Guest editorial

The practice and recent development of corporate finance and governance in China

Introduction

China's impressive economic development and success are attracting the attention of academics, policy makers and practitioners around the world. Due to its unique institutional background, the corporate structure and governance of Chinese firms are very different from those in developed markets. Furthermore, fast growth of the Chinese economy and regulatory changes make Chinese studies on corporate finance and governance outdated quite quickly. This special issue contributes to our understanding of the corporate finance and governance practice and recent developments in China.

The papers in this special issue provide detailed discussions on the unique institutional features in the Chinese capital market and how these features shape corporate behaviour and governance in China. To provide an overview, we summarize a few major characteristics of the Chinese corporate behaviour and governance here. First, state control and political intervention are very strong in the Chinese listed firms, as most listed firms were partially privatised state-owned enterprises (SOEs) (Sun and Tong, 2003; Fan, Wong and Zhang, 2007). At share issue privatizations (SIPs), state shares (approximately two-thirds of the total shares) are issued based on a firm's net asset value, which is typically much lower than the market value, and these state shares could not be traded in the secondary market until the non-tradable share (NTS) reform[1] launched in 2005. State shareholders could extract rents from firms to fulfil their social or political goals (Shleifer and Vishny, 1994) and have incentives to expropriate minority shareholders in particular when they cannot benefit from the stock price appreciation in the secondary market (Jiang, Lee, and Yue, 2010; Liao, Liu and Wang, 2014). However, political connections could also add value to firms as connections help to access key resources and deal with various external uncertainties (Pfeiffer and Salancik, 1978). Second, ownership concentration of Chinese listed firms is very high in comparison with firms in other countries. Liu *et al.* (2014) show that the largest shareholding before the NTS reform was on average 42.4 per cent, and these shares were mainly controlled directly or indirectly by the government. The high ownership concentration leaves little room for minority shareholders to have a significant impact on corporate decisions. Third, the legal protection of minority shareholders tends to be relatively weak in China compared to that of most developed economies (Allen *et al.*, 2005). The quality of information disclosure and high possibility of earnings management are concerns in China as well (Liu and Lu, 2007).

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Special issue overview

Given the above characteristics, papers in this special issue have attempted to find the new ways or factors to improve corporate decision-making in Chinese firms.

Jingjing Yang, Naiwei Chen and Hao-Chang Sung find that firm ownership concentration has a negative impact on investment efficiency, and this impact is more pronounced in SOEs than in private firms. They find that incentive-based compensation improves investment efficiency. In addition, mutual funds have a positive impact on the investment efficiency of portfolio firms.

Fang Hu, Jenny Stewart and Weiqiang Tan investigate the importance of political connections to audit opinions. They find that CEOs' political connections are positively associated with subsequent favourable opinions. This relationship is more significant in non-SOEs that lack political ties from the ownership arrangement. Moreover, the association between CEOs' political connections and audit opinions is more pronounced in regions with a less developed market and lower investor protection.

Kam Chan, Fansheng Jia, Yilin Zhang and Sujuan Xie explore the relation between religiosity and formal financing measured by long-term and short-term corporate loans. They find that when a private firm locates in a high religiosity region, it is more likely to get more corporate loans; religiosity causes a private firm getting more (less) short-term (long-term) loans; a private firm in a high religiosity region could incur lower interest cost related to more short-term loans; and the results are confined to Buddhism, Taoism and Christianity.

Qing (Sophie)Wang, Hamish Anderson and Jing Chi investigate how venture capital (VC) backing influences the board composition and firm market performance in China. They find evidence that VC-backed IPOs have higher board independence. They present some evidence that independent directors with industry relevant expertise enhance long-term stock returns. In addition, VCs with management political ties also improve IPO long-run stock performance.

Yi Wei, Jianguo Chen and Carolyn Wirth study the relationship between accounting values in balance sheets and the exposure of firm fraudulent activities. They show that other receivables, inventories, prepaid expenses, employee benefits payables and long-term payables are all important indicators of fraudulent financial statements. They indicate that asset account manipulation is popular and cast doubt on earlier conclusions by researchers that inflation of liabilities is the most common source of financial statement manipulation.

Liping Zou and William Wilson find that earnings announcements contain little new information of value, demonstrating the Chinese markets are not informationally efficient. The study sheds light on the issue of the information content of earning announcements. For China to truly be an international and efficient market, it needs further development of earnings information, and greater attention paid to accounting standards.

Interestingly, Shiguang Ma and Liangbo Ma find that low earnings quality (characterized by unhealthy profitability and/or untrue financial information) is related to high accounting based or market-based corporate performance for the Chinese listed firm, and earnings management is only a contributor to the negative relationship, not its main driver. They argue that this negative association is just a phenomenon of a new emerging market within an economic boom period within China.

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Note

1. The NTS reform is to grant non-tradable shareholders the right to trade their shares gradually in the secondary market. Given the different issuing prices of two types of shares, compensations in the forms of cash or shares or both are paid to from non-tradable to tradable shareholders during the reform.

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