic changes in the corporate disclosure environment. Firms listed in the stock market in more recent years have a disclosure environment which is significantly different from the disclosure environment when the two stock exchanges opened in early 1990s. Their information
Disclosure behavioral characteristics are, accordingly, different from the firms listed in the stock market in China nearly a decade ago. Hence, the first drawback of coverage is irrelevant to this study. In terms of the second drawback, the attrition problem can be overcome by the sample selection process. Caution was taken in selecting listed firms for the sample. To qualify for the sample, a firm must have been continuously listed on the Chinese stock exchange between the 1995 and 2006 financial reporting periods. A sample of 297 listed firms was chosen through this selection process. Therefore, the attrition problem is not an issue in this study. Details of the sample selection will be discussed in the ‘Sample Selection’ section.

As a longitudinal approach focuses on changes, it has been widely used in social science research, such as in the dynamics of poverty, employment instability, social mobility and demographic events: births, marriages, divorce, deaths and migration (Buck, 1990). There are also a large number of corporate disclosure studies, particularly focusing on firms’ disclosure behavior changes. These empirical studies can be further categorized into multi- and single-firm studies (Bartlett and Jones, 1997). Among the multi-firm studies, Gray et al. (1995) provide an overview of social and environmental disclosure by UK firms over a 13-year period (1979-1991). They suggest legitimacy theory and stakeholder theory enrich our understanding of corporate social disclosure practices. Deegan and Gordon (1996) review corporate disclosure practices in the period from 1980 to 1991 and find there is a general increase in environmental disclosures during the period 1988 to 1991, caused by increases in environmental group membership. Tsang (1998) fills in the literature gap by looking at corporate social responsibility (CSR) disclosure for a ten-year period from 1986 to 1995, in a developing country, Singapore. The time period chosen is to
capture the steady increase in CSR disclosure during the late 1980s and the stable level of disclosure since 1993. Campbell et al. (2003) captured social disclosure data from annual corporate reports between 1975 and 1997 in order to trace the effect of an oil spillage event on corporate social reporting in the annual reports of five oil companies in the UK. Chalmers and Godfrey (2004) investigated managers’ responses to derivative financial instrument disclosure requirements proposed by the Australian accounting standard setting bodies, by looking at the voluntary derivative disclosure made by Australian firms in their annual reports for the period 1992 to 1996. Among single-firm studies, Bartlett and Jones (1997) examined the annual report disclosures in a UK listed company, Bulmers, from 1970 to 1990. They found that while mandatory disclosure increased sharply, the even steeper increase in voluntary disclosure was part of a wide-ranging package of measures introduced to reflect a new corporate philosophy. Deegan et al. (2002) examined the social and environmental disclosures of one of the largest Australian companies, BHP, from 1983 to 1997, to ascertain the extent and type of social and environmental disclosures in their annual reports over the period. Their findings lend support to legitimacy motives for a company’s social and environmental disclosures, and also show a trend in providing greater social and environmental information in BHP’s annual reports in recent years.

Following prior longitudinal studies, the longitudinal approach adopted in this study is expected to document the gradual impact of the changed corporate disclosure environment on the Chinese corporations studied in respect of their information disclosure. In addition, this approach is also expected to provide valuable insight into
the nature, extent and motivation behind the 297 firms’ voluntary disclosures and will report the trends and switch points in their voluntary disclosure.

6.2.2 Annual report examination

The channels of corporate disclosure may include quarterly reporting, interim reports, annual reports, press releases and direct communication with investors and analysts. Data collection based on the voluntary disclosures made in the annual reports published by listed firms in the Chinese stock market is used for the following reasons. First, reporting and disclosure are the most important tools that firms use to communicate with their stakeholders. Chang and Most (1985) used a mail survey to study the perceived usefulness of financial statements for investment decisions of various groups of investors, including institutional and individual investors. Although investors refer to all sources of information to make decisions about companies they invest in, the investors in the Chang and Most (1985) study ranked the annual report highest as a communication source. Their finding is supported by Kent and Ung (2003) and Aljifri and Hussainey (2007). Secondly, there is strong support for the view that annual corporate reports can be accepted as an appropriate source of a company’s attitudes towards reporting and disclosure (Gray et al., 1995). Lang and Lundholm (1993) and Botosan (1997) also find that annual report disclosure is positively related to corporate disclosure in other media, suggesting that firms coordinate their overall disclosure policy. Thirdly, listed firms in the Chinese stock market have been required by the CSRC since 1993 to release their annual reports four months (30th April) after the reporting date, 31 December, using a uniform format stipulated by the CSRC - *The Standards of Contents and Formats of Information Disclosure by Public Issuing Companies*. Therefore, comparability of
annual reports of listed firms is higher than for other information disclosure channels. In addition, the timing differences of annual reports are minimized (Aljifri and Hussainey, 2007). Finally, the use of annual reports alone in this study is also influenced by availability and completeness. In comparison to the information disclosed by listed firms through other disclosure channels, information released in annual reports is the best archived data. By using the CSMAR database, access to the full context of annual reports of all sample firms over the entire testing period is available. Through reading the full context of annual reports, it is possible to identify voluntary disclosure made by listed firms and score voluntary disclosure items according to the voluntary disclosure checklist developed for this study.

6.3 Testing period

Time is part of the definition of a longitudinal approach which requires a long period of longitudinal data. The annual reports of the reporting period, 1995-2006, are examined in order to determine the voluntary disclosures of strategic information, financial information and non-financial information made by listed firms in the Chinese stock market. The primary purpose of such an examination is to determine a general trend of the gradual changes in voluntary disclosure made by listed firms over the twelve annual reporting periods. To determine factors affecting firms’ voluntary disclosure during different phases of the Chinese stock market, in Chapter 5 the entire testing period is further divided into three distinct testing phases. The three phases are named Phase I, the developing phase 1995-1998, Phase II, the corporate governance
régime phase 1999-2002, and Phase III, the convergence phase, 2003-2006, respectively.

6.4 Sample selection

To be included in the sample, listed firms must satisfy the following selection criteria in order to test the hypotheses developed in Chapter 5:

(1) Firms must be listed continuously on either the Shanghai Stock Exchange or the Shenzhen Stock Exchange spanning 1995-2006 and, thus, twelve years’ annual reports are available for examination.

(2) Firms must belong to an industry classification other than banking and financial institutions, which are subject to a different accounting system and disclosure requirements in China.

(3) Firms must issue either only A shares, both A and B shares, or only B shares.

The first selection criterion is to ensure the continuous observation of the disclosure behavior of the same group of listed firms during the entire testing period to satisfy the minimum requirement of a longitudinal study. The second selection criterion is to ensure that all sample firms are under the same regulatory régime in respect of their information disclosure. In such a way, the information disclosed by sample firms is comparable. Application of the above criteria results in a sample of 297 firms across 12 industries, and the sample is broad enough to cover large, medium and small firms within a majority of the industries. Table 6.1 documents the components of the sample. There are 227 firms that only issue A-shares; 66 firms issue dual-class shares, both A-shares and B-shares; and 5 firms only issue B shares. As the preceding
discussion shows, firms issuing A-shares need to follow the Chinese GAAP and accounting standards, while firms issuing B-shares need to satisfy the requirements of the IAS when they compile financial reports. Firms issuing dual-class shares need to cope with different reporting requirements which co-exist as they expose their disclosure to foreign investors as well. As a result, firms issuing dual-class shares need to prepare two sets of financial statements, one under China GAAP and a second according to international accounting standards, respectively, for each year’s annual reports.

Table 6.1 Industry classification of the sample

<table>
<thead>
<tr>
<th>Industry Classification</th>
<th>No. of firms issuing A-shares only</th>
<th>No. of firms issuing dual class shares</th>
<th>No. of firms issuing B-shares only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, fishing and forestry</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Mining</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>90</td>
<td>42</td>
<td>4</td>
</tr>
<tr>
<td>Electrical and power</td>
<td>12</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Construction</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Transportation and storage</td>
<td>3</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Information technology</td>
<td>18</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Wholesale and retail</td>
<td>33</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Real estate development</td>
<td>22</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Social services</td>
<td>5</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Culture</td>
<td>4</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>33</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>226</strong></td>
<td><strong>66</strong></td>
<td><strong>5</strong></td>
</tr>
</tbody>
</table>
6.5 Construction of a voluntary disclosure checklist

6.5.1 Voluntary disclosure checklist construction

To investigate the impact of a changed disclosure environment in China on the disclosure behavior of listed firms over a twelve-year period, a measurement tool of voluntary disclosure needs to be employed. This measurement tool should be able to identify the type, and measure the extent, of information disclosed voluntarily by listed firms in this study. A voluntary disclosure checklist needs to be designed. To standardize the measurement of the extent of voluntary disclosure among firms, prior academic studies normally construct a disclosure checklist that allows comparison between sample firms. The construction of a disclosure checklist for a disclosure study must involve the consideration of the purpose of the study and the method of item selection. Botosan (1997) indicates such a practical research tool involves some degree of subjectivity when selecting voluntary disclosure items to be included in the checklist. Marston and Shrives (1991) also argue that subjectivity cannot be completely removed, nor is it reasonable to expect that it can be.

Owusu-Ansah (1997) suggests researchers, however, could minimize the subjectivity effect by reviewing existing practices, consulting previous studies and considering the socio-economic environment of the country subject to the study. Applying these ideas, three systematic steps are taken in designing the voluntary disclosure checklist for this study, in order to ensure its validity and credibility: (1) compile three voluntary disclosure checklists for the preliminary test over the three testing periods;
(2) survey the academic literature; and (3) refer to the voluntary disclosure framework recommended by the Financial Accounting Standards Board (FASB) in the US.

**Step One – Checklists developed for a preliminary test**

Three voluntary disclosure checklists were developed for testing periods 1995, 2000 and 2005, respectively, for the purpose of preliminary tests. The primary purpose of a preliminary test is to test whether there are voluntary disclosures in sample firms’ annual reports, and whether the level of voluntary disclosure shows an increasing trend in the 1995, 2000 and 2005 periods. In this process, all mandatory disclosure requirements released by the MOF and the CSRC in these three testing periods are collected. The comparison of these three mandatory disclosure lists enables identification of the differences between the disclosure items required by the government regulators during the three financial reporting periods. Over the years, the mandatory disclosure items increase gradually as a result of a more regulated disclosure régime in the Chinese stock market. Some mandatory disclosure items in the reporting periods 2000 and 2005, therefore, were voluntary disclosure items in the 1995 reporting period. Some mandatory disclosure items in the 2005 reporting period were voluntary disclosure items in the 2000 reporting period. The voluntary disclosure items for 2005 are established by referring to the Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement, released by the Hong Kong Society of Accountants in March 2001. Items such as “Prospects and plans for the future”, and “Forecast” are voluntary disclosure items for all three testing periods.
Of the three voluntary disclosure checklists, the 1995 one is longest, with 65 voluntary disclosure items. The number of voluntary disclosure items is reduced to 59 in the year 2000 checklist. The 2005 checklist consists of 51 items. The preliminary test is conducted based on these three checklists. The results of preliminary tests show that voluntary disclosures have increased gradually over the 1995, 2000 and 2005 periods.

Step Two – Survey of the academic literature

The checklist item selection generally includes a review of the relevant literature (Chow and Wong-Boren, 1987). The purpose of the academic literature review is to identify commonly-used voluntary disclosure items in voluntary disclosure research. A disclosure checklist has been used as a research instrument in numerous voluntary disclosure studies (Buzby, 1974; Cooke, 1989; Meek et al., 1995; Botosan, 1997; Eng and Teo, 1999; Eng et al., 2001; Eng and Mak, 2003; Chalmers and Godfrey, 2004). Most researchers make attempts to create a checklist that is valid in the particular research environment being investigated (Marston and Shrives, 1991). To examine the relationship between disclosure level and cost of equity capital in the US, Botosan (1997) compiled a checklist, guided by recommendations provided in the American Institute of Certified Public Accountants’ (1994) study of business reporting, the SRI International (1987) survey of investor information needs, and the Canadian Institute of Chartered Accountants’ (1991) study of the annual report. Botosan’s (1997) checklist includes five categories of voluntary information which are identified by investors and financial analysts as useful in investment decision-making: background information; ten or five year summary of historical results; key non-financial
statistics; projected information; and management discussion and analysis. Meek et al. (1995) compiled their checklist based on an analysis of international trends and observations of standard reporting practices of the US, UK and continental European multinational corporations, taking into account the disclosure index used by Tonkin (1989) in his comprehensive surveys of 200 annual reports from the world’s leading companies. The sample of Eng et al. (2001) is listed firms on the Stock Exchange of Singapore, and the checklist constructed by Eng et al. (2001) is based on the recommendations provided by the Institute of Certified Public Accountants of Singapore (ICPAS). Both Meek et al.’s (1995) and Eng et al.’s (2001) checklists consist of three categories of voluntary information: strategic information, non-financial information, and financial information. The sub-categories both studies identified under every information category are also consistent with each other. Most of the Botosan (1997) checklist items are covered by the checklists established by Meek et al. (1995) and Eng et al. (2001). A combination of the three checklists from Meek et al. (1995), Botosan (1997) and Eng et al. (2001) is then used as the main reference for the checklist constructed for this study.

Three checklists used for the preliminary tests are then compared against the combined checklist from the academic literature review, in order to decide which disclosure items should be included in the final checklist used for this study. This study examines twelve years of voluntary disclosures among 297 listed firms in the Chinese stock market. As a result of increased disclosure regulations, some of the voluntary disclosure items in the early stages of the testing periods become mandatory disclosure items in the later stages of the testing periods. These items are eliminated from the final checklist to ensure that it enables comparison of voluntary disclosures.
across the entire testing period, 1995-2006. Some items in the checklists for the preliminary test purpose are combined or simplified in the final checklist. For example, categories such as “Prospects and plans for the future” and “Forecast” in the checklists for the preliminary tests are combined into one category, “Future prospects”, in the final checklist. The above changes result in a checklist used for this study which is very similar to the checklist compiled by Meek et al. (1995). The main information categories and sub-categories of the final checklist are as follows:

- **Section 1: Strategic information**
  - Category one: General corporate information
  - Category two: Corporate strategy
  - Category three: Management discussion and analysis, including operating review and financial review
  - Category four: Future prospects
  - Category five: Other useful strategic information

- **Section 2: Financial information**
  - Category one: Performance indicators (not from financial statements)
  - Category two: Financial review
  - Category three: Project information
  - Category four: Foreign currency information
  - Category five: Stock price information
  - Category six: Other useful financial information

- **Section 3: Non-financial information**
  - Category one: Information about directors
  - Category two: Employee information
  - Category three: Social policy
Category four: Other useful non-financial disclosures

Including “Social policy” as one of the voluntary disclosure categories in the checklist can be justified by the increasing pressure put on firms in China, from a number of different sources, including the state and local government, the State Environmental Protection Agency (SEPA) and the CSRC, to engage in voluntary environmental reporting and disclosure over the years (Guo, 2005). The aim of including environmental issues related to a voluntary disclosure item in the checklist of this study is to find out the changes made by listed sample firms in respect of their social corporate responsibility disclosure over the period of 1995-2006.

Step Three – Consider the voluntary disclosure framework recommended by the FASB

To further assess whether the established checklist for this study has captured the significant financial and non-financial information which should be contained in corporate annual reports over the testing period, the voluntary disclosure framework recommended by the FASB in the US is also used as a reference. In 2001, a Steering Committee under the FASB issued a report named Improving Business Reporting: Insights in Enhancing Voluntary Disclosure (FASB, 2001). The Steering Committee’s framework for providing voluntary disclosures is:

- Identify the aspects of the company’s business that are especially important to the company’s success. These are the critical success factors for the company.
- Identify management’s strategies and plans for managing those critical success factors in the past and in the future.
- Identify metrics (operating data performance measures) used by management to measure and manage the implementation of their strategies and plans.

- Consider whether voluntary disclosures about the company’s forward-looking strategies and plans and metrics would adversely affect their competitive position, and exceed the expected benefit of making the voluntary disclosure.

- If disclosure is deemed appropriate, determine how best to voluntarily present that information. The nature of metrics presented should be explained, and those metrics should be consistently disclosed from period to period to the extent that they continue to be relevant.

Five Working Groups identified present practices in eight industries in the US for the voluntary disclosure of useful business information. The findings show that for companies in the US, voluntary disclosure can be classified into six categories: business data; management’s analysis of business data; forward-looking information; information about management and shareholders; background about the company; and information about intangible assets.

A comparison between the checklist used for this study and the above framework and research findings in the US, shows the checklist has covered most of the areas outlined in the framework and the six categories of voluntary disclosure by firms in the US. Table 6.2 shows the details of this comparison.
Table 6.2 How disclosure checklist addresses FASB voluntary disclosure framework

<table>
<thead>
<tr>
<th>FASB Voluntary Disclosure Framework</th>
<th>Voluntary Disclosure Checklist</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Identify the aspects of the company’s business that are especially important to the company’s success.</td>
<td>Section 1, category three Section 1, category four Section 3, category one Section 3, category two</td>
</tr>
<tr>
<td></td>
<td>Management discussion and analysis Future prospects Information about directors Employee information</td>
</tr>
<tr>
<td>2 Identify management’s strategies and plans for managing those critical success factors in the past and in the future.</td>
<td>Section 1, category two Section 1, category four</td>
</tr>
<tr>
<td></td>
<td>Corporate strategy Future prospects</td>
</tr>
<tr>
<td>3 Identify metrics (operating data performance measures) used by management to measure and manage the implementation of their strategies and plans.</td>
<td>Section 2, category one Section 2, category two Section 2, category three Section 2, category four Section 2, category five</td>
</tr>
<tr>
<td></td>
<td>Performance indicators Financial review Project information Foreign currency information Stock price information</td>
</tr>
<tr>
<td>4 Consider whether voluntary disclosures about the company’s forward-looking strategies would adversely affect competitive position and exceed the expected benefit of making the voluntary disclosure.</td>
<td>Can’t be measured by using voluntary disclosure checklist</td>
</tr>
<tr>
<td>5 If disclosure is deemed appropriate, determine how best to voluntarily present that information.</td>
<td>Can’t be measured by using voluntary disclosure checklist</td>
</tr>
</tbody>
</table>
6.5.2 Checklist weighting

Consideration is also given to the weighting or non-weighting of checklist items used in this study, and to the different opinions and approaches adopted by researchers in respect of voluntary disclosure weighting. While Chow and Wong-Boren (1987), Firth (1980), Cooke (1989), Meek et al. (1995) and Chalmers and Godfrey (2004) choose not to weight their checklist items, Buzby (1974), Botosan (1997), Eng and Teo (1999), Eng et al. (2001) and Eng and Mak (2003) take the opposite view.

Three main reasons are given by researchers who choose not to weight their voluntary disclosure checklists. The first is that subjectivity could be involved in assigning weights when users’ preferences are unknown (Meek et al., 1995). Second is the necessity for disclosure. Both Cooke (1989) and Meek et al. (1995) use the research findings of Spero (1979) to back up their argument. Spero (1979) reports that companies better at disclosing “important” items are also better at disclosing “less important items”. Therefore, companies would be scored the same way regardless of whether items are weighted or un-weighted. The third reason is that weighted and un-weighted scores show similar results (Firth, 1980; Chow and Wong-Boren, 1987; Chalmers and Godfrey, 2004). To overcome the subjectivity problem and identify perceptions as to the importance of the checklist items in their study, Chalmers and Godfrey (2004) conducted a postal survey among equity analysts before assigning weighting to the disclosure items. The lack of differentiation between results based on a weighted checklist and an un-weighted checklist led to the abandonment of a checklist weighting approach in their study.
Supporters for attaching unequal importance to each item in a disclosure checklist argue different items of information can be perceived as having different degrees of importance for the user group (Marston and Shrives, 1991). Buzby (1974) surveys a number of respondents and takes the resulting means as his weighting. Botosan (1997) refers to the SRI International Survey (1987) of investor information needs. According to the SRI International Survey, a summary of historical results, key non-financial statistics, projected information, and management discussion and analysis are as important, or extremely important, compared to investors’ rating of a company’s background information. Therefore, Botosan (1997) assigns one point for each background item disclosed, two points for company performance statistics and ratios, and three points to forward-looking information. A similar method is adopted by Eng and Teo (1999), Eng et al. (2001) and Eng and Mak (2003).

In this study, the argument is that a different level of importance should be attached to different disclosure categories and to each specific item in order to reflect the significance of different types of information to investors’ decision-making during the development of the Chinese stock market. The method used by Eng et al. (2001) to score voluntary disclosure checklist items is followed. Giving different scores to checklist items is, essentially, an extension of the weighting system (Marston and Shrives, 1991). Criteria for the computation of voluntary disclosure scores are as follows:

**Strategic information:**

One point is assigned to each “General corporation information” item, one point to each “Corporate strategy” item if a general statement is given, two points if a
quantitative statement is given, and three points if detailed elaboration on the strategy, with both qualitative and quantitative information, is given in the annual report examined. The same criteria are applied to some “Management discussion and analysis” items, including “Review of operations”, “Competitive environment” and “Significant events of the year”. To reflect the importance of “Future prospects”, one point is assigned to annual reports that provide only a general statement about a firm’s new developments, three points to annual reports providing quantitative information, and five points to detailed elaboration on this information. Table 6.3A shows the assignment of scores to the “Strategic information” section on the disclosure checklist.

Table 6.3A Assignment of scores to the strategic information section

<table>
<thead>
<tr>
<th>Section/category</th>
<th>Voluntary disclosure items</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 1 Strategic information</strong></td>
<td></td>
<td>-------</td>
</tr>
<tr>
<td>Category One - General Corporate Information</td>
<td>brief history of company</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>organizational structure/chart</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>general description of business/activities</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>principal products</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>principal markets</td>
<td>1</td>
</tr>
<tr>
<td>Category Two - Corporate Strategy</td>
<td>statement of corporate goals or objectives</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>current strategy</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>impact of strategy on current results</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>future strategy</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>impact of strategy on future results</td>
<td>1 2 3</td>
</tr>
<tr>
<td>Category Three - Management Discussion and Analysis</td>
<td>review of operations</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>competitive environment</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>significant events of the year</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>change in sales/profits</td>
<td>1 2</td>
</tr>
<tr>
<td></td>
<td>change in expenses</td>
<td>1 2</td>
</tr>
<tr>
<td></td>
<td>change in inventory level</td>
<td>1 2</td>
</tr>
<tr>
<td></td>
<td>change in market share</td>
<td>1 2</td>
</tr>
<tr>
<td>Category Four - Future Prospects</td>
<td>new developments</td>
<td>1 3 5</td>
</tr>
<tr>
<td></td>
<td>forecast of sales/profit</td>
<td>1 2</td>
</tr>
<tr>
<td></td>
<td>assumptions underlying the forecast</td>
<td>1 2</td>
</tr>
<tr>
<td>Category Five - Other Useful Strategic Information</td>
<td></td>
<td>1 2 3</td>
</tr>
</tbody>
</table>

Table 205
Financial information:

One point is assigned to financial ratios under “Performance indicators” and two or three points to “Historical figures for last five years or more”, as historical summaries of financial figures are useful in trend analysis (Eng et al., 2001). Only one point is assigned to all “Financial review” disclosure category items if voluntary disclosure is found from annual reports. To reflect the importance of the “Projected information” disclosure category, three points are assigned to any voluntary disclosure related to “Cash flow forecast”, “Capital expenditure and/or R&D expenditure forecast” and the “Earnings forecast”. For “Foreign currency information”, “Stock price information” and “Other useful financial information” categories, one point is assigned for a general statement, two points for quantitative information and three points for a detailed elaboration. Table 6.3B shows the assignment of scores to the financial information section on the disclosure checklist.
Table 6.3B Assignment of scores to the financial information section

<table>
<thead>
<tr>
<th>Section/category</th>
<th>Voluntary disclosure items</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 2 Financial information</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Category One - Performance Indicators (not from financial statements)</td>
<td>historical figures for last five years or more</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>profitability ratios</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>cash flow ratios</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>liquidity ratios</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>gearing ratios</td>
<td>1</td>
</tr>
<tr>
<td>Category Two - Financial Review</td>
<td>disclosure of intangible valuations (except goodwill)</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>dividend payout policy</td>
<td>1</td>
</tr>
<tr>
<td>Category Three - Projected Information</td>
<td>cash flow forecast</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>capital expenditure and/or R&amp;D expenditures forecast</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>earnings forecast</td>
<td>3</td>
</tr>
<tr>
<td>Category Four - Foreign Currency Information</td>
<td>impact of foreign exchange fluctuations on current results</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>foreign currency exposure management description</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>major exchange rates used in the accounts</td>
<td>1</td>
</tr>
<tr>
<td>Category Five - Stock Price Information</td>
<td>market capitalization at year-end</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>market capitalization trend</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>size of shareholdings</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td>type of shareholder</td>
<td>1 2 3</td>
</tr>
<tr>
<td>Category Six - Other Useful Financial Information</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Key non-financial information:**

One point is assigned to a general statement of information about directors items, two points to quantitative information, and three points to detailed qualitative and quantitative information. The same criteria are applied to social policy items as well. For employee information, one point is assigned to all items except “Data on accidents” and “Cost of safety measures”. These two items are assigned two points if disclosure is found in annual reports.

The weighted voluntary disclosure checklist is presented in Table 6.3. Sample firms’ annual reports are examined and scored according to the degree of specificity of each of the information items in the checklist. The disclosure level of a sample firm,
therefore, is the aggregation of the scores in the voluntary disclosure checklist. A sample firm’s disclosure level is represented by a Voluntary Disclosure Score (VDS). Table 6.3C shows the assignment of scores to the key non-financial information section on the disclosure checklist.

<table>
<thead>
<tr>
<th>Section/category</th>
<th>Voluntary disclosure items</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 3 Key non-financial information</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Category One - Information about Directors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>commercial experience of the executive directors</td>
<td>1 2 3</td>
<td></td>
</tr>
<tr>
<td>other directorships held by executive directors</td>
<td>1 2 3</td>
<td></td>
</tr>
<tr>
<td><strong>Category Two - Employee Information</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>amount spent on training</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>nature of training</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>categories of employee trained</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>number of employees trained</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>data on accidents</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>cost of safety measures</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>redundancy information</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td><strong>Category Three - Social Policy</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>safety of products</td>
<td>1 2 3</td>
<td></td>
</tr>
<tr>
<td>environmental protection programs - quantitative</td>
<td>1 2 3</td>
<td></td>
</tr>
<tr>
<td>charitable donations (amount)</td>
<td>1 2 3</td>
<td></td>
</tr>
<tr>
<td>community programs (general)</td>
<td>1 2 3</td>
<td></td>
</tr>
<tr>
<td><strong>Category Four - Other Useful Non-Financial Disclosure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1 2 3</td>
<td></td>
</tr>
</tbody>
</table>

### 6.5.3 Reliability

The reliability of the VDS score could be measured by the stability and reproducibility of the VDS. The objective of testing stability is to see, after a time lapse, whether the score assigned to the same item is consistent. Reproducibility involves choosing a small number of the sample across the testing period and re-assigning the scores in order to find out whether the scores assigned and re-assigned are consistent. In respect of the stability of the VDS, the score assigned for the
same/similar item used in the checklists constructed for the preliminary test\textsuperscript{25} is compared with the formal data collection across the three periods, 1995, 2000 and 2005. To test the reproducibility, thirty sample firms (10\% of total sample firms) are randomly chosen across 1995-2006 and a score for their annual reports is assigned for the second time. For the majority of cases, both scores assigned to the same firms are consistent with each other. The above two steps suggest that the VDS measure in this study possesses stability and reproducibility.

6.6 Measuring the impact of changed disclosure environment on firm disclosure behavior

6.6.1 Measurement of the level of voluntary disclosure

The level of voluntary disclosure is measured by the number of firms that voluntarily disclose information, the extent of voluntary disclosure and the type of voluntary disclosure. The number of disclosing firms shows how many firms voluntarily disclose information each year during the entire testing periods and each testing phase, respectively, covered in this study. The extent of voluntary disclosure is reflected by the voluntary disclosure scores assigned to sample firms. As disclosure items are weighted in the checklist, the disclosure score assigned is able to show both depth and extent of disclosure. Descriptive statistics of each disclosure category and item, including mean and number of observations, are used to reflect the type of

\textsuperscript{25} Preliminary test is conducted in May 2007 and formal test is conducted in March 2009 for this study.
voluntary disclosure. Thus, the type of information the firm prefers to disclose voluntarily can be shown.

### 6.6.2 Factors affecting firms’ voluntary disclosure decisions

In this study, an Ordinary Least Squares (OLS) regression is employed to examine the relationship between listed firms’ voluntary disclosure and factors affecting listed firms’ disclosure decision-making. The following regression is estimated:

\[
VDS = \alpha + \beta_1STA + \beta_2LEG + \beta_3TRB + \beta_4BOD + \beta_6IAC + \\
\beta_7LEV + \beta_8PRO + \beta_9GRO + \beta_{10}AUD + \beta_{11}SIZE + \beta_{12}IND + \varepsilon
\]

(Equation 6.1)

**Where:**

- VDS = voluntary disclosure score firm \(i\) in time \(t\)
- STA = percentage of state ownership for firm \(i\) in time \(t\)
- LEG = percentage of legal-person ownership for firm \(i\) in time \(t\)
- TRB = percentage of tradable share B ownership for firm \(i\) in time \(t\)
- BOD = percentage of independent directors on the board for firm \(i\) in time \(t\)
- IAC = dummy variable, coded as 1 if there is an internal audit committee for firm \(i\) in time \(t\), 0 otherwise
- LEV = a ratio of total liabilities to total assets for firm \(i\) in time \(t\)
- PRO = a ratio of return of shareholder’s equity for firm \(i\) in time \(t\)
- GRO = a ratio of market value of equity to book value of equity for firm \(i\) in time \(t\)
- AUD = dummy variable, coded as 1 if the auditor for firm \(i\) in time \(t\) is an international auditor, 0 otherwise
SIZE = logarithm of total assets for firm $i$ in time $t$

IND = dummy variable, coded as 1 if firm belongs to manufacturing industry for firm $i$ in time $t$, 0 otherwise

6.6.2.1 Independent variable constructs

This section discusses the measurement of the explanatory variables employed in the voluntary disclosure model in order to find out some specific factors which have influenced individual listed firms’ voluntary disclosure. The independent variables can be classified into four groups: ownership structure, corporate governance related, economics-based variables, and external auditor.

Ownership structure group

There are three independent variables in this group, namely, state ownership, legal-person ownership and foreign ownership. It is predicted in Chapter 5 that these different types of share ownership in the Chinese stock market will influence the level of voluntary disclosure of listed firms. State ownership and legal-person ownership will have a negative impact on firms’ voluntary disclosure, while foreign ownership will have a positive impact on firms’ voluntary disclosure. State ownership is measured by the percentage of ordinary shares held by government agencies and state-owned enterprises. Legal-person ownership is measured by the percentage of ordinary shares held by legal-persons. The legal-person shareholders tend to have strong, state-related roots and the shareholders comprise various domestic institutions in China, including private companies, state-owned enterprises and non-backed financial institutions such as investment funds and security companies (Xu and Wang,
Foreign ownership is measured by percentage of B shares or H shares issued by a listed firm. The full context of annual reports contained in the CSMAR database provides the total ordinary shares issued by sample firms and the number of shares held by state enterprises, legal-persons and foreign investors.

**Corporate governance related group**

Corporate governance-related factors are predicted to have a positive impact on firms’ voluntary disclosure in the Chinese stock market, especially after 2001 when the CSRC advocates strongly the corporate governance régime among listed firms. Two independent variables used in voluntary disclosure regression are independent directors and the existence of an internal audit committee. Independent directors are measured by the percentage of independent directors on a firm’s board of directors. The existence of an internal audit committee is a dummy variable, coded as 1 if a listed firm has an internal audit committee, and coded as 0 if otherwise. The number of independent directors, total number of directors on the board, and the existence of an internal audit committee, can be identified from the annual report in the CSMAR database.

**Economics-based variables**

Economics-based variables used in the voluntary disclosure regression model include leverage, profitability, growth opportunity and two control variables - firm size and industry classification. Leverage is measured by the ratio of a firm’s total liabilities to total assets. Profitability is measured by a firm’s return on its shareholders’ equity. Growth opportunity is measured by the ratio of a firm’s market value of equity to the book value of equity. All Statement of Financial Position and Performance items are
obtained from the CSMAR database. Market value of the equity of sample firms is also obtained from the same data source.

*External auditors*

The voluntary disclosure model predicts that firms using international auditing firms will present a higher level of voluntary disclosure than firms using domestic CPA firms as an auditor. If a firm’s annual report is audited by an international auditing firm, a classification of 1 is assigned. If a firm’s annual report is audited by a domestic CPA firm, 0 is assigned to that firm. The information related to the status of external auditor can be collected from the annual reports in the CSMAR database.

**6.6.2.2 Control variables**

There are two control variables - firm size and industry classification. Firm size is measured by the natural logarithm of total assets of each sample firm. The amount of total assets can be extracted from the balance sheet in the annual report. Industry classification is a dummy variable; coded as 1 if a firm is classified as a manufacturing firm, and coded as 0 if otherwise.

Table 6.4 summarizes the construction of independent variables used in this study.
Table 6.4 Summary of the construction of independent variables

<table>
<thead>
<tr>
<th>Hypothesis established in Chapter 5</th>
<th>Independent variable</th>
<th>Label</th>
<th>Measurement</th>
<th>Data source</th>
</tr>
</thead>
<tbody>
<tr>
<td>H2a, H2b, H2c</td>
<td>State ownership</td>
<td>STA</td>
<td>= Number of shares issued to state shareholders/Total number of shares issued</td>
<td>Datastream</td>
</tr>
<tr>
<td>H3a, H3b, H3c</td>
<td>Legal-person ownership</td>
<td>LEG</td>
<td>= Number of shares issued to legal-person shareholders/Total number of shares issued</td>
<td>Datastream</td>
</tr>
<tr>
<td>H4a, H4b, H4c</td>
<td>Foreign ownership</td>
<td>TRB</td>
<td>= Number of shares issued to foreign shareholders/Total number of shares issued</td>
<td>Datastream</td>
</tr>
<tr>
<td>H5a, H5b, H5c</td>
<td>Independent directors</td>
<td>BOD</td>
<td>= Number of independent directors/Total number of directors on the board of directors</td>
<td>Manually identified from annual reports</td>
</tr>
<tr>
<td>H6b, H6c</td>
<td>Internal audit committee</td>
<td>IAC</td>
<td>Dummy variable 1 = if a firm has an internal audit committee 0 = if a firm does not have an internal audit committee</td>
<td>Manually identified from annual reports</td>
</tr>
<tr>
<td>Hypothesis established</td>
<td>Independent variable</td>
<td>Label</td>
<td>Measurement</td>
<td>Data source</td>
</tr>
<tr>
<td>------------------------</td>
<td>----------------------</td>
<td>-------</td>
<td>----------------------------------------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>H7a, H7b, H7c</td>
<td>Leverage</td>
<td>LEV</td>
<td>= Total liabilities/Total assets</td>
<td>CSMAR-A Database</td>
</tr>
<tr>
<td>H8a, H8b, H8c</td>
<td>Profitability</td>
<td>PRO</td>
<td>= Return/Total shareholders’ equity</td>
<td>CSMAR-A Database</td>
</tr>
<tr>
<td>H9a, H9b, H9c</td>
<td>Growth opportunity</td>
<td>GRO</td>
<td>= Market value of equity/ Book value of equity by the end of financial period</td>
<td>CSMAR-A Database and Datastream</td>
</tr>
<tr>
<td>Firm size – control variable</td>
<td>SIZE</td>
<td></td>
<td>= log of total assets</td>
<td>CSMAR-A Database</td>
</tr>
<tr>
<td>Industry classification – control variable</td>
<td>IND</td>
<td></td>
<td>Dummy variable</td>
<td>CSRC Industry Classification</td>
</tr>
<tr>
<td>International auditor</td>
<td>AUD</td>
<td></td>
<td>Dummy variable</td>
<td>Manually identify from annual reports</td>
</tr>
<tr>
<td>H10a, H10b, H10c</td>
<td></td>
<td></td>
<td>1 = if a firm’s auditor is an international audit firm</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>0 = if a firm’s auditor is a domestic firm</td>
<td></td>
</tr>
</tbody>
</table>
6.7 Summary

This chapter focuses on the study’s research design. The research methodology used in this study is discussed, including the justification for adopting a longitudinal approach, examination of annual reports, and why voluntary disclosure can be used to represent firms’ disclosure behavior. Also explained are the reasons used to determine the appropriate testing period to investigate firm’s voluntary disclosure. The entire testing period is further divided into three phases which represent different stages of the development of the Chinese stock market. The sample selection procedure is then described. There are 297 listed firms selected as the sample. To satisfy the minimum requirement of a longitudinal study, the sample firms have been continuously listed on the Chinese stock market between 1995 and 2006. The voluntary disclosure checklist used for this study is a combination of the checklists developed for the preliminary test, a survey of checklists among prior voluntary disclosure studies and reference was also made to the voluntary disclosure framework recommended by the FASB in the US. The final checklist consists of three voluntary disclosure sections - strategic, financial and non-financial information. There are fifteen disclosure categories under three disclosure sections. Different scores are assigned to each disclosure item to reflect the importance of some disclosure items to investors’ decision-making. The validity of the checklist is ensured by its stability and reproducibility. The level of voluntary disclosure is measured by the number of disclosing firms over the testing period and the extent and type of voluntary disclosure. An OLS regression model is employed to explore the relationship between levels of voluntary disclosure and the independent variables identified in Chapter 5. The proxy variable measurement is also discussed. The purpose of the next chapter is to present and analyze the results of testing the hypotheses developed in Chapter 5.
CHAPTER 7

RESULTS AND ANALYSIS

7.1 Introduction

The longitudinal nature of this study requires data for multiple periods. Using the research methodology and specific research methods discussed in Chapter 6, voluntary disclosures are collected from 297 listed sample firms. The full context of their annual reports from 1995-2006 are examined line by line. Voluntary disclosures are identified based on the voluntary disclosure checklist designed in Chapter 6. Each disclosure item is assigned with an appropriate score based on the extent and depth of disclosure made by the listed sample firms.

This chapter describes and analyses the results. Section 7.2 reports the voluntary disclosures made by listed sample firms over the years. The results are presented in four sections: strategic information, financial information, non-financial information and a summary of three disclosure sections. The changes in voluntary disclosures are represented by the number of firms voluntarily disclosing information beyond statutory requirements in the three testing phases, the descriptive statistics of each disclosure category, and the main content of voluntary disclosure under each disclosure category. Section 7.3 summarizes and analyzes the main characteristics exhibited by sample firms’ voluntary disclosure over the years. The
comparison of disclosure levels between Phase I and Phase II, Phase II and Phase III are discussed. Section 7.4 reports the results of regression tests which demonstrate whether the factors predicted in Chapter 6 are supported by the data collected from the sample. Section 7.2, Section 7.3 and Section 7.4 group results into the three distinctive testing phases defined in Chapter 5. Phase I, Phase II and Phase III in this chapter represent “Developing phase: 1995-1998”, “Corporate governance régime phase: 1999-2002”, and “Convergence phase: 2003-2006”, respectively. Section 7.5 presents a summary and conclusion of the chapter.

7.2 Voluntary disclosure made by listed firms

This section looks at three aspects of voluntary disclosure made by the sample firms: the number of voluntarily disclosing firms, the descriptive statistics of voluntary disclosure categories and the main content of voluntary disclosures. The number of voluntarily disclosing firms reflects the increment or decrement of the number of firms voluntarily disclosing information in three testing phases. Descriptive statistics report the mean, maximum, median of second half (Q3), median and standard deviation of voluntary disclosure scores (VDS) assigned to strategic information, financial information and non-financial information disclosures. Descriptive statistics reflect the extent of voluntary disclosure in the Chinese stock market. The main content of voluntary disclosure for each disclosure category is illustrated in order to determine the sample firms’ preferences regarding voluntary disclosure.
7.2.1 Strategic information

7.2.1.1 Number of disclosing firms

Table 7.1 reports the number of firms voluntarily disclosing strategic information in each individual reporting year throughout 1995–2006 and the average number of disclosing firms in three phases. During Phase I, the number of disclosing firms increased from 14 (5%) in 1995, to 110 (37%) in 1996; 135 (45%) in 1997; and 206 (69%) in 1998. Thus, the average number of firms voluntarily disclosing strategic information in this phase is 116, representing 39% of total sample firms. During Phase II, the number of firms disclosing strategic information changes from 228 (76%) in 1999 to 235 (79%) in 2000; to 266 (89%) in 2001; and 268 (90%) in 2002. The average number of disclosing firms in this phase is 250, representing 84% of sample firms. The number of disclosing firms slightly increased from 269 (91%) in 2003 to 270 (91%) in 2004; 271 (91%) in 2005; and 272 (92%) in 2006 during Phase III. The average number of disclosing firms for this phase is 271, representing 91% of sample firms.

The above results show that, first, there is a progressive increase in the number of firms making voluntary strategic information disclosures over the three testing phases. Secondly, there is a significant increase in the number of firms voluntarily disclosing strategic information during Phase II. The average number of disclosing firms in Phase II is more than double the average number of disclosure firms in Phase I. In summary, the examination of the number of firms disclosing strategic information indicates that listed firms in the Chinese stock market responded positively to the changed disclosure environment over the three
testing phases, especially during Phase II (1999-2002) when the Chinese government strengthened the financial reporting and disclosure regulations.

7.2.1.2 Descriptive statistics of strategic information disclosure

Table 7.2 details the descriptive statistics of five disclosure categories under the strategic information section. The Management Discussion and Analysis category has the highest disclosure mean across the three testing phases. The mean VDSs are 0.39, 1.14 and 1.69 for the three testing phases, respectively. The maximum disclosure score is 4 in Phase I, and reaches 7 in both Phase II and Phase III. Following this category is the Future Prospects category. The mean changes from 0.1 in Phase I to 0.55 in Phase II and 1.19 in Phase III. The maximum disclosure score reaches 8 in Phase III, indicating some sample firms’ willingness to disclose forward-looking information in their annual reports. The mean of the Corporate Strategy category sits in the middle of the strategic information section. The mean is increased from 0.07 in Phase I to 0.44 and 0.98 in Phase II and Phase III, respectively. General Corporation Information and Other Useful Strategic Information have a relatively low mean VDS. The maximum disclosure score reaches 3 for both disclosure categories.

7.2.1.3 Content of strategic information disclosure

The mean VDS of each strategic information disclosure item during the three testing phases are reported in Table 7.3. The primary purpose of further analysis of the mean of each disclosure item under disclosure categories is to determine listed firms’ preferences in disclosing strategic information.
General corporate information

This category has five disclosure items, covering the history of the firm, organization structure, main business activities the firm is engaged in, principal products and market. There is no information disclosed voluntarily by listed firms to illustrate their firms’ history and organization structure throughout the three testing phases. The mean VDS of General Description of Business Activities is changed from zero in Phase I, to 0.5 in Phase II and 1 in Phase III. The example of voluntary disclosure is a detailed description of the scope of firms’ business assets and properties. Voluntary disclosures are made in respect of principal products and markets throughout the three testing phases. Firms are found detailing their products, brand names and registered trademarks in their annual reports. The strongest disclosure made under this information category is the principal market. Firms choose to indicate which provinces in China are their current markets and where their potential markets are located, both domestically and internationally. The mean VDS increase from 0.75 in Phase I, to 7.75 in Phase II and 11.75 in Phase III.

Corporate strategy

This category covers firms’ current and future strategies and their impact on firms’ results in the present and in the future. Voluntary disclosures are found for all five disclosure items throughout the three testing phases. Examples of current management strategies disclosed in annual reports are strategies to control operating expenses and strategies for spending on research and development. Strategies to develop new products with high-technology components, future acquisitions and expanding overseas markets are examples of future strategy disclosures. Both types of strategies are related to factors that are important to firms’
success in the long run. The Future Strategy disclosure item sees the strongest trend in voluntary disclosure, with mean VDS increases from 13.25 in Phase I, to 84.5 in Phase II and 193.8 in Phase III. This is followed by the Current Strategy disclosure item. Few firms voluntarily disclose the impact of their strategies on current and future results. The voluntary disclosures of the impact of strategies on current and future results are qualitative rather than quantitative. One of the possible reasons could be that the sample firms have difficulty in measuring and predicting the impact accurately.

Management discussion and analysis

This category focuses on firms’ operations. It includes management’s overview of a whole year’s operation, firms’ business environment, significant events during the year and changes in business input and output. Stronger disclosures are found for the review of operations, changes in sales, profits, expenses and market share. Details of growth or decline in market share in the main market and newly expanded markets are found in annual reports. Changes in sales, profits and expenses are discussed based on comparisons between the previous year and current years. Firms reporting decreased sales revenue often detail the reasons causing the decline, while firms with increased sales rarely provide more details. The low mean VDS of Competitive Environment and Significant Events of the Year show sample firms are not keen to disclose information in those two areas. It can be seen that listed firms avoid pointing out their main competitors or making comparisons with competitors in terms of sales and market share. Changed state government legislation and firms’ lawsuits are two typical examples disclosed under Significant Events during the year. Many firms describe the details of events but only a few discuss the impact of the events on their operations at the time or in the future.
Future prospects

This category consists of forward-looking information disclosure items. They are new developments, forecasts of sales/profit and assumptions underlying the forecasts. The strongest voluntary disclosure can be seen from New Developments, with its average disclosure score increasing from 27.25 in Phase I, to 87.5 and 195.5 in Phase II and Phase III, respectively. Examples of new developments found from annual reports are detailed descriptions of products in the developmental stage, and new plans for expansion and brand introductions to specific domestic and international markets. Intensive investment in research and development activities is frequently mentioned as one of the most important measures to achieve new developments. Forming joint ventures with international partners is disclosed as a way for listed firms in China to expand their market. The mean VDS of forecasts of sales or profit increase significantly from only 2 in Phase I, to 53.75 in Phase II and 117.8 in Phase III. Many firms choose to quantify their targets for growth in revenues, net income and gross margin in the following financial year. Some also specify targeted sales revenues for particular products or production lines. Twenty–five observations are found to forecast a loss for the next year due to cash-flow liquidity problems and heavy interest payments associated with borrowing. Interestingly, firms disclosing their forecast are not willing to disclose the underlying assumptions on which the forecast is based. Fewer than half of the firms offering a forecast have explained the circumstances supporting their forecasts.

Other useful strategic information

This category only has one disclosure item, which is designed to capture any strategy-related information not covered by other disclosure categories. For example, one firm discloses the
potential risk that the firm would be delisted from the Shanghai Stock Exchange in the near future due to consecutive losses made in the past. This category presents a clear trend of decline in voluntary disclosure, with the mean of disclosure reduced from 0.083 in Phase I, to 0.051 in Phase II and 0.001 in Phase III. The explanation could be that more strategic information is voluntarily disclosed in Phase II and Phase I, leaving fewer disclosures under the other useful strategic information category.

In the analysis of the disclosing firms over the three phases of the Chinese stock market, the mean disclosure scores of each disclosure category, and each specific disclosure item under the Strategic Information section, show the level of voluntary disclosure increases over the three testing phases. These results lend support to H1. By comparing five voluntary disclosure categories and the individual disclosure items under each category, it is not difficult to identify what strategic information listed firms prefer to disclose voluntarily. Items include new development, future strategy, review of operations, change in sales/profit, change in market share, and forecast of sales/profit experience in the relatively strong increases in voluntary disclosure over time. It is also worthwhile to note that significant increments in the level of voluntary disclosure occurred in Phase II, which includes the 1999-2002 reporting periods.
Table 7.1 Number of firms voluntarily disclosing strategic information

<table>
<thead>
<tr>
<th>Testing Phase</th>
<th>Year</th>
<th>No. of disclosing firms</th>
<th>Percentage (%)</th>
<th>Average disclosing firms per period (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>1995</td>
<td>14</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>110</td>
<td>37</td>
<td>116 (39)</td>
</tr>
<tr>
<td></td>
<td>1997</td>
<td>135</td>
<td>45</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>206</td>
<td>69</td>
<td></td>
</tr>
<tr>
<td>Phase II</td>
<td>1999</td>
<td>228</td>
<td>76</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>235</td>
<td>79</td>
<td>250 (84)</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>266</td>
<td>89</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>268</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>Phase III</td>
<td>2003</td>
<td>269</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2004</td>
<td>270</td>
<td>91</td>
<td>271 (91)</td>
</tr>
<tr>
<td></td>
<td>2005</td>
<td>271</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2006</td>
<td>272</td>
<td>92</td>
<td></td>
</tr>
</tbody>
</table>
Table 7.2 Descriptive statistics of strategic information disclosure categories in the three testing phases

<table>
<thead>
<tr>
<th>Category</th>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Max.</td>
<td>Q3</td>
</tr>
<tr>
<td>General corporate information</td>
<td>0.009</td>
<td>1.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Corporate strategy</td>
<td>0.066</td>
<td>4.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Management discussion and analysis</td>
<td>0.394</td>
<td>4.000</td>
<td>1.000</td>
</tr>
<tr>
<td>Future prospects</td>
<td>0.101</td>
<td>3.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Other useful strategic information</td>
<td>0.083</td>
<td>3.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Disclosure category</td>
<td>Disclosure item</td>
<td>Phase I</td>
<td>Phase II</td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>------------------------------------------------------</td>
<td>---------</td>
<td>----------</td>
</tr>
<tr>
<td>General corporate information</td>
<td>Brief history of company</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>Organizational structure or chart</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>General description of business activities</td>
<td>0.000</td>
<td>0.500</td>
</tr>
<tr>
<td></td>
<td>Principal products</td>
<td>2.000</td>
<td>4.500</td>
</tr>
<tr>
<td></td>
<td>Principal market</td>
<td>0.750</td>
<td>7.750</td>
</tr>
<tr>
<td>Corporate strategy</td>
<td>Statement of corporate goals or objectives</td>
<td>1.500</td>
<td>3.750</td>
</tr>
<tr>
<td></td>
<td>Current strategy</td>
<td>2.250</td>
<td>31.25</td>
</tr>
<tr>
<td></td>
<td>Impact of strategy on current results</td>
<td>1.500</td>
<td>6.000</td>
</tr>
<tr>
<td></td>
<td>Future strategy</td>
<td>13.25</td>
<td>84.50</td>
</tr>
<tr>
<td></td>
<td>Impact of strategy on future results</td>
<td>1.250</td>
<td>6.250</td>
</tr>
<tr>
<td>Management discussion and analysis</td>
<td>Review of operations</td>
<td>23.25</td>
<td>78.50</td>
</tr>
<tr>
<td></td>
<td>Competitive environment</td>
<td>11.25</td>
<td>42.50</td>
</tr>
<tr>
<td></td>
<td>Significant events of the year</td>
<td>9.250</td>
<td>29.25</td>
</tr>
<tr>
<td></td>
<td>Change in sales/profit</td>
<td>36.25</td>
<td>87.00</td>
</tr>
<tr>
<td></td>
<td>Change in expenses</td>
<td>7.500</td>
<td>18.75</td>
</tr>
<tr>
<td></td>
<td>Change in inventory</td>
<td>4.000</td>
<td>11.25</td>
</tr>
<tr>
<td></td>
<td>Change in market share</td>
<td>25.50</td>
<td>71.50</td>
</tr>
<tr>
<td>Future prospects</td>
<td>New development</td>
<td>27.25</td>
<td>87.50</td>
</tr>
<tr>
<td></td>
<td>Forecast of sales/profit</td>
<td>2.000</td>
<td>53.75</td>
</tr>
<tr>
<td></td>
<td>Assumptions underlying the forecast</td>
<td>0.750</td>
<td>21.00</td>
</tr>
</tbody>
</table>
7.2.2 Financial information

7.2.2.1 Number of disclosing firms

Table 7.4 reports the number of firms disclosing financial information in each individual reporting year throughout 1995–2006, and during the three phases. It reports a progressive increase in the number of firms making voluntary financial information disclosures. During Phase I, the number of disclosing firms increased from zero in 1995, to 40 (13%) in 1996 and 104 (35%) in 1997, but decreased to 88 (30%) in 1998. The average number of disclosing firms in this period is 58, representing 20% of total sample firms. During Phase II, the reported number of firms disclosing financial information changed from 102 (34%) in 1999, to 113 (38%) in 2000, and from 136 (46%) to 145 (49%) in 2002. The average number of disclosing firms during this period is 124, representing 42% of the sample firms. In Phase III, the number of disclosing firms has slightly increased from 146 (49%) in 2003, to 149 (50%) in 2004, and from 154 (52%) in 2005 to 157 (53%) in 2006. The average number of disclosing firms in Phase III is 152, representing 51% of the sample firms. These results show that over the 1995-2006 period, there has been a gradual increase in the total number of firms disclosing financial information. Similar to the number of firms disclosing strategic information, Phase II also sees a significant increase. The average number of disclosing firms in Phase II is double the number of disclosing firms in the first tests. Phase III sees a slight increase, compared to Phase II.
7.2.2.2 Descriptive statistics of financial information categories

Table 7.5 reports the descriptive statistics of six disclosure categories under the financial information section. A comparison of six disclosure categories shows the Foreign Currency Information category has the highest voluntary disclosure, with mean VDS changes from 0.17 in Phase I, to 0.34 for both Phases II and III. Following the Foreign Currency Information category is Projected Information, with mean disclosure score increases from 0.032 in Phase I, to 0.16 in Phase II and 0.29 in Phase III. This category also has the highest maximum score of disclosure (5) under the financial information section. The mean VDS of the Financial Review category and Other Useful Financial Information sit in the middle of the financial information section. The Performance Indicator category is found to be the second lowest voluntary disclosure, with disclosure scores changing slightly from 0.01 in Phase I, to 0.05 and 0.07 in Phase II and Phase III, respectively. The mean VDS of Stock Price Information category shows that sample firms are not willing to disclose information related to the stock price trend and market capitalization.

7.2.2.3 Content of financial information disclosure

Table 7.6 reports the mean VDS of each financial information disclosure item during the three testing phases. The primary purpose of this analysis is to determine listed firms’ preferences when they voluntarily disclose their financial performance and financial position.
Performance indicators (not from financial statements)

Several important financial performance ratios and historical figures constitute this disclosure category. Very little voluntary disclosure is found describing or comparing firms’ historical performance over the past five years or more. Only one firm from the sample is found offering the past five years’ comparative information, and three firms from the sample are found disclosing the past three years’ financial performance indicators in both Phase II and Phase III. The majority of listed firms provide the previous financial year’s comparative information. The order of the mean VDS of the four financial performance ratio disclosures, from highest to lowest, is: liquidity ratios, cash flow ratios, profitability ratio and gearing ratios.

Financial review

There are two items under this category, disclosure of intangible assets and dividend payout policy. The mean VDS of Disclosure of Intangible Assets shows that sample firms voluntarily disclose information related to firms’ initial recognition and subsequent measurements of their goodwill, trademarks and brands across the three testing phases. However, the mean VDS increases from 29.75 in Phase I to 34.50 in Phase II, but reduces to 30.25 in Phase III. In respect of intangible asset impairment, sample firms disclose impairment according to the mandatory requirements of the Chinese Accounting Standard, and there is no discussion of the indicators of asset impairment and circumstances surrounding the impairment decisions. Information which is more relevant to investment decision-making, such as fair value of intangible assets, cannot be found in annual reports. Although goodwill is recognized in financial statements, there is a lack of explanation of the
goodwill associated with business acquisitions. The mean VDS of Dividend Payout Policy are 2, 3.75 and 3 for the three testing phases, respectively; showing that voluntary disclosure in this area is much lower than firms’ disclosure of intangible asset-related information.

Projected information

This category addresses cash flow forecasts, capital expenditure and/or R&D expenditure forecasts and earnings forecasts. Strong voluntary disclosure of earnings forecasts is consistent with the strong disclosure of forecast sales/profit under the strategic information section. The mean VDS of earning forecasts is increased significantly from 3.3 in Phase I and 18.5 in Phase II, to 55.25 in Phase III. Some sample firms discuss projected three-year earnings growth; however, there is no comparison with peers in the same industry. Voluntary disclosure of cash flow forecasts involves in-depth discussion of actions taken by sample firms to collect outstanding debts, and disclosure of heavy interest payments on loans. One of the issues commonly mentioned in annual reports is the difficulty they have experienced in collecting outstanding debts. This reflects the cash flow liquidity problem found by listed firms in the Chinese stock market. A gradually increasing mean VDS for capital expenditure and/or R&D expenditure forecasts reflects the view that capital expenditure and R&D expenditure are important factors contributing to firms’ long-term success.

Foreign currency information

This category covers the impact of foreign exchange fluctuations on current results, foreign currency exposure management descriptions and major exchange rates used in the accounts. Strong voluntary disclosure in this category reflects the interactions between listed firms in
China and their overseas counterparts as a result of the Open Door policy implemented by the Chinese government. Voluntary disclosure of the impact of foreign exchange fluctuations on current results has the highest mean disclosure score in the three phases, followed by the major exchange rates used in the accounts. Foreign currency exposure management, however, is relatively low, with mean VDS increased from 4 in Phase I, to 8.8 in Phase II and 17.8 in Phase III. Low disclosure reflects the lack of risk management associated with foreign exchange rate fluctuations among Chinese listed firms.

**Stock price information**

This category includes market capitalization at year end, market capitalization trends, size of shareholdings and type of shareholder. There is no voluntary disclosure for the whole disclosure category in Phase I. Voluntary disclosures of the size of shareholdings and type of shareholders are only found during Phase III, with the mean VDSs being 0.75 and 1.25, respectively. Mean VDS of market capitalization at year end and market capitalization trends during Phase II are 0.75 and 0.5, respectively. During Phase III, the mean VDS of market capitalization trends remains the same, while the mean VDS of market capitalization at year end increases to 2 in Phase III.

**Other useful financial information**

The Other Useful Financial Information category only includes one item, which is designed to capture the information related to the financial performance of sample firms that is not included in other disclosure categories. Examples of Other Useful Financial Information disclosure are majority shareholders’ occupation of listed firms’ funds, weak earning capacity
of low quality assets, contingent liabilities related to lawsuits, related party transactions and severe cash flow problems of large customers. The mean disclosure scores (0.14 for Phase I, 0.06 in Phase II and 0.13 in Phase III) did not reflect any typical trend of this category/disclosure item.

In summary, the discussion of the number of firms disclosing financial information, the descriptive statistics and the main content of each voluntary disclosure category under the financial information section, show that voluntary disclosure of financial information has increased gradually over the years. These results also support H1. Firms give preference to foreign-currency-related information and forward-looking information disclosures, including cash flow forecasts and earnings forecasts. Stock-price-related information has a low mean VDS across the three testing phases.
Table 7.4 Number of firms voluntarily disclosing financial information

<table>
<thead>
<tr>
<th>Testing Phase</th>
<th>Year</th>
<th>No. of disclosing firms</th>
<th>Percentage (%)</th>
<th>Average disclosing firms per period (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>1995</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>40</td>
<td>13</td>
<td>58 (20)</td>
</tr>
<tr>
<td></td>
<td>1997</td>
<td>104</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>88</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1999</td>
<td>102</td>
<td>34</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>113</td>
<td>38</td>
<td>124 (42)</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>136</td>
<td>46</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>145</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td>Phase II</td>
<td>2003</td>
<td>146</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2004</td>
<td>149</td>
<td>50</td>
<td>152 (51)</td>
</tr>
<tr>
<td></td>
<td>2005</td>
<td>154</td>
<td>52</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2006</td>
<td>157</td>
<td>53</td>
<td></td>
</tr>
</tbody>
</table>
Table 7.5 Descriptive statistics of financial information disclosure categories in the three testing phases

<table>
<thead>
<tr>
<th>Category</th>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Max.</td>
<td>Q3</td>
</tr>
<tr>
<td>Performance indicators</td>
<td>0.008</td>
<td>1.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Financial review</td>
<td>0.107</td>
<td>1.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Projected information</td>
<td>0.032</td>
<td>3.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Foreign currency information</td>
<td>0.173</td>
<td>2.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Stock price information</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Other useful financial information</td>
<td>0.014</td>
<td>1.000</td>
<td>0.000</td>
</tr>
</tbody>
</table>
Table 7.6 Mean disclosure scores of financial information disclosure items in the three testing phases

<table>
<thead>
<tr>
<th>Disclosure category</th>
<th>Disclosure item</th>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance indicators</td>
<td>Historical figures for last five years or more</td>
<td>0.000</td>
<td>1.000</td>
<td>1.000</td>
</tr>
<tr>
<td></td>
<td>Profitability ratios</td>
<td>0.750</td>
<td>2.000</td>
<td>4.000</td>
</tr>
<tr>
<td></td>
<td>Cash flow ratios</td>
<td>0.750</td>
<td>4.250</td>
<td>6.000</td>
</tr>
<tr>
<td></td>
<td>Liquidity ratios</td>
<td>0.500</td>
<td>4.500</td>
<td>7.250</td>
</tr>
<tr>
<td></td>
<td>Gearing ratios</td>
<td>0.250</td>
<td>1.500</td>
<td>2.750</td>
</tr>
<tr>
<td>Financial review</td>
<td>Disclosure of intangible assets</td>
<td>29.75</td>
<td>34.50</td>
<td>30.25</td>
</tr>
<tr>
<td></td>
<td>Dividend payout policy</td>
<td>2.000</td>
<td>3.750</td>
<td>3.000</td>
</tr>
<tr>
<td>Projected information</td>
<td>Cash flow forecast</td>
<td>2.250</td>
<td>13.50</td>
<td>21.50</td>
</tr>
<tr>
<td></td>
<td>Capital expenditure and/or R&amp;D expenditure forecast</td>
<td>4.000</td>
<td>16.50</td>
<td>28.75</td>
</tr>
<tr>
<td></td>
<td>Earnings forecast</td>
<td>3.250</td>
<td>18.50</td>
<td>55.25</td>
</tr>
<tr>
<td>Foreign currency information</td>
<td>Impact of foreign exchange fluctuation on current results</td>
<td>36.75</td>
<td>64.25</td>
<td>55.25</td>
</tr>
<tr>
<td></td>
<td>Foreign currency exposure management description</td>
<td>4.000</td>
<td>8.750</td>
<td>17.75</td>
</tr>
<tr>
<td></td>
<td>Major exchange rates used in the accounts</td>
<td>10.50</td>
<td>27.50</td>
<td>27.25</td>
</tr>
<tr>
<td>Stock market information</td>
<td>Market capitalization at year end</td>
<td>0.000</td>
<td>0.750</td>
<td>2.000</td>
</tr>
<tr>
<td></td>
<td>Market capitalization trend</td>
<td>0.000</td>
<td>0.500</td>
<td>0.500</td>
</tr>
<tr>
<td></td>
<td>Size of shareholdings</td>
<td>0.000</td>
<td>0.000</td>
<td>0.750</td>
</tr>
<tr>
<td></td>
<td>Type of shareholder</td>
<td>0.000</td>
<td>0.000</td>
<td>1.250</td>
</tr>
</tbody>
</table>
7.2.3 Non-financial information

7.2.3.1 Number of disclosing firms

Table 7.7 reports the number of firms which disclose non-financial information in each individual reporting year throughout 1995–2006 and the three testing phases. It reports a progressive increase in the number of firms making voluntary non-financial information disclosures over 1995-2004, and a slight decrease over the period of 2005-2006. During Phase I, the number of disclosing firms has increased from 4 (1%) in 1995, to 55 (19%) in 1996, and from 61 (21%) to 77 (26%) in 1998. The average number of disclosing firms in this period is 49, representing 17% of total sample firms. A significant increase in the number of firms disclosing non-financial information can be observed in 1996. During the second testing phase, the reported number of firms disclosing non-financial information slightly increased from 91 (31%) in 1999, to 99 (33%) in 2000, and from 106 (36%) to 107 (36%) in 2002. The average number of disclosing firms during this period is 101, representing 34% of the sample firms. No significant change in the number of disclosing firms can be observed in Phase III. The number of disclosing firms remained at 106 (36%) in both 2003 and 2004, reduced to 103 (35%) in 2005, and to 100 (34%) in 2006. The average number of disclosing firms for Phase III is 104, representing 35% of sample firms. These results show that over the 1995-2006 period, there was a gradual increase in the total number of disclosing firms disclosing non-financial information. Compared to the average number of disclosing firms in Phase I (49), Phase II sees a significant increase. The average number of disclosing firms (101) is double the number of disclosing firms in the first phase. The third period sees a slight increase in respect of the average number of firms disclosing non-financial information.
7.2.3.2 Descriptive statistics of non-financial information disclosure

Table 7.8 details the main descriptive statistics of four voluntary disclosure categories under non-financial information over the three testing phases. The Social Policy category achieves the highest voluntary disclosure. However, with the mean disclosure score increasing from 0.25 in Phase I to 0.32 in Phase II, but decreasing to 0.23 in Phase III, there is no established general trend of voluntary disclosure in respect of social policy. Following Social Policy is Employee Information, with the mean disclosure score changing from 0.06 in Phase I, to 0.09 in Phase II and 0.22 in Phase III. The second lowest mean disclosure score is observed for Information about Directors category, while Other Useful Non-financial Information has the lowest mean VDS among the four disclosure categories.

7.2.3.3 Content of non-financial information disclosure

The mean VDSs of each disclosure item under the non-financial information section are reported in Table 7.9. The comparison and analysis of these disclosure items allow for identification of sample firms’ preference when disclosing non-financial information.

Information about directors

Information about the director category consists of two disclosure items, commercial experience of the executive directors and other directorships held by executive directors. The mean VDS of CEO duality shows that there is no voluntary disclosure of CEO duality in Phase I. In Phase II, the mean VDS are 14 and increases to 16.5 in Phase III. Although there
was a gradual increase, these results show voluntary disclosure of CEO duality was relatively low throughout the entire testing period. The voluntary disclosure of commercial experience of CEOs does not show any consistency. The mean VDS of the commercial experience of executive directors increase from 4.75 in Phase I, to 10.5 in Phase II and reduce to only 3 in Phase III.

**Employee information**

The seven disclosure items under this category can be combined into three groups: employee training-related, safety-related and redundancy-related. The mean VDSs of the three phases show that all three groups experience low voluntary disclosure in Phase I, increased disclosure in Phase II and a decline of voluntary disclosure in Phase III. The employee training-related group has the strongest increase over Phase I and Phase II. The mean VDS of the nature of training increased from 5.5 in Phase I to 10.5 in Phase II. Together with the amount spent on training, categories of employees trained and number of employees trained, the increased disclosures in this area indicate that listed firms wish to signal to investors the skills and knowledge of their employees and, accordingly, the better quality of their workforce. Disclosures of redundancy among listed firms reflect the loss of job security in Chinese society since the economic reforms. The employee safety-related area has the lowest mean VDS under the Employee Information category.

**Social policy**

This category covers four disclosure items, namely, safety of products, environmental protection programs, charitable donations and community programs. Both the safety of
products and charitable donations show strong voluntary disclosures over the years, with their mean VDS ranging between 25 and 45. Firms list various awards granted by state or local government for good quality products or contributions made to the community. Many disclosing firms used the ISO certification\(^\text{26}\) to represent the quality and safety of their products. Charitable donations reflect firms’ commitment to Chinese society. Strong voluntary disclosure in this area shows listed firms’ interest in developing a good reputation in society.

It is worthwhile to note that the voluntary disclosure of environmental protection programs achieves a relatively low mean VDS throughout the three phases, with 2.5 in Phase I, and 7 for both Phase II and Phase III. Only a few firms discuss briefly the actions taken to reduce environmental pollution. This result supports the research findings of Guo (2005). Listed firms in China have not established the awareness that to be a good “corporate citizen”, enterprises should take social responsibility and leadership in environmental protection.

Other useful non-financial information

The Other Useful Non-financial Information category/item is designed to capture relevant and useful information which is not covered by other categories in the Non-financial Information section. This category demonstrates unstable movements over the years, with the mean VDS being 1 in both Phase I and Phase III, and no disclosure in Phase II. A possible reason is that other disclosure items and categories have comprehensively covered most of the non-financial information disclosures. Examples of other useful non-financial information

\(^{26}\) China is a member of ISO (International Organization for Standardization). The ISO is the world's largest developer and publisher of International Standards.
include the warnings and sanctions imposed by the CSRC during the year regarding misleading information disclosure, and the detailed compensation schemes of CEOs.

In summary, it is difficult to identify a general trend for the level of voluntary disclosure of non-financial information because of some unstable movements in the number of firms voluntarily disclosing non-financial information, and the extent of voluntary disclosures. The result in this section does not support H1. Firms’ preference in voluntary disclosure, however, can still be identified. Listed firms prefer to disclose voluntarily to investors, information related to the safety of their products and their donations to society. Information related to employee, directors and environmental protection all have a relatively low mean VDS.
Table 7.7 Number of firms voluntarily disclosing non-financial information

<table>
<thead>
<tr>
<th>Testing phase</th>
<th>Year</th>
<th>No. of disclosing firms</th>
<th>Percentage (%) (=No. of disclosing firms/297 sample firms)</th>
<th>Average disclosing firms per period (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1995</td>
<td>4</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>55</td>
<td>19</td>
<td>49 (17)</td>
</tr>
<tr>
<td></td>
<td>1997</td>
<td>61</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>77</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Phase II</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1999</td>
<td>91</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>99</td>
<td>33</td>
<td>101 (34)</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>106</td>
<td>36</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>107</td>
<td>36</td>
<td></td>
</tr>
<tr>
<td>Phase III</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>106</td>
<td>36</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2004</td>
<td>106</td>
<td>36</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2005</td>
<td>103</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2006</td>
<td>100</td>
<td>34</td>
<td></td>
</tr>
</tbody>
</table>
Table 7.8 Descriptive statistics of non-financial information disclosure categories in the three testing phases

<table>
<thead>
<tr>
<th>Category</th>
<th>Phase I</th>
<th></th>
<th></th>
<th>Phase II</th>
<th></th>
<th></th>
<th>Phase III</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Max.</td>
<td>Q3</td>
<td>Median</td>
<td>Std. Dev.</td>
<td>Mean</td>
<td>Max.</td>
<td>Q3</td>
<td>Median</td>
</tr>
<tr>
<td>Information about directors</td>
<td>0.016</td>
<td>1.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.126</td>
<td>0.083</td>
<td>2.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee information</td>
<td>0.058</td>
<td>3.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.251</td>
<td>0.088</td>
<td>3.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social policy</td>
<td>0.247</td>
<td>2.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.462</td>
<td>0.323</td>
<td>3.000</td>
<td>1.000</td>
<td>0.000</td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other useful non-financial information</td>
<td>0.002</td>
<td>1.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.041</td>
<td>0.001</td>
<td>1.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 7.9 Mean disclosure scores of non-financial information disclosure items in the three testing phases

<table>
<thead>
<tr>
<th>Disclosure category</th>
<th>Disclosure item</th>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information about directors</td>
<td>Commercial experience of CEOs</td>
<td>4.750</td>
<td>10.50</td>
<td>3.000</td>
</tr>
<tr>
<td></td>
<td>Other directorships held by CEOs</td>
<td>0.000</td>
<td>14.00</td>
<td>16.50</td>
</tr>
<tr>
<td>Employee information</td>
<td>Amount spent on training</td>
<td>2.000</td>
<td>2.500</td>
<td>1.000</td>
</tr>
<tr>
<td></td>
<td>Nature of training</td>
<td>5.500</td>
<td>10.50</td>
<td>2.000</td>
</tr>
<tr>
<td></td>
<td>Categories of employees trained</td>
<td>1.250</td>
<td>1.250</td>
<td>1.50</td>
</tr>
<tr>
<td></td>
<td>Number of employees trained</td>
<td>0.250</td>
<td>0.750</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>Data on accidents</td>
<td>0.750</td>
<td>2.500</td>
<td>1.250</td>
</tr>
<tr>
<td></td>
<td>Cost of safety measures</td>
<td>0.250</td>
<td>0.250</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>Redundancy information</td>
<td>7.250</td>
<td>8.500</td>
<td>0.750</td>
</tr>
<tr>
<td>Social policy</td>
<td>Safety of products</td>
<td>33.25</td>
<td>45.00</td>
<td>36.75</td>
</tr>
<tr>
<td></td>
<td>Environmental protection programs</td>
<td>2.500</td>
<td>7.000</td>
<td>7.000</td>
</tr>
<tr>
<td></td>
<td>Charitable donations</td>
<td>36.75</td>
<td>44.00</td>
<td>25.25</td>
</tr>
<tr>
<td></td>
<td>Community program</td>
<td>1.000</td>
<td>0.000</td>
<td>1.000</td>
</tr>
</tbody>
</table>
7.2.4 Summary of the three information disclosure sections

This section combines and compares the levels of disclosure of the three information sections. Table 7.10 sets out the changes of the three information disclosure sections in the three testing phases. It is interesting to note that among the three sections of voluntary disclosure, strategic information disclosure achieves the highest mean voluntary disclosure score in each individual testing phase, followed by the financial information section, and this leaves the non-financial information section having the lowest mean disclosure scores. The mean disclosure score achieved by the sample firms in disclosing strategic information is increased significantly from 0.65 in Phase I, to 2.44 in Phase II and 3.94 in Phase III. The voluntary disclosure score for financial information also increases over the entire testing period; however, the increment is not as significant as that seen in the strategic information section. The mean disclosure score of the sample firms changed from 0.33 in Phase I, to 0.76 in Phase II and 0.96 in Phase III. The non-financial information section experienced slow growth in voluntary disclosure. The mean disclosure scores for non-financial information disclosure achieved by sample firms are 0.07, 0.21 and 0.14, respectively, in the three testing phases. The results do not show a general trend of increased voluntary disclosure of non-financial information in the three testing phases.
Table 7.10 Descriptive statistics of the three information sections in the three testing phases

<table>
<thead>
<tr>
<th>Testing phase</th>
<th>Disclosure section</th>
<th>Mean</th>
<th>Max.</th>
<th>Q3</th>
<th>Median</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>Strategic information</td>
<td>0.653</td>
<td>6.000</td>
<td>1.000</td>
<td>0.000</td>
<td>0.917</td>
</tr>
<tr>
<td></td>
<td>Financial information</td>
<td>0.334</td>
<td>3.000</td>
<td>1.000</td>
<td>0.000</td>
<td>0.659</td>
</tr>
<tr>
<td></td>
<td>Non-financial information</td>
<td>0.076</td>
<td>3.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.292</td>
</tr>
<tr>
<td>Phase II</td>
<td>Strategic information</td>
<td>2.436</td>
<td>10.00</td>
<td>4.000</td>
<td>2.000</td>
<td>1.807</td>
</tr>
<tr>
<td></td>
<td>Financial information</td>
<td>0.761</td>
<td>5.000</td>
<td>1.000</td>
<td>0.000</td>
<td>0.991</td>
</tr>
<tr>
<td></td>
<td>Non-financial information</td>
<td>0.210</td>
<td>4.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.583</td>
</tr>
<tr>
<td>Phase III</td>
<td>Strategic information</td>
<td>3.937</td>
<td>14.00</td>
<td>5.000</td>
<td>4.000</td>
<td>2.409</td>
</tr>
<tr>
<td></td>
<td>Financial information</td>
<td>0.961</td>
<td>6.000</td>
<td>2.000</td>
<td>0.000</td>
<td>1.256</td>
</tr>
<tr>
<td></td>
<td>Non-financial information</td>
<td>0.143</td>
<td>4.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.544</td>
</tr>
</tbody>
</table>
7.3 Characteristics of voluntary disclosure in the Chinese stock market

The description of the results of each of the three voluntary disclosure sections in this chapter, and the comparison of the three voluntary disclosure sections, suggest that listed firms’ voluntary disclosure behaviors in the Chinese stock market exhibit three characteristics. First, there is a significant increase of voluntary disclosure in both the number of disclosing firms and the extent of voluntary disclosure during Phase II. Second, listed firms are selective with their voluntary disclosure. Third, the level of forward-looking information disclosure is significantly higher than for other types of information disclosure.

7.3.1 Significant increase in voluntary disclosure during 1999-2002

Table 7.11 reports the descriptive statistics on the comparison of disclosure categories between Phase I and Phase II, and Phase II and Phase III. The comparison of the mean VDS of disclosure categories between Phase I and Phase II shows that the $p$ values of corporate strategy, management analysis and discussion, future prospects and projected information are all significant at 1 percent level, meaning that the mean VDS of these disclosure categories in Phase II is increased significantly when compared with Phase I. The $p$ value of the total combined disclosure categories is also significant at 1 percent level, meaning that, overall, the VDS increased significantly from Phase I to Phase II. Comparing Phase II and Phase III, there is no significant increase in Phase III. Therefore, in the three testing phases, it can be concluded that there is a significant increase in voluntary disclosure during Phase II which
includes the 1999-2002 financial years. Comparing to Phase II, Phase III (2003-2006) represents a more established phase of the Chinese stock market. Firms made voluntary disclosure in Phase II continued their practices in Phase III. However, the increment of voluntary disclosure is not as high as the increment observed in Phase II.

The economic environment of the Chinese stock market during Phase II is marked by further globalization of China’s economy, the MOF’s step forward in harmonizing China’s GAAP with international accounting standards, several high-profile financial scandals in the Chinese stock market, CSRC’s actions in stipulating investor protection regulations, and the strengthening of their enforcement. China’s accession to the WTO in 2001 signals China’s participation in economic globalization at a higher level and with a wider scope. It enables the Chinese enterprises to be involved in greater and deeper cooperation and competition in the global market. However, as China moved to meet its commitments under the Protocol on Accession, systemic reforms and substantial changes to trade-related laws and regulations that are inconsistent with WTO rules had been put in place (Shi, 2001). Since 2001, China has made remarkable progress in opening its economy, welcoming imports and inviting foreign investment. Some of the regulations implemented soon after China’s accession to the WTO were driven by “the authorities’” desire to deepen the economic reform and have created an even more attractive business environment for foreign investments.

As an emerging economy, China not only made great commitments to opening up its stock market upon its entry into the WTO, but also fulfilled those commitments. Since 2002, the Chinese government has promulgated a series of regulations, aiming to relax the restrictions against foreign trade and investment. As a result, by 2006, foreign institutional investors owned equity valued at about 3 billion US dollars in 214 listed firms, becoming the second
largest investor group in the Chinese currency-dominated share markets (CSRC, 2007). In line with a more open stock market are the higher expectations of quality financial information. The accession to the WTO also demanded a significant improvement in business transparency in China. The harmonization of the Chinese financial accounting system with internationally accepted practices resulted in the issuance of a series of Chinese Accounting Standards between 1997 and 2003, and the promulgation of the Accounting System for Business Enterprises (The System) in 2001 by the MOF. It is anticipated that effective application of the new accounting system and accounting standards, which are based on international norms, will serve as a catalyst for better quality accounting information in the Chinese stock market (Zhang, 2005).

Phase II also witnesses the changing role of one of the main stakeholders of listed firms in the Chinese stock market, namely, the regulatory agency group. The 1998 Securities Law empowers the CSRC as the overall regulator of the Chinese stock market. Between 1999 and 2002, the CSRC accomplished its changing role, from its initial function of undertaking some administrative roles, including approving the listing and transferring of non-tradable shares among institutional investors, to regulating listed companies’ information disclosure and fostering good corporate governance. The CSRC sees itself as a pro-active regulator in fostering corporate governance, in enforcing rules, in safeguarding the integrity of the Chinese stock market, and in championing the rights of public investors (Tomasic and Andrews, 2007). The CSRC also implements some important strategies to promote corporate governance among Chinese listed firms. In early 2001, the CSRC declared a “year of market supervision”. During the same year, the CSRC issued the Code of Corporate Governance for Listed Companies in China and the Notice of Establishing an Independent Directors System.
The primary aim of these initiatives was to increase transparency and enhance the credibility of financial statements.

The investment community has also started to create a demand for transparency of corporate disclosure. As the main stakeholder of listed firms, public shareholders play a role in imposing the “norm” of transparent corporate disclosure. By using legal mechanisms, investors start to seek compensation from companies for their financial losses due to misleading disclosure or non-disclosure of information. The success of the first civil compensation case due to fraudulent financial information in China in November 2002, signals that public investors have built up a sense of fairness, and know how to use legal proceedings to protect their own interest. The case also reflects the change of government authority and regulatory agencies’ attitudes in respect of further strengthening the legal enforcement of various regulations among listed firms.

Deegan (2006) suggests that as the level of stakeholder power increases, the importance of meeting stakeholder demands increases. In the Chinese stock market, especially during Phase II, there are significant increases in stakeholders’ power, represented by action on the part of the regulatory agencies and the investment community. Both have demanded transparency in information disclosure by listed firms. Increased voluntary disclosure during this period of time could be regarded as one way that listed firms in the Chinese stock market responded positively to the changed disclosure environment and management of stakeholder salience.

### 7.3.2 Selective information disclosure
The comparison between the three information disclosure sections in Table 7.10 indicates clearly that, despite the increase in the quantity of information disclosed overall, listed firms in the Chinese stock market are selective in choosing the information to disclose. Voluntary disclosure of strategic information is much higher than the disclosure of financial information and non-financial information. The mean disclosure score of strategic information disclosure for the entire testing period reached 7.03, while the average scores of financial information and non-financial information are only 2.06 and 0.43, respectively.

Table 7.12 further reports the comparison of sensitive information and non-sensitive information by using the $T$ test. Fifty checklist items are divided into two groups: a sensitive information group and a non-sensitive information group. There are nine items that can be classified in the sensitive information group and they are: dividend payout policy, foreign currency exposure management description, market capitalization at year end, market capitalization trend, CEO’s commercial experience, CEO duality, data on accidents, cost of safety measures, and redundancy information. In the $T$ test, these items are coded as 1 whereas other items are coded as zero. The results show the $F$ test of equal variances is significant; therefore, the unequal variance $t$ value, 2.45, is the appropriate value to use. The mean VDS of the non-sensitive information group are 78, while the mean VDS of the sensitive information group are only 24. The $p$ value is significant at 1 percent level, meaning the mean VDS of the sensitive information group are significantly lower than that for the non-sensitive information group.

These results indicate clearly that listed firms in the Chinese stock market feel more comfortable disclosing information on their operational areas, such as changes in sales/profit, expenses, inventory levels and market share. Firms are also keen to disclose their future
strategy, new projects or products under development, and their forecast of earnings for the near future. On the other hand, firms choose not to disclose more sensitive information, such as CEO duality and data on accidents. Information such as stock price performance, market capitalization at year end or market capitalization trends are rarely discussed by the majority of listed sample firms, although some firms disclosed their size of shareholdings and type of shareholders. It is interesting to note that no information on year end stock price was voluntarily disclosed until 2001. A low level of voluntary disclosure is consistent with the research finding of Liu (2005) that listed firms do not disclose sensitive information such as year-end share price and share price trends.

In respect of corporate governance disclosure, the voluntary disclosure of CEO’s commercial experience is only significantly higher in Phase II, with a mean VDS of 10.5, compared to 4.75 and 3 in Phase I and Phase III, respectively. The disclosure of the commercial experience of CEOs is relevant to investors because commercial experience can be used as one of the benchmarks to assess the quality of firms’ senior management. In the early stage of corporatization of SOEs, the senior managers, the board and supervisory committee members were CCP party officials without any commercial experience (Xu and Wang, 1999). The appointment of non-commercially experienced CEOs of listed firms was caused by the majority holdings by the state. Tam (1995) conducted a survey which confirmed that nearly 54% of board vice-chairmen in listed firms in the Chinese stock market were members of the CCP committee. Tam (1995) also suggests a high percentage of CCP members on boards reflect the nature of the continuing bureaucratic power of the administrators and the CCP members. The CSRC suggests the selection of management personnel of listed firms should be carried out in a fair and transparent manner. The nominated candidates should possess relevant professional knowledge and the capacity to make good business decisions. A
significant increase in voluntary disclosure in this area during Phase II reflects the listed firms’ realization of how value-relevant the commercial experience of CEOs is to investors.

The sample firms start to disclose their CEO duality from Phase II. CEO duality is another main corporate governance issue among Chinese listed firms, as Tam (1995) and Firth et al. (2007) point out. CEO duality has impacted on the effectiveness of a board in its various functions as it undermines the board’s independent ability to oversee the senior managers. The board’s role as an effective guardian of stockholders’ interests in the system of corporate governance may also be jeopardized. It has been argued that separating the two roles allows the development of initiatives, innovation and more effective leadership of the firm (Fama and Jensen, 1983). The survey conducted in China by Tam (1995) revealed 60% of board chairmen among listed firms were also the CEOs of firms, and 25% of vice-chairmen were either CEOs or Deputy CEOs. This issue is significant enough to attract the regulatory body’s attention. In 2001, the CSRC recommended that listed firms separate the roles of CEO and chairman. Xiao and Yuan (2007) showed that in 2002, there was only 11% CEO duality among the 559 listed firms investigated in their study. The disclosure of CEO duality in Phase II and Phase III could be seen as firms’ responses to the CSRC’s pressure during this period of time.

Low voluntary disclosure of environmental-protection-related information among the sample firms provides further support for the research findings of Guo (2005). As Guo (2005) suggested, corporate environmental reporting and disclosure is still in its initial stages in China, and is in need of further development in parallel with improvements in corporate governance and increasing public awareness about sustainable development. Although Chinese society can be thought of as a stakeholder of listed firms, it does not directly control
the financial resources of firms, except as investors and creditors. At this stage, the investment community is only profit-oriented. There is not much pressure exerted on listed firms to disclose environmental protection-related information. Therefore, the firms’ only priorities are operations and performance-related information disclosure.

Selective information disclosure indicates that firms assess the power, legitimacy and urgency possessed by powerful stakeholders. To manage the relationship between firms and stakeholders effectively, the information demanded from the most powerful stakeholders is satisfied first. Investors and creditors have control over the financial resources of listed firms and they also have strong support from the regulatory agencies. Firms use financial information disclosure as a way of stakeholder salience.

### 7.3.3 High level of forward-looking information disclosure

As discussed in the previous sections of this chapter, disclosure items, including future strategy, new developments, forecasts of sales/profit, current strategy and earnings forecasts, have all presented strong voluntary disclosures over the years. The results show that listed firms in the Chinese stock market give preference to forward-looking information disclosure. Hussainey (2004) classifies the information disclosed in annual reports into two categories, namely, backward-looking information and forward-looking information. Backward-looking disclosure is the class of information that refers to past financial results and their related disclosures. Forward-looking disclosure is the class of information that refers to current plans and future forecasts that enable investors and other users to assess a company’s future financial performance. Such forward-looking disclosure involves financial forecasts such as next years’ products, strategies, plans, forecasted performance and the anticipated earnings,
revenues and cash flows. Forward-looking disclosure also involves risks and uncertainties that could significantly affect actual results and cause them to differ from projected results. Forward-looking information can normally be found from the Management Discussion and Analysis (MD&A) section of annual reports (Clarkson et al., 1994; Bryan, 1997).

The result of Table 7.13 further confirms this disclosure characteristic. Table 7.13 compares forward-looking information and non-forward-looking information disclosure. Forward-looking information items are coded as 1, while non-forward-looking information items are coded as zero in the $T$ test. The forward-looking information classification in the $T$ test follows Clarkson et al. (1994), Bryan (1997) and Kent and Ung (2003). The forward-looking information group includes a statement of corporate goals or objectives, current strategy, impact of strategy on current results, future strategy, impact of strategy on future results, review of operations, competitive environment, significant events of the year, changes in sales/profit, changes in expenses, changes in inventory, changes in market share, new development, forecasts of sales/profit, assumptions underlying the forecast, cash flow forecasts, capital expenditure and/or R&D expenditure forecasts and earnings forecasts.

Given the $F$ value is 6.25 and $p$ value is less than 0.0001, it is appropriate to use the unequal variance $t$ value, -4.78. The mean VDS of the forward-looking information group are 117, while the mean VDS of the non-forward-looking information are 24. The $p$ value of unequal variances is 0.001, indicating the mean VDS of the forward disclosure group is significantly higher than the mean VDS of the non-forward-looking information group. The importance of forward-looking information for users of corporate financial information has been stressed by official pronouncements in the US and Canada. The Securities and Exchange Commission (SEC) in America encouraged firms to disclose voluntarily forward-looking information in
the early 1970s (Celik et al., 2006). In 1994, the Jenkins Committee Report issued by the American Institute of Certified Public Accountants (AICPA) was regarded as a stronger impetus for the provision of forward-looking information. In the report called *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures*, issued by the Financial Accounting Standards Board (FASB) in 2001, forward-looking information was added as one of the business information voluntary disclosure categories. In the *Management’s Discussion and Analysis: Guidance on Preparation and Disclosure* issued in 2002, the Canadian Institute of Chartered Accountants (CICA) called for descriptions of not only anticipated future events, decisions, circumstances, opportunities and risks that management considers likely to materially impact future prospects, but also matters such as management’s vision, strategy and key performance drivers.

Several academic studies have looked at the benefits of forward-looking information and factors attributed to the level of forward-looking disclosure. Using 250 US firms as a sample, Bryan (1997) finds that indications of future operations and capital expenditures can assist users to assess firms’ short-term prospects. Clarkson et al. (1999) used firms listed on the Toronto Stock Exchange to investigate the usefulness of forward-looking information disclosed in the MD&A section in annual reports. They found further evidence that changes in the level of forward-looking information in the MD&A vary directly with future corporate performance. This suggests that forward-looking disclosures in the MD&A provide credible and relevant information. Schleicher and Walker (1999) used a sample of UK firms, providing evidence that forward-looking information disclosure is associated with a more accurate level of share price anticipation. In respect of factors influencing the decision of listed firms to disclose forward-looking information, Kent and Ung (2003) suggest that larger companies with less volatile earnings in Australia tend to provide more future earnings’ information than smaller companies with relatively volatile earnings. Celik et al. (2006) find
forward-looking information is positively related to firm size and foreign offers, and is negatively related to ownership structure and profitability. O’Sullivan et al. (2006) investigate the role played by a firm’s corporate governance framework in the decision to voluntarily disclose forward-looking information in published financial reports between 2000 and 2002. They find corporate governance attributes, such as audit quality, board committees and the overall corporate governance system, all contribute to forward-looking information disclosure.

In China, the forward-looking information is addressed by one of the most important regulations stipulated by the CSRC - *The Standards of Contents and Formats of Information Disclosure by Public Issuing Companies*. Under the 1999 version of this regulation, the CSRC only encouraged listed firms to disclose their operational plan in the next financial period, including progress to be made on new projects. Under the 2003 version, Article 39 expands forward-looking information disclosure by stating that the board of directors of listed firms may disclose an annual business plan, including (but not limited to) income, cost and expenditure budget, new operational goals such as increasing sales, market share, reducing cost and budget for research and development expenditure. Firms that disclose the above information should also give information on strategies that need to be implemented and actions that will be taken in order to achieve the above goals. If listed firms wish to disclose the forecast for the next financial year’s profit, the forecast needs to be verified by their CPA firms.

Although forward-looking information is not mandatorily required by the CSRC, the results in this study show listed firms actively respond to the CSRC’s calls for forward-looking information disclosure. The forward-looking information found from sample firms’ annual reports include forecasts of sales for the coming year, discussion of the growth opportunities
of major customers, next year’s targets for growth in revenue, projected cash flow, projected earnings, percentage growth goals for revenue, earnings per share (EPS) and return on equity (ROE). However, a common characteristic of the above disclosure is that listed firms prefer to disclose positive and qualitative forward-looking information, rather than negative and quantitative information. This result is similar to the findings of Kent and Ung (2003), which suggest most Australian companies do not provide quantitative earnings forecasts in annual reports. Although more than half of the firms under investigation disclose forward-looking information relating to future earnings, they do not specifically disclose point estimates for the future, and they mostly supply qualitative information with a positive bias.

Forward-looking information reveals opinions and viewpoints about the operations of firms. Voluntarily disclosing forward-looking information in the Chinese stock market helps investors to understand managers’ views of a firm’s future and plans. As discussed in Chapter 5, to legitimate their status in the Chinese stock market, listed firms need to acknowledge that investors have the right to get access to relevant information which enables them to make efficient decision-making in terms of how to allocate their financial resources. If listed firms identify the investment community and regulatory agencies as “powerful” stakeholders, who have power, legitimacy and urgency over their capital resources, they will employ information disclosure as a major element to manage the stakeholder salience, in order to gain the support and approval from powerful stakeholder groups. Disclosing more forward-looking information among listed firms, therefore, provides further support to Hypothesis 1.
Table 7.11 Descriptive statistics on Phase I, Phase II and Phase III - comparisons of disclosure categories

<table>
<thead>
<tr>
<th>Category</th>
<th>t-stat</th>
<th>$p$-value (two-tailed)</th>
<th>t-stat</th>
<th>$p$-value (two-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GI</td>
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<td>0.25</td>
<td>3.0</td>
<td>0.25</td>
</tr>
<tr>
<td>CS</td>
<td>7.5</td>
<td>0.01*</td>
<td>7.5</td>
<td>0.06</td>
</tr>
<tr>
<td>MA</td>
<td>4.0</td>
<td>0.01*</td>
<td>14</td>
<td>0.02</td>
</tr>
<tr>
<td>FP</td>
<td>7.8</td>
<td>0.01*</td>
<td>7.0</td>
<td>0.05</td>
</tr>
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<td>0.15</td>
<td>3.0</td>
<td>0.25</td>
</tr>
<tr>
<td>PI</td>
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<td>0.01</td>
<td>5.0</td>
<td>0.13</td>
</tr>
<tr>
<td>FR</td>
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<td>0.50</td>
<td>-1.5</td>
<td>0.50</td>
</tr>
<tr>
<td>PRI</td>
<td>12</td>
<td>0.01*</td>
<td>3.0</td>
<td>0.25</td>
</tr>
<tr>
<td>FC</td>
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<td>-0.5</td>
<td>1.00</td>
</tr>
<tr>
<td>ST</td>
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<td>0.50</td>
<td>3.0</td>
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</tr>
<tr>
<td>OUF</td>
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<td>0.15</td>
<td>4.0</td>
<td>0.15</td>
</tr>
<tr>
<td>DIR</td>
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<td>0.50</td>
<td>-0.5</td>
<td>1.00</td>
</tr>
<tr>
<td>EI</td>
<td>7.5</td>
<td>0.06</td>
<td>-12</td>
<td>0.05</td>
</tr>
<tr>
<td>SP</td>
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<td>-2.0</td>
<td>0.50</td>
</tr>
<tr>
<td>OUN</td>
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<td>-1.5</td>
<td>0.50</td>
</tr>
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<td>TOTAL DISCLOSURE</td>
<td>39.5</td>
<td>0.01*</td>
<td>28.5</td>
<td>0.07</td>
</tr>
</tbody>
</table>

*Significant at 1 % level
Table 7.12 Comparison of sensitive information and non-sensitive information

<table>
<thead>
<tr>
<th>Variable : mean of disclosure</th>
<th>N</th>
<th>Mean</th>
<th>Std Dev</th>
<th>Std Error</th>
<th>Maximum</th>
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<tbody>
<tr>
<td>Sensitive information</td>
<td>41</td>
<td>78.28</td>
<td>92.65</td>
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</tr>
<tr>
<td>1</td>
<td>9</td>
<td>24.04</td>
<td>32.45</td>
<td>7.443</td>
<td>125</td>
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Variances

<table>
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<tr>
<th>t-stat</th>
<th>DF</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unequal</td>
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<td>48.00</td>
</tr>
<tr>
<td>Equal</td>
<td>2.98</td>
<td>40.50</td>
</tr>
</tbody>
</table>

For H0: Variances are equal

F = 8.15, DF = (30, 18), Pr> F = <0.0001

Table 7.13 Comparison of forward-looking information and non-forward-looking information

<table>
<thead>
<tr>
<th>Variable : mean of disclosure</th>
<th>N</th>
<th>Mean</th>
<th>Std Dev</th>
<th>Std Error</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward looking information</td>
<td>32</td>
<td>24.09</td>
<td>39.20</td>
<td>6.930</td>
<td>156</td>
</tr>
<tr>
<td>1</td>
<td>18</td>
<td>117.4</td>
<td>98.01</td>
<td>23.10</td>
<td>310</td>
</tr>
</tbody>
</table>

Variances

<table>
<thead>
<tr>
<th>t-stat</th>
<th>DF</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unequal</td>
<td>-4.78</td>
<td>48.00</td>
</tr>
<tr>
<td>Equal</td>
<td>-3.87</td>
<td>20.10</td>
</tr>
</tbody>
</table>

For H0: Variances are equal

F = 6.25, DF = (17, 31), Pr> F = <0.0001
7.4 Factors affecting voluntary disclosure

This section discusses factors influencing firms’ voluntary disclosure decisions. Regression models established in Chapter 6 are run to test whether factors developed in Chapter 5 have linear relationships with the level of voluntary disclosure. Before regression results are reported and discussed, the characteristics of each independent variable are examined and correlations between independent variables are discussed, in order to detect any highly correlated relationship.

Here is the regression estimated in Chapter 6:

\[
VDS = \alpha + \beta_1 STA_t + \beta_2 LEG_t + \beta_3 TRB_t + \beta_4 BOD_t + \beta_5 IAC_t + \\
\beta_6 LEV_t + \beta_7 PRO_t + \beta_8 GRO_t + \beta_9 AUD_t + \beta_{10} SIZE_t + \beta_{11} IND_t + \epsilon_t \\
(Equation 6.1)
\]

Where:

VDS = voluntary disclosure score firm \( i \) in time \( t \)

STA = percentage of state ownership for firm \( i \) in time \( t \)

LEG = percentage of legal-person ownership for firm \( i \) in time \( t \)

TRB = percentage of tradable share B ownership for firm \( i \) in time \( t \)

BOD = percentage of independent directors on the board for firm \( i \) in time \( t \)

IAC = dummy variable, coded as 1 if there is an internal audit committee for firm \( i \) in time \( t \), 0 otherwise

LEV = a ratio of total liabilities to total assets for firm \( i \) in time \( t \)

PRO = a ratio of return of shareholder’s equity for firm \( i \) in time \( t \)
GRO = a ratio of market value of equity to book value of equity for firm $i$ in time $t$

AUD = dummy variable, coded as 1 if the auditor for firm $i$ in time $t$ is an international auditor, 0 otherwise

SIZE = logarithm of total assets for firm $i$ in time $t$

IND = dummy variable, coded as 1 if firm belongs to manufacturing industry for firm $i$ in time $t$, 0 otherwise

### 7.4.1 Independent variables and correlations

#### 7.4.1.1 Independent variables

Table 7.14 reports descriptive statistics for variables included in the regression models. These variables can be classified into four groups. The Ownership Structure group includes state ownership, legal-person ownership, domestic public ownership and foreign ownership. The corporate governance related group has two variables: the proportion of independent directors on the board of directors and the audit committee (dummy variable). Economics-based group variables are leverage, profitability and growth opportunity. The external auditor group has only one dummy variable, namely, the type of external audit firm.

In the Ownership structure group, the means (medians) of state ownership (STA) present a slow decrease over the testing period, changing from 30.47% (32.67%) of total shares issued by sample listed firms in 1995, to 27.48% (29.09%) in 2001, and 23.97% (24.13%) in 2006. However, the maximum state ownership in 2006 is still 83.75%, meaning that in some listed firms, state ownership is still significantly higher than other types of ownership. The same trend can be seen from the change of legal-personal ownership (LEG) as well. The mean
(median) of legal-person ownership decreased from 29.75% (21.8%) in 1995 to 27.89% (22.51%) in 2001 and 22% (15.28%) in 2006. Changes of state ownership and legal person ownership reflect ownership reform undertaken among listed firms in 2005. In April 2005, the Chinese government initiated an ownership reform program, aiming to eliminate various share ownership types and make all shares legally tradable A shares. By mid 2006, this conversion process covered 94% of listed firms (Jiang et al., 2008). Although domestic public ownership (TRA) is not part of the regression models, the descriptive statistics of this variable can also reflect the change of ownership structure among listed firms. Both public ownership and foreign ownership (TRB) present a gradual increase over the testing period. The mean (median) of public ownership increased from 30.08% (28.81%) in 1995, to 36.19% (36.8%) in 2001, and to 44.31% (45.65%) in 2006. Foreign ownership also increases over time, but at a slow pace. The mean is changed from 6.68% in 1995 to 8.11% in 2001 and 8.56% in 2006. Maximum foreign ownership is increased from 49.79% in 1995 to 54.34% in 2006. The increased tradable A shares and foreign ownership could be the result of the opening up of the A share market and B share market in 2001 and 2002. In 2001, domestic public investors could have B shares if they had a US dollar account. Since December 2002, foreign investors have been allowed to trade in A shares under the Qualified Foreign Institutional Investor (QFII) program. The change of ownership structure among sample firms over the testing period mirrors the ownership reform in the Chinese stock market in recent years. The direct result is that state ownerships (STA and LEG) experienced a gradual decrease, while public ownership (TRA and TRB) increased.

There were no requirements for the composition of the board of directors among listed firms until the CSRC released the Notice of Establishing an Independent Directors System in Listed Firms in 2001, requiring listed firms’ boards to have at least one-third independent directors.
by June 2003. Therefore, it is not surprising to see a low proportion of independent directors in boards of directors prior to 2003. Although the maximum of the proportion of independent directors (BOD) reached 33.33% during the 1995-1999 period, and increased to 40% during the 2000 to 2002 period, the mean of the proportion of independent directors is low, with the average less than 1% of independent directors in the board before 1999, and 2% independent directors in the board between 2000 and 2002. The mean of independent directors becomes 32.02% in 2003 and increases to 32.09% between 2004 and 2006. It is interesting to note that the maximum of independent directors was 60% from 2003, meaning some listed firms have had more than half of the board composed of independent directors since the CSRC’s regulation was issued. Audit committees did not exist among sample firms until 2000, when only two firms were identified with an audit committee. Sixteen sample firms established audit committees by 2003, two years after the CSRC’s Code of Corporate Governance stipulation. By 2006, there were 34 audit committees in existence among the 297 sample firms.

Among the economics-based variables, the average means of the sample firms’ leverage (LEV) are 0.46, 0.49 and 0.54 for the three phases, respectively, meaning listed firms in the Chinese stock market increased their borrowing relative to their assets to fund business operations over the testing period. Although average means of profitability (PRO) increase from 0.11 in Phase I, to 0.12 in Phase II and 0.16 in Phase III, the minimum profitability is negative across the entire testing period, with average minimum profitability being -6.4, -10.14 and -10.29 for the three phases, respectively. This result shows that in every reporting period there are some firms among the sample with negative reported earnings. Growth opportunity (GRO) represents a firm’s future investment opportunities. The mean for this independent variable fails to show any stable trend. The average mean of growth opportunity
The results indicate that the market value of firms’ equity is much lower than firms’ book value of equity. Accordingly, the average future investment opportunity of sample firms is low. Maximum growth opportunities, however, show some sample firms have better investment opportunities by having higher growth opportunities, including 0.13 in 2001, 0.32 in 2002, and 0.25 in 2003 and 0.45 in 2006.

### 7.4.1.2 Correlation

Table 7.15 reveals some significant correlations among the dependent and independent variables. These suggest that, potentially, some of the hypotheses established in Chapter 5 are supported. The total voluntary disclosure score (VDS) is significantly correlated to foreign ownership (TRB), the proportion of independent directors (BOD), the existence of an audit committee (IAC) and an international audit firm (AUD), size (SIZE) and industry classification (IND). Meanwhile, positive and negative correlations are shown between the independent variables. Size (SIZE) is positively correlated to the proportion of independent directors (BOD), foreign ownership (TRB), and the existence of an audit committee (IAC) and an international audit firm (AUD). An audit committee (IAC) is positively correlated to the proportion of independent directors (BOD). Growth opportunity (GRO) is positively correlated to profitability (PRO). A high correlation is found between State ownership and Legal-person ownership. State ownership (STA) and legal-person ownership (LEG) are negatively and highly correlated ($\beta = -0.79$).

Xu and Wang (1999) observe that including both state ownership and legal-person ownership in the same regression is problematic because these two variables are highly and negatively
correlated to each other. This view gains support from Jiang et al.’s (2008), study, which suggests state ownership and legal-person ownership have several commonalities, including neither is legally tradable and they are usually government owned\textsuperscript{27}. A survey of disclosure studies focusing on the Chinese stock market shows research has adopted three different approaches in handling state ownership and legal ownership in regressions. Sun et al. (2002) include both variables in the same regression model. To avoid a potential multicolinearity problem, Xiao et al. (2004) include either state ownership or legal-person ownership in their regressions. Jiang et al. (2008) take the aggregation of the state share and legal person share proportions as the proxy for the government-owned share proportion. Given the high correlation between state ownership and legal-person ownership, this study follows the approach used by Xiao et al. (2004). OLS regressions are run with either state ownership or legal ownership.

\textsuperscript{27} Although legal-person shares are held by domestic institutions such as other stock firms, state-private mixed enterprises and non-bank financial institutions, government-related institutions owned at least 81.5\% of total legal-person shares between 1991-2001 (Jiang et al., 2008).
Table 7.14 Descriptive statistics of independent variables

<table>
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<tbody>
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<td>STA</td>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td>Mean</td>
<td>30.47</td>
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<td>29.58</td>
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<td>27.24</td>
<td>27.48</td>
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<td>26.64</td>
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<td>88.58</td>
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<td>88.58</td>
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<td>83.75</td>
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<td>Median</td>
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<td>30.00</td>
<td>28.57</td>
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<td>28.57</td>
<td>27.98</td>
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<td>Min.</td>
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<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
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<td>0.00</td>
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<td>LEG</td>
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Table 7.15 Pearson correlations

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Notes:

1. The sample is based on observations of 297 firms over the 1995-2006 period.
2. Variables are defined in Chapter 6.
7.4.2 Regression results

Tables 7.16 to 7.18 report multivariate test results. Regression models are run for Phase I, Phase II and Phase III, respectively. Each table consists of two panels. Panel A shows the result of a regression model including independent variable state ownership (STA) but not legal-person ownership (LEG). Panel B shows the result of a regression model including legal-person ownership (LEG) but not state ownership (STA).

7.4.2.1 Phase I (1995-1998)

Table 7.16 details the results for Phase I. In this period, due to lack of data, the independent variable audit committee (IAC) is dropped when running the regression models. It can be concluded that during the early development stage of the Chinese stock market, ownership structure, especially state ownership, had a significant impact on firms’ information disclosure. State ownership (STA) exhibits a negative and significant influence on firms’ information disclosure with a \( p \) value significant at 1 percent level. Thus, the higher the percentage of state ownership, the lower the voluntary disclosure made during Phase I. Legal-person ownership (LEG) has a negative coefficient, as hypothesized by H3a, meaning that during that period, legal-person ownership also had an inverse relationship to firms’ disclosure but the impact was not significant. Foreign ownership (TRB) is positively related to the total voluntary disclosure score (VDS), as evidenced by a positive coefficient. However, this variable does not have any significant influence. These results lend strong support to H2a but not to H3a and H4a.
For the corporate governance related factor, the proportion of independent directors (BOD) shows no relation to firms’ disclosure decisions, although the coefficient is positive, as hypothesized. It means independent directors did not play any significant role in improving listed firms’ disclosure transparency during the 1995-1998 period. Given the low proportion of independent directors on the board of directors among the sample firms during this period (average 1% prior to 1999), it is not surprising to see such an insignificant result. Therefore, H5a is not supported.

Among the three economics-based variables, leverage (LEV) does not show any significance in influencing a firm’s level of voluntary disclosure, although the coefficient is positive, as predicted in H7a. This means that listed firms’ borrowing has a positive influence on voluntary disclosure but not at a significant level. During the development stage of the Chinese stock market the importance of creditors as one of the stakeholder groups of listed firms was not recognized. Profitability (PRO), on the other hand, is significantly associated with the sample firms’ level of disclosure, with a \( p \) value significant at 1 percent level; however, it is significant in a negative way. This result shows that during the 1995-1998 period, the less profit made by listed firms, the more voluntary disclosure they would make to the market. The voluntary disclosure made by poorly performing firms can be explained by the profitability requirements of the CSRS after the firms’ IPO listing. A listed firm could be delisted if it made a loss in three consecutive years. The less profitable firms could, therefore, adopt voluntary disclosure in an effort to maintain investors’ confidence. Growth opportunity (GRO) is significantly associated with the level of voluntary disclosure in a positive way, with a \( p \) value significant at 1 percent level, showing that firms with better future investment opportunities prefer to disclose more information to investors. These results support H8a and H9a but not H7a.
Regression results do not support H10a, as an international auditing firm (AUD) does not show any significant influence on firms’ voluntary disclosure during the 1995-1998 period, although the coefficient is positive, as predicted in H10a. Both control variables, size (SIZE) and industry (IND), as predicted, are positively and significantly related to firms’ levels of voluntary disclosure, with their $p$ values both significant at 1 percent level. The larger the firm, the more information they disclose, and firms engaged in the manufacturing industry disclose more information than other categories of firms.

7.4.2.2 Phase II (1999-2002)

The results for Phase II are reported in Panel A and Panel B of Table 7.17. During the corporate governance régime phase, state ownership (STA) is still significantly and negatively associated with a firm’s level of voluntary disclosure, with a $p$ value significant at 5 percent level. Legal-person ownership (LEG), however, shows a positive coefficient, meaning the relationship between firms’ disclosure and legal-person ownership has changed from negative to positive. The impact of legal-person ownership to firms’ voluntary disclosure is still not significant though. While foreign ownership (TRB) does not show any major impact on firms’ decisions on disclosure during the early stage of the Chinese stock market, it becomes one of the positive influential factors during the 1999-2002 period, with a $p$ value significant at 1 percent level. The more foreign ownership a firm has the more voluntary disclosure the firm makes. These results support H2b and H4b but not H3b.

Although Phase II saw the corporate governance régime as strongly promoted by government regulatory agencies in China, especially the CSRC, corporate governance related explanatory
variables, the proportion of independent directors (BOD) and an audit committee (IAC), do not show any significant influence on improving firms’ voluntary disclosure. The coefficients of both corporate governance related variables are positive, and in the direction hypothesized. The result could be interpreted that although the CSRC released various regulations in 2001 to require firms to have a certain proportion of independent directors on the board in listed firms by July 2003, the regulations did not have any immediate impact on firms’ board composition during the 1999-2002 period. The proportion of independent directors increased only slightly, from less than 1% before 1999 to 2% before 2003. Thus, both H5b and H6b are not supported by regression results during the 1999-2002 period.

Among the three economics-based variables, during the 1999-2002 period, leverage (LEV) is statistically significantly related to voluntary disclosure, with a $p$ value significant at 1 percent level, showing that the more borrowing the listed firms have, the more information disclosure they like to make to the capital market. Profitability (PRO) is still negatively associated with information disclosure. However, in contrast to the results in Phase I, the association is not statistically significant during this period. Growth opportunity (GRO) significantly influenced firms’ voluntary disclosure in a negative way during Phase II, with a $p$ value significant at 1 percent level, meaning firms with lower future investment opportunities disclose more information to the stock market. Thus, H7b and H9b are supported, while H8b is not. An international audit firm (AUD) exhibits a stronger positive impact on firms’ disclosure levels, with a $p$ value significant at 5 percent level, showing international audit firms play a significant role in improving firms’ disclosure transparency. H5 is supported by regression results during the 1999-2002 period. Two control variables, size (SIZE) and industry (IND), are all significantly related to information disclosure, with
their \( p \) values both significant at 1 percent level, and also in the direction predicted in the hypotheses.

### 7.4.2.3 Phase III (2003-2006)

Table 7.18 details regression results in Phase III. During this period, state ownership (STA) has a negative coefficient, as predicted by H2c. However, the impact of this variable on firms’ voluntary disclosure becomes insignificant. Legal-person ownership (LEG) still presents a positive coefficient but insignificant results. On the contrary, foreign ownership (TRB) is statistically significant and positively related to firms’ voluntary disclosure, with a \( p \) value significant at 1 percent level. Thus, during the 2003-2006 period, H4c is supported but not H2c and H3c. It is interesting to note that of the two corporate governance related variables, the proportion of independent directors on the board (BOD) significantly and positively contributes to an increased level of voluntary disclosure, with a \( p \) value significant at 1 percent level, while the audit committee (IAC) still fails to show any significance, although the coefficient is in the same direction as hypothesized. Thus, regression results of Phase III lend support to H5c but not H6c.

Among the three economics-based variables, leverage (LEV) is the only variable showing significance positively, with a \( p \) value significant at 5 percent level, meaning that during the 2003-2006 period, the more borrowings firms have, the more information they disclose. Both profitability (PRO) and growth opportunity (GRO) fail to show any significant influence on firms’ information disclosure decisions. Therefore, in Phase III, H7c is supported, but not H8c and H9c. An international audit firm (AUD) still presents a positive and significant influence on voluntary disclosure during this period, with a \( p \) value significant at 5 percent level, and, therefore, H10c is supported. The two control variables, size (SIZE) and industry
(IND), are all significantly and positively associated with firms’ voluntary disclosure in Phase III, with a $p$ value for size significant at 5 percent level, and a $p$ value for industry significant at 1 percent level.
Table 7.16 Regression results Phase I (1995-1998)

<table>
<thead>
<tr>
<th>Variable (Predicted Sign)</th>
<th>Panel A</th>
<th></th>
<th></th>
<th>Panel B</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Parameter Estimate</td>
<td>Standard Error</td>
<td>t value</td>
<td>p value</td>
<td>Parameter Estimate</td>
<td>Standard Error</td>
<td>t value</td>
</tr>
<tr>
<td>Intercept</td>
<td>-3.8291</td>
<td>1.0191</td>
<td>-3.76</td>
<td>0.0002</td>
<td>-3.4795</td>
<td>1.0256</td>
<td>-3.39</td>
</tr>
<tr>
<td>STA (-)</td>
<td>-0.5336</td>
<td>0.1529</td>
<td>-3.49</td>
<td>0.0005***</td>
<td>-0.0801</td>
<td>0.1489</td>
<td>-0.54</td>
</tr>
<tr>
<td>LEG (+)</td>
<td>0.7108</td>
<td>0.4814</td>
<td>1.48</td>
<td>0.1401</td>
<td>0.6767</td>
<td>0.4882</td>
<td>1.39</td>
</tr>
<tr>
<td>BOD (+)</td>
<td>1.5189</td>
<td>0.8902</td>
<td>1.71</td>
<td>0.0883*</td>
<td>1.4986</td>
<td>0.8979</td>
<td>1.67</td>
</tr>
<tr>
<td>LEV (+)</td>
<td>0.3527</td>
<td>0.2491</td>
<td>1.42</td>
<td>0.1571</td>
<td>0.2226</td>
<td>0.2498</td>
<td>0.89</td>
</tr>
<tr>
<td>PRO (?)</td>
<td>-2.1615</td>
<td>0.6146</td>
<td>-3.52</td>
<td>0.0005***</td>
<td>-1.9044</td>
<td>0.6161</td>
<td>-3.09</td>
</tr>
<tr>
<td>GRO (?)</td>
<td>17.001</td>
<td>21.344</td>
<td>0.79</td>
<td>0.0001***</td>
<td>167.19</td>
<td>21.47</td>
<td>7.79</td>
</tr>
<tr>
<td>AUD (+)</td>
<td>0.0638</td>
<td>0.1460</td>
<td>0.44</td>
<td>0.6622</td>
<td>0.0468</td>
<td>0.1474</td>
<td>0.32</td>
</tr>
<tr>
<td>SIZE (+)</td>
<td>0.1975</td>
<td>0.0511</td>
<td>3.87</td>
<td>0.0001***</td>
<td>0.1773</td>
<td>0.0511</td>
<td>3.47</td>
</tr>
<tr>
<td>IND (+)</td>
<td>0.5719</td>
<td>0.0807</td>
<td>7.09</td>
<td>0.0001***</td>
<td>0.5172</td>
<td>0.0801</td>
<td>6.46</td>
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<tr>
<td>F statistic</td>
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<td></td>
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<td>15.70</td>
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<tr>
<td>Significance</td>
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<td></td>
<td></td>
<td>&lt;0.0001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adj. R²</td>
<td>0.1289</td>
<td></td>
<td></td>
<td></td>
<td>0.1183</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
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<td></td>
<td></td>
<td>987</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Statistically significant at the 10% level, two-tailed test.
**Statistically significant at the 5% level, two-tailed test.
***Statistically significant at the 1% level, two-tailed test.
Table 7.17 Regression results Phase II (1999-2002)

### Total VDS as Dependent Variable Phase II (1999-2002)

<table>
<thead>
<tr>
<th>Variable (Predicted Sign)</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t value</th>
<th>p value</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t value</th>
<th>p value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>1.8667</td>
<td>1.6702</td>
<td>1.12</td>
<td>0.2640</td>
<td>1.8075</td>
<td>1.6940</td>
<td>1.07</td>
<td>0.2863</td>
</tr>
<tr>
<td>STA (-)</td>
<td>-0.5135</td>
<td>0.2674</td>
<td>-1.92</td>
<td>0.0500**</td>
<td>0.2984</td>
<td>0.2647</td>
<td>1.13</td>
<td>0.2599</td>
</tr>
<tr>
<td>LEG (+)</td>
<td>2.4383</td>
<td>0.8001</td>
<td>3.05</td>
<td>0.0024***</td>
<td>2.5701</td>
<td>0.8069</td>
<td>3.19</td>
<td>0.0015***</td>
</tr>
<tr>
<td>BOD (+)</td>
<td>0.0052</td>
<td>0.0810</td>
<td>0.06</td>
<td>0.9492</td>
<td>0.0017</td>
<td>0.0812</td>
<td>0.02</td>
<td>0.9830</td>
</tr>
<tr>
<td>LEV (+)</td>
<td>1.7311</td>
<td>0.3839</td>
<td>4.51</td>
<td>0.0001***</td>
<td>1.7178</td>
<td>0.3851</td>
<td>4.46</td>
<td>0.0001***</td>
</tr>
<tr>
<td>PRO (?)</td>
<td>-1.0086</td>
<td>0.6473</td>
<td>-1.56</td>
<td>0.1195</td>
<td>-1.1220</td>
<td>0.6441</td>
<td>-1.74</td>
<td>0.0818*</td>
</tr>
<tr>
<td>GRO (?)</td>
<td>-4.8011</td>
<td>12.889</td>
<td>-3.32</td>
<td>0.0009***</td>
<td>-45.247</td>
<td>12.834</td>
<td>-3.52</td>
<td>0.0004***</td>
</tr>
<tr>
<td>AUD (+)</td>
<td>0.7806</td>
<td>0.3704</td>
<td>2.11</td>
<td>0.0353**</td>
<td>0.7818</td>
<td>0.3709</td>
<td>2.11</td>
<td>0.0353**</td>
</tr>
<tr>
<td>SIZE (+)</td>
<td>0.1946</td>
<td>0.0653</td>
<td>2.98</td>
<td>0.0029***</td>
<td>0.1916</td>
<td>0.0657</td>
<td>2.91</td>
<td>0.0036***</td>
</tr>
<tr>
<td>IND (+)</td>
<td>1.0683</td>
<td>0.1359</td>
<td>7.86</td>
<td>0.0001***</td>
<td>1.0349</td>
<td>0.1344</td>
<td>7.70</td>
<td>0.0001***</td>
</tr>
<tr>
<td>F statistic</td>
<td>15.20</td>
<td></td>
<td></td>
<td></td>
<td>14.92</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Significance</td>
<td>&lt;0.0001</td>
<td></td>
<td></td>
<td></td>
<td>&lt;0.0001</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adj. R²</td>
<td>0.1284</td>
<td></td>
<td></td>
<td></td>
<td>0.1262</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
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<td></td>
<td></td>
<td>965</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Statistically significant at the 10% level, two-tailed test.

**Statistically significant at the 5% level, two-tailed test.

***Statistically significant at the 1% level, two-tailed test.
Table 7.18 Regression results Phase III (2003-2006)

| Variable (Predicted Sign) | Panel A | | Panel B | |
|---------------------------|---------|----------------|---------|----------------|---------|
|                           | Parameter Estimate | Standard Error | t value | p value | Parameter Estimate | Standard Error | t value | p value |
| Intercept                 | 2.2146  | 1.7437         | 0.12    | 0.9021  | 2.6743  | 1.7892         | 0.38    | 0.7064  |
| STA (-)                   | -0.3498 | 0.3346         | -1.05   | 0.2960  | 0.3888  | 0.3389         | 1.15    | 0.2515  |
| LEG (+)                   | 2.9775  | 0.8951         | 3.33    | 0.0009*** | 2.9214 | 0.8981         | 3.25    | 0.0012*** |
| IAC (+)                   | 2.5142  | 1.3737         | 1.83    | 0.0675  | 2.5165  | 1.3735         | 1.83    | 0.0672  |
| BOD (+)                   | 0.6772  | 0.2556         | 2.65    | 0.0082*** | 0.7001 | 0.2555         | 2.74    | 0.0063*** |
| LEV (+)                   | 0.2642  | 0.1321         | 2.00    | 0.0458** | 0.2604 | 0.1324         | 1.97    | 0.0495** |
| PRO (?)                   | -0.0789 | 0.2031         | -0.39   | 0.6977  | -0.0729 | 0.2031         | -0.36   | 0.7197  |
| GRO (?)                   | -8.7116 | 8.4747         | -1.03   | 0.3042  | -8.0019 | 8.4743         | -0.94   | 0.3453  |
| AUD (+)                   | 0.4585  | 0.2209         | 2.08    | 0.0382** | 0.4945 | 0.2212         | 2.24    | 0.0256** |
| SIZE (+)                  | 0.2021  | 0.0817         | 2.47    | 0.0136** | 0.1808 | 0.0829         | 2.18    | 0.0293** |
| IND (+)                   | 1.8389  | 0.1645         | 11.18   | 0.0001*** | 1.7889 | 0.1627         | 10.99   | 0.0001*** |
| F statistic               | 19.68   | 19.71          |         |         |         |         |         |         |
| Significance              | <0.0001 | <0.0001        |         |         |         |         |         |         |
| Adj. R²                   | 0.1650  | 0.1652         |         |         |         |         |         |         |
| N                         | 946     | 946            |         |         |         |         |         |         |

*Statistically significant at the 10% level, two-tailed test.
**Statistically significant at the 5% level, two-tailed test.
***Statistically significant at the 1% level, two-tailed test.
7.4.3 Changes in stakeholder power over the years

A close examination of the results presented in Tables 7.16 to 7.18 finds that factors influencing listed firms’ voluntary disclosure changed throughout the 1995–2006 period. Changed influential factors over the three distinctive phases of the Chinese stock market reflect the changes that occurred to various stakeholder groups of listed firms. As stakeholders of listed firms, the power possessed by public investors, regulatory agents, creditors and professional services over listed firms have gradually increased. Table 7.19 summarizes the influential factors regarding firms’ voluntary disclosure in the three phases.

Table 7.19 Influential factors in the three phases

<table>
<thead>
<tr>
<th>Influential factor</th>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Significance</td>
<td>Direction</td>
<td>Significance</td>
</tr>
<tr>
<td>STA</td>
<td>√</td>
<td>-</td>
<td>√</td>
</tr>
<tr>
<td>LEG</td>
<td>x</td>
<td>-</td>
<td>x</td>
</tr>
<tr>
<td>TRB</td>
<td>x</td>
<td>+</td>
<td>√</td>
</tr>
<tr>
<td>BOD</td>
<td>x</td>
<td>+</td>
<td>x</td>
</tr>
<tr>
<td>IAC</td>
<td>x</td>
<td>+</td>
<td>x</td>
</tr>
<tr>
<td>LEV</td>
<td>x</td>
<td>+</td>
<td>√</td>
</tr>
<tr>
<td>PRO</td>
<td>√</td>
<td>-</td>
<td>x</td>
</tr>
<tr>
<td>GRO</td>
<td>√</td>
<td>+</td>
<td>√</td>
</tr>
<tr>
<td>AUD</td>
<td>x</td>
<td>+</td>
<td>√</td>
</tr>
<tr>
<td>SIZE</td>
<td>√</td>
<td>+</td>
<td>√</td>
</tr>
<tr>
<td>IND</td>
<td>√</td>
<td>+</td>
<td>√</td>
</tr>
</tbody>
</table>

(√: representing significant influence; x: representing insignificant influence)

State ownership (STA) has a consistent negative association with firms’ voluntary disclosure. Although the mean of the state ownership of sample firms decreased from
30.47% in 1995 to 23.97% in 2006, the impact of state shareholders on firms’ disclosure choice is significant during the developing phase (1995-1998) and the corporate governance régime phase (1999-2002) of the Chinese stock market. During the 2003-2006 period, the impact of state ownership on firms’ disclosure is not significant; however, a negative coefficient shows it still has an inverse relationship with the total voluntary disclosure scores (VDS). The higher the proportion of state ownership a listed firm has, the lower the number of voluntary disclosures made by a firm. State ownership, as discussed in Chapters 4 and 5, is the result of a unique institutional setting when state owned enterprises were transformed into listed firms. This ownership structure does not truly represent any stakeholders’ interest in the listed firms, except for the “inside controllers”. Pursuing profitability is not a state shareholders’ primary concern. State shareholders also have privileged access to private information. These factors mean state shareholders lack interest in encouraging public disclosure. The result in this study is similar to Xiao et al.’s (2004) finding, which concludes there is a negative association between state ownership and information disclosure in the Chinese stock market.

No significant impact is found from firms’ legal-person ownership (LEG) on their disclosure level in this study. According to Delios and Wu (2005), legal-person identity was created by the Chinese policy-makers to aid the transition of China’s SOEs to privately-owned status. Although legal-person shareholders are analogous to institutional shareholders, legal-person shareholders tend to have strong state-related roots in the early stage of the Chinese stock market. The implication is that legal-person ownership does not represent any stakeholders’ interest in the early stage of the Chinese stock market. Non-state related legal-persons increase substantially
during the development of the Chinese stock market. Private companies, investment funds and securities companies become main shareholders under the legal-person ownership category (Delios and Wu, 2005). Several prior studies suggest that legal-person ownership is motivated to pursue profit maximization and it is better equipped with the power and ability to monitor a firms’ management (Tam, 2002; Xiao et al., 2004; Delios and Wu, 2005). Therefore, legal-person ownership has changed its status from state-related ownership to becoming part of the public investment community.

It is worthwhile to notice that, in this study, although regression results throughout the entire testing periods fail to show any significant relationship between legal-person ownership and levels of voluntary disclosure, the coefficients change from negative in the 1995-1998 period to positive during the 1999-2006 period. As has been seen before when legal-person ownership changed from strong state-related shareholders to private institutions, legal-person ownership is now beginning to represent public investors’ economic stakes and financial interests.

Prior studies investigating the association between legal-person ownership and firms’ performance provide inconclusive results. Major findings of Xu and Wang (1999), Qi et al. (2000), Sun et al. (2002) and Delios and Wu (2005) suggest a positive and significant impact of legal-person ownership on firms’ performance measures, while Wei and Varela (2003) show a negative and significant relationship between these two variables. However, Delios and Wu (2005) indicate that legal-person shareholders contribute to profit-oriented governance only if this type of shareholding has a high level of ownership concentration and is not in a minority ownership position. Only a
high level of ownership provides incentives to effectively monitor a firm’s management.

In respect of information disclosure, while Xiao et al. (2004) find a positive relationship between legal-person ownership and firms’ disclosure levels, Xiao and Yuan (2007) report no relationship between this ownership and voluntary disclosure, based on 2002 financial year data. The result of this study is similar to the finding of Xiao and Yuan (2007). No relationship is found between legal-person ownership and firms’ disclosure levels.

Foreign ownership (TRB), on the other hand, is positively and significantly related to firms’ voluntary disclosure during the 1999-2002 and 2003-2006 periods. As illustrated in Chapter 4, initially, B shares were exclusively issued to foreign investors. Since 2001, domestic individual investors were allowed to invest in B shares by using foreign currencies. Therefore, foreign ownership, in fact, represents an economic stake of both foreign investors and some domestic investors. As experienced investors, foreign ownership shareholders could exert more effective external monitoring and pressure on listed firms’ management to disclose more information. Following International Accounting Standards when preparing financial statements for foreign investors could also contribute to a higher level of voluntary disclosure. In addition, as discussed in Chapter 5, listed firms with foreign ownership are politically visible in China. Liu and Eddie (2007) suggest listed firms with foreign investment participation increase information disclosure voluntarily in their annual reports, in order to enhance their reputation and credibility. More extensive voluntary disclosures and a widened dissemination of financial information can create an
impression of greater transparency in the Chinese stock market as a whole. Transparent information disclosure will increase an overseas investment community’s confidence in investing in China. The result of this study provides strong support for the findings of Xiao et al. (2004), Liu and Eddie (2007), and Xiao and Yuan (2007).

The corporate governance related variable, the proportion of independent directors (BOD), only shows its significance during the last testing phase, the 2003-2006 period, while another independent variable, audit committee (IAC), does not show any relationship with firms’ voluntary disclosure. Both an independent directors system and an audit committee are advocated by the CSRC, aiming to improve corporate governance among listed firms. The political objective of regulatory agencies in the Chinese stock market is minority investor protection. The protection of the minority investor is one of the essential principles to ensure long-term and healthy growth of the capital market in China, and development of the capital market is part of the sustainable development of the Chinese economy. The viewpoint taken by the CSRC is that only a good corporate governance structure can achieve minority investor protection in the Chinese stock market. Independent directors can effectively monitor management’s performance and represent public shareholders’ interest. In the process of establishing an independent director system, the CSRC not only exerted its power by stipulating an important regulation, *Guide Opinion on Establishing Independent Director System by Listed Companies* in 2001, but also organized training of independent directors and set up an “independent director candidature pool” for listed firms. It is reasonable to assume that independent directors started to play a positive and significant role in improving firms’ disclosure transparency in the Chinese stock market during the 2003-2006 period. This result supports the findings
of Xiao et al. (2004) and Xiao and Yuan (2007), whose studies both used data collected from annual reports after 2001. Audit committees are supposed to monitor firms’ internal controls and review the internal audit system. Establishing an audit committee was recommended by one of the CSRC’s regulations stipulated in early 2001, the Code of Corporate Governance for Listed Companies in China, but setting up an audit committee is voluntary for listed firms rather than being compulsory. One possible explanation for the insignificant impact of an audit committee on firms’ levels of voluntary disclosure is the low proportion of audit committees that existed among the sample firms.

The importance of creditors has gradually been recognized by listed firms over the years. The creditor group can be identified as one of the powerful stakeholders of listed firms. Leverage represents firms’ financial structure and associated risk; the higher the leverage, the higher the risk of creditors’ investment. In this study, leverage (LEV) is significantly related to levels of voluntary disclosure over the 1999-2006 period, although no significant association is found between firms’ leverage and voluntary disclosure during the 1995-1998 period, the early development stage of the Chinese stock market. Gradually declining “Policy Loans” and increasing commercial loans to listed firms may explain the relationship between leverage and the level of voluntary disclosure. The risks associated with commercial loans could also motivate creditors to increase their demands for information disclosure from listed firms. Similar to public investors, their information demands are supported by the regulatory agencies in the Chinese stock market. Results in this study show firms with high leverage choose to disclose more information. This is similar to what Liu and Eddie
(2007) found, but contrasts with the result of Xiao and Yuan (2007), which shows there is no significant relationship between a firm’s leverage and its disclosure level.

An external international audit firm (AUD) is shown by the empirical results in this study as one variable that consistently contributes to an increased level of voluntary disclosure. Firms issuing B shares are required to prepare two sets of financial statements, based on Chinese GAAP and international accounting standards (IAS), respectively, and to have their annual reports audited by international auditors. Meanwhile, some large domestic listed firms also employ international auditing firms. According to signaling theory, employing audit firms with an international reputation is a way of obtaining greater potential gains from external monitoring (Xiao et al., 2004). Under legitimacy theory, reputation is one of the concerns of large/high reputation audit firms. As Chalmers and Godfrey (2004) suggest, to maintain or enhance their reputation and avoid reputation costs, high audit reputation firms are more likely than lower reputation audit firms to persuade or demand their clients to adhere to the recommended disclosure régime. The results in this study are consistent with the findings in Xiao et al. (2004), Xiao and Yuan (2007) and Liu and Eddie (2007).

Profitability (PRO) and growth opportunity (GRO) present mixed results. The coefficients across the three tables indicate that the impact of these two variables on the level of voluntary disclosure is not unidirectional. These results are not consistent with prior studies (Liu and Eddie, 2007; Xiao and Yuan, 2007). Liu and Eddie (2007) find profitability in the Chinese stock market has a positive impact on firms’ voluntary disclosure, while Xiao and Yuan (2007) find firms with growth
opportunities are reluctant to disclose more information. Given the unstable increase and decrease of profitability and growth opportunity presented by descriptive statistics, it is concluded that profitability and growth opportunity do not have explanatory power in explaining firms’ disclosure decisions.

Two control variables, firm size (SIZE) and industry classification (IND), are both in the direction hypothesized. Throughout the 1995–2006 period, both of them are significantly related to firms’ voluntary disclosure. The results prove that large listed firms are politically sensitive and visible in Chinese society, and political factors drive them to disclose more information to external investors. Further, firms engaged in the manufacturing industry disclose more information than non-manufacturing firms. These results are all consistent with the findings of Liu and Eddie (2007).

7.5 Summary

This chapter discusses the extent and characteristics of listed firms’ voluntary disclosure over the three testing phases. It also reports and analyses tests of the associations between disclosure and firm characteristics, in order to find out, specifically, what factors motivated listed firms to voluntarily disclose information to investors.

The voluntary disclosures made by listed firms in the Chinese stock market increased over the three testing phases. The number of disclosing firms increased significantly from Phase I to Phase II for all three disclosure sections. Consistent with the number
of disclosing firms, the voluntary disclosure scores of the three disclosure sections also increased dramatically during Phase II. These results show that listed firms positively reacted to a changed corporate disclosure environment in China. Among the three disclosure sections, strategic information disclosure is found to have the highest voluntary disclosure scores, followed by financial information and non-financial information. Close examination of the three disclosure sections demonstrates that listed firms are selective in their information disclosure. Forward-looking information, under both the strategic information and financial information sections, was found to have a strong connection with voluntary disclosure, meaning that to satisfy the information demand of regulatory agencies and the investment community, listed firms used voluntary disclosure to manage stakeholder relationships and legitimate their social status in the Chinese stock market.

The study also investigates factors affecting listed firms’ voluntary disclosure. It finds that state ownership had a significant negative impact on firms’ disclosure decisions during the 1995-2003 financial years. Legal ownership does not have any impact on firms’ disclosure behavior. Foreign investment, however, has a significant positive influence on firms’ voluntary disclosure. The corporate governance related factor, the proportion of independent directors, shows its significance only during Phase III, reflecting increased pressure from the corporate governance régime in the Chinese stock market. International audit firms were found to play a positive and significant role in improving disclosure transparency among listed firms. Among the economics-based variables, leverage became an influential factor from the late 1990s, and firms with a high proportion of loans tend to disclose more information. The larger the firm, the more voluntary disclosure is found. Firms engaged in the manufacturing industry
were found to disclose more information than firms not engaged in the manufacturing industry. Finally, profitability and growth opportunity, however, present mixed results and their influence on firms’ disclosure decisions are inconclusive.
CHAPTER 8

SUMMARY AND CONCLUSION

8.1 Introduction

This chapter reviews the study by revisiting the purpose of the study in Section 8.2, and summarizing the main contents of each of the preceding chapters. Section 8.3 summarizes the findings of the study and discusses the implications of the findings for the stakeholders of listed Chinese firms and the regulatory bodies in China. Section 8.4 addresses the limitations of the study in respect of research design. The implications of this study for future research are explored in Section 8.5. Section 8.6 concludes the thesis by summarizing the contribution made by this study to the voluntary disclosure literature.

8.2 Review of the study

8.2.1 Purpose of the study

This thesis argues that the political, economic and social changes in China have led to the changes in the corporate disclosure environment for listed firms. The economic reforms launched by the Chinese government since the late 1970s have allowed China to undergo a remarkable transformation, from a centrally-planned economy to a more
open and market-oriented economy. The increasing sophistication of the Chinese economy and the profound reform of the state-owned enterprises have led to the establishment of the Chinese stock market. The rapid development of the Chinese stock market over the years has become one of the driving forces behind the establishment of the regulatory framework of corporate disclosure in China and its harmonization with the international accounting standards. The political and social liberalizations in China can be seen both as causes and results of the economic development and reforms of the past three decades. New stakeholders of listed Chinese firms have emerged and they now demand transparent information disclosure. All these changes have created a challenging disclosure environment for publicly-listed firms in China.

The purpose of this study is to investigate how the changed disclosure environment has impacted on the disclosure behavior of Chinese listed firms. In order to address this issue, the investigation is empirically conducted by examining the voluntary disclosure of the strategic, financial and non-financial information made available by listed Chinese firms in their annual reports in the 1995-2006 reporting periods in this study. It examines to what extent listed Chinese firms have increased their disclosure transparency during this period of time, and what the driving factors behind their voluntary disclosures are.

The investigation of voluntary disclosure made by listed Chinese firms during 1995-2006 is motivated by: (1) the strategic importance of the Chinese stock market to China’s economic and social development; (2) the controversial and complex nature of the Chinese stock market; and (3) the dramatically changed disclosure environment
in China during the past two decades. The significance of the Chinese stock market to
the Chinese economy is the important role it plays in improving the allocation of
financial resources to facilitate the growth of the corporate sector, inducing
fundamental changes in corporate governance, providing new channels to attract
foreign investment, and facilitating the integration of China into the global economic
system. In respect of social development in China, the Chinese stock market has
offered diversified investment opportunities to domestic investors in China, provided
support to the establishment of a social security system, and nurtured new industries
and new professionals in Chinese society. Due to its unique historical background and
institutional setting, the Chinese stock market is characterized by the different types
of shares, such as tradable and non-tradable shares, domestic A Shares and foreign
investor owned B Shares, and the conflicting interests between the majority
shareholders and the minority investors in listed firms. To reduce information
asymmetry, improve corporate governance of listed firms and improve corporate
disclosure transparency, the Chinese government and its regulatory agency has made
remarkable efforts in establishing a comprehensive regulatory framework for
corporate disclosure. The objective of corporate disclosure has shifted from satisfying
the government’s information needs to satisfying investors and other stakeholders’
information needs. The power of stakeholders over the financial resources of listed
firms has increased dramatically during the past twenty years. In order to make more
informed economic decisions, stakeholders have gradually increased their demands
for transparent information disclosure from the listed firms.

To investigate how the changed disclosure environment has impacted on listed firms’
voluntary disclosure, this study addresses these two specific research questions:
1) To what extent has the level of voluntary disclosure of listed firms in the Chinese stock market changed over the 1995-2006 period?

2) What are the factors that have contributed to the changed level of voluntary disclosure in the Chinese stock market?

In answering these two research questions, the study empirically investigates the predictive ability of legitimacy theory and stakeholder theory. Voluntary corporate disclosure has long been researched within the information perspective and contracting research paradigm. These economics-based views, however, narrow the investigation of firms’ voluntary disclosure down solely to the relationship between investors and firms’ management, without considering the broader social impact of corporations’ behavior.

Legitimacy theory and stakeholder theory suggest that corporations are operating in a social environment. To legitimate their social status and improve their social image, corporations need to comply with commonly-accepted social norms and values. Corporations’ prospects are affected by various stakeholder groups existing in society and corporations need to satisfy powerful stakeholders’ demands. Applying legitimacy theory and stakeholder theory to the Chinese context, it is suggested that the changed corporate disclosure environment has created a challenging and demanding information disclosure régime for listed Chinese firms. To satisfy powerful stakeholders’ information demands, listed firms are expected to voluntarily disclose information to the Chinese stock market.

The whole testing period, 1995-2006, is further divided into three testing phases which reflect the different development stages of the Chinese stock market. Phase I is
the developing phase (1995-1998); Phase II is the corporate governance régime phase (1999-2002); and Phase III is the convergence phase (2003-2006). The extent of voluntary disclosure made by firms continuously listed on the Chinese stock market between 1995 and 2006 is examined, and the different factors contributing to firms’ disclosure decision-making during different testing phases are explored.

8.2.2 Content of preceding chapters

Chapter 2 critically reviews the extant literature of voluntary information disclosure. The economic-based views include an information perspective and a contact perspective. These two perspectives suggest that the purposes of voluntary disclosure are to reduce the information asymmetry existing between the management of firms and external investors; to reduce firms’ cost of capital; and to signal a firm’s good performance to the stock market. The alternative view employed to explain voluntary disclosure is the system-oriented view, which includes legitimacy theory, stakeholder theory and institutional theory. The system-oriented view argues that the motivations behind firms’ voluntary disclosure cannot be fully explained without referring to the social environment in which firms operate. Legitimacy theory, stakeholder theory and institutional theory suggest that firms use voluntary disclosure to legitimate their social status and satisfy powerful stakeholders’ information demands. The review of the voluntary disclosure literature provides the theoretical underpinnings for the study.

Chapter 3 illustrates the political reform, economic reform and social changes that have occurred in China over the past three decades. The shift of political emphasis from political campaigns to economic construction and development by the Chinese
Communist Party (CCP), paved the way for the economic reform and social changes. The economic reforms have called for a more accommodating financial system for state-owned enterprises. Without funds and capital being centrally-administered and allocated to enterprises by the state government, Chinese firms needed to diversify their funding channels. Banks and public investors have become the new providers of financial resources for Chinese enterprises, and the ownership structure of these Chinese enterprises has fundamentally changed from public ownership to full or partial private ownership. The emergence of the Chinese stock market is a response to the call for new fund-raising channels for Chinese enterprises. Creditors and investors, therefore, have become the new stakeholders of listed firms. A revitalized Chinese economy has also led to some changes in social values and norms. A more open and competitive society has enhanced the individualism of the Chinese people; pursuing power and wealth are now commonly accepted by Chinese society. Public investors can now exert pressure on listed firms for transparent information disclosure using legal mechanisms.

Chapter 4 elaborates on the establishment of the regulatory framework of corporate disclosure. Two regulatory agents of the Chinese government, the Ministry of Finance and the China Securities Regulatory Commission have played essential roles in building up the regulatory framework of corporate disclosure. The transformation from state-owned enterprises to listed firms has resulted in a large stake of state ownership now existing among listed firms. State ownership was not tradable between 1990 and 2004. However, the co-existence of tradable and non-tradable shares has created an agency problem among listed firms. The agency problem is in the form of the conflicting interests between majority shareholders, who represent state
ownership, and minor investors who own tradable A or B Shares. Poor corporate governance practices such as “one dominating state-owned share monopolizes” and “insider control” have hampered the sustainable development of the Chinese stock market. To maintain investors’ confidence, the Chinese government has implemented a series of measures to improve corporate governance and protect minority investors’ interests. Chapter 4 provides a chronology of the MOF’s efforts in harmonizing the Chinese accounting standards with internationally accepted accounting standards. The important regulations and enforcement mechanisms of the CSRC in respect of strengthening information disclosure and corporate governance, are also illustrated in this chapter. Collectively, Chapters 3 and 4 identify the important stakeholders of the listed firms in the Chinese stock market.

Chapter 5 justifies the use of legitimacy theory and stakeholder theory to explain the disclosure behavior changes of listed firms in the Chinese context, and assesses stakeholders’ attributes in order to identify the powerful stakeholders of listed Chinese firms. Propositions established are that listed firms in the Chinese stock market: need to legitimate their social status in response to the changed disclosure environment and increased voluntary disclosure as a result of stakeholder salience; ownership structures reflect shareholders’ financial stake in listed firms and influence firms’ disclosure behavior; corporate governance variables reflect the political stakes of regulatory agencies and influence firms’ disclosure behavior; firms’ economic attributes are closely related to creditors’ and shareholders’ financial stakes and are associated with firms’ disclosure behavior; and listed firms use auditing firms with a good reputation to legitimate their social status. Chapter 5 divides the entire testing period, 1995-2006, into three testing phases: Phase I Developing phase (1995-1998);
Phase II Corporate governance régime phase (1999-2002); and Phase III Convergence phase (2003-2006). Hypotheses are then developed for each phase based on the theoretical underpinnings and institutional environment discussed in preceding chapters.

Chapter 6 explains several important aspects of the research design. The justifications for employing a longitudinal approach, examination of annual reports and voluntary disclosure are provided. To satisfy the minimum requirement of a longitudinal study, 297 listed firms that were continuously listed on the Chinese stock market between 1995 and 2006 were selected as the sample. A voluntary disclosure checklist designed for this study is based on the preliminary test, the survey extant voluntary disclosure literature, as well as reference to the voluntary disclosure framework recommended by the FASB in the US. The checklist consists of three information disclosure sections: strategic, financial and non-financial information. Each disclosure item is assigned with a different score, reflecting the importance of some disclosure items to investors’ decision-making. Stability and reproducibility tests were conducted to ensure the validity of the checklist. To determine different factors motivating sample firms’ voluntary disclosure during different testing phases, OLS regression models were run for the three different testing phases.
8.3 Findings of the study and the implications

8.3.1 Findings

The findings of the study are reported and discussed in Chapter 7. Over the three testing phases, listed Chinese firms have gradually increased their voluntary disclosures. This is evidenced by the gradually increasing number of disclosing firms and the increased voluntary disclosure scores attained by the sample firms. Therefore, the findings are consistent with the hypotheses that listed firms positively react to a changed corporate disclosure environment in China by increasing their information disclosure transparency. Three main characteristics of voluntary disclosures are found: a significant increase in voluntary disclosure, selective information disclosure, and a high volume of forward-looking information disclosure. These characteristics reflect the response of listed firms to the power changes of various stakeholder groups in the Chinese stock market over the years under study.

During Phase II (1999-2002), the government regulatory agency of the Chinese stock market, the CSRC, changed its role from administrative approval to stock market supervisor. It initiated a series of reforms to boost the quality of listed firms, protect investors’ interests and rights, and promote the sustained and robust development of the Chinese stock market. Regulations stipulated during this period of time, especially the Code of Corporate Governance for Listed Firms in China and the Notice of Establishing an independent Directors System in Listed Firms, are aimed at enhancing listed firms’ disclosure transparency, corporate governance and the overall quality of reporting. Strong enforcement actions and measures implemented during this period
make the CSRC a definitive stakeholder of listed firms. It exhibits a strong political stake, power, legitimacy and urgency over listed firms’ financial resources. The CSRC’s public condemnation, investigation, suspension, imposed financial penalties and delisting, could severely damage a firm’s reputation and image in the Chinese stock market and, hence, investors’ confidence and perceptions of a firm. Investors are the stakeholder group that has an economic stake in listed firms. They have gradually increased their demands for transparent information disclosure and have realized that they can use legal mechanisms to protect their financial interests. Several high-profile legal proceedings between investors and listed firms occurred during the 1999-2002 period. The investor group has now become a dependent stakeholder of listed firms. Commercialized state-owned banks are another new stakeholder group for listed firms. From being forced to make “Policy Loans” to the Chinese enterprises, to pursuing economic benefits from their investments, these creditors possess the stakeholder attributes which enable them to become definitive stakeholders of listed firms. The professional association, CICPA, has its political stake in listed firms. However, due to weak enforcement of its rules and standards, this stakeholder group is only a discretionary stakeholder. Significantly increased voluntary disclosure in Phase II is the response of listed firms to the changed role of the CSRC and to the increased importance of investors and creditors to firms’ financial resources. A high volume of forward-looking information has been disclosed in response to the CSRC’s call for information transparency. To satisfy the information demands of regulatory agencies and the investment community, listed firms use voluntary disclosure to manage stakeholder relationships and legitimate their social status in the Chinese stock market. However, selective information disclosure is evidenced by the disclosure of more strategic information than the disclosure of financial and non-
In respect of the driving forces of voluntary disclosure, this study finds that state ownership has had a significant negative impact on firms’ disclosure decisions over the years. Legal ownership, however, does not have any significant impact on firms’ disclosure decisions. Foreign investment has been a strong influence on firms’ voluntary disclosure since the establishment of the Chinese stock market. In addition, independent directors and reputable audit firms have played a positive and significant role in improving firms’ information disclosure transparency. Among the economics-based variables, leverage became an influential factor from the late 1990s. The results also show that firms with a high proportion of loans tend to disclose more information. Profitability and growth opportunities, however, present mixed results and their influence on firms’ disclosure decisions are inconclusive. Firm size is found to be positively related to voluntary disclosure; the larger the firm, the higher the level of voluntary disclosure the firm adopts. This finding is consistent with voluntary disclosure literature, which suggests that larger firms are subject to greater public scrutiny. Another finding indicates that firms engaged in the manufacturing industry disclosed more information than firms not engaged in manufacturing.

8.3.2 Implications of research findings

There are three important implications of the research findings of this study. First, this study provides further empirical evidence to support Chinese regulatory bodies’ actions in promoting and implementing a good corporate governance régime among listed firms in the Chinese stock market. The positive association between corporate
governance and the level of voluntary disclosure shows that the implementation of corporate governance structures in Chinese firms is beneficial to investors. Further, the requirements on board composition and roles that should be undertaken by independent directors have improved the information disclosure transparency. This result may help the regulatory bodies of other emerging capital markets to improve their countries’ market transparency by introducing a similar requirement. In addition, the establishment of the independent director system in China involves CSRC training independent directors and enforcing listed firms to have at least one-third of the directors on board independent by a certain date. These measures have effectively exerted the pressure from the regulator to implement a good corporate governance régime, and have made firms realize the importance of the CSRC’s regulations to their firm’s long-term success. They have also sent strong signals to firms that corporate governance is essential to protect minority investors’ interests. Therefore, an implication of this study is that the regulatory bodies of the Chinese stock market should continue to strengthen corporate governance among listed firms by maintaining the enforcement of their regulations.

Second, the negative association between state ownership and voluntary disclosure found in this study provides strong support for the non-tradable state ownership reform which has been implemented by the CSRC since 2005. Due to the lack of a “true owner” under the state ownership structure, state ownership cannot truly represent the state’s financial stake in listed firms. Rather, “one dominating state-owned share monopolizes” and “insider control” agency problems are derived from the non-tradable state ownership in the Chinese stock market. State ownership has become an important factor which hampers the disclosure transparency of listed firms.
The existence of state ownership provides evidence that, in the early stage of China’s transformation from a planned economy to a market-driven economy, the Chinese government was careful with the changes in ownership structure. Fear of losing control over listed firms is the primary purpose of having non-tradable state ownership. It is plausible that to improve the efficiency of the Chinese capital market, the CSRC launched the non-tradable shares reform in 2005. The ultimate goal of the reform was to make all shares tradable in the Chinese stock market. The signal sent by the Chinese government was that the development of the Chinese stock market should follow market principles rather than operate under the shadow of a planned economy.

Third, the significant and positive relationship found between foreign investment and voluntary disclosure in this study provides empirical evidence to support the Chinese government’s Open Door policy, in general, and the opening-up of the Chinese stock market more specifically. As foreign investors from developed countries have more experience and skills in monitoring firms’ performance and demanding more information, they have played a positive role in improving disclosure transparency. By the end of 2006, the CSRC had fulfilled the commitments made for accession to the WTO in opening-up the Chinese stock market. Since 2001, foreign enterprises have been permitted to apply for listing on the Chinese stock market. In 2002, foreign investors were allowed to purchase state shares and legal-person shares. In 2006, foreign investors were allowed to make a strategic investment in the A shares of listed firms which had completed their non-tradable share reform (CSRC, 2009). The opening-up of the Chinese stock market will be beneficial to investors and improve the overall efficiency of the market.
8.4 Limitations of the study

There are two things to be noted when interpreting the results of this study. First, this study does not intend to measure the quality of voluntary disclosure made by listed firms. The focus of the empirical study is to measure the changes to the extent of voluntary disclosure over the years. Second, the empirical investigation of voluntary disclosure in this study is based on the assumption of stock market efficiency. In addition, this study has some limitations in respect of its research design and data collection. This section discusses the imprecision in measuring the dependent variable, the limited scope of voluntary disclosure data collection, and the inability to differentiate entities that do not disclose any extra information voluntarily and entities having no extra information to disclose. It is suggested that the findings of this study should be interpreted with care because of these limitations.

8.4.1 Imprecision in measuring the dependent variable

Imprecision in measuring the dependent variable could be caused by two possible reasons, voluntary disclosure checklist design and manual data collection. This study investigates the disclosure behavior changes of listed firms over the years in the Chinese stock market through examining voluntary disclosure. The data needs to be collected for the dependent variable; however, the total number of voluntary disclosures of the sample firms is not readily available from databases. Although a preliminary test was conducted, and the design of the voluntary disclosure checklist referred to available statutory requirements and extant literature to ensure the comprehensiveness of the checklist, it is not certain that the checklist designed for the study has captured all possible voluntary disclosures that the sample of listed firms
have made. It is also not certain that compiling the checklist is free from some degrees of subjectivity. The data was collected manually from the annual reports, according to the checklist, and a score assigned. Although measures were put into place to ensure the reliability of the data collection, it is not possible to avoid errors in selecting voluntary disclosure items and assigning different scores to each item.

8.4.2 Scope of data collection

The data for the dependent variable is limited to the annual reports of the sample firms in this study because of the availability of the data. Extant disclosure literature suggests that disclosures made in annual reports can be regarded as an appropriate source of a firm’s attitude towards reporting and disclosures (Gray et al., 1995). Annual report disclosure is found to be positively related to corporate disclosure in other media (Lang and Lundholm, 1993; Botosan, 1997). In addition to annual reports, listed firms in the Chinese stock market are also required to provide quarterly reports, interim reports and press releases. There is a possibility that these disclosure channels may contain voluntary disclosures which are not captured by sample firms’ annual reports. In addition, the sample selection is narrowed down to the firms continuously listed from 1995 to 2006. The rationale of such a sample selection method is to satisfy the requirements of a longitudinal research approach, which involves repeated observations of the same samples for multiple time periods. It is believed that the changes in voluntary disclosures made by firms continuously listed from 1995 to 2006 better reflect the trend of listed firms’ disclosure behavior changes during the changing disclosure environment. However, the findings based on the sample firms may not be generalizable to other firms listed on the Chinese stock market during a different period of time, especially since state-ownership reform, as
these firms work in a different disclosure environment from the firms listed in the early stages of the Chinese stock market.

8.4.3 Inability to differentiate non-disclosure firms and non-information firms

In the process of extracting voluntary disclosure examples from the sample firms, it is impossible to differentiate between the firms that have extra information but choose not to disclose it for reasons such as proprietary costs, and the firms that genuinely have no extra information to disclose. Nor is it reasonable to make an assumption that non-disclosure firms in this study are the firms that have extra information but do not want to disclose it to the public. Therefore, there is a possibility that the results of this study are affected by the firms that genuinely do not have any extra information to disclose.

8.5 Implications for future research

8.5.1 Value relevance and economic benefits of voluntary disclosure

This study focuses on voluntary disclosure made by listed firms to the Chinese stock market. It investigates the changes in disclosure behavior of listed firms in response to a changed disclosure environment. The increased level of voluntary disclosure over the years reflects the viewpoint of preparers of annual reports, or the providers of the information, rather than users’ viewpoints. Whether users find the voluntary disclosures made by listed firms are useful for their decision-making has not been investigated by this study. Therefore, it would seem desirable that future studies
address the information usefulness of voluntary disclosure in the Chinese stock market by exploring, first, value relevance of voluntary disclosure and, second, the linkage between voluntary disclosure and economic benefits. Value relevance studies are able to determine users’ reaction to the voluntary disclosures, which could be represented by movements of share prices and trading volumes. The studies examining the linkage between voluntary disclosure and economic benefits are able to find out whether voluntary disclosures could contribute to a reduced cost of capital for listed firms in the Chinese stock market.

8.5.2 Accuracy and predictability of forward-looking information disclosure

One of the findings of this study is that listed firms are in favor of forward-looking information disclosure. Listed firms disclose their earnings forecasts, targeted sales, and projected cash flow, although the information is not compulsorily required in an annual report. Future research could examine whether the forward-looking information voluntarily disclosed by listed firms possesses accuracy and predictability in the Chinese stock market. The accuracy and predictability can be examined by comparing forward-looking information disclosed with firms’ future measures, such as future sales, future operating cash flow, future capital expenditure and future earnings.

8.5.3 Voluntary disclosure post-2007

The testing period covered by this study is 1995 to 2006. For the Chinese stock market, the 2007 financial year was a milestone for two specific reasons. First, the Chinese government initiated non-tradable share reform from April 2005. The
objective of the non-tradable share reform was intended to lift trading restrictions imposed on state ownership and make the shares publicly tradable. By the end of 2007, 1298 listed firms had either initiated or completed the process of non-tradable share reform, accounting for 98% of the total listed firms in the Shanghai and Shenzhen Stock Exchanges. Only 33 listed firms had not completed the reform. Therefore, the non-tradable share reform was mostly completed by the end of 2007. Given the negative association between state ownership and voluntary disclosure, as the findings of this study have shown, future research could examine the voluntary disclosure made by listed firms in post-state ownership periods. The second milestone occurred on 16th February 2006, when the MOF announced a revised *Accounting Standard for Business Enterprises (revised ASBE)*, which is effective from 1 January 2007. The revised *ASBE* consists of the ASBE and 38 specific ASBEs that are substantially in line with international standards. The release of the new ASBE marks the full harmonization of the Chinese accounting standards with IFRS, and the new *ASBE* is expected to provide more decision-useful information (MOF Press Release, February 2006). Given the significance of this event, it is worthwhile for future research to investigate voluntary disclosure made by listed firms, and the factors which are motivating firms to voluntarily disclose information post-2007.

8.5.4 Another possible explanatory variable – managerial ownership

Reviewed in Chapter 2, managerial ownership has been suggested as one of the important factors motivating firms to voluntarily disclose information. However, due to a low proportion of managerial ownership in the sample firms, this study does not include managerial ownership as one of the independent variables in the regression model. With the implementation of non-tradable share reform, the legal foundations
and market environment for providing incentive structures steadily improved among listed firms (CSRC, 2009). In late 2005, the CSRC released *Opinions on Regulations of Stock Incentives by Listed Companies*, enabling listed firms that had completed non-tradable share reform to implement a stock incentive mechanism. In 2006, the CSRC announced the *Administrative Measures on Stock Incentives by Listed Firms (Provisional)*, aiming to promote the establishment and improvement of a sound incentive and supervision mechanism for listed firms. The new regulation prescribed that stock incentives should be mainly in the form of restricted shares and share options. As the proportion of managerial ownership increases gradually, especially during the post state ownership period, future research could explore whether managerial ownership becomes another possible factor motivating listed firms to voluntarily disclose information in the Chinese stock market.

### 8.6 Conclusion

The purpose of this study is to investigate the impact of the changed disclosure environment on the disclosure behavior of listed firms in the Chinese stock market. More specifically, this study investigates the impact of the changed corporate disclosure environment during the past twenty years on the level of voluntary corporate disclosure in the Chinese stock market. It aims to make several contributions to the literature and to business practice. First, this study extends the literature of voluntary disclosure by providing empirical evidence in an emerging capital market. The study investigates voluntary disclosures for a relatively large sample of firms listed on the Chinese stock market and operating across most industries. The use of longer time data (1995-2006) enables shifts in voluntary
disclosure strategies to be identified and to incorporate the time periods during which several important regulations on external reporting were promulgated. It contributes to the understanding of firms’ responses to the changes in the corporate disclosure environment since the beginning of the 1990s. Second, this study applies and operationalizes legitimacy theory and stakeholder theory in the Chinese context. Previously, corporate disclosure in the Chinese stock market has been researched within a contracting research paradigm and firm characteristics. There has not been a study particularly focused on the behavioral changes of Chinese listed firms by the application of legitimacy theory and stakeholder theory. This study, therefore, extends the literature by using a system-oriented theoretical framework to explain corporate disclosure behavior in the Chinese setting. Third, this study provides empirical evidence, for the Chinese regulatory bodies and investors in the Chinese stock market, of the changes in disclosure decisions over the years, along with the dramatic changes in the corporate disclosure environment. It shows the effectiveness of the regulatory framework relating to disclosure and of the introduction of a corporate governance régime in the Chinese stock market.
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