International Review of Financial Analysis 36 (2014) 106–119

Contents lists available at ScienceDirect

International Review of Financial Analysis

Corporate governance and the information environment: Evidence from Chinese stock markets

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ARTICLE INFO

Available online 4 April 2014

JEL classification:
G14
G30
M41

Keywords:
Corporate governance
Information environment
Chinese stock markets

ABSTRACT

This article explores the relationship between corporate governance and the information environment in Chinese stock markets. We construct a parsimonious governance measure for public firms using a 2003 through 2011 sample period. We use four indicators to proxy for the information environment: analyst following, analyst forecast accuracy, analyst forecast dispersion, and price timeliness. We find that better governed firms tend to be associated with larger analyst followings and more informative forecasts. We also find that better governed firms tend to improve on the timeliness of bad news relative to good news.

1. Introduction

The Chinese economy has grown dramatically over the last few decades, primarily because of substantial economic reforms. It is now the second largest economy in the world by GDP; growth rates over the last thirty years have averaged 10%.[3] This growth spurt, along with the East Asian financial crisis, has led to increased interest in corporate governance in China by academics and practitioners. Corporate governance (*CG*) is generally defined as a set of mechanisms by which outside investors can protect themselves against expropriation by insiders (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). It also describes the structure of stakeholders' rights and responsibilities (Aguilera & Jackson, 2003).

Despite the numerous reforms made by the Chinese government (Cheung, Jiang, Limpaphayom, & Lu, 2008), however, the prevalence of corporate governance in China remains contested. For example, China continues to suffer from widespread corruption. In 2013, China ranked 80th out of 178 countries on Transparency International's Corruption Perceptions Index. This is on a comparable level with Serbia and Trinidad and Tobago, and a more corrupt level than Sri Lanka and most developed countries.[4] Moreover, collusion between individual businesspeople and agents of the state permeates Chinese culture, which further inhibits the cultivation of good governance practices. The secret agreements made between these two groups typically aim to avoid governance provisions and ultimately negate their intended effects.

Since the 2000s, however, significant progress has been made by the government to transform the corporate culture, in line with lofty ideals such as building a "Harmonious Socialist Society." The Code of Corporate Governance was released in 2001, followed by several governance reforms such as the non-tradable shares reform in 2005. Ultimately, it remains unclear how much good corporate governance matters to corporate operations and capital markets in China, though. This paper attempts to shed light on this issue by highlighting the relationship between corporate governance and the information environment of Chinese firms. The latter is a critical component of information transparency and pricing efficiency.

The Shanghai and Shenzhen stock markets opened in 1990 and 1991, respectively, and greatly increased investments from domestic and foreign market participants (Sami, Wang, & Zhou, 2011). The increased globalization has played an important role in forcing Chinese firms to adopt international practices and oversight mechanisms, including corporate governance rules, in order to increase trade and ties with other countries. However, the Chinese market has some unique features that challenge the implementation and effectiveness of corporate governance measures.

First, the existence of state control leads to a specific type of agency problem, whereby the state retains the power to expropriate minority shareholders (Bai, Liu, Lu, Song, & Zhang, 2004; Clarke, 2003; Shleifer & Vishny, 1997). Second, China uses a two-tiered board structure consisting of a main board of directors and a board of supervisors. However, ownership and control are not fully separate, which can potentially lead to governance problems.

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[3] Source: http://www.imf.org/external/pubs/ft/weo/2013/01/weodata.
[4] Source: http://cpi.transparency.org/cpi2013/results/.

http://dx.doi.org/10.1016/j.irfa.2014.03.010
1057-5219/

Finally, prior to 2005, listed firm shares were divided into non-tradable and tradable shares. Non-tradable shares were generally state shares and legal entity shares, while tradable shares were held by individuals, institutions, and private businesses. Consequently, shares held by the main shareholders could only be transferred through negotiation and auctions. Thus, there was often a conflict of interest for the majority shareholders over their motivation to improve company performance (Chen, Jin, & Yuan, 2011). This split share structure increased agency problems between majority and minority shareholders (Claessens & Fan, 2002; Jian & Wong, 2010; Jiang, Lee, & Yue, 2010). Such features are a prime example of the strong need for good corporate governance mechanisms.

To investigate the relationship between a firm's corporate governance level and its information environment, we construct an aggregate firm-level corporate governance index. We proxy for the information environment by using the number of analysts following a particular firm, their forecast accuracy, forecast dispersion, and the timeliness of price discovery. Our sample consists of listed firms in China from the 2003 through 2011 period. Our results indicate that better governed firms are associated with larger analyst followings and more informative forecasts. In addition, we find that better governed firms tend to improve the timeliness of bad news relative to good news. Results are robust for an instrumental variable analysis, confirming a causal relationship between the quality of corporate governance and the informativeness of a firm.

The remainder of this paper is organized as follows. Section 2 discusses the research background and develops our hypotheses. Section 3 describes the data and methods, while Section 4 presents our empirical results. Section 5 concludes.

2. Research background and hypothesis development

2.1. Research background

La Porta et al. (2000) find that firms in emerging economies may be discounted in financial markets because of perceptions of weak governance. A survey by McKinsey and Company (2002) reveals that investors are willing to pay a 25% average premium for shares in well-governed firms. This dramatically highlights the importance of good governance to Chinese firms in increasing investor confidence and access to capital (Buchanan, Le, & Rishi, 2012; Ding & Sun, 1997; Rajagopalan & Zhang, 2008).

In recent years, the Chinese government has launched programs and reforms driven by globalization and privatization that have been declared transformational to the landscape of corporate governance. However, as we mentioned earlier, the Chinese economy possesses three unique characteristics that challenge the effectiveness of corporate governance.

First, the Chinese market contains an unusually high proportion of state-owned enterprises (SOE) (Chen, Firth, & Xu, 2009). Privatization, or more diversified ownership structures, can lead to two agency conflicts and consequently to a greater need for better governance: 1) the traditional principal agency problem, whereby management's interests are not aligned with shareholders' interests, and 2) the principal–principal agency problem, whereby majority shareholders expropriate minority shareholders' interests (Dharwadkar, George, & Brandes, 2000; Liu, Uchida, & Yang, 2012; Naceur, Ghazouani, & Omran, 2007; Shleifer & Vishny, 1997).[5]

Second, the customary two-tiered board structure in China, which consists of a main board of directors and a board of supervisors, can be problematic for the goals of good corporate governance. Chinese law states that the board of supervisors should be independent of the board of directors in order to better monitor managerial behavior and decision-making. However, in practice, the board of supervisors is rather limited in their latitude of action, because supervisors have no voting rights. Also, the board of supervisors is ultimately subject to oversight by the board of directors because the supervisory board members are firm employees.

In addition, the government plays an outsize role in the appointment of board and supervisory board members. One major concern is that board members' lack of independence means they actually contribute little to the monitoring of management, and hence the efficiency of Chinese firms (Chen et al., 2009; Fan, Wong, & Zhang, 2007; Hu, Tam, & Tan, 2010). As a complement to the board of supervisors, the independent director system is required by the Code of Corporate Governance issued by the CSRC (CSRC, 2002). Evidence shows that independent directors in China can serve as effective corporate governance mechanisms (Conyon & He, 2011; Fan et al., 2007; Kato & Long, 2006). Furthermore, Lo, Wong, and Firth (2010) find that a more independent board and a separation between the roles of CEO and chairperson suggest that a firm is less likely to engage in transfer pricing manipulations; Liu and Lu (2007) find that firms with better corporate governance have lower levels of earnings management.

Finally, prior to 2005, Chinese firms had both tradable and non-tradable shares. In 2005, China removed all trading restrictions from non-tradable shares. This reform was one of the starting points in the transition from primarily state ownership to public ownership.[6] The split share structure, in which both types of shares have the same voting rights but different prices, greatly impacted corporate governance. First, large shareholders holding non-tradable shares had little incentive to improve firm performance, because they could only trade their shares at book value (Chen & Yuan, 2006). Second, the split share structure induced conflicts of interest between the different types of shareholders (Chen et al., 2011). Larger shareholders were prone to using their control rights for, e.g., tunneling, whereby they attempt to artificially increase dividends as a means to transfer more cash to their own pockets (Lee & Xiao, 2004), and/or transfer resources to benefit controlling shareholders at the expense of minority shareholders (Aharony, Wang, & Yuan, 2010; Jiang et al., 2010).

Thus, good corporate governance in China is especially important because of the severity of agency problems. Despite the fact that the third issue became much less important after 2005, the other two issues remain problematic. Research has found that good corporate governance is associated with increased market valuations (Bai et al., 2004), a reduced propensity to commit fraud (Chen, Firth, Gao, & Rui, 2006), greater influence over capital structure decisions (Li, Yue, & Zhao, 2009; Wen, Rwegasira, & Bilderbeek, 2002), higher performance persistence (Haß, Johan & Schweizer, 2014), improvements in operating performance (Sami et al., 2011), and increased firm liquidity (Tang & Wang, 2011). Moreover, increased public enforcement in China was effective in deterring tunneling behavior (Haß, Johan & Müller, 2014).

[5] In most Chinese-listed firms, there is a single dominant shareholder. Chen et al. (2009) find that, for the 1999–2004 period, the median holding of the largest shareholder is 42.61%, while the median of the second largest shareholder is only 5%, and that of the third-largest shareholder is 1.89%. The dominant shareholder therefore wields considerable power and influence over a firm's operations.

[6] Another effort by the government to diversify ownership was to increase the presence of institutional investors in the local stock market. It is widely acknowledged that institutional shareholders can help improve corporate governance quality while reducing information asymmetries (Aggarwal et al., 2011; Smith, 1996; Woidtke, 2002). Mutual funds were introduced by the China Securities Regulatory Commission (CSRC) in 1998. By the end of June 2007, there were 343 open-ended mutual funds with a total net value of over 1.7 trillion Chinese yuan. In addition, the Qualified Foreign Institutional Investor (QFII) program, launched in 2002, allows licensed foreign investors to buy and sell yuan-denominated "A" shares on China's mainland stock exchanges. According to Lane and Milesi-Ferretti (2007), portfolio equity inflows had grown to the U.S. $450 billion by 2007, from the U.S. $13 billion in 2001.