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Determinants of disclosures of A-, B- and H-share companies

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Abstract

Purpose – This study attempts to examine the issues relating to corporate financial reporting of Chinese listed companies under specified institutional settings as companies with different share-categories are required to prepare annual reports under various General Accepted Accounting Principles (GAAP).

Design/methodology/approach – This study selects Chinese companies that issue negotiable shares to examine whether corporate disclosure patterns are different under various institutional settings. Negotiable shares can be traded on stock exchanges and are divided into A-, B- and H-shares. The extent of corporate disclosure is obtained from the content analysis of annual reports for 191 sampled Chinese listed companies with various share categories. The association are hypothesized and tested between the level of corporate disclosure and the following corporate determinants: company size, profitability, auditor, leverage, industry and ownership structure.

Findings – The extensive regulations and different standards influence on disclosures of companies with foreign investment participation and overseas listing status. By reconciliation of their annual reports according to the IFRSs or the GAAP of the listing country, these companies increased information disclosure voluntarily in order to enhance their reputation and credibility. Some corporate factors, such as company size, profitability and the size of auditor, have influenced the level of corporate disclosure in annual reports of domestic and foreign share-based companies. Ownership structure has positive impact on the level of disclosure for companies with domestic investors.

Originality/value – This study advances knowledge of the influence that legislative circumstances and ownership structures can have on disclosure decisions made by management in their annual reports. This information is of high interest to domestic and foreign investors and regulators in understanding of financial reporting in Chinese listed companies.

Keywords China, Disclosure, Securities markets, Shareholders, Corporate ownership

Paper type Research paper

1. Introduction

The purpose of this paper is to examine how the political costs impact on disclosure patterns of companies incorporated in China that have attracted foreign shareholders by listing on domestic and overseas securities markets. This comparative study of Chinese companies listed on domestic and overseas securities markets examines the differences in listing methods and corporate disclosure. The extent of corporate disclosure is empirically measured using a disclosure index applied to 191 Chinese

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listed companies with various shareholder categories. This study finds that political cost influences the extent of corporate disclosure in both foreign-share based companies and domestic-share based companies. Choosing an international accounting firm as auditor is found to be the method that is used to improve the credibility and worthiness of companies to foreign investors. Further, ownership structure is found to be significantly associated with the extent of corporate disclosure which indicated that governmental influence is strong on corporate disclosure issues in order to attract domestic investors' involvement in domestic-share based listed companies. These results provide an understanding of corporate disclosure as an effective tool for Chinese listed companies to reduce exposure to potential political costs and as a results, to manipulate earnings are a strategy for them to deal with potential political pressures.

The contributions of this study are fourfold. First, the study not only assists management in selecting an appropriate course of action to achieve strategic performance but also benefits investors' knowledge of significant factors that explain the variability of disclosure quality in annual reports. Second, the study adds to the literature of international accounting research by extending the knowledge and discussions of corporate information reporting to a developing country, namely China. Previous studies have focused less on the accounting system classification in developing countries. Due to difficulties in data collection previous studies that focused on corporate disclosure studies in China were concerned mostly with conceptual discussions. In contrast, this study conducts an empirical analysis on the quality of corporate disclosure from qualitative and quantitative perspectives in Chinese listed companies. Third, this study facilitates investors' ability to assess their investment decisions in share-based Chinese listed companies. Finally, the findings of this study provide recommendations to regulators of relevant stock exchanges and securities markets relating to activities and credibility of listing entities.

Foreign investment has show attention to the Chinese fast growing transitional economy either in joint venture or by holding shares in listed companies. Foreign capital companies include Sino-foreign capital joint ventures, Sino-foreign partner enterprises and foreign investment enterprises. Corporatisation, a process to convert state-owned enterprises (SOEs) into companies with limited liabilities, is considered as an effective way to clarify property rights, facilitate raising capital, restructure ownership and carry out other reforms (Xiang, 1998). However, most listed Chinese firms have originated as SOEs and are mandated to have three separate classes of ownership shares that distinguish them from those in more mature economies. State-owned shares are held by the central government, government ministries, or provincial, and municipal governments. Institutional shares (also called legal person shares) are owned by separate legal entities, such as investment institutions, other enterprises, and the foreign partners of a corporative joint venture. These two types of ownerships of shares cannot be traded on domestic stock exchanges – Shanghai and Shenzhen (SHSE and SZSE) Stock Exchanges, though the latter can be sold to other legal entities by agreement and on approval by the government. Finally, shares issued to individuals can be further classified into A-, B- and H-shares. A-shares restrict to domestic trading by Chinese citizens and B-shares can be sold to foreign individuals and entities. While some Chinese companies issue both A- and B-shares, the number is

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relatively small. Additionally, H-share companies are listing on Hong Kong and other foreign stock exchanges.

The different institutional settings suggest the need for more extensive studies on corporate disclosure of Chinese listed companies, since financial reports are less accessible or comparable for far distance and inconvenient foreign listings/share ownerships against domestic standards. In general, it is argued that foreign shareholders are likely to face higher levels of information asymmetry that lead to adverse market consequences (Inchausti, 1997; Lin and Wang, 2001). Lev (1988) found that disclosure regulations are intended to mitigating adverse effects resulting from such market inequity. The coexistence of domestic accounting standards alongside International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs) means that Chinese companies with different share categories can create information asymmetry. Lin and Wang (2001) argue that this information asymmetry is affected by the degree of government involvement, the strength of the equity market and the effect of accounting professionals. As compared to firms with A-shares, Chinese companies issuing B- or H-shares are required to also follow IASs/IFRSs or the local accounting standards of foreign countries where their shares are listed. These additional disclosures tend to encompass a broader scope than the domestic one (Xiao *et al.*, 2004). In addition, the reports for B- and H-share companies are required to be audited by international auditors, which should increase the likelihood of monitoring cost.

This study seeks to test hypotheses based on political costs and agency costs as explanations of corporate financial reporting under specified institutional setting of Chinese listed companies. Positive accounting theory or the political costs has been suggested in previous studies to explain why firms make voluntary social disclosures. Several studies (e.g. Belkaoui and Karpik, 1989; Ness and Mirza, 1991; Deegan and Hallam, 1991; Inchausti, 1997; Xiao *et al.*, 2004) have directly attempted to empirically examine the relationship between voluntary disclosures and the political cost hypothesis, based on the original studies of Watts and Zimmerman (1978). Companies with foreign shareholders who are more politically visible and subject to more public scrutiny, may potentially improve information transparency in order to reduce political costs – for example, increased regulation, the pressure from labour unions for increase wages, consumer boycotts and higher taxes.

Given foreign shareholders' ability to price-protect themselves against potential losses that arise from information asymmetry, positive accounting theory implies that Chinese firms with foreign shareholders would voluntarily disclose more transparent information to foreign investors for their economic decision making. More extensive voluntary disclosures and a widened dissemination of financial information also can create an impression of greater transparency, confidence of investors and creditworthiness of companies. Researchers (e.g. Schipper, 1981; Raffournier, 1995; Hossain *et al.*, 1994; Cooke, 1998; Ferguson *et al.*, 2002) report that firms that are quoted on several stock exchanges make more information disclosures.

The rest of the paper is organised as follows. Following the introduction, the study provides a review on previous studies focusing on share-based companies and comparisons of corporate disclosure and listing methods of Chinese companies. Section three presents the hypotheses discussed in the study. Section four outlines the sample selection, data collection and model development. The results of statistical analysis of

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corporate disclosure in foreign-based companies are given in section five, where evidence of associations between some corporate characteristics and the extent of corporate disclosure is also given. In the last section, discussions and limitations of the study are provided.

2. Comparisons of listing on domestic versus overseas markets

The rapid development of securities markets and the opening up of Chinese markets has encouraged local SOEs to obtain funds from domestic and overseas securities markets. In particular, with China's entry into the World Trade Organisation (WTO), more companies began to seek capital from overseas markets, especially the Hong Kong and USA securities markets. A total of 1,232 A-share and 109 B-share companies are listing on the Shenzhen and Shanghai Stock Exchanges to the end of June 2006 (CSRC, 2006). The market valuation of listed companies in the domestic market was about 45 per cent of China's gross national product in 2002 (Xiao *et al.*, 2004). After the establishment of stock exchanges in Shanghai and Shenzhen in 1990, some companies have promulgated B-shares to foreign investors on the Shanghai and the Shenzhen Stock Exchange since 1992. From 1993 many companies applied to obtain capital from overseas capital markets. In 1993 Tsingtao Brewery Company Ltd was the first Chinese IPO listing on the New York Stock Exchange (NYSE) and the Hong Kong Stock Exchange (HKSE) respectively. There were 12 Chinese companies listed on the NYSE, two on the Singapore Stock Exchange (SPSE), five on the London Stock Exchange (LOSE), and 117 on the HKSE by the end of 2006 (CSRC web site: www.csrc.gov.cn).

A comparison of listing methods, listing requirements and corporate disclosure on various stock exchanges can be made on the basis of their unique institutional settings. The requirements of listing rules are similar for the two domestic stockmarkets and the HKSE in that they have similar requirements regarding the type of business, capitalisation, financial ratio requirements, number of shareholders, public float and accuracy of financial reports for the three years preceding a share issue. Although the NYSE does not require newly issued shares to be accompanied by information about the type of business, financial ratios, and number of shareholders, it does require disclosures regarding higher levels of capitalisation, pre-tax earnings and the public float. For example, NYSE request that pre-tax earnings of listed companies must total at least US$100 million in aggregate for the last three fiscal years with a minimum of $25 million in each of the most recent two years. Further operational cash flow is required to be at least US$100 million in aggregate for the last three fiscal years, where each of the two most recent years is reported at a minimum of US$25 million, for a company with no less than US$500 million market capitalisation and US$100 million revenues in the most recent 12-month period. For companies with no less than US$1 billion total worldwide market capitalisation and with not less than US$100 million revenues in the most recent fiscal year, there are no additional financial requirements. For an affiliated company the NYSE requires disclosures about market capitalisation (if US$500 million or greater), the minimum of months of operation, whether parent or affiliated company is a listed company in good standing, and whether the parent/affiliated company retains control of the entity or is under common control with the entity (NYSE web site: www.nyse.com).

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The co-existence of different share types in the Chinese market has attracted researchers' interest regarding corporate financial measurement and disclosure issues. Chen *et al.* (2002) reported factors that are responsible for the differences between Chinese General Accepted Accounting Principles (GAAP) earnings and IASs/IFRSs earnings. These factors include inventory/temporary investment valuation, allowance for bad debt, long-term investment valuations and consolidations, deferred tax and depreciation and revaluation. The profits calculated under the PRC GAAP are more significant in relation to share prices. Lin and Wang (2001) stated that financial report provided limited information to reconcile the differences between the different accounting methods used. The corporate reporting of Chinese listed companies with different share-categories is complicated for international investors and has had an impact on investment decisions in the domestic and overseas securities markets. The listing methods and corporate disclosure requirements in domestic and overseas securities markets are discussed below.

2.1. Comparisons of listing methods

The listing rules affect the listing choice of companies. This section discusses the factors influencing Chinese listed companies on the domestic securities markets – the SHSE and the SZSE, and the foreign securities markets – the HKSE and the NYSE.

There are several ways to develop a public trading market in the domestic markets for equity securities:

- sponsor shares;
- private placement of legal person shares;
- employee shares;
- second offering;
- an IPO of negotiable shares; or
- buying a "shelf" company.

Sponsor shares are shares that purchased by sponsors. Foreign direct investment (FDI) may be involved in three types of investment: Sino-foreign capital, Sino-foreign contract and foreign investment. According to the company law, sponsors are not allowed to hold lower than certain proportion of the company's total shares (China Securities Regulatory Commision, 1993). Employee shares are shares issued to employees. Before 1992 many companies raised equity capital from employees, but they were not allowed to list on the stock exchange for the first three years after issuing. This restriction was withdrawn in 1993. Many companies raise capital through IPO – issuing negotiable shares including A-, B- and H-shares. A second offering is a way for listed companies to raise capital. Finally, companies can exchange their equity for shares of a shelf company that has already been registered and listed on the securities markets.

There were problems in the early stage of Chinese securities markets: shareholders could not access annual reports; there were no regulations for share issues and dividends policy; first day abnormal returns occurred; and poor liquidity existed in that there was no formal market for share trading (Xiao, 1997). With the enactment of the securities law, activities were standardised and regulated under the supervision of the CSRC.

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The Chinese companies that traded on the HKSE included H-shares and red chips. H-shares are Chinese companies that are incorporated in Mainland China, listed on the HKSE and can be traded by overseas investors. The Chinese government owns no more that 35 per cent of the total shares of the red chip companies that are incorporated overseas. Chinese listed companies have been included in the Heng Seng index since 1997.

Chinese companies issue equity securities in the USA in three ways:

(1) through an IPO or American Depositary Receipts (ADR) in combination with a stock exchange listing which is reviewed by the US SEC;

(2) by facilitating secondary trading in securities that USA investors purchased in overseas markets or that foreigners issued stocks to USA investors in private placement through the establishment of various ADR programs;

(3) so-called "back door" transactions.

The latter transactions involve a business combination where the shareholders of a Chinese company exchange their shares for shares in a USA shelf company that has already been registered under the Exchange Act (Luk, 2001).

2.2. Comparisons of corporate disclosure requirements

An equity share issued in Mainland China must comply with the securities law, the company law and other regulations. The PRC Securities Law stipulated that when a Chinese enterprise directly or indirectly offers securities overseas and lists on a secondary market, it must be subject to the approval by the domestic securities regulatory authorities. First, listed companies must disclose their quarterly, half-yearly and annual financial reports within 45 days, two months and three months respectively after the end of each financial period. Second, the format and content of financial reports is to be compiled according to Chinese accounting standards and corporate disclosure requirements. Third, to enhance the overseas listing of Chinese enterprises, China has enacted legislation to protect investor which includes the "Special Regulation of the State Council on Raising Capital and Listing Overseas by Joint-Stock Company Limited" (1994), the "Compulsory Provisions of Companies for Overseas Listing" and the "Notice on Further Strengthening the Management of Overseas Equity Offering and Overseas Listing" (1997). To reinforce communication and regulatory cooperation, the CSRC has entered into a memorandum on regulatory cooperation with a number of overseas securities supervisory institutions and set up a regular liaison meeting system with Hong Kong securities regulation authorities. China is now working with relevant agencies on practical policies overseeing the operations of overseas listed companies.

For the companies listed on the HKSE, issuers from the mainland are required to present a financial report conforming to applicable PRC rules, and containing a statement of the financial effect of material differences with the Hong Kong GAAP (Charltons, 2003). Chinese listed companies should publish annual reports and half-yearly reports within five months and three months respectively after the end of each fiscal year.

Foreign private issuers need to file a special series of forms (called "F forms") for those who publicly offer securities on the NYSE. However, the "F" form provides a slightly more liberal set of disclosure rules than the domestic requirements. The

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periodic reporting requirements applicable to foreign private issuers are more limited than those applicable to a USA issuer. First, foreign private issuers may report six months after the end of the fiscal year (rather than 90 days as the USA counterparts do). Second, they need not file quarterly reports on Form 10-Q or current reports on Form 8-K; they are only required to file "home country" reports annually under the cover of Form 20-K. Third, foreign private issuers are exempt from proxy rules and from the "short swing profits" rules applicable to USA issuers (Luk, 2001). Thus, the disparities are evident between regulations and listing choices that are faced by Chinese companies listed on domestic and foreign trading markets.

3. Hypothesis development

3.1. Earnings management and political costs

Watts and Zimmerman (1986, p. 230) argue that, because corporations are particularly vulnerable to wealth-extracting political transfers in the form of legislation and/or regulation, companies may use earnings management to decrease net income in periods of increased political sensitivity. Leftwich (1994) contends that increased regulations and implementing of new regulatory policies will increase relevant costs associated with produced accounting information. He contends that restricting management's choice of accounting rules for external reporting can impose costs on shareholders. A number of recent studies (Jones, 1991; Cahan *et al.*, 1997; Han and Wang, 1998) provide evidence that firms use income reducing techniques to avert adverse public, legislative, or other political attention in periods of increased political exposure. Earnings management relates to the use of discretionary accounting accruals to manipulate reported earnings figures (Schipper, 1989; Jones, 1991). Income smoothing averts stakeholders' concerns which arise from low reported operating profits. These concerns can relate to investors seeking dividends, lenders concerned about loan security, employees concerned about future employment prospects, suppliers and customers assessing future stability, or governments investigating unviable industries (Godfrey *et al.*, 1999).

Some studies (Aharony *et al.*, 2000; Lin and Wei, 2000; Liu and Li, 2000) examined the evidence of earnings management and financial packaging prior to an Initial Public Offering (IPO) in Chinese listed companies. Aharony *et al.* (2000) revealed that earning returns peaked in the year that companies issued shares to the public and declined significantly thereafter in unprotected industries, but not in protected industries (e.g. energy, petrochemicals and raw materials) in the process of financial packaging in H-share and B-share companies. The results suggested that the protected industries are favoured by the state in the corporatisation selection process. The study of Lin and Wei (2000) found that reported earnings peaked one or two years before an IPO year and declined significantly in the IPO year. In addition, the study revealed that manufacturing firms had significant earnings management before an IPO. In contrast, utilities firms had significant less earnings management. It is speculated that multi-share status in Chinese listed companies has made companies experience dual corporate reporting systems which enables them to engage in income smoothing for capital raising purpose, as well as reduce political costs.

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3.2. The impact of political costs on disclosure

A number of recent studies argue that financial report disclosure is used as a tool to reduce sensitivity to political pressure as results of political costs hypothesis and earnings management (Patten, 1992; Blacconiere and Patten, 1994; Walden and Schwartz, 1997). In support of this claim, prior research (Deegan and Rankin, 1996; Patten, 2000, 2002) gives evidence that corporations appear to use disclosure to offset negative political reactions to poor environmental performance. In addition to the use of disclosure as a response to increased pressures, disclosure may also be used as a proactive policy tool. As discussed by Preston and Post (1975, p. 4), economic and social concerns, including corporate environmental responsibilities, are addressed through the public policy process. Within this context, Godfrey *et al.* (1999) assert that disclosure may be made with the intention of gaining an influential voice in public social policy decisions. In essence, firms may believe that by projecting an image of environmental concern and awareness they can reduce the likelihood of having negative government actions initiated or passed. Consistent with such claims, there is evidence of an association between market returns and higher levels of financial report environmental disclosure at the time of increased potential regulatory costs (Blacconiere and Patten, 1994; Patten and Nance, 1998).

China has a tradition of direct government involvement in accounting regulations and financial policies-making as a result of a centrally planned economy. The autonomy of the accounting professional body is weak so that the Chinese Accounting Standard Committee (CASC) established in 1998 is viewed as a consultative body largely influenced by the Ministry of Finance (MOF) (Xiao *et al.*, 2004). The influential power of a majority government or legal person shareholding (e.g. the State-Asset Management Bureau, or other departmental agencies) in listed companies, suggests that state ownership has a dominant place in listed companies' business operations and resources allocation decisions. Therefore, the government is regarded as the main user of accounting information. Consequently, accounting standards and corporate disclosure regulations are developed to satisfy the demands of both internal institutional settings and external investors' pressures. Accounting standards are intended as a mean of reducing government intervention into business affairs and implementing its open door policy (Xiao *et al.*, 2004). The pressures for international accounting harmonization advocate that corporate disclosure practices of foreign-share companies incorporate internationally prevailing concepts and conventions and improve reporting understandability.

3.3. Hypotheses development

This study investigates whether there are disclosure differences between A-share, AB-share, B-share and AH-share companies during the period 1992-2000. These multi-share categories confuse investors at times, because companies obey diverse accounting standards and follow various disclosure requirements. Companies that issued shares to foreign investors were required to adjust their annual reports according to the IFRS or the GAAP of overseas listing place. Therefore, there are observed earnings differences in annual reports of Chinese multiple share-type companies due to different GAAPs. There is also expected to have differences in the levels of corporate disclosure. More extensive disclosure requirements are expected by

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companies that issue B-shares and H-shares than those that issue A-shares because of competition for equity funds of foreign investors. Hence, *H1* is:

H1. The levels of disclosures are significantly different between A-share, AB-share, B-share and H-share companies.

Prior research has found that certain corporate characteristics are associated with the level of disclosure in annual reports (Cooke, 1989; Raffournier, 1995; Mirshekary, 1999; Patton and Zelenka, 1997; Inchausti, 1997, Xiao *et al.*, 2004). Corporate characteristics developed in this study include: company size (LOGASS), return on equity (ROE), leverage (LEVE), auditor size (AUDIT), industry (INDUS) and ownership diffusion (OWDI). Whether disclosure levels are associated in the same way to these corporate characteristics for Chinese listed companies with domestic compared to foreign shareholders – that is A-share, foreign-share including AB-share, B-share and AH-share companies – is a research question that has not been previously tested. The hypothesised relationship between corporate disclosure and corporate characteristics for Chinese listed companies is:

H2. There are different associations between the levels of disclosures and corporate characteristics for A-share, AB-share, B-share and AH-share companies.

4. Research design

Sample companies

In this study observations of all Chinese companies that listed on domestic and overseas stock exchanges were carried out in the first stage. Listed companies have been selected because they are likely to attract the attention of investors who are interested in the quality of corporate disclosure in China and because financial reports and other data are publicly available. The sample is restricted to non-banking/finance companies and to those with a primary or significant interest in manufacturing activities in order to control for non-comparable financial structures or characteristics across industries.

The sampled companies were classified into four groups: A-share, B-share, AB-share and AH-share companies. A-share companies are companies that issued A-shares only and are listed on domestic stock exchanges. AB-share companies are companies that issued A-shares and B-shares with an initial offering of A-shares. B-share companies are companies that issued B-shares only or A-shares and B-shares, but B-shares were initially issued. AB- and B-share companies are listed on domestic stock exchanges. AH-share companies are companies that issued A-shares and H-shares and are listed on both domestic and overseas stock exchanges: H-shares were an earlier issue. A total number of 191 sample companies were selected: A-share companies (69), AB-share companies (52), B-share companies (44) and AH-share companies (26) during 1992-2000.

Data collection

The CSRC required that all IPO companies must publish their information concerning stock issuing, half-yearly-report, annual report and reports of important events through particular newspapers, the stock exchange and the government web site. The prospectuses and annual reports of the sample companies in this study were collected

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from government web sites (www.csrc.gov.cn, www.cnlist.com and www.cninfo.com.cn). Moreover, the prospectuses and annual reports can be sourced through the government nominated newspapers The Securities and the Chinese Securities Times. In addition, some companies provide databases of financial data relating to their securities trading and issuing – for example, Shenzheng Guotaian Co Ltd. For the purpose of consistency to compare information between companies, the prospectuses and annual reports collected in this study were in Chinese.

Disclosure Index (DI)

An unweighted dichotomous DI of 147 items, including mandatory and voluntary disclosure was categorised to measure the extent of disclosure. Items of DI are observed to determine whether or not they are disclosed in prospectuses and annual reports in order to calculate the disclosure score of assets. If the item was included in a prospectus or an annual report, the disclosure score was 1; otherwise the score was 0. By aggregating the number of disclosed items for each particular company the disclosure score was obtained. The extent of disclosure is the figure of the actual disclosure score (TD) divided by the maximum possible score (M).

Independent variables

Size. Company size has been regarded as the proxy of political costs. First, investors are likely to increase the credibility and mobility of securities if the disclosure level is improved. Diamond and Verrecchia (1991) found that greater disclosure reduced the transaction cost and increased the demand for a firm's securities by enhancing stockmarket liquidity. Hossain *et al.* (1994) considered that larger organisations tended to be listed on a stock exchange and listing status motivated organisations to make greater disclosure in order to maintain or create demand for their securities. Second, larger corporations are more likely to voluntarily disclose financial information because they are more visible to the public and may potentially faced extra political costs – for example, increased regulation, the pressure from labour unions for increase wages, consumer boycotts and higher taxes (Watts and Zimmerman, 1978). Jensen and Meckling (1976) suggested that voluntary disclosure reduced a firm's agency costs that are otherwise incurred to have bonding and monitoring arrangements. Agency theory predicts that voluntary disclosure by larger corporations will assist to reduce the potential of wealth transferring from outside capital suppliers to managers. Third, smaller corporations are reluctant to disclose full information to their competitors for strategic reasons so that they prefer to raise capital from inside fund providers and profit retentions. Small corporations are more likely to endanger their competitive position in the market relating to obtaining materials, reducing costs and improving production than their larger counterparts (Raffournier, 1995). Therefore, a company with larger size is likely to provide more financial information than a smaller company.

Profitability. Raising capital from capital markets incurs significantly increased costs as opposed to raising capital from profit retention. There has been evident that corporations with a higher profitability have a greater ability to absorb increasing costs and a better competitive position from which to improve future performance (Singhvi and Desai, 1971; Wallace *et al.*, 1994). In addition, corporations with higher returns would have a more stable and successful position which provides investors with more confidence in their price competitiveness. Henderson *et al.* (2004) have

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argued that companies with a higher rate of return have a greater ability to support the continuance of operations including management compensation, thereby increasing the worthiness of the company. Moreover, a higher rate of return gives a favourable perception of the quality of the company's management. Watts and Zimmerman (1986) employing agency theory hypothesised that managers might voluntarily disclose more information to investors when a corporation had a higher rate of return in order to reduce agency costs by connecting their compensation plan with corporations' performance. Hence, it is likely that a company with a higher rate of return is likely to provide more financial information.

Leverage. The agency costs are higher for firms with higher level of leverage in their capital structure than those with lower leverage (Jensen and Meckling, 1976; Myers, 1977; Watts and Zimmerman, 1986; Hossain *et al.*, 1994; Inchausti, 1997; Henderson *et al.*, 2004). These studies observed that the owner-manager might potentially employ accounting policies to transfer wealth from debt-holders because of opportunistic behaviour under positive accounting theory. Consequently, debt-holders might include appropriate covenants in the debt contract concerning debt restriction and asset restriction. Since there is no separate reporting other than annual reports to demonstrate a company's debt covenants compliance, including the credibility of its investing and borrowing activities, to debt-holders, the company management might disclose relevant and sufficient information in their annual reports to increase debtors' confidence in a company with a higher debt ratio. In addition, in order to enhance the marketability of securities, companies that publicly issue shares might increase the information disclosure (Singhvi and Desai, 1971; Courtis, 1979). The higher the level of information disclosure, the easier it was for corporations with a higher leverage of public bond to trade their securities. Choi (1973), in particular, found that the level of company disclosure increased prior to entering the Euro-capital market. Salammon and Dhaliwal (1980) showed that companies with long-term external capital were most likely to disclose segmental information voluntarily. Courtis's (1979) study showed a significant association between leverage and the level of annual report disclosure. Thus, it is expected in this study that a company with a higher level of leverage will disclose more information than one with lower level of leverage.

Auditor. Agency theory holds that auditing helps to alleviate the interest conflicts between management and investors. Generally, because they have more to lose from damage to their reputations, larger audit firms have a stronger incentive to maintain their independence and to impose more stringent and extensive disclosure standards (DeAngelo, 1981; Malone *et al.*, 1993). Hence, larger auditor firms are more likely to be hired by managements that can get greater potential gains from external monitoring. The reasoning is that managers are cognizant of larger auditors' incentives to demand higher quality disclosure, and engagement of such auditors is a signal of their acceptance of such demands (Datar *et al.*, 1991; Healy and Palepu, 2001). The findings of Craswell and Taylor (1992) and Inchausti (1997) support this inference of a positive relationship between firms employing larger auditors and their levels of disclosure.

Given this literature, it is argued that large auditors, especially the Big four international audit firms, are more likely to elicit the confidence of investors as compared to smaller or Chinese domestic auditors. First, these large auditors'

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reputations can provide some protection against the uncertainty and loss of control from disclosing via the reports. Second, they can both serve as role models and provide implementation assistance. Combining agency theory, signalling and political costs considerations, it is argued in this study that the extent of corporate disclosure will be greater among Chinese companies audited by the big international audit firms.

Industry. Many studies have discussed the influence of industry on the extent of information such as Cooke (1992), Djoko (1992), Wallace *et al.* (1994), Raffournier (1995), Inchausti (1997), Patton and Zelenka (1997) and Owusu-Ansah (1998). Cooke (1992) reported that the levels of disclosure in corporate annual reports are not likely to be identical throughout all sectors of the economy. Different countries promulgate industrial development policies that lead to an uneven development in their industrial sectors. In the case of Japan, Cooke (1992) found that manufacturing companies disclosed more information than non-manufacturing companies. The international exposure of a country's manufacturing sector may affect the level of disclosure in annual reports, and this facet differs from other sectors. Wallace *et al.* (1994) stated that companies in a particular industry might adopt additional regulations in disclosure practices that were not mandatory for companies in all industries. Owusu-Ansah (1998) reported that the disclosure in certain industries might be different depending on the nature of the work involved. For example, oil companies are known to have difficulty in recording depreciation, depletion and exploration of land. In addition, the type of product line and the diversity of product might also influence differential disclosure. Owusu-Ansah (1998) considered that a company dealing with many products might tend to disclose more information than one with a small line and few products. Hence, it is expected that companies in the manufacturing industry will disclose more information that non-manufacturing industry.

Ownership structure. Agency theory investigated by the studies of Jensen and Meckling (1976) and Fama and Jensen (1983) showed that companies with widely held shares attracted more potential interest than whose shares are closely held. Since annual reports are the main source of information for investors, management may have an incentive to provide more information to show that they are acting in a manner consistent with the interests of shareholders. In addition, the costs brought about by the separation of ownership and control have generated conflicts of interest between managers and shareholders. Owusu-Ansah (1998) reported that the costs of making information for internal decision-making purposes tend to be transferred to outside users. Therefore, it is expected that a widely held company is likely to have the ability to reduce the preparation cost and, therefore, increase information disclosure in its financial reports.

There has been a mixture of findings relating to ownership diffusion. Ruland *et al.* (1990) found that there was a significant relationship between voluntary disclosure, manager forecast and ownership structure. Djoko (1992) revealed that the extent of voluntary corporate disclosure was greater for foreign-based companies than their domestic counterparts. Mirshekary (1999) discussed the influence of government ownership on disclosure. Xiao *et al.* (2004) found that internet-based disclosure of Chinese listed companies were negatively associated with domestic share-ownership, positively related to legal person ownership and foreign-based ownership, and no relationship with individual shareholders.

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5. Results

5.1. Hypotheses testing

Student F-test was used to test the differences of levels of disclosure between various shareholder categories in this study. The F-test compares the observed differences between the means of sample groups. The *t* statistic and probability values are produced to indicate significant differences between groups. The probability value is critical at the 0.05 level. The study rejects the null hypothesis when the probability value is less than the 0.05 level, indicating that there are significant differences in disclosure between companies with different shareholder categories.

Figure 1 shows the mean of overall disclosure levels among the four types of companies in three periods. During 1992-2000 the average disclosure level for the entire sample companies was 26.95 per cent. The average disclosure levels were 23.95 per cent for A-share companies and 30.78 per cent for AH-share companies. The highest disclosure level was for B-share companies (31.50 per cent). During 1992-1996 the average of overall disclosure level was 23.18 per cent. The highest disclosure levels were AH-share companies (28.39 per cent), and the lowest disclosure was for A-share companies (20.06 per cent). The average disclosure level during 1997-2000 was 34.48 per cent. The disclosure levels for B-share (34.43 per cent) and AH-share (35.86 per cent) companies were higher than those of A-share companies (29.49 per cent). There were no AB-share companies in the sample during this period.

Table I reveals the result of Student's F-test to examine the disclosure by sample companies according to different categories of shareholders. The average disclosure level of B-share and AH-share companies was higher than that of A-share companies. Furthermore, the study observed the divergences in detail for the periods 1992-1996 and 1997-2000. To eliminate the effect of time of issue, the sample companies were

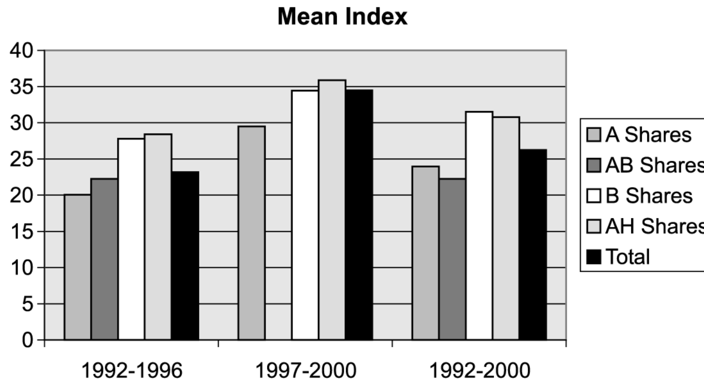

Figure 1.
Mean disclosure levels of companies with various shareholder categories (1992-2000)

Table I.
Mean differences and F-test between companies

	A-shares	AB-shares	B-shares	AH-shares	One-way ANOVA test F statistics	Significance
1992-1996	20.0573	22.2322	27.7755	28.3937	33.092	0.000
1997-2000	29.4931		34.4303	35.8559	12.015	0.000
1992-2000	23.9533	22.2322	31.4956	30.7771	47.015	0.000

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classified into two groups: those issuing equity before 1997 and those after. The results of Student F-test in Table I show that there are significant differences in the disclosure levels between A-share, AB-share, B-share and AH-share companies in the three periods at the 0.01 level. Therefore, *H1* that the levels of disclosures are significantly different between A-share, AB-share, B-share and AH-share companies, is accepted.

5.2. Multi-regression analysis

Model development. The dependent variable in this study is the extent of asset disclosure. To investigate the impact of political costs, earning management and institutional setting on corporate disclosure, the dependent variables in the model are divided into three disclosure indices: indices of overall companies, domestic-share companies and foreign-share companies. The independent variables in this study are corporate characteristics: company size (LOGASS), return on equity (ROE), leverage (LEVE), auditor size category (AUDIT), industry category (INDUS) and ownership diffusion (OWDI). A multi-regression model is established based on the development of dependent and independent variables.

$$DI = \alpha + \beta_1 LOGASS_i + \beta_2 ROE_i + \beta_3 LEVE_i + \beta_4 AUDIT_i + \beta_5 INDUS_i + \beta_6 OWDI_i + \varepsilon$$

where:

DI	= disclosure index.
$LOGASS_i$	= log of total assets.
ROE_i	= return on equity, ratio of net profit after tax to shareholders' equity.
$LEVE_i$	= ratio of total debts to the book value of total assets.
$AUDIT_i$	= 1 if company is audited by international accounting firm, otherwise 0.
$INDUS_i$	= 1 if company is manufacturing, otherwise 0.
$OWDI_i$	= ratio of the number of shares held by the top ten shareholders to the number of ordinary outstanding shares.
ε	= residual error.
α	= the constant.
β_i	= regression coefficients of impendent variables 1 to 6.
i	= 1, 2, ..., N and indicated the ith IPO in the sample.

Tables II–IV presents the results of multi-regression analysis of the relationship between asset disclosure and corporate characteristics. Model 1 tests the relationship for all sampled companies. The independent variables explain 41.3 per cent of the variance in the level of overall disclosure through the coefficient of adjusted R-squared. The relationship between dependent and independent variables is significant since the F statistic (21.594) is significant at a probability level of 0.001. The results indicate that

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LOGASS, ROE and AUDIT are significantly related to the level of overall disclosure for sampled companies at the 0.05, 0.001 and 0.001 levels respectively.

Model 2 tests the relationship in sampled companies for domestic-share based companies only. The independent variables explain 24.7 per cent of the variance in the level of overall disclosure through the coefficient of adjusted R-squared. The relationship between dependent and independent variables is significant since the F statistic (4.219) is significant at a probability level of 0.001. The results indicate that LOGASS, ROE and OWDI significantly influence the level of overall disclosure for domestic companies at the 0.005, 0.05 and 0.01 levels respectively.

Table II. Multi-regression results for asset disclosures – Model 1 – total sample: the results of single-step entry regression for DI

Variable	Coefficients	Beta	*T*	*p*-value
Constant	10.075		1.224	0.223
LOGASS	4.418	0.179	2.580	0.011
ROE	− 0.353	− 0.225	− 3.801	0.000
LEVE	4.637E-02	0.076	1.283	0.201
AUDIT	9.469	0.404	5.906	0.000
INDUS	1.236	0.058	1.023	0.308
OWDI	2.219E-02	0.029	0.478	0.634

Notes: Model 1 DI=10.08+0.042LOGASS − 0.004 ROE +0.0947 AUDIT; *R* square=0.643, Adjusted *R* square=0.413, F=21.594, *p*-value=0.000, Durbin-Watson=1.174

Table III. Multi-regression results for asset disclosures – Model 2 – Domestic share-type only: the results of single-step entry regression for DI

Variable	Coefficients	Beta	*T*	*p*-value
Constant	− 27.319		− 1.543	0.128
LOGASS	10.923	0.346	3.002	0.004
ROE	− 0.357	− 0.233	− 2.083	0.041
LEVE	1.731E-02	0.032	0.279	0.781
INDUS	1.788	0.095	0.865	0.391
OWDI	0.146	0.190	1.711	0.092

Notes: Model 2 DI= − 0.273+0.109 LOGASS − 0.004 ROE+0.0001 OWDI; *R* square=0.497, Adjusted *R* square=0.247, F=4.219, *p*-value=0.000, Durbin-Watson=1.407

Table IV. Multi-regression results for asset disclosures – Model 3 – foreign share-type only: the results of single-step entry regression for DI

Variable	Coefficients	Beta	*T*	*p*-value
Constant	14.652		1.606	0.111
LOGASS	3.531	0.144	1.893	0.061
ROE	− 0.250	− 0.161	− 2.221	0.028
LEVE	5.995E-02	0.091	1.375	0.172
AUDIT	13.272	0.575	7.265	0.000
INDUS	0.867	0.039	0.607	0.545
OWDI	− 4.348E-02	− 0.058	− 0.820	0.414

Notes: Model 3 DI=0.147+0.036 LOGASS − 0.003 ROE +0.113 AUDIT; R square=0.531, Adjusted *R* square=0.507, F=21.737, *p*-value=0.000, Durbin-Watson=1.495

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Model 3 tests the relationship in sampled companies with foreign-share based companies. The independent variables explain 50.7 per cent of the variance in the level of overall disclosure through the coefficient of adjusted R-squared. The relationship between dependent and independent variables is significant since the F statistic (21.737) is significant a probability of 0.001. The results indicate that LOGASS, ROE and AUDIT significantly relate to level of overall disclosure for sampled foreign-share companies at the 0.01, 0.05 and 0.001 level respectively.

The results in Tables II-IV support *H2* that there are different relationships between the levels of disclosures and corporate characteristics for A-, AB-, B- and AH-share companies. But the acceptance of *H2* applies for the corporate characteristics of LOGASS, ROE and to a lesser extent, AUDIT and OWDI.

6. Discussions and conclusions

The evidence of *H1* suggested systematic differences in financial disclosure and reporting among various groups of companies. For instance, B- and AH-share companies disclosed 31.5 per cent and 30.78 per cent of investigated items in their annual reports. In contrast, A- and AB-share companies disclosed 23.95 per cent and 22.23 per cent respectively. Therefore, B-share and AH-share companies provided more transparent information than A- and AB-share companies. Companies with foreign shareholders disclosed more information (36.49 per cent) than those with domestic investors only (32.79 per cent). The findings can be explained as follows. First, firms with both B- and H-shares disclose more information than those with only A-shares because the state has incentives to showcase the former on international capital markets (Ferguson *et al.*, 2002). Second, companies with foreign investment participation and overseas listing status will employ the IFRSs or the GAAP of the listing country to adjust annual reports, these companies increased information disclosure voluntarily in their annual reports in order to enhance their reputation and credibility.

Several factors have been identified by the extant literature as being relevant to voluntary disclosure levels. Firm size (LOGASS) was included because larger firms are subject to more public and regulatory scrutiny (Watts and Zimmerman, 1986) and thus are likely to voluntarily disclose more information to muster public support for reducing political costs and to raise capital (Chow and Wong-Boren, 1987; Lang and Lundholm, 1993). The finding of *H2* is consistent with the results of prior studies by Ettredge *et al.* (2002), Debreceny *et al.* (2002), and Ferguson *et al.* (2002) relating to Chinese listed companies' financial disclosures in annual reports.

Firm profitability was included because managers of profitable firms have greater incentives to disclose information to support the continuance of their positions and compensation arrangements (Wallace *et al.*, 1994; Inchausti, 1997) and to attract capital or to reduce the risk of being undervalued by the market (Grossman and Hart, 1980). The results in Tables II-IV provide evidence that the higher the firm's ROE, the less its disclosure. This result was found in the annual reports of both domestic share-category companies and foreign share-category companies. It is an unexpected result because it is in the opposite of that predicted traditional information economics theorems. A possible reason is that firms with foreign shareholders and overseas listing status faced more political exposure due to increased corporate disclosure regulations and

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political influence may intend to minimise that costs by choosing ways to smooth operating profit and manage earnings.

The findings in Tables II-IV also show that for companies employing international accounting firms are likely to provide more transparent information in reports. This result is consistent with agency theory that auditing helps to alleviate the interest conflicts between management and investors in companies. It is more apparent in companies with the involvement of foreign investment because they are more distant and have difficulties in understanding domestic standards. The larger audit firms have a stronger incentive to maintain their independence and to impose more stringent and extensive disclosure standards (DeAngelo, 1981; Malone *et al.*, 1993). In addition, larger auditors are more likely to be hired by managements who are cognizant of the signal of disclosure quality that larger auditors generate in the securities market (Datar *et al.*, 1991; Healy and Palepu, 2001).

The study's final finding applies to companies with domestic investors only – the higher the level of ownership concentration, the higher the level of disclosure. The reason is that Chinese listed companies traditionally have more state-owned shares and legal or institutional-shares than individual owned shares. Thus, the greater availability of corporate information serves to improve the confidence of state in its power over the company's resources allocation, while showing the efficiency of business operations in order to increase the willingness of other current and potential domestic investors to entrust their resources to the corporate sector.

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