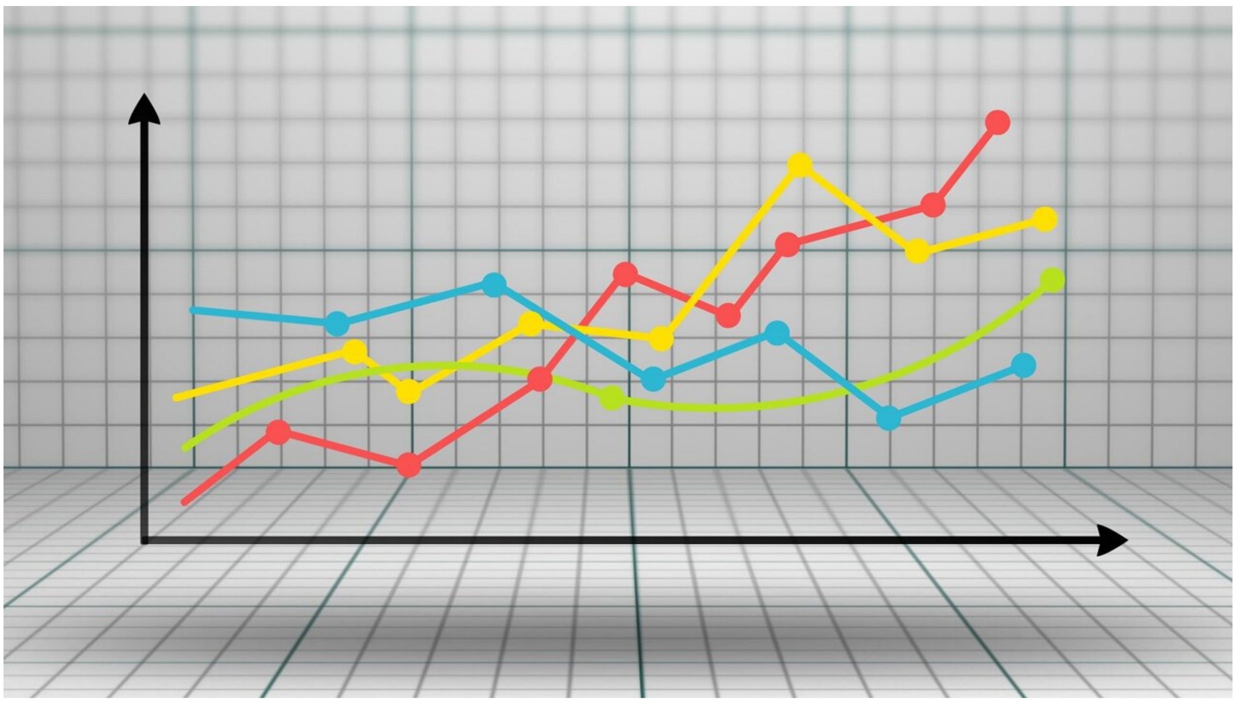
Chinese financial reporting prioritizes communicating stability, strong connections to stakeholders vs. shareholders

September 12 2023



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It's commonly accepted that U.S. and Chinese companies treat financial reporting and disclosure differently.

New research not only confirms that but digs into the motivations behind the distinction, using surveys with more than 200 Chinese executives who hold reporting responsibility. An overriding interest in communicating long-term stability and inspiring confidence in the company's prospects among a diverse range of stakeholders, and not primarily shareholders, as in the U.S., was a signature driver for the Chinese business leaders.

The study appears in the Journal of Accounting and Economics.

"Acknowledging differences in approaches and incentives behind financial reporting practices can help to open the 'black box' of the decision-making process of Chinese executives," said researcher Hai Lu, the McCutcheon Professor in International Business and professor of accounting, at the University of Toronto's Rotman School of Management who studies Chinese capital markets.

Prof. Lu and his co-researchers—Jee-Eun Shin, an assistant professor of accounting at the Rotman School, and Mingyue Zhang of the University of Waterloo—found that Chinese executives leaned more strongly towards using earnings information to underscore their firm's sustainability and predict future performance. Previous research has found that U.S. firms avoid long-term estimates in favor of validating recent earnings numbers.

While businesses in both countries are keen to present earnings information that demonstrates steady performance, Chinese executives were less motivated to manipulate earnings numbers through accounting practices, unlike U.S. companies. Instead, they worked with other stakeholders involved with their business, such as debt holders, controlling shareholders, suppliers, employees and government to coordinate activities that would reduce fluctuations. This is what happened in 2021 when a state-owned coal mining company worked with dozens of bond holders to push back a payout deadline, avoiding default.

Such close ties, and the Chinese cultural tendency to conduct business through social relationships, means that Chinese companies are less motivated to use the voluntary disclosure of company information to satisfy investors. Chinese firms also do not share American companies' urgency for issuing bad news about performance quickly, putting a higher priority on positive news.

These differences are rooted in fundamental variations in what drives each country's economy, the researchers say. In the U.S., it's financial markets, populated by diverse shareholders. But in China, governments and banks wield far more influence, along with other closely involved stakeholders. Chinese companies also tend to have concentrated ownership—government or private owners—giving minority shareholders significantly less power and lower priority when it comes to financial reporting.

Coupled with China's weak legal system, the differences suggest that "foreign investors should be aware" of the low litigation risks faced by Chinese companies and their differing attitudes towards the timing of bad news disclosure as compared with U.S. norms, said Prof. Lu.

Researchers generated their survey data by working with New Fortune Magazine, an influential Chinese media outlet that conducts a variety of annual rankings and is well-connected to Chinese firms and investors. The magazine distributed the researchers' survey to its contact list and helped researchers set up follow-up interviews. The survey questions were taken from previous surveys of U.S. firms and the data generated from research in each country were compared. A second survey of board secretaries in China with 595 responses, published in an online annex, supported the findings.

More information: Hai Lu et al, Financial reporting and disclosure practices in China, *Journal of Accounting and Economics* (2023). DOI: 10.1016/j.jacceco.2023.101598

Provided by University of Toronto