Voluntary Disclosure in a Changing Regulatory Environment – Evidence from Chinese Stock Market

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Abstract

This paper investigates the voluntary disclosure made by 297 Chinese listed firms in their 1995-2006 annual reports. It aims to determine how firms in the Chinese stock market have responded to the coercive pressure exerted upon them by the market regulatory body, the Chinese Security Regulatory Commission (CSRC) in terms of providing transparent information to the stock market. The findings show that over the study period, listed firms have gradually increased their voluntary disclosure. This paper also explores the main characteristics of voluntary disclosure made by listed firms in the Chinese stock market. It is concluded that voluntary disclosure has been adopted by firms to achieve institutional legitimacy in the stock market.

Keywords: Institutional theory, Voluntary disclosure, The Chinese stock market

1. Introduction

After more than three decades' development, the Chinese stock market has been transformed into the largest emerging stock market in the world. It is the biggest stock market in Asia outside Japan with total market capitalization equivalent to US$2.6 trillion at 2009 (CSRC, 2009). The institutional environment in which Chinese listed firms operate is characterised by heavy government involvement and intervention. This reflects the main characteristic of China's so called "socialist market economy". The regulatory agent of the Chinese government, the Chinese Security Regulatory Commission (CSRC) has closely managed and monitored listed firms in the Chinese stock market since it was established in the early 1990s. With the economy's hunger for direct foreign investment, the CSRC has the political power over listed firms to ensure that the political anxiety of the Chinese government is minimized. The CSRC recognizes the importance of "investor protection" as the foundation of the future prospects of the stock market and has employed a series of strategies and actions to improve stock market efficiency. These actions include stipulating corporate disclosure regulations, establishing a corporate governance regime, providing training for investors and independent directors, and imposing public sanctions against listed firms. These actions have sent a clear and strong signal to listed firms that they need to devote themselves to transparent disclosure.

The aim of this paper is to investigate how Chinese listed firms have responded to the pressure exerted by the CSRC in respect of their information disclosure behaviour. It examines empirically the voluntary disclosure made by 297 listed firms between the 1995 and 2006 financial reporting periods. The findings of this longitudinal study represent the long-term trend of voluntary disclosure in the Chinese stock market and present the characteristics of these voluntary disclosures. Voluntary disclosures are the disclosures made by firms in excess of mandated disclosure requirements. They represent free choices on the part of management to provide information deemed relevant to the decision needs of users of their annual reports (Meek *et al.*, 1995). Eng and Mak (2003) classify voluntary disclosure into strategic information, financial information and non-financial information. It is asserted that voluntary disclosure reduces firms' cost of capital and improves transparency by reducing information asymmetry and investors react to information voluntarily disclosed to the stock market, meaning voluntary disclosure is value-relevant to investors' decision-making (FASB, 2001).

The strategic importance of the Chinese stock market provides the motivation for this study. The establishment of the Chinese stock market is a direct outcome of the economic reform in China. The Shanghai and Shenzhen Stock Exchanges were officially opened in 1990 and 1991, respectively. The development of China's stock market is pivotal to the privatization of the country's state-owned enterprises (SOEs). One of the essential factors supporting sustainable economic development in China is the development of its capital market. The 1992 *State Government Report* indicated explicitly that the standardization and prosperity of the capital market in China would serve to optimize the allocation of resources, thereby promoting the growth of the national economy. The established regulatory framework of the Chinese stock market, aiming to protect investors' interest and attract more foreign investment to China, sends a strong signal to Chinese society and global markets that the development of a capital market is essential to China's long-term economic prosperity. However, the effectiveness of the government's regulatory framework in respect of listed firm's disclosure is unknown.

The theoretical framework developed in this paper is based on a system-orientated theory, namely institutional theory, which addresses the importance of the impact of the institutional environment on organizations' behaviour. Institutional theory suggests that institutional pressures may be felt as force, as persuasion, or as an invitation to join in collusion. Organizational change is a direct response to government mandate (DiMaggio & Powell, 1983). Voluntary disclosure is adopted by firms for the purpose of institutional legitimacy. In other words, voluntary disclosure could be seen as firms' response to the pressure exerted on them by regulatory bodies. Adopting institutional theory, this study predicts that Chinese listed firms would change their disclosure behaviour when confronted with the pressure from the CSRC in respect of transparent information disclosure.

This study will make two main contributions to the existing voluntary disclosure literature. First, while the factors motivating firms to voluntarily disclose information have been widely investigated and firm characteristics including profitability, leverage, size, industry classification and firms' corporate governance attributes such as ownership structure, composition of board of directors and existence of audit committee have been identified as determinants of voluntary disclosure (Meek *et al.*, 1995; Eng & Mak, 2003, Xiao & Yuan, 2007), the trend of voluntary disclosure has not been well addressed, especially in the context of emerging and developing stock markets. The development of the Chinese stock market during the past twenty years provides a good research opportunity to explore voluntary disclosure practices in the Chinese context through a longitudinal study. A long-term trend of voluntary disclosure since the early days of the Chinese stock market and any changes related to it can also be traced by repeating observations of the same sample firms. The trend of change will reflect the impact of the institutional environment on firms' disclosure behaviour. In China's case, the trend of voluntary disclosure over the years will reflect the effectiveness of the Chinese government's regulatory framework on firms' disclosure decision-making. Second, this study contributes to the voluntary disclosure literature by providing evidence, showing the characteristics of the content of voluntary disclosure in a developing stock market.

The remainder of the paper is organized as follows. The second section examines and reviews the relevant literature for this study. This is followed by a discussion of the institutional environment of the Chinese stock market. The hypotheses are then developed followed by a description of the research method, sample selection and data collection. Lastly a discussion and analysis are provided, followed by the conclusion.

2. Literature Review

Institutional theory asserts that interacting organizations are linked by symbiotic relationships that can create institutional pressures limiting the set of rational choices they can use in demonstrating legitimacy to the public (Carpenter & Feroz, 1992). Institutional theory implies that the interests, objectives and actions of those external to any given organization may also be critically important in understanding an entity's accounting and disclosure choices. DiMaggio and Powell (1983) propose three classifications that relate to the motivation to adopt institutional

practices – coercive isomorphism, mimetic isomorphism and normative isomorphism. Isomorphism refers to the adoption of an institutional practice by an organization.

Coercive isomorphism results from both formal and informal pressures exerted on organizations by other organizations upon which they are dependent, and by social expectations in the society within which they operate. Deegan (2006) relates this form of isomorphism to stakeholder theory and observes that an entity will use voluntary corporate reporting disclosures to address the economic, social, environmental and ethical values and concerns of those stakeholders who have the most power over the entity. Mimetic isomorphism is a process that takes place when an organization attempts to imitate a more successful referent organization, a process that is often due to the uncertainty and lack of guidance in its own environment. Normative isomorphism stems from professionalization, that is, the collective struggle of members of an occupation to define their conditions and methods of work. In terms of voluntary disclosure, normative isomorphic pressures could arise through less formal group influences from a range of both formal and informal groups to which managers belong – such as the culture and working practices developed within their workplace.

Institutional theory provides a complementary perspective in explaining corporations' disclosure behaviour and in understanding how corporations respond to changing social and institutional pressures and expectations. Carpenter and Feroz (1992) draw on institutional theory to explain the state of New York's decision to adopt GAAP. The evidence indicates that the role of professional élites was an important factor in accelerating the mimetic and coercive isomorphic processes that were creating institutional pressures for New York to adopt GAAP. Various elements of the institutional environment (the nation/state, the professions, resource providers and the public) used powerful representatives to create institutional pressure for adopting GAAP.

3. Regulatory Environment in the Chinese Stock Market

The Chinese government continues to maintain its important influence on the development of the Chinese stock market. Its main regulatory agency, the CSRC, has been actively engaged in the regulation, administration and operation of listed firms in the stock market. La Porta *et al.* (2000) argue a legal approach is a more fruitful way to promote corporate governance and to protect minority investors in a country's stock market. In China, although the Chinese government has enacted the *Company Law* and the *Security Law* in recent years, the overall legal system is still relatively primitive by the standards of capitalist countries (Berkman, 2008). One successful civil suit over fraudulent financial information the first 12 years of the Chinese stock market is a testament to the lack of legal redress in securities cases (Chen *et al.*, 2005). Under the *Security Law*, a civil case against a listed firm can only be brought to the court after the CSRC has made an investigation. Class action lawsuits are not possible in China and so a lawsuit brought by an individual investor is very costly and has a low probability of success (Chen *et al.*, 2005). Given the weak legal mechanism in China in respect of investor protection, the question that needs to be raised is who is in the best position to play this role in the Chinese stock market? Glaeser *et al.* (2001) suggest that in emerging markets with relatively weak legal systems, regulators can provide an effective substitute for ineffective judicial enforcement. This hypothesis is arguably particularly relevant to the Chinese stock market.

3.1 Corporate Disclosure Framework

The primary purpose of a corporate disclosure regulatory framework in China is to improve the efficiency of the Chinese stock market and protect investors' interests (CSRC, 1996). In 1993, the CSRC issued *Detailed Rules for Implementation of Information Disclosure of Publicly Listed Firms*. This regulation marks the beginning of a series of specific disclosure rules and requirements stipulated by the CSRC in order to strengthen the transparency of information disclosure made by listed firms. In early 1994, the CSRC released the *Contents and Formats of Listed Firms' Annual Reports*. It is the first regulation for the content and format of annual reports in the Chinese stock market. In 1997, the CSRC established the formal draft and later amended it in 1998, 1999, 2001 and 2002 respectively. A series of revisions have significantly increased the information that listed firms are mandatorily required to disclose to the market. In addition to financial information, listed firms are required to disclose information related to corporate governance, such as ownership structure and the working experience and education background of directors and management personnel. Hu (2002) indicates that there have been several steps taken by the CSRC in improving the information usefulness of the annual report. First, this regulation explicitly requires firms to disclose the information related to earning distribution. When companies make a profit but decide not to distribute dividends to investors, listed firms are required to disclose reasons and a plan of how the retained profit will be used. This requirement reflects the CSRC's concern for public investors' interest protection. Second, listed firms are required to disclose whether there is a complete separation of management personnel, assets and the financial system between listed firms and their parent entities. Listed firms are supposed to be the pioneer of modern enterprises in China; it is the CSRC's expectation that listed firms should undertake a leadership role in corporate

governance. Third, this regulation addresses specifically the independent role of accounting and auditing firms. An annual report must be accompanied by an auditor's report.

3.2 Corporate Governance Regime

In January 2001, the CSRC issued its *Code of Corporate Governance for Listed Companies in China*, based on the *OECD Principles of Corporate Governance,* 1999. This code signals a new direction in the development of China's corporate sector and has been used as an important tool for raising the standard of corporate governance in China (Tomasic & Andrews, 2007). The *Code* addresses the rights of shareholders and stakeholders, the responsibilities the directors and management of listed firms should undertake, and the importance of information disclosure.

In August 2001, the CSRC released the *Guide Opinion on Establishing Independent Director System by Listed Companies*, with the intention that independent directors would take on more of the monitoring responsibilities that would result in greater transparency in listed firms. In the new regulations, the main responsibility of independent directors is to protect investors' rights, especially public minority investors. Independent directors are authorized to submit proposals to call shareholders' meetings, to recruit or dismiss accounting firms and invite independent auditors to certify independent financial reports, apart from their normal duties as board members. Major related-party transactions have to be approved by independent directors and independent directors can serve as chairs of the auditing, compensation and nomination committees and they must be in the majority on those committees. The independent director system has contributed positively to the credibility of corporate information disclosure and increasing minority investors' wealth (Tomasic & Andrews, 2007).

3.3 Enforcement of Investor Protection

Over the years, investor protection has been acknowledged by the CSRC as one of the most important measures to support the steady growth of the Chinese stock market. Aiming to promote and protect investor interest, the CSRC introduces, on average, twenty major policies each year to address the stock issue system, trading and supervision of listed firms (People's Daily, 2005b). Since the establishment of the CSRC in 1992, more than 300 regulations, rules, standards and guidelines concerning the securities market have been stipulated by the MOF and the CSRC. In respect of its enforcement, the CSRC declares that its major responsibilities are supervising security markets and exercising vertical power of authority over the regional and provincial supervisory institutions of the market, and investigating and penalizing activities violating security laws and regulations. The CSRC acknowledges that investors are expecting stronger supervision of listed firms' information. Firms that fail to provide the capital market with timely, adequate and transparent information will face severe penalties from the CSRC (People's Daily, 2005a). In the early and mid-1990s, the CSRC enforcement actions were weak and punishment was lax. Thus, in the earlier days, the CSRC was viewed as being ineffective (Chen *et al.,* 2005). From 1998, the CSRC gained overall regulatory power and has over-riding control over the securities industry.

The CSRC has also publicly pledged to improve the transparency of its own work to ensure the efficiency of capital market reforms and to curb corruption. In 2005, the CSRC further implemented the stock market reform plans mapped out by the State Council and steadily opened up the market. According to Shang Fulin, the former chairman of the CSRC, strong protection of the interests of public investors is the priority for the reforms, and an accountability culture needs to be developed (CSRC, 2000). The "transparency" principle of the CSRC can be reflected by the composition and work of its listing approval committee. The Committee, which reviews and approves the listing applications of domestic companies, was established by the CSRC in 2003. The members are made up of representatives from other government departments, securities businesses, lawyers, accountants, fund managers and academic scholars who can represent various interest groups and present professional opinion on listings. Since 2003, the names of the members that review each stock or bond issue application have been released on the CSRC's website to ensure transparency. In fighting against corruption in the process of listing approval, the CSRC has also pledged to create legal access for normal communications between listing committee members and the listing applicants, such as giving the latter more opportunities to introduce their enterprises and respond to problems raised during the reviews (CSRC, 2005).

4. Hypothesis Development

Hypotheses developed in this section draw from the review of institutional theory literature and discussion of CSRC's role in managing the Chinese stock market and are used to predict and explain listed firms' voluntary disclosure. The pressure exerted by the CSRC on listed firms to provide transparent information disclosure forms the foundation of the prediction that listed firms would gradually increase the level of voluntary disclosure in their annual reports between 1995 and 2006. Adopting the institutional perspective, the regulatory agent of the Chinese stock market, the CSRC, has created coercive isomorphism in the form of government mandated information disclosure requirements, corporate government regime and strong enforcement of its regulations. Therefore,

coercive isomorphism, in the context of the Chinese stock market, results from pressure exerted on listed firms by the CSRC, the organization that listed firms are dependent on. The dependent relationship between the CSRC and listed firms is reflected by heavy involvement of the CSRC in firms' Initial Public Offer (IPO) process, trading suspension and de-listing decisions (CSRC, 2009).

The CSRC has always encouraged firms to voluntarily disclose information which is relevant to investors' decision-making, in addition to their mandatory information disclosure. For example:

1. The *Standards of Contents and Formats of Information Disclosure by Public Issuing Companies* (1993, 2001 and 2003 versions) states: "*This regulation represents the minimum requirement of information disclosure of listed firms. Firms should also disclose any other information which will affect investors' economic decision-making, no matter this information is required to be disclosed by this regulation*".

2. The *Code of Corporate Governance for Listed Companies in China* (2001) states: "*In addition to disclosing mandatory information, a company shall also voluntarily and timely disclose all other information that may have a material effect on the decisions of shareholders and stakeholders, and shall ensure equal access to information for all shareholders*".

3. The *Guidance of the Relationship between Listed Firms and Public Investors* (2005) states: "*One of the basic principles of establishing a good investor-firms relationship is to have transparent information disclosure. In addition to mandatory disclosure, firms should voluntarily disclose other information which the investors care about*".

As the CSRC strongly advocates that listed firms voluntarily disclose information, it is expected that firms will adopt voluntary disclosure as a means of achieving institutional legitimacy, in order to gain CSRC's support and approval to firms' capital funding raising and trading through the stock market. Therefore, it is expected that the level of voluntary disclosure would have increased in the Chinese stock market across the 1995-2006 reporting periods.

4.1 Longitudinal Disclosure Levels

This study investigates listed firms' voluntary disclosure during the period 1995 to 2006. The entire testing period is further divided into three distinct testing phases: Phase I, 1995-1998; Phase II, 1999-2002; and Phase III, 2003-2006. These three phases represent three distinct phases of the history of the Chinese stock market. According to the main features of each phase, for the purpose of this study, they are named as the "developing phase", "corporate governance regime phase" and "established phase", respectively. The opening of two stock exchanges, one in Shanghai and one in Shenzhen in 1990 and 1991 respectively, marks the establishment of the Chinese stock market. Of the three testing periods, the 1995-1998 periods represent the initial, developing phase of the Chinese stock market. During this testing phase, the regulatory agency, the CSRC, undertook an administration role in the stock market, rather than strategically managing its development. It was not until mid-1992 that the CSRC started to promulgate a series of accounting and reporting regulations to regulate financial information disclosure in the stock market. Therefore, the level of voluntary disclosure in the reporting periods 1995-1998 is expected to be lower than in the later two phases.

The second testing phase covers the reporting periods 1999-2002. During this phase, the CSRC had further committed to the development of the stock market regulatory framework. Significant accounting and reporting regulations implemented during this phase included a series of Chinese accounting standards, the Securities Law and more information disclosure rules. The CSRC changed its emphasis from market administration to public investor protection. The *Guidelines for Establishing Independent Directors System for Listed Companies* and the *Code of Corporate Governance for Listed Companies* released by the CSRC in 2001 and 2002, respectively, highlighted the regulatory agencies' belief that strong corporate governance among listed firms would play a positive role in improving investor interest protection. Several high-profile legal actions against listed firms caused by misleading and fraudulent information disclosure, increased demands from the investment community for improved disclosure. The pressure from the CSRC increased dramatically during this phase. Therefore, the level of voluntary disclosure in this phase is expected to be higher than that in the reporting periods 1995-1998.

The last testing phase includes the reporting periods 2003-2006. In this phase, as required by CSRC regulation, listed firms have all implemented the independent director system, and at least one-third of the directors on their boards are independent directors. The CSRC's aim of establishing the independent director system was to further improve corporate governance of listed firms and protect the interests of investors in the Chinese stock market. The level of voluntary disclosure in this phase is, therefore, expected to be higher than that in both the "developing phase" and the "corporate governance phase". For the longitudinal disclosure level, it is proposed that:

Hypothesis 1: The level of voluntary disclosure increased in the Chinese stock market throughout the 1995-2006 reporting periods.

Hypothesis 2: The level of voluntary disclosure increased in the Chinese stock market statistically significant in the "corporate governance phase".

5. Research Method

The longitudinal approach adopted in this study provides valuable insight into the characteristics of voluntary disclosure made by sample firms and reports the trends and switch points in their voluntary disclosure. To be included in the sample, listed firms must have satisfied the following two selection criteria: (1) Firms must be listed continuously on either the Shanghai Stock Exchange or the Shenzhen Stock Exchange spanning 1995-2006 and, thus, twelve years' annual reports are available for examination; (2) Firms must belong to an industry classification other than banking and financial institutions, which are subject to a different accounting system and disclosure requirements in China. The first selection criterion is to ensure the continuous observation of the disclosure behaviour of the same group of listed firms during the entire testing period to satisfy the minimum requirement of a longitudinal study. The second selection criterion is to ensure that all sample firms are under the same regulatory regime in respect of their information disclosure. In such a way, the information disclosed by sample firms is comparable. Application of the above criteria results in a sample of 297 firms. A voluntary disclosure checklist was designed to capture the level of voluntary disclosure across three testing phases is used. The design of the checklist was based on a survey of the academic literature and reference to the voluntary disclosure framework recommended by the Financial Accounting Standards Board (FASB) in the United States (US). Following the method adopted by Eng *et al.* (2001), Eng and Mak (2003), a different level of importance is attached to different disclosure categories and to each specific item in order to reflect the significance of different types of information to investors' decision-making during the development of the Chinese stock market.

6. Results

The average numbers of firms voluntarily disclosing strategic information are 116 (39%) in Phase I, 250 (84%) in Phase II and 271 (91%) in Phase III. In respect of financial information disclosure, on average 58 (20%) firms made voluntary disclosure in Phase I, 124 (42%) firms in Phase II and 152 (51%) firms in Phase III. For non-financial information, 49 (17%) firms made voluntary disclosure in Phase I, 101 (34%) firms in Phase II and 104 (35%) in Phase III. These results show that, first, there is a progressive increase in the number of firms making voluntary information disclosures over the three testing phases. Secondly, there is a significant increase in the number of firms voluntarily disclosing information during Phase II. The average number of disclosing firms in Phase II is double the average number of disclosing firms in Phase I. The examination of the number of firms disclosing information indicates that listed firms in the Chinese stock market responded positively to the pressure exerted by the CSRC over the three testing phases, especially during Phase II (1999-2002) when the CSRC strengthened the financial reporting and disclosure regulations. Therefore, the results support both Hypothesis 1 and Hypothesis 2.

6.1 Descriptive Statistics of Information Disclosure

The mean voluntary disclosure score (VDS) of each specific information disclosure item during the three testing phases were calculated. Further analysis of the mean of disclosure items within disclosure categories determines listed firms' voluntary disclosure preferences.

General corporate information: this category has five disclosure items, covering the history of the firm, organization structure, main business activities the firm is engaged in, principal products and market. There is no information disclosed voluntarily by listed firms to illustrate their firms' history and organization structure throughout the three testing phases. The mean VDS of General Description of Business Activities is changed from zero in Phase I, to 0.5 in Phase II and 1 in Phase III. The example of voluntary disclosure is a detailed description of the scope of firms' business assets and properties. Voluntary disclosures are made in respect of principal products and markets throughout the three testing phases. Firms are found detailing their products, brand names and registered trademarks in their annual reports. The strongest disclosure made under this information category is the principal market. Firms choose to indicate which provinces in China are their current markets and where their potential markets are located, both domestically and internationally. The mean VDS increase from 0.75 in Phase I, to 7.75 in Phase II and 11.75 in Phase III.

Corporate strategy: this category covers firms' current and future strategies and their impact on firms' results in the present and in the future. Voluntary disclosures are found for all five disclosure items throughout the three testing phases. Examples of current management strategies disclosed in annual reports are strategies to control operating expenses and strategies for spending on research and development. Strategies to develop new products with

high-technology components, future acquisitions and expanding overseas markets are examples of future disclosures. The Future Strategy disclosure item sees the strongest trend in voluntary disclosure, with mean VDS increases from 13.25 in Phase I, to 84.5 in Phase II and 193.8 in Phase III. This is followed by the Current Strategy disclosure item. Few firms voluntarily disclose the impact of their strategies on current and future results. The voluntary disclosures of the impact of strategies on current and future results are qualitative rather than quantitative possibly indicating that the sample firms have difficulty in measuring and predicting the impact accurately.

Management discussion and analysis: this category focuses on firms' operations. It includes management's overview of a whole year's operation, firms' business environment, significant events during the year and changes in business input and output. Stronger disclosures are found for the review of operations, changes in sales, profits, expenses and market share. Details of growth or decline in market share in the main market and newly expanded markets are found in annual reports. Changes in sales, profits and expenses are discussed based on comparisons between the previous year and current years. Firms reporting decreased sales revenue often detail the reasons causing the decline, while firms with increased sales rarely provide more details. The low mean VDS of Competitive Environment and Significant Events of the Year show sample firms are not keen to disclose information in those two areas. It can be seen that listed firms avoid pointing out their main competitors or making comparisons with competitors in terms of sales and market share. Changed state government legislation and firms' lawsuits are two typical examples disclosed under Significant Events during the year.

Future prospects: this category consists of forward-looking information disclosure items. They are new developments, forecasts of sales/profit and assumptions underlying the forecasts. The strongest voluntary disclosure can be seen from New Developments, with its average disclosure score increasing from 27.25 in Phase I, to 87.5 and 195.5 in Phase II and Phase III, respectively. Examples of new developments are detailed descriptions of products in the developmental stage, and new plans for expansion and brand introductions to specific domestic and international markets. Intensive investment in research and development activities is frequently mentioned as one of the most important measures to achieve new developments. Forming joint ventures with international partners is disclosed as a way for listed firms in China to expand their market. The mean VDS of forecasts of sales or profit increase significantly from only 2 in Phase I, to 53.75 in Phase II and 117.8 in Phase III. Many firms choose to quantify their targets for growth in revenues, net income and gross margin in the following financial year. Twenty–five observations are found to forecast a loss for the next year due to cash-flow liquidity problems and heavy interest payments associated with borrowing. Interestingly, firms disclosing their forecast are reluctant to disclose the underlying assumptions on which the forecast is based.

Performance indicators (not from financial statements): several important financial performance ratios and historical figures constitute this disclosure category. Very little voluntary disclosure is found describing or comparing firms' historical performance over the past five years or more. Only one firm from the sample is found offering the past five years' comparative information, and three firms from the sample are found disclosing the past three years' financial performance indicators in both Phase II and Phase III. The order of the mean VDS of the four financial performance ratio disclosures, from highest to lowest, is: liquidity ratios, cash flow ratios, profitability ratio and gearing ratios.

Financial review: there are two items under this category, disclosure of intangible assets and dividend payout policy. The mean VDS of Disclosure of Intangible Assets shows that sample firms voluntarily disclose information related to firms' initial recognition and subsequent measurements of their goodwill, trademarks and brands across the three testing phases. However, the mean VDS increases from 29.75 in Phase I to 34.50 in Phase II, but reduces to 30.25 in Phase III. In respect of intangible asset impairment, sample firms disclose impairment according to the mandatory requirements of the relevant Chinese Accounting Standard, and there is no discussion of the indicators of asset impairment and circumstances surrounding the impairment decisions. The mean VDS of Dividend Payout Policy are 2, 3.75 and 3 for the three testing phases, respectively; showing that voluntary disclosure in this area is much lower than firms' disclosure of intangible asset-related information.

Projected information: this category addresses cash flow forecasts, capital expenditure and/or R&D expenditure forecasts and earnings forecasts. Strong voluntary disclosure of earnings forecasts is consistent with the strong disclosure of forecast sales/profit under the strategic information section. The mean VDS of earning forecasts is increased significantly from 3.3 in Phase I and 18.5 in Phase II, to 55.25 in Phase III. Voluntary disclosure of cash flow forecasts involves in-depth discussion of actions taken by sample firms to collect outstanding debts, and disclosure of heavy interest payments on loans. One of the issues commonly mentioned in annual reports is the difficulty they have experienced in collecting outstanding debts. This reflects the cash flow liquidity problem found by listed firms in the Chinese stock market. A gradually increasing mean VDS for capital expenditure and/or R&D

expenditure forecasts reflects the view that capital expenditure and R&D expenditure are important factors contributing to firms' long-term success.

Foreign currency information: this category covers the impact of foreign exchange fluctuations on current results, foreign currency exposure management descriptions and major exchange rates used in the accounts. Strong voluntary disclosure in this category reflects the interactions between listed firms in China and their overseas counterparts as a result of the "Open Door" policy implemented by the Chinese government. Voluntary disclosure of the impact of foreign exchange fluctuations on current results has the highest mean disclosure score in the three phases, followed by the major exchange rates used in the accounts. Foreign currency exposure management, however, is relatively low, with mean VDS increased from 4 in Phase I, to 8.8 in Phase II and 17.8 in Phase III reflecting the lack of risk management associated with foreign exchange rate fluctuations among Chinese listed firms.

Stock price information: this category includes market capitalization at year end, market capitalization trends, size of shareholdings and type of shareholder. There is no voluntary disclosure for the whole disclosure category in Phase I. Voluntary disclosures of the size of shareholdings and type of shareholders are only found during Phase III, with the mean VDSs being 0.75 and 1.25, respectively. Mean VDS of market capitalization at year end and market capitalization trends during Phase II are 0.75 and 0.5, respectively. During Phase III, the mean VDS of market capitalization trends remains the same, while the mean VDS of market capitalization at year end increases to 2 in Phase III.

Information about directors: information about the director category consists of two disclosure items, commercial experience of the executive directors and other directorships held by executive directors. The mean VDS of Chief Executive Officer (CEO) duality shows that there is no voluntary disclosure of CEO duality in Phase I. In Phase II, the mean VDS are 14 and increases to 16.5 in Phase III. Although there was a gradual increase, these results show voluntary disclosure of CEO duality was relatively low throughout the entire testing period. The voluntary disclosure of commercial experience of CEOs does not show any consistency. The mean VDS of the commercial experience of executive directors increase from 4.75 in Phase I, to 10.5 in Phase II and reduce to only 3 in Phase III.

Employee information: the seven disclosure items under this category can be combined into three groups: employee training-related, safety-related and redundancy-related. The mean VDSs of the three phases show that all three groups experience low voluntary disclosure in Phase I, increased disclosure in Phase II and a decline of voluntary disclosure in Phase III. The employee training-related group has the strongest increase over Phase I and Phase II. The mean VDS of the nature of training increased from 5.5 in Phase I to 10.5 in Phase II. Together with the amount spent on training, categories of employees trained and number of employees trained, the increased disclosures in this area indicate that listed firms wish to signal to investors the skills and knowledge of their employees and, accordingly, the better quality of their workforce. Disclosures of redundancy among listed firms reflect the loss of job security in Chinese society since the economic reforms. The employee safety-related area has the lowest mean VDS under the Employee Information category.

Social policy: this category covers four disclosure items, namely, safety of products, environmental protection programs, charitable donations and community programs. Both the safety of products and charitable donations show strong voluntary disclosures over the years, with their mean VDS ranging between 25 and 45. Firms list various awards granted by state or local government for good quality products or contributions made to the community. Charitable donations reflect firms' commitment to Chinese society. Strong voluntary disclosure in this area shows listed firms' interest in developing a good reputation in society.

It is worthwhile to note that the voluntary disclosure of environmental protection programs achieves a relatively low mean VDS throughout the three phases, with 2.5 in Phase I, and 7 for both Phase II and Phase III. Only a few firms discuss briefly the actions taken to reduce environmental pollution. This result supports the research findings of Guo (2005). Listed firms in China have not established the awareness that to be a good "corporate citizen", enterprises should take social responsibility and leadership in environmental protection.

6.2 Comparison between Three Information Disclosure Sections

This section combines and compares the levels of disclosure of the three information sections. Table 1 sets out the changes of the three information disclosure sections in the three testing phases. It is interesting to note that among the three sections of voluntary disclosure, strategic information disclosure achieves the highest mean voluntary disclosure score in each individual testing phase, followed by the financial information section, and this leaves the non-financial information section having the lowest mean disclosure scores. The mean disclosure score achieved by the sample firms in disclosing strategic information is increased significantly from 0.65 in Phase I, to 2.44 in Phase II and 3.94 in Phase III. The voluntary disclosure score for financial information also increases over the entire

testing period; however, the increment is not as significant as that seen in the strategic information section. The mean disclosure score of the sample firms changed from 0.33 in Phase I, to 0.76 in Phase II and 0.96 in Phase III. The non-financial information section experienced slow growth in voluntary disclosure. The mean disclosure scores for non-financial information disclosure achieved by sample firms are 0.07, 0.21 and 0.14, respectively, in the three testing phases. The results do not show a general trend of increased voluntary disclosure of non-financial information in the three testing phases.

Insert Table 1 here

6.3 Characteristics of Voluntary Disclosure in The Chinese Stock Market

The proceeding analysis suggests that listed firms' voluntary disclosure behaviours in the Chinese stock market exhibit three characteristics in the 1995-2006 periods. First, there is a significant increase of voluntary disclosure in both the number of disclosing firms and the extent of voluntary disclosure during Phase II. Second, listed firms are selective with their voluntary disclosure. Third, the level of forward-looking information disclosure is significantly higher than for other types of information disclosure.

1. Significant increase in voluntary disclosure during 1999-2002

Table 2 reports the descriptive statistics on the comparison of disclosure categories between Phase I and Phase II, and Phase II and Phase III. The comparison of the mean VDS of disclosure categories between Phase I and Phase II shows that the *p* values of corporate strategy, management analysis and discussion, future prospects and projected information are all significant at 1 percent level, meaning that the mean VDS of these disclosure categories in Phase II is increased significantly when compared with Phase I. The *p* value of the total combined disclosure categories is also significant at 1 percent level, meaning that, overall, the VDS increased significantly from Phase I to Phase II. Comparing Phase II and Phase III, there is no significant increase in Phase III. Therefore, in the three testing phases, it can be concluded that there is a significant increase in voluntary disclosure during Phase II which includes the 1999-2002 financial years and Hypothesis 2 is supported.

The institutional pressure exerted on listed firms in Phase II is marked by CSRC's actions in stipulating investor protection regulations, and the strengthening of their enforcement. Phase II witnesses the changing role of one of the main stakeholders of listed firms in the Chinese stock market, namely, the regulatory agency group. The 1998 *Securities Law* empowers the CSRC as the overall regulator of the Chinese stock market. Between 1999 and 2002, the CSRC accomplished its changing role, from its initial function of undertaking some administrative roles, including approving the listing and transferring of non-tradable shares among institutional investors, to regulating listed companies' information disclosure and fostering good corporate governance. The CSRC sees itself as a pro-active regulator in fostering corporate governance, in enforcing rules, in safeguarding the integrity of the Chinese stock market, and in championing the rights of public investors (Tomasic & Andrews, 2007). The CSRC also implements some important strategies to promote corporate governance among Chinese listed firms. In early 2001, the CSRC declared a "year of market supervision". During the same year, the CSRC issued the *Code of Corporate Governance for Listed Companies in China* and the *Notice of Establishing an Independent Directors System in Listed Firms*. The primary aim of these initiatives was to increase transparency and enhance the credibility of financial statements. Increased voluntary disclosure during this period of time could be regarded as one way that listed firms in the Chinese stock market responded positively to pressure of the CSRC for the purpose of institutional legitimacy.

Insert Table 2 Here

2. Selective information disclosure

The comparison between the three information disclosure sections in Table 3 indicates clearly that, despite the increase in the quantity of information disclosed overall, listed firms in the Chinese stock market are selective in choosing the information to disclose. Voluntary disclosure of strategic information is much higher than the disclosure of financial information and non-financial information. The mean disclosure score of strategic information disclosure for the entire testing period reached 7.03, while the average scores of financial information and non-financial information are only 2.06 and 0.43, respectively.

Table 3 further reports the comparison of sensitive information and non-sensitive information by using the *T* test. Fifty checklist items are divided into two groups: a sensitive information group and a non-sensitive information group. There are nine items that can be classified in the sensitive information group and they are: dividend payout policy, foreign currency exposure management description, market capitalization at year end, market capitalization trend, CEO's commercial experience, CEO duality, data on accidents, cost of safety measures, and redundancy information. In the *T* test, these items are coded as 1 whereas other items are coded as zero. The results show the *F*

test of equal variances is significant; therefore, the unequal variance t value, 2.45, is the appropriate value to use. The mean VDS of the non-sensitive information group are 78, while the mean VDS of the sensitive information group are only 24. The *p* value is significant at 1 percent level, meaning the mean VDS of the sensitive information group are significantly lower than that for the non-sensitive information group.

These results indicate clearly that listed firms in the Chinese stock market feel more comfortable disclosing information on their operational areas, such as changes in sales/profit, expenses, inventory levels and market share. Firms are also keen to disclose their future strategy, new projects or products under development, and their forecast of earnings for the near future. On the other hand, firms choose not to disclose more sensitive information, such as CEO duality and data on accidents. Information such as stock price performance, market capitalization at year end or market capitalization trends are rarely discussed by the majority of listed sample firms, although some firms disclosed their size of shareholdings and type of shareholders. It is interesting to note that no information on year end stock price was voluntarily disclosed until 2001. A low level of voluntary disclosure is consistent with the research finding of Liu (2005) that listed firms do not disclose sensitive information such as year-end share price and share price trends.

In respect of corporate governance disclosure, the voluntary disclosure of CEO's commercial experience is only significantly higher in Phase II, with a mean VDS of 10.5, compared to 4.75 and 3 in Phase I and Phase III, respectively. The disclosure of the commercial experience of CEOs is relevant to investors because commercial experience can be used as one of the benchmarks to assess the quality of firms' senior management. In the early stage of corporatization of SOEs, the senior managers, the board and supervisory committee members were Chinese Communist Party (CCP) officials without any commercial experience (Xu & Wang, 1999). The appointment of non-commercially experienced CEOs of listed firms was caused by the majority holdings by the state. Tam (1995) conducted a survey which confirmed that nearly 54% of board vice-chairmen in listed firms in the Chinese stock market were members of the CCP committee. Tam (1995) also suggests a high percentage of CCP members on boards reflect the nature of the continuing bureaucratic power of the administrators and the CCP members. The CSRC suggests the selection of management personnel of listed firms should be carried out in a fair and transparent manner. The nominated candidates should possess relevant professional knowledge and the capacity to make good business decisions. A significant increase in voluntary disclosure in this area during Phase II reflects the listed firms' realization of how value-relevant the commercial experience of CEOs is to investors.

The sample firms start to disclose their CEO duality from Phase II. CEO duality is another main corporate governance issue among Chinese listed firms, as Tam (1995) and Firth *et al.* (2007) point out. CEO duality has impacted on the effectiveness of a board in its various functions as it undermines the board's independent ability to oversee the senior managers. The board's role as an effective guardian of stockholders' interests in the system of corporate governance may also be jeopardized. It has been argued that separating the two roles allows the development of initiatives, innovation and more effective leadership of the firm (Fama & Jensen, 1983). The survey conducted in China by Tam (1995) revealed 60% of board chairmen among listed firms were also the CEOs of firms, and 25% of vice-chairmen were either CEOs or Deputy CEOs. This issue is significant enough to attract the regulatory body's attention. In 2001, the CSRC recommended that listed firms separate the roles of CEO and chairman. Xiao and Yuan (2007) showed that in 2002, there was only 11% CEO duality among the 559 listed firms investigated in their study. The disclosure of CEO duality in Phase II and Phase III could be seen as firms' responses to the CSRC's pressure during this period of time.

Insert Table 3 Here

3. High level of forward-looking information disclosure

Disclosure items, including future strategy, new developments, forecasts of sales/profit, current strategy and earnings forecasts, have all presented strong voluntary disclosures over the years. The results show that listed firms in the Chinese stock market give preference to forward-looking information disclosure. Forward-looking disclosure involves financial forecasts such as next years' products, strategies, plans, forecasted performance and the anticipated earnings, revenues and cash flows. Forward-looking disclosure also involves risks and uncertainties that could significantly affect actual results and cause them to differ from projected results.The results in Table 4 further confirm this disclosure characteristic. Table 4 compares forward-looking information and non-forward-looking information disclosure. Forward-looking information items are coded as 1, while non-forward-looking information items are coded as zero for the *T* test. The forward-looking information classification in the *T* test follows Clarkson *et al.* (1994), Bryan (1997) and Kent and Ung (2003). The forward-looking information group includes a statement of corporate goals or objectives, current strategy, impact of strategy on current results, future strategy, impact of strategy on future results, review of operations, competitive environment, significant events of the year, changes in

sales/profit, changes in expenses, changes in inventory, changes in market share, new development, forecasts of sales/profit, assumptions underlying the forecast, cash flow forecasts, capital expenditure and/or R&D expenditure forecasts and earnings forecasts.

Given the *F* value is 6.25 and *p* value is less than 0.0001, it is appropriate to use the unequal variance *t* value, -4.78. The mean VDS of the forward-looking information group are 117, while the mean VDS of the non-forward-looking information are 24. The *p* value of unequal variances is 0.001, indicating the mean VDS of the forward disclosure group is significantly higher than the mean VDS of the non-forward-looking information group. The importance of forward-looking information for users of corporate financial information has been addressed by official pronouncements in the US and Canada in the *Jenkins Committee Report* (AICPA, 1994), the Financial Accounting Standards Board (FASB, 2001) and the Canadian Institute of Chartered Accountants (CICA, 2002). Benefits of forward-looking information and factors attributed to the level of forward-looking disclosure have been investigated by Bryan (1997), Clarkson *et al.* (1999) and Schleicher and Walker (1999).

In China, the forward-looking information is addressed by one of the most important regulations stipulated by the CSRC - *The Standards of Contents and Formats of Information Disclosure by Public Issuing Companies*. Under the 1999 version of this regulation, the CSRC only encouraged listed firms to disclose their operational plan in the next financial period, including progress to be made on new projects. Under the 2003 version, Article 39 expands forward-looking information disclosure by stating that the board of directors of listed firms may disclose an annual business plan, including (but not limited to) income, cost and expenditure budget, new operational goals such as increasing sales, market share, reducing cost and budget for research and development expenditure. Firms that disclose the above information should also give information on strategies that need to be implemented and actions that will be taken in order to achieve the above goals. If listed firms wish to disclose the forecast for the next financial year's profit, the forecast needs to be verified by their CPA firms.

Although disclosure of forward-looking information is not mandated by the CSRC, the results in this study show listed firms actively respond to the CSRC's calls for forward-looking information disclosure. The forward-looking information found from sample firms' annual reports include forecasts of sales for the coming year, discussion of the growth opportunities of major customers, next year's targets for growth in revenue, projected cash flow, projected earnings, percentage growth goals for revenue, earnings per share (EPS) and return on equity (ROE). However, a common characteristic of the above disclosure is that listed firms prefer to disclose positive and qualitative forward-looking information, rather than negative and quantitative information. This result is similar to the findings of Kent and Ung (2003), which suggest most Australian companies do not provide quantitative earnings forecasts in annual reports. Although more than half of the firms under investigation disclose forward-looking information relating to future earnings, they do not specifically disclose point estimates for the future, and they mostly supply qualitative information with a positive bias. Disclosing more forward-looking information among listed firms, therefore, provides further support to Hypothesis 1.

Insert Table 4 Here

7. Conclusion

This paper investigates the response of listed firms to the institutional environment created by the Chinese government regulatory agency of the Chinese stock market, the CSRC, over the years in respect of their voluntary disclosure. Using institutional theory, this paper argues that the regulatory body of the stock market in China has created coercive isomorphism, in order to promote transparent information disclosure and investor protection to listed firms. Depending on the CSRC's approval and support, listed firms are able to get access to the capital market in raising capital funds from investors. Therefore, this paper suggests that for the purpose of institutional legitimacy, listed firms would increase their voluntary disclosure to the stock market.

The investigation is conducted by examining the voluntary disclosure made by 297 listed firms in their 1995-2006 annual reports. The findings of this study show the trend of voluntary disclosure made by listed firms across the early stage to the established phase of the Chinese stock market and main characteristics of voluntary disclosure. The voluntary disclosures made by listed firms in the Chinese stock market increased over the three testing phases. The number of disclosing firms increased significantly from Phase I to Phase II for all three disclosure sections. Consistent with the number of disclosing firms, the voluntary disclosure scores of the three disclosure sections also increased dramatically during Phase II. These results show that listed firms positively reacted to the coercive isomorphic created by the CSRC in the stock market. Among the three disclosure sections, strategic information disclosure is found to have the highest voluntary disclosure scores, followed by financial information and non-financial information. Close examination of the three disclosure sections demonstrates that listed firms are selective in their information disclosure. Forward-looking information, under both the strategic information and

financial information sections, was found to have a strong connection with voluntary disclosure, meaning that to satisfy the information demand of regulatory agencies and the investment community, listed firms used voluntary disclosure for the purpose of institutional legitimacy in the Chinese stock market.

There are two implications for future research. First, it would seem desirable that future studies address the information usefulness of voluntary disclosure in the Chinese stock market by exploring, first, value relevance of voluntary disclosure and, second, the linkage between voluntary disclosure and economic benefits. Second, one of the findings of this study is that listed firms are in favour of forward-looking information disclosure. Future research could examine whether the forward-looking information voluntarily disclosed by listed firms possesses accuracy and predictability in the Chinese stock market.

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Table 1. Descriptive statistics of the three information sections in the three testing phases

Testing phase	Disclosure section	Mean	Max.	Q3	Median	Std. Dev.
Phase I	Strategic information	0.653	6.000	1.000	0.000	0.917
	Financial information	0.334	3.000	1.000	0.000	0.659
	Non-financial information	0.076	3.000	0.000	0.000	0.292
Phase II	Strategic information	2.436	10.00	4.000	2.000	1.807
	Financial information	0.761	5.000	1.000	0.000	0.991
	Non-financial information	0.210	4.000	0.000	0.000	0.583
Phase III	Strategic information	3.937	14.00	5.000	4.000	2.409
	Financial information	0.961	6.000	2.000	0.000	1.256
	Non-financial information	0.143	4.000	0.000	0.000	0.544

Table 2. Descriptive statistics on Phase I, Phase II and Phase III - comparisons of disclosure categories

	Comparisons between Phase I and Phase II		Comparisons between Phase II and Phase III	
Category	*t*-stat	*p*-value (two-tailed)	*t*-stat	*p*-value (two-tailed)
GI	3.0	0.25	3.0	0.25
CS	7.5	0.01*	7.5	0.06
MA	4.0	0.01*	14	0.02
FP	7.8	0.01*	7.0	0.05
OUS	4.0	0.15	3.0	0.25
PI	14	0.01	5.0	0.13
FR	1.5	0.50	-1.5	0.50
PRI	12	0.01*	3.0	0.25
FC	3.0	0.25	-0.5	1.00
ST	1.5	0.50	3.0	0.25
OUF	4.0	0.15	4.0	0.15
DIR	1.5	0.50	-0.5	1.00
EI	7.5	0.06	-12	0.05
SP	4.0	0.25	-2.0	0.50
OUN	1.5	0.50	-1.5	0.50
TOTAL DISCLOSURE	39.5	0.01*	28.5	0.07

*Significant at 1 % level

Table 3. Comparison of sensitive information and non-sensitive information

Variable : mean of disclosure					
Sensitive information	N	Mean	Std Dev	Std Error	Maximum
0	41	78.28	92.65	16.64	310
1	9	24.04	32.45	7.443	125
Variances	*t-stat*	DF	*p-value*		
Unequal	2.45	48.00	0.010		
Equal	2.98	40.50	0.005		
For H0: Variances are equal	F = 8.15		DF = (30, 18)		Pr> F = <0.0001

Table 4. Comparison of forward-looking information and non-forward-looking information

Variable : mean of disclosure					
Forward looking information	N	Mean	Std Dev	Std Error	Maximum
0	32	24.09	39.20	6.930	156
1	18	117.4	98.01	23.10	310
Variances	*t-stat*	DF	*p-value*		
Unequal	-4.78	48.00	0.001		
Equal	-3.87	20.10	0.001		
For H0: Variances are equal	F = 6.25		DF = (17, 31)		Pr> F = <0.0001