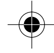

5
Role of Stock Markets and Information Dislosure in the Corporate Governance of Listed Companies

An efficient stock market rewards better corporate governance with lower funding costs. The stock market processes information disclosed by listed companies, but it also creates incentives for acquiring information about firms and, by acting on this information, for disseminating it to other market participants. Efficiently provided information allows company owners to link management incentives with stock prices, which helps align the interests of owners and managers (Levine 1997). Efficient stock markets also create incentives to identify poorly managed companies, facilitate the takeover of such companies, replace their management, and make other changes in the companies' corporate governance. This chapter looks at some of the structural characteristics of Chinese stock markets that affect their capacity to promote good corporate governance, with a focus on information disclosure.

Corporate Governance and Performance

Despite their spectacular development in little more than 10 years, Chinese stock markets are not yet capable of promoting good corporate governance. While rigorous testing of whether market efficiency promotes good governance practices is inherently difficult, some basic tests combined with a rule of thumb approach may provide an indication. For example, using Black's (1986) definition of an efficient market as one in which the stock price is within a factor of two

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of the value, that is, the price is more than half but less than twice the value provides some evidence of inefficiency in Chinese stock markets (table 5.1).[1] Judged by this measure, Chinese stock markets are clearly an outlier among emerging markets: the market to book value ratio is among the highest and does not show any clear trend of convergence toward more normal levels. Regarding corporate governance specifically, the Credit Lyonnais Securities Asia corporate governance watch fails to establish a robust relationship between various indicators of corporate governance and the performance of Chinese companies on the stock market (CLSA 2001).

Because ascertaining the performance of Chinese listed companies with a reasonable degree of confidence is difficult given existing

TABLE 5.1
MARKET TO BOOK VALUE, SELECTED ECONOMIES, 1996–2001

Economy	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Argentina	1.2	1.0	1.0	1.0	1.0	0.9
Brazil	1.6	1.4	1.3	1.4	1.4	1.4
Chile	1.6	1.5	1.5	1.5	1.6	1.5
China	3.7	3.5	3.6	3.7	3.9	3.3
Czech Republic	1.0	1.0	0.8	0.8	0.8	0.8
Egypt	1.8	1.6	1.4	1.5	1.5	1.4
Greece	3.9	3.8	3.0	2.8	2.6	2.3
Hungary	2.6	2.1	2.0	2.1	1.9	1.7
India	2.7	2.7	2.2	2.2	2.2	1.9
Indonesia	1.8	1.8	1.6	1.5	1.7	1.8
Korea	1.0	0.9	0.9	0.9	1.1	1.0
Malaysia	1.6	1.6	1.4	1.3	0.8	0.8
Mexico	1.9	1.8	1.7	1.8	2.1	2.1
Philippines	1.2	1.1	1.0	1.0	1.0	1.0
Poland	2.2	1.9	1.8	1.9	2.0	1.8
Russia	0.6	0.6	0.6	0.7	0.8	0.8
South Africa	2.2	2.2	1.9	2.1	2.3	2.2
Taiwan, China	2.2	2.0	2.1	1.9	1.8	1.7
Thailand	1.6	1.6	1.4	1.4	1.6	1.7
Turkey	3.6	3.0	2.6	4.0	3.9	3.9

SOURCE: Standard & Poor's emerging markets database.

1. Book value is perhaps the most unsophisticated but not necessarily the most unreliable estimate of value.

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accounting and disclosure problems, our basic tests for correlation between governance and performance in our sample of listed companies adopt the following approach. First, we compare the corporate governance patterns in special treatment (ST) and non-ST companies (table 5.2). By definition, ST companies have shown three consecutive years of losses, and their performance is thus unquestionably bad. We look for any corporate governance features common to ST companies. Second, we look at whether the stock market takes these features into account.

TABLE 5.2
OWNERSHIP STRUCTURE AND CORPORATE GOVERNANCE IN SPECIAL TREATMENT AND NON–SPECIAL TREATMENT LISTED COMPANIES, 1999

Category	*ST companies*	*Non-ST companies*
Ownership structure (%)		
Nontradable shares/tradable shares	2.6	2.9
State shares/total shares	27.6	21.2
Legal person shares/total shares	36.7	38.0
Shares held by institutions (tradable)/total shares	0.9	2.4
First three largest shareholders/total shares	46.9	58.1
Shares held by largest shareholder/total shares	38.6	47.3
Performance		
RMB earnings per share	–0.4	0.1
Net assets per share (RMB)	0.8	2.6
Return on net assets (%)	–5.2	5.7
Market capitalization/total assets	0.6	1.5
Market capitalization/net assets	1.9	2.4
Board structure		
Executive directors/board size (%)	63.3	48.5
Directors appointed by largest shareholder/board size (%)	25.5	51.4
Directors appointed by the three largest shareholders (%)	42.2	67.9
Size of board (number)	9.9	9.8
Chairman = general manager (%)	25.0	16.9
Meetings held per year (number)	2.6	2.5

NOTE: Market capitalization = share price × number of tradable shares + net assets per share × nontradable shares.
SOURCE: Survey; authors' calculations.

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As table 5.2 shows, the two categories of companies differ little in terms of ownership structure; however, ST companies have a higher percentage of state shares and a smaller share of tradable shares held by institutional investors than non-ST companies. Also the ownership of ST companies is less concentrated than that of non-ST companies. In terms of board structure, ST companies have more executive directors than non-ST companies, which indicates higher insider control; however, the largest shareholder and the three largest shareholders have fewer seats on the board in ST companies than in non-ST companies, while the chair of the board of directors is also the general manager in more ST companies than non-ST companies.

One way to interpret these results is that control structures dominated by insiders and company management are associated with poorer economic performance, and that in markets with a developing legal framework and enforcement mechanisms, companies with a highly concentrated ownership structure may perform better than those with a less concentrated ownership structure, that is, companies controlled by management. A possible explanation for these relationships is the lack of legal and market mechanisms for exercising control over managers and insiders. A high percentage of executive directors in the context of dysfunctional supervisory boards could lead to too much insider control, and consequently to disappointing performance. A higher proportion of nonexecutive directors appointed by shareholders could provide an effective restraint on insiders.

An alternative explanation of these observations is that they are simply an accounting artifact brought about by the capacity of large shareholders and parent companies to manipulate the books of the companies they control or to enter into related party transactions to provide temporary assistance that disguises bad economic performance. Under this interpretation, ST companies simply lack a shareholder that is big enough or motivated enough to provide assistance in times of difficulty or have an ownership structure that makes it difficult for shareholders to agree to provide such support.

While these explanations are not necessarily mutually exclusive, we can gain further insight by comparing the decisionmaking powers of the boards of directors in ST and non-ST companies. Table 5.3 shows only those areas where significant differences are apparent between the two types of companies. Overall, the boards of directors of non-ST companies are more powerful with respect to key decisions, particularly in the areas of borrowing and forming strategic alliances. This gives some credence to the first hypothesis that management/

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TABLE 5.3
DECISIONMAKING POWER OF BOARDS OF DIRECTORS IN SPECIAL TREATMENT AND NON–SPECIAL TREATMENT LISTED COMPANIES
(percentage of companies)

	ST companies			*Non-ST companies*		
Category	*Substantial power*	*Some power*	*A little power*	*Substantial power*	*Some power*	*A little power*
Financial investments	62.5	0	0	72.2	8.5	2.8
Equity investments	62.5	0	0	72.6	10.5	2.0
Sale of assets	62.5	12.5	0	70.2	10.5	2.4
Borrowing for fixed assets investments	37.5	12.5	0	65.3	14.5	4.8
Borrowing for working capital	25.0	12.5	12.5	52.5	16.9	12.1
Collateral borrowing	37.5	25.0	0	70.2	9.7	3.2
Guarantee for other companies' borrowing	25.0	25.0	0	69.7	10.1	3.6
Decision on amount of donation	37.5	12.5	12.5	65.7	11.3	5.2
Use of donated money	37.5	0	25.0	47.2	14.5	9.6
Tender for major projects	60.0	0	40.0	49.1	13.3	8.8
M&As of other companies	50.0	12.5	12.5	68.6	11.7	0.8
M&As by other companies	37.5	0	25.0	60.5	11.7	2.4
Planning of long-term goals of company	50.0	0	12.5	79.8	8.9	1.2
Strategic planning	50.0	0	12.5	81.1	6.9	1.2
Strategic alliance	25.0	0	25.0	58.5	12.5	8.0
Change of business direction, entry into new industry or market	50.0	0	12.5	72.6	10.9	2.4

SOURCE: Survey; authors' calculations.

insider control is the key factor. We found that higher state shares tend to be associated with more executive directors. To the extent this results in greater insider/management control, it provides a potential link between state ownership and poorer economic performance.

Next we correlated the corporate governance features identified as potentially important with measures of economic and market performance over the entire sample (table 5.4). The results confirm our comparison of ST and non-ST companies: the higher the percentage of executive directors, the worse the company's performance, and the

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TABLE 5.4
CORRELATIONS BETWEEN BOARD CHARACTERISTICS AND SELECTED MEASURES OF COMPANY PERFORMANCE

	Performance		
Board characteristics	*Net profit per share*	*Net profits/ net assets*	*Market value/ book value*
Number of board members	Not statistically significant	Not statistically significant	Not statistically significant
Executive directors/ overall directors	*Negative, statistically significant*	Not statistically significant	Not statistically significant
Directors appointed by the largest three shareholders/overall directors	*Positive, statistically significant*	*Positive, statistically significant*	Not statistically significant
Directors appointed by the largest shareholder/overall directors	*Positive, statistically significant*	*Positive, statistically significant*	Not statistically significant

SOURCE: Authors' calculations.

higher the percentage of directors appointed by key shareholders, the better the company's performance. However, the lack of a statistically significant correlation between these corporate governance features and the market's evaluation of company performance as shown by the market to book value suggests that the market does not reflect these aspects of corporate governance.

Stock Market Role in Promoting Good Governance

Chinese companies possibly still view listing as a privilege and as a fund-raising mechanism for ailing SOEs. Market participants generally believe that the quality of listed companies is poor[2] but that investors are protected, either because the government is likely to provide

2. For example, in a recent interview (*Institutional Investor*, May 1, 2001) an investment banker mentions that he finds that only 15 of the 114 B share companies that he had visited were of good quality. The manager of China Heartland Fund believes that of the more than 1,000 stocks available on the A share market, only about 10 percent are investable based on Western standards.

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direct support or the company will find a "white knight" interested in backdoor listing (the purchase of a significant portion of shares in a listed company by a nonlisted company so as to gain indirect access to the public equity market). Given the perception of poor firm quality and implicit investor insurance, market participants have little incentive to pay attention to fundamentals, including corporate governance.

Supply Side. The government is introducing measures that are likely to change this situation. It has eliminated the quota system for IPOs, and share issuance and future decisions about which companies will access the market and when and where they will do so will be based on market principles. The CSRC's guidelines for assessing IPOs require committee members to pay special attention to corporate governance issues, such as whether the company's shareholders' meetings, board of directors, and board of supervisors have been discharging their duties and exercising their rights independently according to the law; whether the company's management structure is complete; whether the company is engaged in frequent related party transactions; whether its assets, personnel, governing organs, and financing are separated from its parent company; and whether a competitive relationship exists between the company and some of its shareholders. Requirements related to corporate governance aspects also explicitly enter the decisionmaking process in the case of secondary offerings.

However, lifting the quota system may be insufficient to ensure a supply of high-quality companies. Attracting high-quality companies is likely to remain difficult given the immature nature of the stock markets. While companies may be able to enjoy better valuations in China than elsewhere, in the absence of a significant institutional investor base, the amount of money that can be raised in the A and B share markets is limited.[3] In addition, the high volatility of the A market makes executing a substantial fund-raising exercise difficult. As a result, larger and better companies prefer to list overseas.

Recent regulations that make it easier for private and foreign-invested enterprises to list domestically are likely to improve over time the overall quality of listed companies. Allowing companies to issue

3. According to a representative of China Eastern airlines, which issued 300 million shares in Shanghai in 2000, the money raised was not enough to buy a single aircraft.

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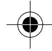

Chinese depository receipts and permitting dual and multiple listings are alternative ways to introduce better quality companies to Chinese stock exchanges. The hope is that listing companies such as Unicom and Mobil would establish benchmarks for disclosure, performance, and corporate governance. However, until the idea of Chinese depository receipts becomes practical, some important issues related to the convertibility of the renminbi, the disclosure regime for issuers of Chinese depository receipts, the promulgation of special regulations, and so on need to be resolved.

To ensure that listed companies are of good quality, market exit is as important as market entry. The new rules for delisting and the first delisting of PT Narcissus show that an exit mechanism has been set up. The new regulations give the power to delist to the CSRC as opposed to the stock exchanges as is the normal practice and stress profitability as the main reason for delisting. International exchanges have a broader list of factors that may include, for example, failure to observe good accounting practices and the creation and perpetuation of conflicts of interest. In an important move the new regulations mandate detailed disclosure of the company's financial status over the years and the reasons for the financial difficulties that led to the delisting, including related party transactions. They also give shareholders the right to request such disclosure without, however, specifying the procedures for exerting such rights.

Despite the breakthrough, delisting is likely to remain a difficult issue, given that local governments are significant owners of listed companies and are likely to resist the delisting of companies under their jurisdiction. In addition to delisting, bankruptcy and privatization will be the next tests for whether listed companies have ceased to be "sacred cows." So far, even though thousands of companies have gone bankrupt, not a single listed company has gone bankrupt or been privatized. Local governments are prepared to grant tax rebates, offer fiscal subsidies, and buy obsolete inventory from listed companies to prevent their bankruptcy. Delisting is a difficult but significant step, because ST and particular transfer methods rarely result in a successful restructuring. Buyers often buy stocks of failing companies expecting a government bailout, a safety net not found in most other markets. Consequently, ST and particular transfer stocks often outperform the market, which makes the use of stock market performance as part of managers' incentive mechanisms impractical.

In addition to the quality of listed companies, the market liquidity of shares is important for market efficiency. In a larger and more

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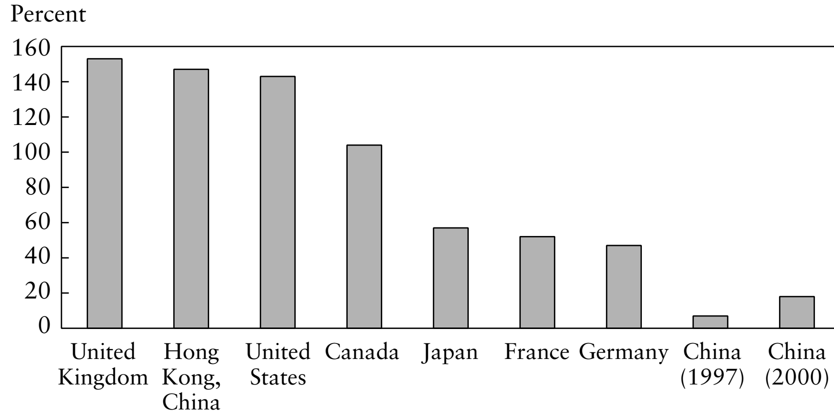
FIGURE 5.1
TOTAL FREE FLOAT/GDP RATIOS, SELECTED ECONOMIES



SOURCE: CSRC; IFC emerging markets database.

liquid market, market participants may have greater incentives to acquire information about firms, as it becomes easier for agents who have acquired such information to disguise their information and make money. Liquidity is a function of free float and market turnover. Chinese markets are characterized by a low free float and excessive turnover (volatility). Despite the rapid growth of China's stock markets, the total free float market capitalization/GDP ratio still lags significantly behind that in some industrial countries (figure 5.1). A low free float tends to increase volatility and therefore to reduce the information content of stock prices. Healthy development of the market requires increasing the amount of tradable shares.

Demand Side. Institutional investors have a small market presence and cannot as yet play a stabilizing role. By February 2001 China had 33 investment funds, which should increase the market's sophistication. The government has allowed closed-end funds to enter the market. Regulations for open-end funds have been released, and the first open-end funds were allowed in September 2001. Insurance companies still have a limited presence on the stock market—less than 9 percent of their investments are in stocks—but the growth potential is huge. They have been allowed and encouraged to invest in the stock

market.[4] Furthermore, the government has begun to explore the links between social security reform and the development of the stock market.

The CSRC's April 2000 regulations on secondary offerings require public offerings of new shares to reserve a certain percentage of shares for institutional investors. This stipulation seeks to encourage institutional investors to become long-term strategic investors. Furthermore, the government is considering plans to introduce a qualified foreign institutional investor scheme similar to that in Taiwan (China). Funds and other institutional investors are likely to be tightly regulated, which is appropriate given the immature nature of the market and the lessons learned from the experience of other transition economies (Johnson and Shleifer 1999).

The lack of a strong institutional investor base is related to the lack of professional stock market analysts. The largest brokerage houses have hired many analysts, but their interactions with listed companies and market coverage are often superficial. Analysts and fund managers do not scrutinize companies sufficiently. This is hardly surprising, given that until recently the prices of new issues were artificially fixed at low levels compared with the price-earnings ratios prevailing in the secondary market. These pricing policies made the underwriting of new shares a risk-free activity. Consequently, underwriters have had little need or incentive to analyze companies and the market. The CSRC's new regulations on share issuance are likely to change that.[5] These regulations introduce market-oriented pricing and impose greater liabilities on listed companies and lead underwriters regarding disclosure and earnings forecasts. The six-month holding period for strategic investors will expose institutional investors to greater risks and would make thorough due diligence worth their while. For securities companies, consignment sales will also create incentives for more rigorous analysis of companies and the market.

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4. As of February 2001, 6 insurance companies have been allowed to invest up to 15 percent of their assets in stocks, 2 companies have been allowed up to 12 percent, 11 companies up to 10 percent, and 3 companies up to 5 percent (UBS Warburg 2001).

5. Circular on Further Improving Methods of Issuing Shares (1999) and Public Share Offerings by Listed Companies Tentative Procedures (2000).

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Compers and Metrick (1998) found that institutional investors prefer stocks that are, on average, larger and more liquid, and possess value characteristics. Thus a shift from individual to institutional investors will increase demand and, other things being equal, will increase prices for large, liquid stocks. This would tend to lower the cost of capital for such companies and encourage them to list or issue shares on the exchange. Preliminary data on the behavior of existing Chinese funds indicate similar behavior, which in the current market results in high concentration in funds' portfolios. According to the data (UBS Warburg 2001), Chinese fund investments favor the electronics and telecommunications equipment sectors. On average, funds' 10 largest holdings account for 64 percent of their total portfolios.

Market for Corporate Control. The existing ownership structure of Chinese listed companies makes successful hostile takeovers unlikely. However, hundreds of M&As take place each year that involve the transfer of nontradable A shares through private agreements. As noted earlier, the largest shareholder has changed since the IPO in 28 percent of the surveyed companies. Table 5.5 shows the mode of change of the largest shareholder.

In these private transactions, shares trade at a fraction of the price of liquid shares. Thus if a buyer were able to find a controlling shareholder willing to part with unlisted shares, the price of acquiring control would likely be low compared with a market takeover. The different

TABLE 5.5
MODE OF CHANGE OF LARGEST SHAREHOLDER

Mode	*Number of companies*	*Percentage of companies*
Transfer of state shares by agreement	24	46
Transfer of legal person shares by agreement	15	28
Transfer gratis	10	19
Change of administrative department of state shares	2	4
Transferred right issues	1	2
Total	52	100

SOURCE: Survey.

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markets for different classes of shares and the resulting price differential has led to the perverse outcome of nonlisted companies buying listed companies, when valuations of A share companies would provide a strong economic rationale for acquisitions to occur in the opposite direction.[6]

The reasons for M&As vary. In addition to the traditional motivation, Chinese companies may need to sell assets to meet profit targets specified by the government or to generate exceptional gains to meet the 10 percent return on equity required to issue new shares. Increasingly, M&As are related to forced asset foreclosure when debtors become unable to honor their commitments. In many cases, large equity stakes, and even majority control, are auctioned off when stakeholders default on bank loans and other debts. While some of these changes are likely to be beneficial for the company in the long run, they do not necessarily align with managerial incentives. In our sample, in 86 percent of cases a change in the controlling shareholder resulted in replacement of the chair of the board of directors and 46 percent of the time in replacement of the general manager. Thus when the controlling shareholder is in financial difficulties, senior managers are likely to feel threatened, and therefore have incentives to take action to avoid a change of majority shareholder.

Another question is whether existing corporate governance structures encourage enough M&As, because the number that take place is insignificant compared with China's restructuring needs. For example, the level of industry concentration is low compared with other economies of a similar size, such as the United States. According to official statistics, of 46 industries only 8 had a concentration level greater than 40 percent based on sales, while most had a concentration level of less than 20 percent (HSBC 2001). Small, uneconomical plants, most of which would be unable to survive without implicit or explicit government subsidies, dominate most industries, with capacity utilization running at about 60 percent in manufacturing. This low indus-

6. A number of A share companies have been acquiring nonlisted companies. Tsingtao Brewery acquired 2 factories in 1997, 5 in 1998, and 15 in 1999, all near bankruptcy. Shanghai Jinling, a company that produces and distributes electronics and communications products, has adopted the growth strategy of acquiring troubled SOEs in the sector and revitalizing them with improved incentive schemes for management. Some listed mining companies, for example, Yanzhou Coal Mining, have also acquired or are planning to acquire existing mines.

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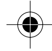

try concentration accounts for the presence of excessive competition: there is excess supply for more than 90 percent of production inputs and consumer products. This industrial structure means that China is not ready to open its markets to foreign competition. Consolidation on a national scale is needed, and M&As are a more effective mechanism to achieve this than, for instance, bankruptcies and foreclosures.

Voluntary M&As could be easier to accomplish in sectors such as petrochemicals and aviation, where a common ultimate shareholder base exists at the national level. However, achieving significant M&A activities in sectors such as power, toll roads, and automobiles, where ownership by local governments is significant, would be difficult, and this is the case for most sectors represented on the stock exchanges. Local governments are likely to oppose M&As, especially if they would result in rationalization of capacity, layoffs in their localities, and tax revenue losses. Thus significant local government ownership is likely to be the major impediment toward establishing truly national market players in China. China cannot integrate itself into the world economy successfully without an integrated national market and national economic players.

Several other factors also limit M&As. Chinese M&As do not typically involve investment banks and are carried out using cash. This is partly because of the lengthy and complicated process of obtaining approvals for issuing new financial instruments, and partly because of the immature nature of the market. Furthermore, foreign and private participation in M&As is still subject to hurdles, and the government's discretionary approach toward M&A applications is a problem. Often which agency must authorize an M&A transaction is unclear, and the responsibilities of different agencies often overlap and change.

The strongest incentive for M&As seems to be to gain access to the stock market. As a result, they are not based on any economic rationale, do little to strengthen the fundamentals of acquired companies, and tend to perpetuate incentives for abuse of majority shareholding positions.

Information Disclosure as a Tool of Corporate Governance

This section examines the demand for disclosure, the incentives for listed companies to supply reliable information, and the role of regulations and of intermediaries such as external auditors.

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Demand for Information Disclosure. Given the stage of development of Chinese capital markets, mature users of financial information, such as institutional investors and analysts, are in short supply.[7] As a result, the market is not yet ready to exercise a supervisory function in relation to auditing and accounting professionals and listed enterprises' disclosure practices. Financial reporting, accounting practices, and disclosure are currently oriented primarily toward satisfying the information needs of taxation authorities and not of investors. Separate reporting for tax and accounting purposes does not exist.

Tax laws and regulations directly affect accounting practices. For example, many enterprises do not accrue bad debt provision, as obtaining approval from the tax authorities to do so is difficult. In the case of discrepancies, tax laws and regulations typically prevail over accounting standards, and in many instances this results in an overstatement of revenue. Such practices have important implications. Because tax regulations drive accounting methods and are designed to prevent taxpayers from minimizing their tax liabilities, some prudent accounting practices that defer income or increase allowable deductions are disallowed. Thus to some extent, the rigidity of accounting norms and regulations derives from the fact that the government, particularly the tax authorities, are the main users of financial information. This explains the apparent paradox that despite a rigid accounting system, enterprises have strong incentives to use loopholes in the system to meet profit targets.

Incentive to Supply Information. China's financial markets do not yet reward better and more transparent companies with lower-cost funds. Until recently, criteria for market access were relatively independent of the quality of companies, which were allowed to list without a meaningful track record. Numerous cases have revealed that the net assets of packaged companies were significantly overstated, which led to losses for minority shareholders.

Subsequent to listing, the interdependence between listed and parent companies creates strong incentives to distort information,

7. The existence of sophisticated users of financial information is directly linked with the integration of Chinese capital markets with the global economy. Analysts do take note of Chinese companies listed on the B share market or on international exchanges.

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particularly information about related-party transactions, which are frequently used to adjust operating results and financial positions. The Shanghai Stock Exchange recently reviewed 2,000 annual reports by listed companies. The results revealed a number of disclosure problems, including the following:

- The disclosure of related party transactions did not fully accord with relevant accounting standards. The pricing policy, the reasons why a related party was using company funds, and the agreements pertaining to assets provided to or occupied by the related party were not fully disclosed, and certain significant financing activities in connection with related parties were not disclosed on time.
- Some listed companies did not fully disclose how they used funds raised from the public. They also did not provide enough explanation about any significant differences between anticipated profits and actual net income.
- The quality of audits by certified public accountants (CPAs) differed, which affected both the reliability of audited accounts and the ease with which they could be compared.

Xiao (1999) found that the overall level of compliance with reporting requirements among listed companies was high, which is to be expected given the mandatory nature of these requirements. Listed companies often provide additional voluntary disclosure of such matters as annual general meetings, performance of subsidiaries, contingent liabilities, and projected earnings. The likely reasons for such voluntary disclosures include (a) old habits from the days of a planned economy; (b) lack of awareness of potential liability, litigation, and confidentiality problems; (c) desire to impress or please investors and regulators; and (d) imitation of foreign practices. In addition to the shortcomings identified by the Shanghai Stock Exchange, Xiao found inadequate disclosure of line segment information, accounting policies, impact of extraordinary items, and effects of changes in government policies. Other common problems relate to the reporting of important investments, capital commitments, consolidated statements, fair value, and contingencies.

The confusion arising from the existence of multiple bases for preparing and auditing financial statements also affects the quality of information. Some companies follow IAS, other use U.S. generally accepted accounting principles, and still others follow domestic standards. Further confusion exists in companies following domestic

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standards, because they may use China's ASBE or industry-specific rules. Often the holding company follows ASBE while subsidiaries use industry-specific accounting systems. Similar problems exist with respect to auditing standards. As a result, comparing information about different firms is difficult.

A number of reasons account for the deficiencies in reporting, including internal auditors' lack of independence in performing their functions. The revised Accounting Law makes some progress toward increasing independence by clearly stating that company management is responsible for accounting information and should assure the truth and completeness of financial reporting. The law also requires that enterprises establish and strengthen internal accounting supervision. However, the procedural underpinning of these provisions is still lacking, and many listed companies have not set up an independent internal audit function to monitor their operating activities because they are not legally required to do so. Thus if carried out at all, internal audits normally concentrate on compliance with laws and regulations and detection of any cheating, and not on a review of business performance.

In addition to inadequate disclosure, selective disclosure is an important problem given the underdeveloped and speculative nature of Chinese capital markets. In the securities market, for example, selectively disclosed information has often resulted in significant changes in share prices or higher than usual trading volumes, to the disadvantage of small and medium shareholders. Companies listed on the A share market are not expected to distribute their financial reports to shareholders.

Intermediaries. Improvements in the quality of accounting and auditing services have lagged behind the recent rapid growth of professional accounting firms. Despite the dramatic development of accounting education, China still lacks a sufficient number of well-educated accounting professionals, and most internal auditors perform their duties without sufficient training.[8] More experienced accountants usually train new staff using on-the-job training. Com-

8. Accounting as a major was reintroduced in universities in 1978. In 1996 more than 120,000 students studied accountancy. In addition, the International Internal Audit Committee has developed a national examination program to improve the quality of internal auditors.

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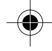

pared with international accounting firms, the overall audit quality of local firms, especially smaller firms, is questionable. Some local medium or large enterprises can only produce an audit report after two or three days of fieldwork by two or three audit staff. Most local accounting firms have no proper procedures for performing risk assessments when accepting clients. They seldom perform internal control assessments as part of the audit to understand the control environment and identify potential risks. Auditors do not apply a systematic and standardized audit approach even within their firms. Quality control policies and procedures to ensure that all audit work fulfills the requirements of independent auditing standards are often lacking. While competition in the industry is intense—for example, in 1999 about 100 large accounting firms competed to provide services for some 1,000 listed companies—this does not seem to exert enough selection pressure to improve overall standards. To increase their market share, many firms compete on price, which leads to a vicious circle of poor audit quality.

Traditionally, auditor-company relationships have been difficult in China. As is the case in many other countries, real and perceived independence is a fundamental problem that both internal and external auditors face, an issue addressed in relevant laws and regulations. Article 5 of the Chinese General Standard on Professional Ethics requires auditors to remain independent. Accountant firms and CPAs cannot undertake audits or other attestation functions if they have vested interests in the clients' performance and face a number of restrictions during the course of their work. However, no limitations are placed on the provision of nonaudit services, such as bookkeeping, preparing financial statements, or consulting on taxation and management issues, nor is any restriction placed on the percentage of a CPA's total income derived from one client. To enhance auditors' independence, some countries prohibit auditors from providing certain services. For example, in Japan and the Netherlands an accounting firm cannot perform tax and consulting services for the same clients for which it also serves as an auditor; in Switzerland fees from a single client cannot exceed 10 percent of the firm's total income; and in Mexico auditors are economically associated with corporations if they are the source of more than 40 percent of the auditors' income in one year (Lin and Chan 2000).

In China, in addition to independence in relation to clients, the issue of independence takes the dimension of independence from the

government. An important positive step in this regard was the 1998 delinking procedure, as a result of which external auditors have severed their links with their sponsors or government authorities in the areas of personnel, finance, and business strategies. However, genuine independence will also require a change in ownership, and is not likely to be achieved without the development of a truly independent, self-regulating accounting body.

Currently, the Chinese Institute of Certified Public Accountants is still in its infancy, and its basic role is likely to be monitoring and supervising rather than providing services to CPA firms. To enhance their legal binding power, all standards developed by the institute are promulgated by the Ministry of Finance. However, as Chinese independent auditing and professional standards are only considered accounting profession standards and the Chinese Institute of Certified Public Accountants is not a government entity, other government entities have not accepted these standards. In lawsuits involving accounting firms and CPAs, Chinese independent auditing and professional standards are not regarded as legal evidence or commonly acceptable practices from the legal perspective and are therefore inadmissible, while accountants and auditors are generally not invited to participate. Such practices further diminish the responsibilities, and consequently the independence, of accountants and auditors.

Even though one of the large international accounting firms set up a representative office in China in 1981, the Chinese accounting industry has not yet fully opened up to the big international accounting firms. The government has adopted an incremental approach to opening up the market for accounting services, encouraging cooperation between international and domestic firms instead of competition. While the "big five" are gradually becoming part of China's accounting community, their impact has been relatively insignificant. This has retarded the introduction of best international practices, but has allowed the evolutionary development of an indigenous accounting industry.

As part of its WTO negotiations with the United States and the European Union, China made some important concessions in the areas of accounting and management consulting. For example, foreign accounting firms will be permitted to affiliate with Chinese firms. These firms must be represented by CPAs licensed by Chinese authorities. CPA licenses will be issued on a national treatment basis. Accountants will be allowed to provide taxation and management consultancy ser-

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vices under the same conditions as accounting services, and will no longer be required to partner with domestic players. The Chinese decree that imposes burdensome requirements that might affect the confidentiality of market research reports will be substantially amended. Reports will no longer be examined by Chinese authorities before being given to the client, and firms will merely have to send copies of questionnaires (not copies of the replies and results) to the authorities.

Regulations and Standards. The ASBE consist of a general standard and a series of specific standards. Since 1993 the Ministry of Finance has promulgated 14 ASBE. Chinese standards are generally consistent with respective IAS but have adapted them to local conditions. The sequencing of their introduction and the differences with IAS also reflect the regulator's priorities. Appropriately, the Chinese standard specifies the disclosure of more details in connection with related enterprises, including their principal business and ownership proportion, while the IAS only require disclosure of the relationships. However, the IAS define related parties more broadly as based on "significant influence" from any principal individual investors, key management personnel, or the close family members of such individuals, whereas the Chinese standard focuses more on control.

On a related issue, the ASBE require revenue to be measured at the price specified in the agreement between the transacting parties, whereas the IAS specify that revenue should be measured at the fair value of the consideration received or receivable. In this sense the IAS are more reasonable than the ASBE, because adjusting profits by intentionally choosing an improper transaction price can be effectively minimized under the IAS. However, the new comprehensive Accounting Regulations for Business Enterprises, adopted by the Ministry of Finance in January 2001, require an explanation about the fairness of any related party transaction in which the transaction price is higher or lower than the normal transaction price.

Chinese standards are generally more restrictive and leave less room for the exercise of professional judgment, partly because of the lack of qualified accounting professionals. This seems to be motivated by the regulator's desire to reduce flexibility during the current formative period of the Chinese accounting profession. One example is the treatment of revaluation. Chinese standards adopt historical cost accounting as the main accounting convention. Revaluation is generally prohibited except in rare cases in which approval by the relevant

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authorities is required. IAS, by contrast, permit revaluation, notably for fixed assets, and regularly evaluate fixed assets for any impairment. Revaluation would make financial information more reliable and relevant. Room for abuse could be limited by specifying the circumstances under which revaluation would be appropriate.

Thus while Chinese accounting standards and regulations are generally in line with IAS, an enterprise's financial statements could differ significantly from those it would produce under IAS (see box 5.1), and many individual IAS have no ASBE equivalents. However, the need for IAS is becoming more urgent with the rapid development of Chinese capital markets, the increasingly important role of M&As, and WTO membership.

The disclosure required by the CSRC includes requirements for annual reports, interim reports, and quarterly reports, as well as information about significant events, such as restructuring, acquisition, or sale of significant assets. Special disclosure guidance is provided to govern information disclosure for companies in specific industries, for instance, banking or real estate.

BOX 5.1
China Minsheng Bank: An Example of the Application of Different Standards

The China Minsheng Bank issued public shares and listed on the Shanghai Stock Exchange at the end of 2000. In early 2001 it disclosed its annual financial report prepared both under Chinese statutory requirements and IAS. The following significant differences were apparent:

	RMB	
Category	*Chinese requirements*	*IAS*
Bad debt provisions	470	1,400
Net profit	429	151
Retained earnings	365	–321

The bank explained these differences by noting that figures provided under Chinese statutory requirements conformed to relevant rules and requirements, while under IAS professional judgment was used.

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Disclosure in annual reports is governed by detailed requirements that focus on short-term rather than long-term objectives and strategies, do not sufficiently emphasize business opportunities and risks, are lenient on segment reporting and corporate governance, and discourage the use of projections. The regulations do not require the distribution of annual reports to shareholders.

Given the focus of disclosure requirements, the CSRC's regulations often introduce new concepts and accounting treatments without providing definitions and detailed explanations or guidelines. In issuing such disclosure requirements, the CSRC primarily takes into account the regulatory needs of the stock market and may not coordinate closely enough with accounting standards and regulation-setting bodies. The lack of such cooperation often results in inconsistent information disclosure practices, which reduces the comparability and the ease of interpretation of the financial statements of listed companies.

Furthermore, significant accounting distinctions based on type of industry or form of business enterprise persist, for instance, SOEs or foreign-invested enterprises. Thus during the current transition period, for investors to compare performance across different industries and types of enterprises is difficult.

While the regulatory regime is still problematic, the government is continually working to improve the situation. In recent years, regulators' investigative powers and expertise have been strengthened, as has their authority to enforce penalties. Important examples are the requirement for supplying the CSRC with an internal control assessment report at the time of new share issues and the requirement for stricter and more detailed disclosures in relation to restructuring, related party transactions, and M&As. To ensure the fairness and reliability of audited statements, the Ministry of Finance and the CSRC require all listed financial institutions appointing international accounting firms to carry out audits under IAS. Moreover, the focus has shifted noticeably from uncovering wrongdoing to preventing it. While in most fraud cases the penalties are small, in some high-profile cases the regulators have imposed weighty penalties, including prison sentences for senior officials.[9] Perhaps the main benefit of the regulatory emphasis

9. As recently as October 2000, two minister-level officials were removed from their posts for their involvement in two separate IPOs where significant wrongdoing, including actions related to disclosure, were uncovered.

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on mandated disclosure during this period of the development of a corporate governance framework in China derives from the principle that the very act of observing or recording an event changes the nature of the event being observed or recorded. This could in itself have a positive impact on corporate governance by raising awareness and increasing the costs of bad corporate governance.

Conclusion

This chapter has identified some of the structural characteristics of the Chinese stock market that prevent the market from playing its role in promoting good corporate governance practices. The market is still incapable of identifying and rewarding good corporate governance practices, the supply of good quality companies is still limited, and the lack of tradability of most stocks has resulted in a volatile market populated largely by individual investors looking for short-term speculative gains.

Chinese capital markets lack mature users of financial information, such as institutional investors and analysts. As a result, the market is not yet ready to exercise a supervisory function in relation to auditing and accounting professionals and listed enterprises' disclosure practices. Financial reporting and disclosure requirements and accounting practices are primarily oriented toward satisfying the information needs of the taxation authorities rather than those of investors.

The confusion arising from the existence of multiple bases for preparing and auditing financial statements also affects the quality of information. In addition to inadequate disclosure, selective disclosure is an important problem given the underdeveloped and speculative nature of Chinese capital markets. Audit quality suffers from such factors as narrow minimum requirements about the coverage of audits, unclear liability of auditors, challenges to the independence of many auditors from the state as owner of audited enterprises, and a general shortage of skilled auditors at the local level. While Chinese standards are generally consistent with respective IAS, a significant gap between IAS and ASBE is still apparent.

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