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Comment Li Jin

Joe Piotroski and T. J. Wong study the financial reporting practices and information environment of Chinese listed firms. The chapter follows Bushman, Piotroski, and Smith (2004) to define corporate transparency as the widespread availability of firm-specific information to market participants outside the publicly-listed firm, and categorize country, regional, and firm-level information mechanisms into three broad headings: (1) the corporate reporting regime, which includes the quality of the firm's financial reports and the underlying audit function; (2) the intensity of private information acquisition activities, which includes the depth and breadth of analyst and institutional investor activity; and (3) the strength of dissemination mechanisms, including the role of media and freedom of the press.

Judged by a variety of standards, corporate transparency in China is not satisfactory. At the stock level, Chinese stocks have high synchronicity, meaning less meaningful firm-specific information is incorporated in the stock prices. There is also high crash likelihood, suggesting that bad news often accumulates in the firm for lack of better disclosure, and only later comes out in batches. Survey evidence indicates that while the over-

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all transparency improves in absolute terms, it continues to lag those in many developed and developing countries. On the surface, Chinese financial reporting standards and practices show trends of improvements, but they still lag behind the rest of the world, particularly as it comes to the actual enforcement of these rules and standards. The lack of sufficient progress is also reflected in the evidences mentioned in the chapter, on the stock market behavior and survey results.

The lack of transparency in China has its deep roots in the unique specification of institutional arrangements in China. The chapter discusses these institutional mechanisms, such as the substantial state ownership of listed firms, the tight government control of capital markets, the weak market institutions and limited protection of property rights, and the use of local auditors whose independence might be questionable.

I very much agree with their assessments, and believe that the chapter laid a solid foundation for a systematic and comprehensive research agenda in understanding the information environment in China. Nonetheless, my role as a discussant is to point out places that evidence is still less than compelling. I will focus on a few issues.

The first is, we could get some additional mileage by reorganizing the impacts of China's institutional features on information production/transparency into the "supply side" and "demand side" of the financial reporting. This might highlight some additional issues that are very relevant for the discussion, but are not sufficiently covered. On the supply side, the question would be: what are the incentives, and conflicts of interests, for the insider/owner to provide timely and accurate financial reporting? The chapter discussed issues such as the lack of accounting standards/execution to push them, the dominant government ownership, and the potential nonprofit maximization objective, which disregard much of the value relevant to private information, and bureaucrats' political needs in hiding bad news, particularly before the important political events. What I would like to see more discussion about also includes insider's desire to manipulate stock price and do insider trading, and the potential collusion of corporate insiders and some perverse outside investors to take advantage of the naivety of the predominantly retail investors, in issuing false/misleading information. On the demand side, we might want to know who are demanding the transparency, and how their behavior is different in China. The chapter points out the dominance of banking system in capital allocation, and the existence and convenience of administrative reporting channel (at least for state-owned businesses). What about the retail investor-dominated market, which is primarily driven by sentiment and not able to consume the financial reports?

The second issue is, some people could question the importance of the improvement of the information environment. In other words, if the Chinese regulatory authority has a number of things to address to improve the efficiency of its capital markets, and only limited resources, how much

priority should it give to the further improvement of the information environment? Piotroski and Wong point out a number of benefits. Better transparency can reduce information and transaction costs in an economy, thus improving resource allocation efficiency. It serves as a basis for effective monitoring and corporate governance, in reducing self-dealing, stock price manipulation, and expropriation of minority and outsider investors. It also ensures the smooth functioning of the stock market in avoiding sudden large crashes, which could be disruptive to the financial market. The ultimate results are that corporate transparency is very important in facilitating the development of public capital markets as an alternative channel of resource allocation, in addition to the traditional channel through the banking system. The enlargement of the participation of investors, particularly small domestic investors and foreign investors, would have the additional benefit of broadening the shareholder base, thus potentially lowering the cost of capital. But are these results really true? Who is consuming the information? As detailed in Choi, Jin, and Yan (2010), the average Chinese stock is held by predominantly retail Chinese investors, who are very subject to short-term sentiments. The average turnover of the Chinese stocks can be as high as 1,000 percent in a year, suggesting that the average investors are holding the stock for about one to two months. If those short-term oriented investors rely more on gossips and market-wide signals such as the macroeconomic policy changes, then it is questionable whether they would demand more corporate transparency, and how much they are willing to pay for that. In addition, evidence is emerging that even institutional investors in China are relying more on market sentiment and macroeconomic indicators in their trade decisions (Mei, Scheinkman, and Xiong 2005; Tan et al. 2008; Kling and Gao 2008), again questioning the need of these institutions to gain additional insights through better corporate transparency. The benefits of the enlargement of a shareholder base, particularly the foreign investor shareholder base, might be appealing at first glance. But careful analysis of the situation in China suggest that too much, not too little, foreign capital is flowing into the Chinese capital market, for geopolitical reasons related to the trade imbalance and the perceived “one-sided bet” on an appreciation of the Chinese currency against the US dollar. In this context, the concern of the regulatory body is more likely to be on discouraging the rapid inflow of capital into Chinese companies, rather than encouraging it. The other argument, about the increased crash likelihood due to lack of sufficient information disclosure and the resulting disruption to the capital market and even real economy, can also be questionable if one factor in the reality that Chinese stock market is pretty responsive to the systematic movement of the market environment, such as macro policy. Existing studies, such as Jin and Myers (2006), point out that the withholding of firm-specific information will lead to the higher likelihood of a crash of individual company

stocks, rather than a crash of the whole stock market. This will thus limit the concern of the regulatory body. To be fair, one should never understate the importance of corporate transparency, and the improved information environment will certainly facilitate the development of the public equity market, which would provide a potentially much more powerful and efficient mechanism of the allocation of capital within China. But that is something that could be considered along with other means to improve the public capital market efficiency, and reform the market in a balanced way.

Another issue is on the emphasis of the enforcement of the regulations and standards. If we look at the rules and regulations, on the surface China has similar regulations as the mature economies. This might not be surprising, as it is easy for China to copy the wordings in the international standards. But the enforcement might be much harder. Is there a way to measure enforcement and its change over time? I would not be surprised if we could find that the actual change of information environment is closely related to the change of the actual enforcement, rather than the adaptation of the regulations and standards.

Responding to suggestions by many conference attendees (myself included), Piotroski and Wong now added a substantial discussion about the role played by the other two categories of information mechanisms: the intensity of private information acquisition activities, which includes the depth and breadth of analyst and institutional investor activity, and the strength of dissemination mechanisms, including the role of media and freedom of the press. The new evidence there indicating the lack of progress on these two fronts pretty much corroborates their evidence on the corporate reporting regime. This is perhaps not surprising, and it is very much related to the next issue that I want to raise.

An interesting follow-up research question to ask would be: What are the key drivers of the change of information environment and standards in China? One can think of a few different causes (not mutually exclusive): (a) the increase of accounting professionals, both inside the corporations and in the investment community, that enables a more efficient dissemination of information; (b) the increasing pressure of investors, particularly sophisticated investors such as domestic and foreign institutions, that demands such high-quality information; (c) the improvements in the rules and regulations governing the disclosure of corporate inside information, and, perhaps more importantly, the increasingly stringent enforcement of the law; (d) the increase of level of sophistication of investors, both foreign and domestic, and individuals and institutions alike, in demanding more corporate transparency; (d) the gradual easing of the Chinese political system on the tight control of information, particularly information that is viewed as politically sensitive. One could imagine that some empirical analysis could be done to see whether and how the relaxation of each of these constraints can impact

the information environment in China. For example, does the high profile prosecution of corporate fraud cases have a meaningful impact on the future disclosure?

In summary, Piotroski and Wong have raised a number of interesting and important issues regarding the development of public equities market in China. However, one needs to be cautious in interpreting the evidence, and further research is required to determine whether and how the features of the institutional and informational environment they identify will spur rapid growth of the local public equity markets.

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