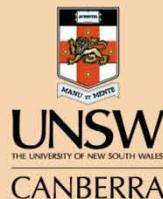


## Identifying Points of Tension for Financial Reporting: China

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## **1. Introduction**

Being seen worldwide as a 'hot place' for capital investment, China has indeed offered many opportunities for capital investors internationally. Equity investment to Chinese companies via stock exchanges is one of them. This type of investment can be beneficial for Chinese companies when they are in need of capital for development. As companies in China collectively are new and thus in their early stage of growth, they may likely offer international investors higher investment returns, compared to their more matured counterparts from developed economies (Ramezani et al, 2002). This potential win-win situation, however, needs to be based on a condition: that is, international investors need to be able to understand Chinese companies. Then, it would be possible for them to make informed investment decisions. Otherwise, this type of investment may take place with high uncertainty and thus high risks (Dow and Werlang, 1992). This situation can be harmful for the international investors and, if pervasive, can become a significant barrier for international capital investment to Chinese companies.

To understand a company, investors in the capital market mainly rely on financial reporting as practised by the company. Financial reporting has become a necessary practice in capital markets worldwide and has been playing an essential role to facilitate capital transactions internationally. Given such importance various international reporting standard bodies such as IFRS and IAS, have established a set of general rules for financial reporting which is increasingly converged internationally (Canibano and Mora, 2000; Choi, Frost, and Meek, 2001; Haverty, 2006). Such rules, described in this article as the international rules, address certain institutional forces which underpin financial reporting at a national level, such as corporate governance, market condition, auditing practice, and regulation. While these rules are still being promoted and accepted in the world landscape, they have been introduced in China since the 1990s.

China has also recently become a full member of IFRS and as such, it can be understood that financial reporting in China should follow the international rules. Hence, when Chinese companies provide an opportunity for capital investment, their financial reporting using the international rules plays an important and necessary role for investors, including international investors, to understand them. This article, identifies the points of tension for financial reporting using the international rules in China.

Tensions perceived to be conspicuous arise from two broad theoretical arguments regarding certain key aspects of financial reporting practice in international capital transactions. On the one hand, financial reporting has developed in free markets (Watts, 1977). In this type of market, the rationale for companies to practise reporting lies at an accountability that company managers owe to the investors (Jensen & Meckling, 1976) as well as a hope to reduce information asymmetry in the market (see Hayek, 1945). In this situation, various market-based forces provide incentives for company managers to practise financial reporting. On the other hand, political and economic pressures have deep impacts on the practice of financial reporting (Ball et al, 2003). Framed within these arguments, the practice of financial reporting may be understood to be based in the market and impacted by the political economy environment in which this practice takes place.

Following these arguments, this article describes the development of financial reporting using the international rules applied under the political economy system of China. The points of tension are, then, derived from assessing the internationally-understood basic rationales as well as the key driving forces of financial reporting in the Chinese context. The central argument is: financial reporting as practised by Chinese companies may take place in a unique institutional context both historically and currently (Jiang, 2011) and because of such an institutional context, the basic rationales as understood internationally may not be applicable. In this situation, the key driving forces for financial reporting in international rules may not be able to take effect in China. Under such circumstances, financial reporting as practised by Chinese companies using the international rules may be unable to play the role it is meant for capital investment both domestically and internationally.

The rest of this article proceeds as follows. Section 2 describes the international rules for financial reporting. It emphasises, the basic rationales for financial reporting as well as the key driving forces which arise from these rationales are discussed. Section 3 discusses how this practice has developed under the political economic system of China. Section 4 identifies the points of tension for implementing international financial reporting rules in China.

## **2. International Reporting Rules**

Financial reporting may generally be understood as a business practice by which companies report various types of business information to the public via various media such as an annual report, a corporate social report, conference calls, and company website. The rationale of financial reporting may reflect a typical characteristic of the free-market contexts that capital employed by companies for economic production is owned by investors in the market. In this situation, company managers owe accountability to the investors and this accountability is enforced by means of contract (Coase, 1937; Hart, 2008). So company managers practise financial reporting in order to discharge this accountability considering the information needs of the investors. This economic explanation for the rationale of financial reporting considers the relationship between company managers and the investors in the free-market contexts. This relationship may be interpreted as an agency relationship which in a free market economy becomes intrinsic for the operation of companies (Jenson and Meckling, 1976).

In a broader sense and under the same market contexts, financial reporting is used by companies to reduce information asymmetry (Hayek, 1961) so as to help solve the ‘lemons’ problem (Akerlof, 1970) in the capital market. Information asymmetry arises from the situation in which company managers have more information than the investors in the market. This situation may lead to the ‘lemons’ problem in the capital market: that is, the uncertainty faced by the investors in understanding the business performance of a company. This uncertainty may result in adverse selection that high-growth companies are undervalued, while low-growth companies overvalued (Spence, 1973). This situation represents one type of inefficiency of the capital market. As the capital market is the primary venue where the capital allocation takes place,

inefficiency in the capital market can affect the well-being of an overall economy (Healey and Palepu, 2001; Bushman et al, 2006). In order to avoid this situation, company managers are required under regulation to supply business information to the capital market for business transparency so that the level of information asymmetry may be reduced. This interpretation for the rationale of financial reporting considers the capital market and also its relationship with the overall economy.

Both of these theoretical interpretations have been popular internationally in explaining the necessity and significance of financial reporting for the companies, the capital market, and the overall economy under the free-market contexts. However, how the necessity and significance can be addressed is associated with the rules for practice. The development of internationally accepted financial reporting rules has been based in the practice of free-market countries such as the US, UK, Germany, and Australia. Initially, these countries had different rules at various levels from each other (Nobes, 1998; Pope and Walker, 1999). But, over the past few decades, there has been a substantial convergence trend internationally (Ball, 2006). With this trend, international standard setting bodies, notably the IFRS and IAS, have been promoting a set of general rules worldwide. These rules may be summarised in four points follows:

1. A commercial legal framework is put in place aiming to enforce economic contractual relationship in society so that the interests of the investors may be protected;
2. Required by such a legal framework, a set of accounting standards is used by companies to record their financial accounting information;
3. Regulated under such a legal framework, corporate governance is practised at the company level so that the daily business operations of a company may be monitored by the board of directors who represent a broad range of investors; and,
4. Auditors provide independent and professional observation in order to make sure for the public that financial reporting prepared by companies under observation is real and also consistent with the required accounting standards

These rules can be useful for capital transactions internationally in that when companies from different countries seek capital investment worldwide, their financial

reporting, if using the internationally accepted rules, may be understood by international investors more conveniently. However, it is also explained in international research that for these rules to be effective, they need to be underpinned by various driving forces.

### ***2.3 Driving Forces for Financial Reporting***

Research on the market-based driving forces for financial reporting has focused on a variety of levels including: the company, the capital market, the product market, and the broader society. But the most fundamental drivers seem to be at the levels of the company and the capital market. In this article it is assumed that the basic rationales of this business practice arise from these two levels. At each level, the driving forces are slightly different but both particular incentives for company managers in their financial reporting practices.

#### *At the company level*

At the company level, agency costs may create a strong incentive for company managers to supply business transparency to the company investors. According to Jensen and Meckling (1976), agency costs arise from an agency relationship between the company managers and their investors. Inherent in this relationship is the information asymmetry between the company managers and the investors. Asymmetric information may lead to various types of negative consequences such as moral hazard (Mirrlees, 1999; Pauly, 1968) and adverse selection (Balakrishnan and Koza, 1993), which can lead to devaluation of the company in the market. To reduce the information asymmetry, investors (principal) require company managers (agent) to practise financial reporting, even if it incurs costs to do so. All such consequences and the costs from financial reporting may be understood as costs inherent in the agency relationship. Thus, such costs are defined as agency costs.

However, the company managers usually bear a significant part of the agency costs (McColgan, 2001). This is because investors usually put in place various mechanisms to align the interests of the company managers with theirs. For instance, it has

become a popular practice in the business world that company managers' compensation is tied up in various ways with the level of agency costs. In this situation, managers provide business transparency to their investors in order to mitigate such costs in their own interests. Thus, according to the agency theory, agency costs provide a driving force at the company level for managers to practise financial reporting.

#### *Driving force at the capital market level*

At the market level, the valuation mechanism in the market provides a driving force for companies to practise financial reporting (e.g. Lang & Lundholm, 1993). Because of this corporate finance theorists (e.g. Myers & Majluf, 1984), explain that companies face the issue of valuation when they compete for financing in the capital market. This issue involves risk assessment from investors' perspective. Companies which are perceived in the market to be of lower risks may incur a lower cost in borrowing capital and vice versa. The level of the cost of capital, in turn, has a likely association with the management ability of the company managers. This may be understood as a set of ratios: the lower the cost of the capital, the higher regard the market has for the management ability within the company (Healy and Palepu, 1993; 1995), and thus the higher reputation and reward the company managers may receive (Noe, 1999; Aboody & Kasznik, 2000; Miller & Piotroski, 2000). Thus, international research suggests a likely association between the cost of capital that a company raises from the capital market and the reputation and the reward of the company managers.

However, the 'lemons' problem resulting from information asymmetry may affect this likely association. To avoid or reduce this potential situation, company managers practise financial reporting to render business transparency to the capital market. The hope held by the managers may be this: when the investors assess the risks associated with their company, the assessment will be most efficient where accurate information about the company is available in the market. As a result, the cost of capital raised by the company may be at a level which positively affects the reputation and reward of the company managers.. Therefore, when companies compete for financing in the capital market, the issue of valuation in the market creates an incentive an incentive

for company managers to practise financial reporting so that their own reputational and reward benefits are what they think they deserve.

In summary, international research has identified two fundamental driving forces for financial reporting in free-market economies at the level of the company and that of the capital market. Understanding these incentives may help build such a general understanding that financial reporting in such contexts may be mainly underpinned by incentives arising from the company and the capital market. So company managers may provide business transparency via financial reporting in order to discharge accountability to company investors as well as to facilitate the company valuation in the capital market.

Overall, theoretical interpretations of financial reporting have, however, mostly been based in the free-market context and assumes that key characteristics of this context are present. However, when financial reporting takes place in an emerging market context, these theoretical interpretations may be challenged. Given the different characteristics of non free-market contexts, it is likely that this practice may experience tensions in emerging market context. To see how likely it is, this article uses China as an example to identify the points of tension.

China, as an important global trade member and an emerging market economy, faces serious challenges as it attempts to introduce international reporting rules in its indigenous companies. This is simply because China's political economic system has been different from that of a typical free-market economy. These differences at various levels under China's political economic system may create points of tension for international reporting rules. This article examines the basic rationales of financial reporting as well as the fundamental driving forces which derive from the rationales in the context of China. The following section provides overview of how financial reporting practice has developed in China is provided in order to establish an understanding of the context in which these practices are being introduced.

### **3. Development of Financial reporting Practice in China**

The development of financial reporting in China is embedded in the country's historical legacy and social reform. From 1949 to the early 1980s, Chinese society

was under tight political control; the economy was centrally planned. As Saxe and Yang (2000) commented, this political economic system brought China into economic bankruptcy, severe poverty, and social chaos. Under such a system, there was no room for capital markets or companies. From the early 1980s, social reform commenced. The key spirit of this reform was to relax the tight political control on social and economic life. It was under this reform that the practice of financial reporting was introduced in China.

By and large, social reform in China has stressed on the economic sector. Significantly, it has included two important elements: (1) market-oriented reform and an (2) open-door trade policy. The market-oriented reform has brought about privatisation of state-owned enterprises and thus the development of companies and a domestic capital market. The open-door trade policy has resulted in tremendous annual volumes of international trade in China. It may be because of these elements that China has achieved great success economically over the past three decades. From 1980 to 2010, China has maintained a record-high average GDP growth rate of 9.5 percent. Because of this growth rate, China became the second largest economy in the world from the beginning of 2011<sup>1</sup>. According to the *World Bank Report 2010*, 60 percent of this growth rate was contributed by China's international trade. With such a high level of dependence on trading internationally, China is under pressure to harmonise its economic sector with international business practices. Perhaps, this pressure provides the strongest incentive for China to introduce various international rules in its economic sector. Financial reporting as an essential practice for cross-border capital investment is one of them.

In addition, China joined the WTO in 2002 becoming a full member of this world trade organisation. This means China has promised to follow all the WTO rules in international business and trade activities<sup>2</sup>. Providing business transparency is always emphasised by WTO as a fundamental condition for all the member countries. Thus, it may be interpreted that introducing international reporting rules is an outcome of both the economic incentive that China has faced and the promise it has made to the world business community.

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<sup>1</sup> <http://www.bloomberg.com/news/2010-08-16/china-economy-passes-japan-s-in-second-quarter-capping-three-decade-rise.html>

<sup>2</sup> [http://www.wto.org/english/docs\\_e/legal\\_e/04-wto.pdf](http://www.wto.org/english/docs_e/legal_e/04-wto.pdf)

To introduce this practice, China has established a regulatory regime for financial reporting. Under this regime, a commercial legal system has been built, involving Company Law, Accounting Law, Securities Law, and Auditing Law. The fundamental principle of this system, as provided in the *Company Law 2004*, is to protect the interests of company investors. The other laws provide guidance for particular practices. The general rules facing publicly-traded companies' financial reporting under this legal system may be summarized in four points:

1. Corporate governance must be practised.
2. A set of internationally-accepted accounting standards, either China GAAP or IAS, must be used to record business activities and transactions.
3. A qualified external auditor must be employed to observe the internal procedures of such companies for financial reporting.
4. Financial reports must be published in a timely manner on designated media.

All of these are consistent with the international rules for financial reporting and thus at a formal level it may be said that the international reporting rules have been put in place in China by now. However, introducing these rules may not mean effectively practising them in the context of China. A more precise understanding may be obtained by examining the key driving forces which underpin this practice in China. It is this examination which reveals the points of tension for financial reporting in China, which is the key focus of this article.

#### **4. Points of Tension for Financial Reporting: China**

Sticking to the basic rationales for financial reporting as they emerge from international commentary, the necessity for financial reporting practice in China arises primarily from two situations. One is the question of the existence of an agency relationship between the investors and the company managers. If such a relationship does not exist for Chinese companies financial reporting may be unnecessary for them and thus lack the key underpinning of financial reporting practice at the company level may be missing.

In terms of the second rationale of international practice - the importance of the capital market for companies - under the current political economic system of China,

the government still plays a significant role in the capital allocation process in the overall economy. In this situation, the capital market may not be important enough to create an order of necessity for companies to practise financial reporting. As such, China may lack this second key driving force to the practice of financial reporting. Focusing on these two rationales, the points of tension for financial reporting in China can be identified at the levels of companies and the capital market.

#### ***4.1 Chinese companies***

The concept of the company is new to modern China. Since 1949 the dominant form of industrial production unit was the state-owned enterprise, which was effectively one type of government department (Sachs and Yang, 2000). Under the market-oriented reform in China, Chinese companies have developed, by privatisation, out of the formerly state-owned enterprises. The ongoing reform has been undertaken by the Chinese government in a gradual mode. The short history of Chinese companies under the gradual progressing reform may suggest that these companies lack the agency relationship of their counterparts under free-market contexts. Further, it may also suggest that the ideas and management practices of central planning may still prevail in these companies.

A body of corporate governance literature on China has provided empirical evidence that Chinese government is usually the largest shareholder of Chinese listed companies (e.g., Xu and Wang, 1999; Bai et al., 2004; Fan et al., 2007; Tian and Estrin, 2008). Perhaps because of this situation, the appointment of company managers in Chinese publicly-traded companies is either made directly from government bureaucrats or significantly influenced by the government (Fan et al., 2007). When the government is the largest shareholder and has a large stake in appointing the company managers, the relationship between such managers and their government shareholder can be regarded as the primary principal-agent relationship in most Chinese listed companies.

This type of relationship differs fundamentally from the classic agency relationship as it exists in companies in the free-market contexts. First, the government

shareholder may not resemble individual or institutional investors in terms of economic interests. Lin (2002) indicated that the virtual property right bound to the Chinese socialist ideology creates a serious lack of economic incentive for the government to monitor the business performances of the government-related companies in China. Second, under this type of relationship, the company managers are closer to their government shareholder than to other individual and minority investors in the capital market. Thus, they may prefer the government to investors in the capital market. This may be the realistic circumstance under which Chinese listed companies have been practising financial reporting using the international rules.

Under such a circumstance, there exists a question about the rationality of financial reporting using the international rules in these companies. More specifically, under the unique principal-agent relationship in operation in China, the agency costs as understood in free-market contexts may not be applicable. In this situation, financial reporting by Chinese listed companies would not be underpinned by such agency costs. Hence, the likely different principal-agent relationship in Chinese listed companies may create a serious point of tension for international financial reporting rules to be applied in China.

#### ***4.2. Capital Market in China***

Besides a likely different agency relationship in Chinese listed companies, China seems to also have a different capital market. China's domestic capital market has resulted from the development of capitalism after the social reform. On the equity side is represented by two stock exchanges in Shanghai and Shenzhen. On the debt side primarily consists of the banks operating in China. However, this market may not work in the way as those familiar with free-market countries would expect.

The equity side, marked by the establishment of the two stock exchanges, began to operate in the early 1990s. Commencing from 11 companies listed in total, now the number has exceeded 1800. The development of this equity market apparently has been very rapid. Besides the domestic individual investors, international investors are allowed to invest through these stock exchanges. But, a strict limit is applied for international investors that they may not hold more than 5 percent of the total shares of any single company (Securities Law of China, 2005). In addition to the domestic

equity market, around 300 Chinese companies are listed in international stock exchanges, mainly in Hong Kong, the US, the UK, and Singapore.

Altogether, equity investment in these stock exchanges provides a useful channel for Chinese companies to access financial capital for business development. Meanwhile, the diverse groups of investors in these stock exchanges provide a certain level of market force driving the listed Chinese companies to practise financial reporting. However, the debt side of the capital market for China may undermine the overall level of the market force faced by such Chinese companies.

Though China's social reform has brought about market-oriented changes in many aspects of society, the banking system of China has not substantively changed. It has up to now remained dominated by the state-owned banks. Despite a fact that a number of international banks are operating in China, their business scope and volume have been highly limited by the government policy. For instance, China Bank Law (2006) clearly stipulates that foreign banks are prohibited from lending to companies in industrial areas of strategic important. These areas mainly include heavy industry, telecommunication, energy and mining industry, creating a monopoly for Chinese listed companies in these industries (Liu, 2006). In this situation, when such companies seek financial capital from a bank, they go to the state-owned banks. Given that the Chinese government is always their largest shareholder, such companies may easily obtain financial capital from the state-owned banks at a favourable cost.

International research on China's banking system provides empirical evidence that China's industrial sector has experienced serious soft budget problem (Dong and Putterman, 2003; Guo and Yao, 2005). This problem has been reflected in persistently overwhelming level of non-performing loans (NPL) in China's state-owned banks (Chen, 2006; Ariff and Can, 2008). The World Bank in 2009 estimated that 87 percent of loans which had been issued by the Chinese banking sector have gone to non-private enterprises and that 85 percent of these loans turned to be non-performing. The combination of NPL and the soft budget problem in China seems to confirm Chinese listed companies' easy access to cheap financial capital through the state-owned banks of China.

This situation suggests that the debt side of the capital market in China is rather a government-controlled channel for listed companies to obtain financial capital than a market. Thus, Chinese listed companies may not need to be concerned about valuation in the equity market. While they do not have this concern, their financial reporting may not be underpinned by any driving force from the capital market. Thus, the state-owned banking system of China seems to create a significant point of tension for the international reporting rules to be applied in China.

## **5. Conclusion**

In this article, two points of tension are identified for financial reporting using the international rules in China. One is the likelihood that Chinese listed companies may have a unique principal-agent relationship rather than the classic one as understood in the free-market contexts. The other that the state-owned banking system of China may provide an easy channel for such companies to access cheap financial capital. Both of these factors may create serious points of tension for the international reporting rules to be applied in China. Thus, financial reporting by Chinese listed companies may not be able to play the role that this business practice plays internationally.

Specifically, it may not be used to supply business transparency for a wide range of investors due to the distortions in the agency relationship. Nor may it be used to reduce information asymmetry in the capital market for efficient company valuation. It may better be understood as a signal to the world business community of China's cooperative attitude as an important international trade partner. Also, it may be used show to the world that China has fulfilled its promise as a WTO member country. However, if financial reporting only symbolic rather than effective, it may lead to high investment risks for international investors in Chinese companies. This situation can be harmful for the economic interests of these investors. In the long run, it can discourage such investors from investing in Chinese companies and thus become a significant barrier for international capital to flow to China.

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