CORPORATE GOVERNANCE AND THE TIMELINESS OF FINANCIAL REPORTING: AN EMPIRICAL STUDY OF THE PEOPLE’S REPUBLIC OF CHINA

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ABSTRACT

Timeliness of financial reporting is one of the attributes of good corporate governance identified by the OECD and World Bank. Shareholders and other stakeholders need information while it is still fresh and the more time that passes between year-end and disclosure, the more stale the information becomes and the less value it has.

This paper examines the timeliness of financial reporting in the People’s Republic of China. The timeliness of financial reporting was measured by counting the number of days that elapsed between year-end and the date of the independent auditor’s report for a number of Chinese companies. Those results were then compared to data of non-Chinese companies in developed market economies to determine whether there was a significant difference. This study also examines which independent audit firms issued the audit opinion and which sets of accounting standards were used (IFRS, US GAAP or Chinese accounting standards) to determine which audit firms and accounting standards dominate.

INTRODUCTION

Transparency is a very important component of financial reporting. Companies must disclose anything that might influence the investment decision of an informed investor. Nothing of consequence may be hidden. This rule is widespread and pervasive. Stock exchanges require it. Government agencies require it. Various accounting rulemaking bodies require it, including the Financial Accounting Standards Board in the United States and the International Accounting Standards Board.

One aspect of transparency is timeliness. Generally speaking it is better to disclose information sooner rather than later, although there are some tradeoffs. For example, companies that issue their annual reports on January 1 are extremely timely but there is a certain probability that some of the information in that report is not as complete or accurate as would be the case if the company had spent more time preparing the statements and had issued them a few weeks or months later. There is an inverse relationship between the quality of financial information and the timeliness with which it is reported (Kenley & Staubus, 1974). Accounting information becomes less relevant with the passage of time (Atiase, Bamber & Tse, 1989; Hendriksen & van Breeda, 1992; Lawrence & Glover, 1998).
At the other extreme are financial statements that are issued a year or two after the end of the fiscal year. Although the statements may fairly reflect the financial position of the company, the information is stale by the time it reaches the public. Somewhere between one day and a year or two is the optimum delay between year-end and the issuance of the annual financial statements. Companies must have sufficient time to prepare the statements and the independent auditor must have sufficient time to audit the statements after they are prepared, but the public must have the information available before it becomes stale.

Some stock exchanges and securities regulatory commissions have rules regarding how long financial statements may be delayed before issuance but not all countries and stock exchanges have such rules and even where such rules exist they may not always be followed.

There is some evidence that companies in transition economies issue their financial statements far later than do companies in the more developed market economies (McGee, 2006; 2007a&b). That has been the case in some former Soviet Union countries, at least. China might fit the definition of a transition economy, in the sense that it is moving away from central planning and toward a market model. But the Chinese transition has been different than the transition from central planning to a market economy that has taken place in the former Soviet Union, Eastern and Central Europe. Perhaps Chinese companies are as timely in their financial reporting practices as are the companies in the more developed market economies. To date no study has been done to answer this question. Thus, there is a gap in the literature that the present study aims to fill.

**REVIEW OF THE LITERATURE**

Studies show mixed conclusions regarding the relationship of quickness of reporting and the nature of the information being reported. Some studies show that good news is reported before bad news whereas other studies show that bad news is reported before good news.

There is some evidence to suggest that it takes more time to report bad news than good news (Bates, 1968; Beaver, 1968), both because companies hesitate to report bad news and because companies take more time to massage the numbers or resort to creative accounting techniques when they have to report bad news (Givoli & Palmon, 1982; Chai & Tung, 2002; Trueman, 1990). Stated differently, there seems to be a tendency to rush good news to press, such as better than expected earnings, and delay the reporting of bad news or less than expected earnings (Chambers & Penman, 1984; Kross & Schroeder, 1984). Dwyer & Wilson (1989) found this relationship to hold true for municipalities. Haw, Qi and Wu (2000) found it to be the case with Chinese companies. Leventis and Weetman (2004) found it to be the case for Greek firms.

However, Annaert, DeCeuster, Polfliet & Campenhout (2002) found that this was not the case for Belgian companies and Han & Wang (1998) found that this was not the case for petroleum refining companies, which delayed reporting extraordinarily high profits during the Gulf crisis of the 1990s, perhaps because political repercussions outweighed what would otherwise have been a good market reaction. Rees & Giner (2001) found that companies in France, Germany and the UK tended to report bad news sooner than good news.

A study by Basu (1997) found that companies tend to report bad news quicker than good news, presumably because of conservatism. Gigler & Hemmer (2001) discuss this point in their study, which finds that firms with more conservative accounting systems are less likely to make timely voluntary disclosures than are firms with less conservative accounting systems.
Building upon the Basu study (1997), Pope and Walker (1997) found that there were cross-jurisdictional effects when extraordinary items were either included or excluded, using US and UK firms for comparison. Han & Wild (1997) examined the potential relationship between earnings timeliness and the share price reactions of competing firms. But Jindrichovska and Mcleay (2005) found that there was no evidence of conservatism in the Czech accounting system when it came to reporting bad news earlier than good news, presumably because the Czech tax system offers little incentive to do so. Ball, Kathari and Robin (2000) found that companies in jurisdictions that have a strong shareholder orientation tend to disclose earnings information sooner than companies in countries operating under a legal code system.

There is also a relationship between the speed with which financial results are announced and the effect the announcement has on stock prices. If information is released sooner, the effect on stock prices is more pronounced. The longer the time lapse between year-end and the release of the financial information, the less effect there is on stock price, all other things being equal (Ball & Brown, 1968; Brown & Kennelly, 1972). This phenomenon can be explained by the fact that financial information seems to seep into the stock price over time, so the more time that elapses between year-end and the release of the financial reports, the more such information is already included in the stock price.

Some countries report financial results faster than other countries. DeCeuster & Trappers (1993) found that Belgian companies take longer to report their financial results than do Anglo-Saxon countries. Annaert, DeCeuster, Polfliet & Campenhout (2002) found this to be the case for interim information as well. Companies can report financial results faster on the internet and the information can be more widely disbursed but posting two-year-old annual reports does nothing to improve timeliness (Ashbaugh, Johnstone & Warfield, 1999).

Atiase, Bamber & Tse (1989) found that large companies report earnings faster than small companies and that the reporting of earnings has a more significant market reaction for small firms than for large firms. In a study of Australian firms, Davies & Whittred (1980) found that small firms and large firms made significantly more timely reports than medium-size firms and that profitability was not a significant variable.

Whittred (1980) found that the release of financial information for Australian companies is delayed the first time an audit firm issues a qualified report and that the extent of the delay is longer in cases where the qualification is more serious. Keller (1986) replicated that study for US companies and found the same thing to be true. Whittred and Zimmer (1984) found that it took Australian firms in financial distress a significantly longer time to publish their financial information. A study of more than 5,000 annual reports of French companies found that it took longer to release audit reports where there had been a qualified opinion, and that the more serious the qualification, the greater the delay in releasing the report (Soltani, 2002).

Krishnan (2005) found that the audit firm’s degree of expertise has an effect on the timeliness of the publication of bad earnings news. Audit firms that specialize in the industry in which the company operates are timelier in reporting bad financial news than are audit firms that have less industry expertise.

A few studies have been published that compare the timeliness of financial reporting in transition economies and the more developed market economies. McGee (2006, 2007b) found that companies in the Russian energy sector take a significantly longer amount of time to report financial results than do non-Russian companies in the energy sector. Another study found the same thing to be true of the Russian telecom industry (McGee, 2007a).
METHODOLOGY

In order to determine the timeliness of financial reporting in China it was necessary to locate the annual reports of Chinese companies, then find the audit opinion and count the number of days between year-end and the date of the audit report. Only companies that publish English language annual reports were selected. However, this subset of Chinese companies is also the group most likely to solicit international capital, since companies that publish their financial statements only in Chinese are unlikely to attract foreign investment to the extent that English language financial statements would.

Eighteen Chinese companies were selected. Some of them appear on Hoover’s Most Viewed Company list. Twenty-one non-Chinese companies were chosen for comparison purposes. The five most recent annual reports were selected (usually 2002 – 2006) and the number of days between year-end and the date on the audit report were counted and compiled. Information regarding audit firm and accounting standards used was also compiled.

FINDINGS

Table 1 shows some statistics. A total of eighty-nine (89) calendar years for 18 Chinese companies were examined. One hundred five non-Chinese company annual reports were also examined for comparison purposes.

The audit opinion for the average Chinese company was dated 92.1 days after year-end. However, the range varied widely, from a low of 24 days to a high of 181 days. In other words, the average Chinese company with a December 31 year-end had an audit opinion dated April 3, although some Chinese companies had a date as early as January 24 and others had a date as late as June 30.

The average date for non-Chinese companies was 65.5 days, or March 7. The range of dates was 46 to 111, or February 15 to April 21. The means for the two groups was significantly different at the 1 percent level [p <= 1.483e-17].

<table>
<thead>
<tr>
<th>Sample Size</th>
<th>Days Delay</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese Companies</td>
<td>89</td>
<td>92.1</td>
</tr>
<tr>
<td>Non-Chinese Companies</td>
<td>105</td>
<td>65.5</td>
</tr>
</tbody>
</table>

p <= 1.483e-17

Chart 1 shows the range of scores for the Chinese and non-Chinese companies. From the chart it is obvious that Chinese companies take longer to issue their financial statements than do non-Chinese companies. And since the Chinese companies selected for this study are some of the
best Chinese companies, it is reasonable to expect that the average Chinese company takes even longer to issue its financial statements than the companies included in this study.

Table 2 shows the frequency with which the various audit firms were hired by the Chinese companies in the study. The total count was 95 for the audit firms, compared to 89 for the dataset of days delay because the number of days delay could not be determined in 6 cases.

<table>
<thead>
<tr>
<th>Audit Firm</th>
<th>Freq.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>BDO</td>
<td>5</td>
<td>5.3</td>
</tr>
<tr>
<td>Deloitte &amp; Touche</td>
<td>1</td>
<td>1.1</td>
</tr>
<tr>
<td>Ernst &amp; Young</td>
<td>16</td>
<td>16.8</td>
</tr>
<tr>
<td>KPMG</td>
<td>25</td>
<td>26.3</td>
</tr>
<tr>
<td>PWC</td>
<td>34</td>
<td>35.8</td>
</tr>
<tr>
<td>Other</td>
<td>14</td>
<td>14.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>95</td>
<td></td>
</tr>
</tbody>
</table>

PricewaterhouseCoopers was the audit firm of choice, with 35.8 percent of the audit opinions for Chinese companies, followed by KPMG with 26.3 percent. The other Big-4 audit
firms also issued some audit opinions, although Ernst & Young issued many more than Deloitte & Touche. This result is somewhat surprising, given the fact that Deloitte & Touche has a strong presence in former Soviet countries. BDO also issued five audit opinions in the sample. Other audit firms accounted for 14.7 percent of total audit opinions.

Table 3 shows which accounting standards Chinese companies used in their annual reports. All Chinese companies are required to use Chinese accounting standards, but some Chinese companies also issue their financial statements using either International Financial Reporting Standards (IFRS) or U.S. GAAP, since these are the two internationally recognized standards that most international investors understand. Companies that want to raise capital abroad more or less need to have their financial statements prepared in accordance with one of these internationally recognized sets of standards.

IFRS were used twice as frequently as U.S. GAAP but Chinese and Hong Kong standards were used far more frequently than either of the two internationally recognized standards. There are several possible explanations for the relatively infrequent use of IFRS and U.S. GAAP. Chinese companies that finance internally within China have little or no use for any kind of international accounting standards. Also, it is possible that some of the Chinese companies in the sample do have financial statements prepared in accordance with either IFRS or U.S. GAAP but merely did not post them on their websites.

It was not a surprise to find that IFRS were used more frequently than U.S. GAAP. The convergence of accounting standards that has been taking place for more than a decade has caused IFRS to rise in terms of importance while the importance of U.S. GAAP has declined over time.

<table>
<thead>
<tr>
<th>Standard Used</th>
<th>Freq.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese</td>
<td>43</td>
<td>45.3</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>23</td>
<td>24.2</td>
</tr>
<tr>
<td>IFRS</td>
<td>19</td>
<td>20.0</td>
</tr>
<tr>
<td>U.S.GAAP</td>
<td>10</td>
<td>10.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>95</strong></td>
<td></td>
</tr>
</tbody>
</table>

**CONCLUDING COMMENTS**

The goal of the study was achieved. It was determined that Chinese companies take significantly longer to issue their financial statements than do non-Chinese companies. Thus, Chinese financial statements are less timely than the financial statements of non-Chinese companies in developed market economies. Since timeliness is an attribute of good corporate governance (OECD, 1998), it is also reasonable to conclude that the corporate governance in
Chinese companies is not yet on the same level with that of companies in OECD countries, at least not as far as the timeliness of financial reporting is concerned.

It is likely that the situation will improve. Chinese companies will likely take less time to issue their financial statements and annual reports in the years to come. There are several reasons for this prediction. For one, the Chinese government is aware of corporate governance principles as advocated by the OECD, World Bank, IMF and others. Secondly, Chinese companies are also aware of corporate governance principles, although they are not always easy to adopt and implement. But this situation will change over time.

Another influential factor is the communication that takes place between Chinese company management and foreign investors. If foreign investors put pressure on Chinese companies to issue their financial statements in a more timely manner, there is a tendency for them to do so. The Big-4 audit firms will also help to make the goal of more timely financial reporting a reality. Thus, it is probably only a matter of time before Chinese companies will issue their financial reports in as timely a manner as non-Chinese companies. However, that point has not yet been reached.

REFERENCES


Hoover’s Most Viewed Company Directory by Country
[www.hoovers.com/free/mvc/country.xhtml](http://www.hoovers.com/free/mvc/country.xhtml)


