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Structural Changes in the Chinese Stock Market: A Review of Empirical Research*

Haitian Lu and Jiajia Fu[1]

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Abstract

China's stock market has gone through major structural changes since its inception in the early 1990s. In this survey article, we review the empirical literature published in 15 leading accounting and finance journals from 1998 to 2013 that documents these important structural changes. In analysing this literature, we focus on the 'distinctiveness' of the Chinese stock market compared with developed stock markets (e.g. US) and the research opportunities generated by the China setting. Key themes include China's share issue privatisation (SIP) reforms, the political connections in privately owned companies, the characteristics of Chinese listed companies and their governance, the regulatory environment reforms in China, and the evolving role played by auditors and other information intermediaries.

***Keywords*:** China, Stock Market, Structural Change, Corporate Governance, Financial Accounting, Auditing, Executive Compensation, Financial Reporting
***JEL*:** D82, D86, G21, G30, G34, G38, M40, M41, M50, M52, M55

I. Introduction

Since the market-oriented economic reforms in 1978, China has entered into a stage of financial deregulation and liberalisation. An important part of China's financial development is the inception and growth of a stock market since 1991. Guided by the

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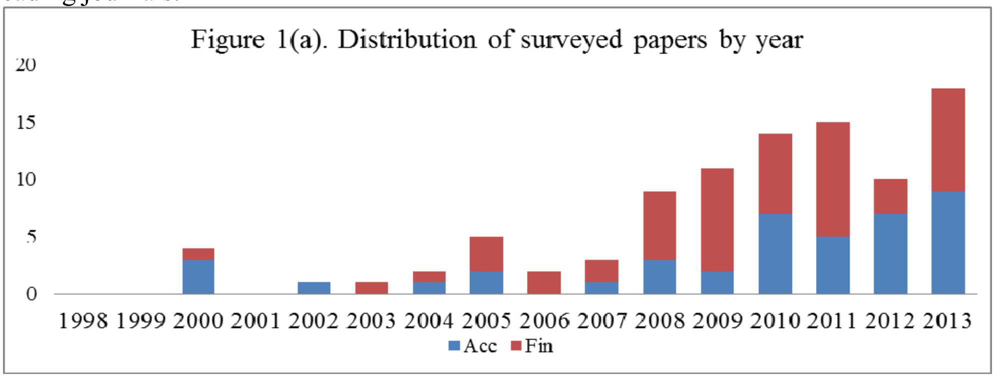
[1] Haitian Lu, Associate Professor, School of Accounting and Finance, The Hong Kong Polytechnic University; email: haitian.lu@polyu.edu.hk. Jiajia Fu, Ph.D candidate, School of Accounting and Finance, The Hong Kong Polytechnic University.

philosophy of "crossing the river by touching the stones", the Chinese Government has launched a series of reforms to nurture a stock market that is comparable to those in developed countries. These structural reforms include share issue privatisation (SIP), the reform of non-tradable shares, the reform of firms' access to the capital market, the regulation of financial intermediaries, the refinement of the legal system governing the capital market, the convergence of Chinese accounting standards with IFRS (International Financial Reporting Standards), and audit market reforms. These reforms, in conjunction with China's institutional environment, generated important research questions and have made the Chinese stock market a natural laboratory in accounting and finance research.

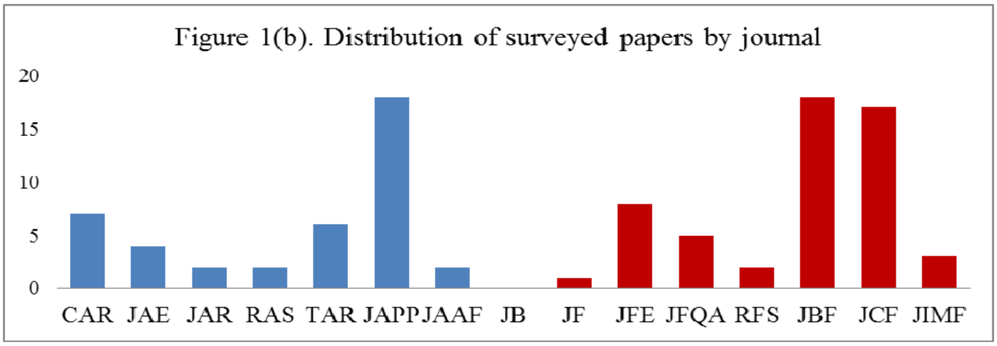
The purpose of this paper is threefold: (1) to identify important structural changes in the Chinese stock market since the 1990s; (2) to highlight the salient features of the Chinese stock market compared with developed markets like the US and the research opportunities that have been generated; and (3) to review corresponding empirical evidence, summarise the key research findings, and identify potential areas for future research. As this is a survey article, to keep the scope of our review manageable, we only review papers from 15 world renowned journals (7 in accounting and 8 in finance, as listed in Figure 1), but we refer to other works when it helps to put the issue in a broader context.[2] The selection criteria are as follows: We first search for articles in these 15 journals from 1998 to 2013 whose title contains the word "China" or "Chinese" and then manually identify empirical studies that use data from firms publicly traded on the Chinese stock market. As our focus is on China's stock market, we exclude articles on Chinese banking, the debt market, the futures market, and the money market. These search criteria leave us with 95 articles; Figure 1 shows the distribution of these articles by year and by journal.

Figure 1 Distribution of surveyed papers by year and by journal from 1998 to 2013

Figure 1(a) presents the distribution of surveyed papers in the 15 leading journals by year from 1998 to 2013. Figure 1(b) presents the distribution of surveyed papers by the 15 leading journals.



[2] The journals surveyed were as follows: The Accounting Review (TAR), Journal of Accounting & Economics (JAE), Journal of Accounting Research (JAR), Contemporary Accounting Research (CAR), Review of Accounting Studies (RAS), Journal of Accounting and Public Policy (JAPP), Journal of Accounting, Auditing & Finance (JAAF); Journal of Finance (JF), Journal of Financial Economics (JFE), Review of Financial Studies (RFS), Journal of Financial and Quantitative Analysis (JFQA), Journal of Business (JB), Journal of Banking & Finance (JBF), Journal of Corporate Finance (JCF), and Journal of International Money and Finance (JIMF).



The rest of this paper proceeds as follows. Section II discusses the purpose and course of the SIP reform, a giant step forward in state-owned enterprise (SOE) reform in the 1990s. We review a vast SIP literature that focuses on the ownership structure of privatised SOEs and the efficacy of SIP. We also discuss China's unique reform of non-tradable shares initiated in 2005 that aims at solving fundamental corporate governance problems and creating a stock market boom. Another equally interesting question we analyse in this section concerns the puzzle of the A-B/A-H share price discount and the investor protection environment disparity between the A-share market and the H-share market. Section III discusses the role of political connections in China and its implications for a number of capital market activities. We begin by illustrating the structural changes regarding firms' access to the capital market and then outline the various ways in which political connections are valuable or costly to firms. In Section IV, we outline the nature of the agency problem and review the literature on corporate governance in publicly traded firms in China. Aspects of our examination include the Type II agency problem, related-party transactions, board structure, executive compensation, CEO turnover, and dividend payout policies. Section V focuses on the evolution of the regulatory environment in China, especially on a comprehensive list of corporate governance issues aimed at enhancing investor protection, litigation risk, and accounting standard reform. We begin by discussing several examples examining the efficacy of corporate governance regulations. We then show the timeline of the evolution of litigation risk in China. Finally, we discuss the financial reporting incentives and the disclosure environment in China and evaluate the efficacy of the accounting standards reform. Section VI considers the external monitoring of Chinese publicly traded firms through auditors and other financial institutions. We outline the salient features of the auditing market in China and then move on to discuss the auditing research on audit quality and auditor independence. We also address the monitoring and information roles of other information intermediaries such as institutional investors and financial analysts. Section VII concludes the paper and suggests directions for future research.

II. Share Issue Privatisation (SIP)

Share issue privatisation (SIP), in which the government sells shares in SOEs to private investors, has been the most popular method of privatisation and has been successful in improving firm efficiency and profitability (Megginson and Netter, 2001; Gupta, 2005; Shleifer, 1998). The development of the Chinese stock market must be understood in the context of the process of the "partial privatisation" of SOEs in the 1990s. Early in the 1980s, the Chinese Government launched the SOE reform with the desire to promote the market by decentralising the central government's managerial decision rights in SOEs. In the 1990s, the government allowed SOEs to be partially privatised by issuing *new* and *minority* shares to individual investors, who could trade their shares freely on the newly developed Shanghai and Shenzhen stock markets, which had been set up in early 1990 and 1991, respectively. Fan *et al*. (2012) describe this reform as an "exogenous shock" in the sense that it was a politically motivated reform aimed at creating a stock market that is representative of the various geographical regions and industries in China. The central government decided which subset of SOEs was to be carved out and listed; the firms themselves had little say in the process. However, this partial privatisation process prohibited the government from selling its controlling stake in the firms. This created a unique dichotomy between tradable (or negotiable) and non-tradable (or non-negotiable) shares. In other words, the (minority) shares held by public investors are freely tradable on the stock market, while the (majority) shares held by the state and legal persons are not tradable. On the other hand, the booming private sector has generated large numbers of privately owned companies that also tap the stock market. La Porta, Lopez-de-Silanes, and Shleifer (1999) survey the ownership of large listed companies around the world and find that it is mostly concentrated in the hands of families and/or the state, except in the UK and the US, where ownership is dispersed. In China, we have a laboratory where companies of these two ownership types coexist and compete on efficiency grounds.

2.1 The ownership structure in privatised SOEs

China has adopted a two-step approach to privatisation. The first step is 'partial' privatisation, which involves SOEs selling a *minority stake* to public investors which are listed on the stock market. The second step is 'complete' privatisation, in which the government sells its controlling rights in selected SOEs to private investors.

One salient feature of the ownership structure in partial privatisation is that the government remains the largest controlling shareholder in privatised firms (Sun and Tong, 2003) and usually its ownership far exceeds that of the second largest shareholder. Specifically, on average, state-owned shares and legal person shares (indirectly owned by the government) accounted for 70% of the total number of shares in Chinese listed firms during the sample period 1998-2004 (before the reform of non-tradable shares). In a typical partially privatised Chinese SOE, the largest stockholder owns, on average, more than 40% of a firm's shares while the second largest stockholder owns less than 10% (Peng, Wei, and Yang, 2011). As such, an equally important research question is the identity of large shareholders. A vast literature on state ownership implicitly assumes there is just one type of state owner. However, the state ownership of listed firms in China is undertaken by different types of agencies with various degrees of political intervention and different objectives. Therefore, using share type as a proxy for owner type is not valid and can lead to erroneous conclusions. Indeed, government ownership is represented by various entities such as government agencies (the state asset management bureau at various levels), state asset holding/management companies, and SOEs. By tracing the identity of the ultimate controller, Chinese listed companies can be grouped into SOEs controlled by state asset management bureaus (SAMBs), SOEs affiliated to the central government, and SOEs affiliated to the local government (Chen, Firth, and Xu, 2009).

2.2 The effect of China's partial privatisation

Gupta (2005) argues that although partial privatisation does not transfer control to private owners, there is a role that the stock market can play in monitoring and rewarding managerial performance. How effective China's partial privatisation is in terms of the value, performance, and behaviour of firms is an interesting empirical question. We survey the findings of this empirical literature in Table 1.

Table 1 The Effect of China's (Partial) Privatisation: A Summary of Empirical Findings

Main Variables of Interest	Main Findings	Source
Ownership & Firm Value	Both state and legal person shares are significantly negatively related to firm value proxied by Tobin's Q.	Wei, Xie, and Zhang (2005)
Ownership & Firm Performance	Share issue privatisation (SIP) has a positive effect on earnings ability, real sales, and workers' productivity. Legal persons behave differently from the state government due to monitoring and business ties.	Sun and Tong (2003)
	SIP firms continued to experience negative post-SIP profitability changes; however, their performance decline was significantly less than that of their matched non-SIP SOEs.	Jiang, Yue, and Zhao (2009)
	Control transfer from state to private is associated with better operating performance and positive market reaction, but control transfer from state to state has no such effect.	Chen *et al*. (2008)
	Private ownership of listed firms in China is not necessarily superior to certain types of state ownership.	Chen, Firth, and Xu (2009)
Ownership & Investment Decision	The share of private ownership has a positive effect on profit reinvestment rates.	Cull and Xu (2005)
	Non-state firms in China use a much higher discount rate in guiding their investment decisions than SOEs, and an SOE uses a higher discount rate to invest after privatisation.	Liu and Siu (2011)
Ownership & Transparency	Synchronicity (a proxy of firm-specific information) is higher when the largest shareholder is government related, and foreign ownership and auditor quality is inversely associated with synchronicity.	Gul, Kim, and Qiu (2010)
Ownership & Earnings Management	SOEs have a lower incentive to manipulate earnings than non-SOEs.	Chen *et al*. (2011)
Ownership & Pay-for-Performance Sensitivity	Private ownership positively affects pay-for-performance sensitivity.	Cao, Pan, and Tian (2011)
	Even within state ownership, PPS is	Firth, Fung, and Rui

	higher for an SOE as a controlling shareholder than for a state agency as a controlling shareholder	(2006)
Ownership & Accounting Conservatism (AC)	SOEs adopt less accounting conservatism than non-SOEs because lenders are less concerned with downside risk for SOEs than for non-SOEs.	Chen *et al*. (2010)
Ownership & Choice of Auditor	Compared with non-SOEs, local SOEs are more likely to hire small local auditors.	Wang, Wong, and Xia (2008)
Ownership & Audit Fee	SOEs incur significantly lower audit fees than non-SOEs because the lower bankruptcy risk brings a lower litigation risk for auditors.	Liu and Subramaniam (2013)

Table 1 shows that the empirical results are generally consistent with the hypothesis of an efficiency gain after the partial privatisation of SOEs. The increase in minority private ownership is shown to be associated with higher perceived firm value (Wei, Xie, and Zhang, 2005); higher profit reinvestment rate (Cull and Xu, 2005); higher discount rate in making investment decisions (Liu and Siu, 2011); improved firm's earnings ability, real sales, and workers' productivity (Sun and Tong, 2003); better transparency of firm's specific information (Gul, Kim, and Qiu, 2010); lower earnings management (Chen *et al*., 2011); higher pay-for-performance sensitivity (Cao, Pan, and Tian, 2011); higher accounting conservatism (Chen *et al*., 2010); and the choice of higher quality auditors (Wang, Wong, and Xia, 2008). The primary argument is that the stock market provides incentives for investors to gather information that is reflected in share price and this information can improve managerial incentives in a number of ways.

However, from at least two perspectives, partial privatisation has its limitations. First, due to the unique institutional background (such as weak legal enforcement, overall poor corporate governance, etc.), the monitoring role of private ownership over companies is questioned: For example, although most studies on developed markets agree that direct bank ownership provides better capital access to, and better monitoring of, companies (Diamond, 1984; Barth *et al*., 2006), Lin, Zhang, and Zhu (2009) document that bank ownership in China is associated with poorer operating performance, possibly due to inefficient investments.

Second, the management in partially privatised SOEs generally has a very small or even non-existent ownership stake, and this distinctive shareholding structure fails to align the incentives of managers with firm performance. Specifically, managerial ownership, foreign ownership, and employee ownership represent less than 2% of the outstanding shares, and so they do not constitute major voting blocks (Chen, Firth, and Xu, 2009). Regarding managerial ownership, for a sample of 5,284 publicly traded Chinese firms, Wei *et al*. (2005) report an average stock holding of only 0.015% by senior managers and directors for partially privatised SOEs. Due to such low managerial ownership, most of the related literature on ownership structure has unanimously ignored managerial shares. Using a unique sample of *non-listed* Chinese firms, Hu and Zhou (2008) find that firms with significant managerial ownership outperform firms whose managers do not own equity shares. As for employee shares, China introduced an employee stock ownership plan (ESOP) in 1992 purely as an employee incentive scheme, but it was abruptly terminated 2 years after initiation. This created an opportunity to investigate the impact of the ESOP on corporate performance. Meng *et al*. (2011) exploit this policy experiment and find that the ESOP did not appear to have an effect on firm value and performance.

The second step in China's SOE privatisation process involves the government selling the controlling ownership stake in some selected partially privatised firms to private investors. However, this is a highly controlled process in which any transfer of controlling ownership from the state to private hands requires special approval and is subject to valuation by the state asset management authority or its delegates. Evaluating the gains and efficiency of such a transfer of control, Chen *et al*. (2008) find that the transfer of control from the state to private hands is associated with better operating performance and positive market reaction, but transfer of control from one state authority to another has no such effect.

2.3 Reform of non-tradable shares

The other major structural change in China's stock market was the reform of non-tradable shares, which started in 2005 and which had been completed by most listed companies (with over 98% of the stock market's capitalisation) by the end of 2007. Prior to 2005, common stocks in China were classified into two groups: tradable shares (TS) and non-tradable shares (NTS), each with the same cash flow and voting rights. State and legal person shares are not tradable on the stock exchange and have concentrated ownership. In contrast, domestic individual shares are tradable and widely held. As of February 2005 (immediately before the reform of NTS), NTS accounted for 63.51% of all outstanding stock and approximately 70% of all NTS were held by SOEs (Jiang, Lee, and Yue, 2010). The holders of TS were usually minority owners in a firm and were not effective in monitoring management, and controlling shareholders could not benefit from share value appreciation because their shares were non-tradable. Divergent interests and incentive conflicts between the holders of TS and NTS inevitably impacted corporate decisions and led to the expropriation of minority investors by controlling shareholders. For example, Huang, Shen, and Sun (2011) examine how the unique split share structure affected cash dividend payments in China during the period 1994–2006. They find that since dividends are the main lawful income that the holders of NTS can expect from holding their stocks, they may press firms to pay more dividends. Furthermore, the predominance of NTS made the corporate takeover market almost dormant, exacerbating corporate governance problems and the efficiency of firms (see, for example, Beltratti and Bortolotti, 2006; Deng, Gan, and He, 2008; Firth, Lin, and Zou, 2010; Chen *et al*., 2005; Chen *et al*., 2008). Eventually, the Chinese Government recognised that the predominance of NTS in the stock market constituted a major problem for the market's proper development and expansion.

To help solve these fundamental problems, the Chinese Government initiated the reform of the NTS programme in April 2005. This reform involves the holders of NTS proposing a compensation package to the holders of TS in exchange for the listing rights of their shares. Two studies in our survey examine factors that determine the compensation package. Li *et al*. (2011) find that the size of compensation is positively correlated with gains from risk sharing and the price impact of more shares coming onto the market following the reform. Their finding highlights the role of risk sharing in determining the size of the compensation package in this reform. Firth, Lin, and Zou (2010) study the role of mutual funds (the largest institutional owners of TS) and state ownership (the state being the major owners of NTS) in determining the compensation package and find that state ownership has a positive effect on the final compensation ratio whereas mutual fund ownership has a negative effect, implying that state shareholders have incentives to complete the reform quickly and exert political pressure on mutual funds to accept the terms without a fight.

The intended benefits of the NTS reform have been confirmed by empirical evidence. For example, Lin and Tian (2012) find that the NTS reform reduced the incentive of controlling shareholders to tunnel, as evidenced by the decreased excess leverage in firms with excess control rights and the more positive market reaction to announcements of related-party transactions after the NTS reform.

2.4 Market segmentation and share price

Another institutional feature of China's stock market is that the *same* company's shares can be listed on different stock markets and can target different investor bases. Before 2001, the Chinese stock market was a perfect example of market segmentation: Domestic investors could only trade A-shares (denominated in RMB), and foreign investors could only trade B-shares (denominated in US$ on the Shanghai Stock Exchange and HK$ on the Shenzhen Stock Exchange). The Chinese Government made the trading of B-shares available to domestic investors in 2001 and the trading of A-shares available to qualified foreign institutional investors (QFIIs) in 2002. Furthermore, beginning in 1993, Chinese enterprises started applying to list in Hong Kong as H-shares. Sun, Tong, and Wu (2013) present comparative market statistics for firms listed in China and Hong Kong. They find that since the 1990s, the Hong Kong market has played an increasingly important role as a fund raising platform for Chinese firms. Taking the number of H-share firms relative to A-share firms into consideration, the initial public offering (IPO) proceeds raised from the H-share market are larger than those raised from the A-share and B-share markets. Sun, Tong, and Wu (2013) also find that the market price-earnings (P/E) ratio and turnover rate in the Hong Kong market is much lower than in the A-share market.

The benefits of international diversification attract free capital to move across borders. Such benefits prompt investors to pay higher prices for foreign stocks than what they would pay at home. Prior studies uniformly find that unrestricted shares that can be held by both local and foreign investors trade at premium prices relative to the prices of restricted shares that can only be held by local investors. However, contrary to what has been observed in other countries with a similar market segmentation structure, B-shares in China (the equivalent to unrestricted shares in other markets)[3] are traded at a price discount relative to A-shares (the equivalent to restricted shares). The literature has offered a number of explanations to help understand this puzzling phenomenon. For example, Sun and Tong (2000) provide the risk-based explanation that the discount is caused by domestic investors' willingness to accept a lower risk-adjusted return in the A-share market due to the limited supply of A-shares. They highlight the role of the H-share market as a substitute for the B-share market and find when more H-shares and red chips are listed in Hong Kong, the B-share discount becomes larger. Chan, Menkveld, and Yang (2008) propose an information asymmetry explanation: They attribute the A-B share price discount to the information disadvantage of foreign investors, who only trade B-shares, relative to domestic investors, who only trade A-shares. Recently, Tong and Yu (2012) have offered another governance explanation, which claims that foreign investors care more about a firm's governance quality than domestic investors do. They find that the B-share price discount is higher for firms with weaker governance characterised by

[3] Sun and Tong (2000) posit that the B-share market, technically speaking, is also a restricted market – restricted to only foreign investors. Local investors are not allowed to trade B-shares in China.

higher ownership concentration, ineffective boards with a higher proportion of directors appointed by the parent company, lower dividend payouts, and higher levels of information asymmetry.

Besides the A-B share price disparity, A-H share price disparity is also intriguing and has attracted the attention of researchers. Chung, Hui, and Li (2013) show that in addition to existing explanations, parameter uncertainty also explains the disparity. Their argument is that Mainland and Hong Kong investors may have different perceptions of a firm's value due to the discrepancy in the information sets available to them, and this leads to different prices for the firm's A- and H- shares even if the fundamentals of the firm are the same. It is widely accepted that investor protection in Hong Kong (a common law jurisdiction) is higher than it is in mainland China (Brockman and Chung, 2003). For example, under the unique "one country, two systems" arrangement, it is stipulated in the law that the investor protection rules and laws in Hong Kong are not enforceable for H-share firms (which are incorporated in China). As such, H-share companies and other local Hong Kong firms are subject to very different investor protection regimes in the same stock market. Using this setting, Fung, Su, and Gul (2013) investigate the effect of investor protection on financial reporting quality. They find that H-shares companies are associated with higher earnings management than local Hong Kong firms and that this relationship is weaker since China implemented the Securities Law in 1999, providing evidence that better investor protection contributes to higher financial reporting quality. Ke, Rui, and Yu (2012) compare the managerial pay-for-performance sensitivity among SOEs cross-listed in Hong Kong in the form of H-shares, red chips (i.e. companies incorporated outside China but whose business is in China), and A-share SOEs. They find that red chip share companies have higher managerial pay-for-performance sensitivity relative to that of A-share and H-share companies, while there is no difference in managerial pay-for-performance sensitivity between H-share and A-share companies (both of which are incorporated in China).

III. Political Connections

3.1 Structural changes in firms' access to the capital market

In China, access to the equity market is a politically determined process. Before 1999, a *quota system* was used: Central government determined the overall size of the IPO market on a yearly basis, and each province received its IPO quota and identified prospective candidates on the basis of applications made by firms under its jurisdiction. Since IPO regulations are a function of accounting performance, firms manipulated earnings to meet the requirement in the pre-IPO period, and IPO firms that reported better pre-IPO accounting performance had larger declines in post-IPO profitability, lower first-day stock returns, and worse long-run post-IPO stock performance (Kao, Wu, and Yang 2009). In addition, the tight quota system left almost all listed firms undercapitalised and hungry for the privilege of rights offering. The overwhelming demand for rights offering forced the China Securities Regulatory Commission (CSRC) to use the return on equity (ROE) requirement to set the threshold. As a result, not only did a majority of firms manipulate earnings to meet the ROE requirement (Chen and Yuan, 2004; Haw *et al*., 2005; Yu, Du, and Sun, 2006; Liu and Lu, 2007), but also local governments provided subsidies to help listed firms, especially those firms largely held by local governments, to boost their ROE (Chen, Lee, and Li, 2008).

In 2000-2004, regulators adopted a *channel system* that assigned channels directly to IPO sponsors according to their size and performance. Sponsors with channels recommended prospective firms to the CSRC for an IPO. From 2005 to the present, a *sponsor system* has been adopted. The sponsor recommends its client firms for an IPO listing, which must be approved by the CSRC. State firms usually receive priority for an IPO, whereas only a few (politically connected) private entrepreneurial firms are selected for listing, thus creating a strong incentive for private firms to establish political connections. Furthermore, since politicians are rewarded for capital market activity, the career incentive of local politicians can accelerate the pace of IPO activity in certain politicised environments (Piotroski and Zhang, 2013), making political connections even more important in the IPO market. While state firms have 'natural' political connections, private entrepreneurs can establish such connections by (1) participating in politics themselves and/or (2) hiring politicians to sit on their board of directors (Fan, Wang, and Zhang, 2007).

3.2 The value of political connections

The growing body of research into the impact of political connections provides mixed evidence on their effect on the market value and performance of firms. As economists have noted, the source of the value of political connections can take various forms: preferential treatment by government-owned enterprises (such as banks), lighter taxation, preferential treatment in competition for government contracts, and relaxed regulatory oversight of the company in question, to name but a few. However, politicians themselves will extract at least some of the rents generated by connections. Therefore, corporate value will be enhanced only when the marginal benefits of the connections outweigh their marginal costs (Faccio, 2006).

The resource-based theory of the firm can be used to explain the positive effects of political connections. This theory posits that a firm's competitive advantage is based on its possession of resources that are difficult or costly for other firms to obtain. Hence, the positive impact of political connections is mainly driven by the advantage of obtaining resources from the government. Studies in our survey find that political connections are valuable in several ways. First, ties with the government help firms to have more IPO opportunities, a higher offering price, lower under-pricing, and lower fixed costs during the process of going public (Francis, Hasan, and Sun, 2009). Second, politically connected firms have easier access to the equity market and thus have less incentive to manipulate earnings to increase their IPO chances. Third, SOEs have political connections and enjoy preferential access to capital and government bailout when in financial distress. This privilege lowers SOEs' bankruptcy risk and consequently affects their financial reporting and auditor choice. Specifically, compared with non-SOEs, SOEs have a lower demand for large or non-local auditors (Wang, Wong, and Xia, 2008), a lower earnings management incentive (Chen *et al*., 2011), less conservative accounting (Chen *et al*., 2010), and lower audit fees (Liu and Subramaniam, 2013). Fourth, the value of political connections is endorsed by the market, as evidenced by the positive market reaction to a firm's political ties. Calomiris, Fisman, and Wang (2010) find that when partially privatised firms announce proposed sales of remaining government shares, the stock market reacts negatively, and there is a symmetric positive reaction to the cancellation of such a plan. The authors argue that the benefits of political ties outweigh the efficiency costs of government shareholdings.

In addition, instead of focusing, as many studies do, on the value of political connections to listed firms, Yang (2013) investigates the value of political connections to audit firms by using a data set in which auditors participate directly in the IPO regulatory decision-making process. He finds that after their partners are appointed to the CSRC's

Stock Issuance Examination and Verification Committee, non-top-tier audit firms significantly increase their IPO audit fees and market share and significantly reduce the IPO rejection risk for their clients, whereas this is not the case for top-tier audit firms.

Political connections are also found to be associated with acquirer's returns. In China, the government allows some partially privatised SOEs to sell their control rights to private investors in the second step of privatisation. The transfers of government-controlled NTS to private entities must be reviewed and approved by the local/state government authorities. The process of identifying a preferred bidder is influenced by a variety of factors, including the offer price, the impact of the sale on local tax revenues and employment, the prior relationship between the bidder and the target firm, and the political influence of the bidder. In most cases, government-appointed bureaucrats are directly involved in identifying potential acquirers. Consequently, close political connections may help these acquirers to secure more favourable deals. Tu, Lin, and Liu (2013) find that politically connected private acquirers receive preferential treatment and acquire higher quality firms during full privatisation but tend to tunnel a firm after acquisition.

In contrast, other studies find that political ties have a negative effect on firm value and performance. This is particularly true among local SOEs as they are ultimately controlled by local governments, which have both the power and incentives to intervene in firm operations to achieve social and political objectives such as reducing the unemployment rate. Fan, Wong, and Zhang (2007) find that politically connected firms underperform those without politically connected CEOs, and the likely explanation they provide is that government bureaucrats make the board unprofessional. Chen *et al*. (2011) suggest that government intervention in SOEs distorts investment behaviour and harms investment efficiency. They find that the sensitivity of investment expenditure to investment opportunities is significantly weaker for SOEs and firms with political connections, as proxied by the appointment of managers with political connections. Wu *et al*. (2012) find that private firms with politically connected managers enjoy tax benefits, whereas local SOEs with politically connected managers are prone to more severe over-investment problems. Lin and Su (2008) find that government-controlled multi-segment firms have lower Tobin's q than non-government-controlled multi-segment firms, providing evidence in support of the political cost hypothesis of diversification. Firth *et al*. (2012) examine how government control influences the investment-cash flow relation and document that government control and political forces induce firms to invest more, even if the investment opportunities are poor, so that multiple socioeconomic objectives such as employment can be achieved. Using a sample of distressed firms, Pan, Huang, and Zhu (2013) investigate how institutional factors influence the behaviour of distressed firms in emerging markets, where bankruptcy laws are often weak and debtors have greater bargaining power in times of distress. They find that private firms have better operating performance during the distress period and are more likely to recover than SOEs.

On the other hand, the political promotions or career concerns of local officials also result in the negative association between political connections and firm value/performance as their promotion prospects largely depend on regional GDP, regional deficit numbers, and regional unemployment rates during their tenure (Li and Zhou, 2005). For example, Hung, Wong, and Zhang (2012) explore why politically connected SOEs are more likely to list overseas than non-politically connected SOEs. They find that connected firms' post-overseas listing performance is worse than that of non-connected firms, and indeed the managers of connected SOEs list their firms overseas for political (private) benefits, as evidenced by the higher probability of receiving political media coverage or a promotion to a senior position following a successful overseas listing than following a domestic listing. Using the government's evaluation scores and ratings given to 63 SOEs directly affiliated to the central government between 2005 and 2007, Du, Tang, and Young (2012) point to another mechanism. They argue that officials with the discretion to adjust evaluation output can treat larger SOEs with politically influential executives more favourably, and in return, they hope for reciprocity from these executives who may later wish to advance their careers. Susceptible to such a subjective evaluation system, SOE executives may divert their time and effort away from maximising firm value and towards pleasing government officials and, in the process, forgo business opportunities.

IV. Corporate Governance in Chinese Publicly Traded Firms

4.1 Type II agency problem and evidence from propping and tunnelling through related-party transactions

Agency problems may arise from the separation of owners and managers (Type I) or from conflicts of interest between controlling and non-controlling shareholders (Type II). In Chinese publicly traded firms, the primary corporate governance problem is the Type II agency problem whereby controlling shareholders (often the state or private families) use their control rights to expropriate wealth from minority shareholders. In practice, the resource transfer between the listed firm and its controlling shareholder is achieved through various types of related-party transactions. Statistics show that out of 719 listed firms in 1997, 84.6% were involved in different degrees of connected transactions. In 2000, the figure reached 93.2%. Among these connected transactions, more than 70% were conducted between the controlling shareholders and their listed firms (Peng, Wei, and Yang, 2011). In 2004, firms listed on the Shanghai Stock Exchange (SSE) were required to disclose the gross profits on related-party sales transactions as well as the gross profits on unrelated-party sales (CSRC, 2004; SSE, 2004). No such disclosure requirement is included in the CSRC (2005) or later regulations. Therefore, this information is unique to China and to the year 2004. Lo, Wong, and Firth's (2010) study, which is based on a unique sample of 266 listed companies that disclosed their gross profits on related-party transactions in 2004, shows that the mean manipulation of transfer price was 0.649 and the mean related-party sales over total sales was 10.3%.

Tunnelling and propping are the two major behaviours of controlling shareholders when they engage in related-party transactions within a group of affiliated firms. Friedman *et al*. (2003) developed a model in which it is optimal for controlling shareholders to prop when there is a moderate adverse shock. If there is no shock or the shock is very small, controlling shareholders choose to tunnel. Following this conjecture, the controlling shareholders not only have an embedded incentive to tunnel the listed firm but also have strong incentives to prop up the listed firms during financial distress in order to avoid delisting. Peng, Wei, and Yang (2011) examine when and to what extent controlling shareholders are likely to choose tunnelling or propping and find that controlling shareholders tunnel (prop) when their company are financially healthy (in financial distress, i.e. "ST status") and that the market reacts unfavourably (favourably) to the announcement of these transactions. Regarding specific ways to tunnel or prop, studies have identified channels such as abnormal related sales (Lo, Wong, and Firth, 2010; Aharony, Wong, and Yuan, 2010), inter-corporate loans (Jiang, Lee, and Yue, 2010), and loan guarantees (Berkman, Cole, and Fu, 2009). Jian and Wang (2010) find that controlling shareholders prop up their listed firms through abnormal related sales and then tunnel back through related lending. Wang and Xiao (2011) find that controlling shareholders that engage in tunnelling activities have less incentive to demand high pay-for-performance sensitivity in executive compensation.

4.2 Executive compensation

Executive compensation plays a central role in corporate governance by aligning the interest of the manager with that of the owner (for a discussion of this literature, see Murphy, 2012). In the case of China, the managerial ownership in listed SOEs is minimal. For a sample of partially privatised SOEs, Wei *et al*. (2005) report an average stock holding by senior managers and directors of only 0.015%. Employee stock ownership is also not common, and Meng *et al*. (2011) find that employee stock ownership plans (ESOPs) do not appear to have an effect on firm value and performance. In contrast, using a sample of non-listed Chinese firms, Hu and Zhou (2008) find that firms with significant managerial ownership outperform firms whose managers do not own equity shares.

Since 2006, Chinese listed firms have been required by the regulator to report each individual board member's and top management's total compensation as the sum of salary, bonus, stipends, and other benefits (Conyon and He, 2011). This has created an opportunity to study the level and components of Chinese executive pay. It has been found that executive compensation in SOEs consists mainly of a fixed salary and that private ownership positively affects pay-for-performance sensitivity (Cao, Pan, and Tian, 2011). Even within state ownership, Firth, Fung, and Rui (2007) find that pay-for-performance sensitivity is higher for an SOE as the controlling shareholder than for a state agency as the controlling shareholder. Moreover, Ke, Rui, and Yu (2012) find that red chip firms have higher pay-for-performance sensitivity than A- and H-share firms. Interestingly, Gul, Cheng, and Leung (2011) find that although its disclosure is not mandatory, perk consumption constitutes an important part of Chinese executive compensation.[4] The authors also find that firms that provide higher perks to their executives are associated with lower informativeness of stock prices (higher R-square); this result suggests that high perk consumption signals agency problems, which the market interprets negatively.

Executive political power is an important, but under-explored area in the study of Chinese corporate governance. In a Chinese listed company with dominant state ownership, the decision-making power is shared between the Chairman, Party Secretary, and CEO. Therefore, if the CEO also serves as a Party Secretary, his/her decision-making power becomes stronger. Chen, Ezzamel, and Cai (2011) examine the determinants of executive remuneration using managerial power theory and tournament theory after adapting them to fit the Chinese context. Managerial power refers to the ability of managers to influence the remuneration decisions made by the board of directors (Lambert *et al*., 1993). Chen, Ezzamel, and Cai (2011) use three proxies to measure executive power: structural power (executive ownership), political power (Party Secretary), and prestige (executive education). Their results show that executive

[4] In the annual reports of Chinese firms, there is a particular and separate section of notes of accounts called "Cash Payment for the Expenses Related to Operating Activity". Under this section, firms voluntarily disclose perk data, from which Gul, Cheng, and Leung (2011) identify eight possible items related to perks consumed by all employees. The eight items are work-related expenses, communication expenses, traveling expenses, business entertainment expenses, overseas training expenses, board meeting expenses, company car expenses, and meeting expenses.

remuneration in China is positively associated with an executive's structural power, political power, and prestige power and that the remuneration is based more on the political powers than firm performance. Under the tournament theory, they find that the relative pay gap[5] is smaller for firms with higher state ownership, possibly because political promotion reduces executives' cash incentive.

Despite the rising importance of large state-controlled Chinese firms in global financial markets, the incentives of these firms' executives remain a black box to most outsiders. Therefore, the determinants and consequences of the composition of executive compensation are a black box as well. Chen, Guan, and Ke (2013) document that stock options granted to the directors of many, if not all, state-controlled red chip firms are not genuine compensation. Instead, state-controlled red chip firms' stock option compensation plans are merely window dressing to please foreign investors and are never fully implemented due to Chinese SOEs' unique managerial labour market.

4.3 Board structure, CEO turnover, and dividend payout

Whether and how independent directors perform their oversight and governance role in the boardroom have long been the subjects of debate. To boost the effectiveness of independent directors, the CSRC introduced a practice that differs from those adopted in other developed markets: that is, independent directors are obliged to publicly disclose their opinions on important board decisions such as the appointment of top executives, managerial compensation, financial reporting, material related-party transactions, and important investment decisions (CSRC, 2001). Tang, Du, and Hou (2013) utilise this record and find that firms with more independent directors saying 'no' can help to protect the interests of outside investors.

Regarding CEO turnover, Chang and Wang (2009) document an annual CEO turnover rate of 25.5% during 1995-2001, and they find that firms are more likely to replace their CEO when they are incurring financial losses. The authors argue that these results indicate the existence of a time-varying objective function whereby shareholders have a greater incentive to discipline their CEOs on the basis of financial performance when their firms are incurring financial losses rather than profits. In addition, Chen *et al.* (2012) find that the extent to which controlling shareholders delegate control rights to CEOs is positively associated with the sensitivity of the CEO-turnover rate to financial performance, advancing our understanding of the relation between firm performance and CEO turnover.

With regard to dividend payout, Huang, Shen, and Sun (2011) study Chinese listed firms during the period 1994 to 2006 and find that their propensity to pay a cash dividend and the payout ratio are lower than those documented by Von Eije and Megginson (2008) in Europe and by Weston and Siu (2003) in the US. Consistent with the Type II agency problem, they find that the proportion of NTS and the percentage of these shares held by the controlling shareholder are positively associated with the likelihood of paying dividends and the payout ratio, but the authors do not find controlling shareholders used dividend payments to expropriate negotiable shareholders in any significant manner.

V. The Regulatory Environment

China is known for its less developed legal and financial system (Allen *et al.*, 2005).

[5] Relative pay gap refers to the pay difference between HPE1 and HPE2 relative to the pay difference between HPE2 and HPE3. HPE: highest paid executive, and 1, 2, and 3 indicating highest, second highest, and third highest, respectively.

Over the years, the country has introduced a series of laws and regulations aimed at enhancing the level of investor protection. These laws and regulations cover a comprehensive list of corporate governance issues, including matters related to controlling shareholders, shareholders' meetings, the board of directors, management's responsibilities, internal control, executive compensation and accountability, and corporate disclosure, thus creating a bunch of intriguing research questions. For example, in 2004, the CSRC launched a new regulation that requires equity offering proposals to obtain the separate approval of voting minority shareholders. The enforcement of this new rule allowed Chen, Ke, and Yang (2013) to examine whether giving minority shareholders increased control over corporate decisions helps to reduce value-decreasing corporate decisions for firms in weak investor protection countries. They find that the regulation deters management from submitting value-decreasing equity offering proposals in firms with higher mutual fund ownership, suggesting that in weak investor protection countries, whether granting minority shareholders' more control over corporate decisions helps improve the quality of corporate decisions depends on the composition/sophistication of the minority shareholders. As to the efficacy of the legal refinement of investor protection, Berkman, Cole, and Fu (2010) examine the wealth effects of three regulatory changes designed to improve minority shareholder protection in the Chinese stock markets. They find that investors reward the increased minority shareholder protection more for firms with weaker corporate governance, while they react less to firms with strong ties to the government, suggesting that minority shareholders do not expect the regulators to enforce the new rules on firms with strong political connections.

In China, the CSRC is the principal regulator that enforces securities laws and regulations. Due to its crucial role in stabilising and generating confidence in the stock market, it is fairly important to explore the efficacy of the CSRC. Chen *et al*. (2005) investigate whether the CSRC is a tiger with teeth and find that the enforcement actions of the CSRC have a negative impact on stock prices, with most firms suffering wealth losses of around 1-2% in the 5 days surrounding the event. However, Firth, Rui, and Wu (2009) provide evidence that the CSRC does not make timely public disclosure of sanction and enforcement information (SEI) and instead leaves it up to firms to make a public announcement. Consequently, such less timely SEI disclosure by the CSRC gives sanctioned firms a chance to delay their disclosure of SEI for opportunistic reasons such as completing material transactions.

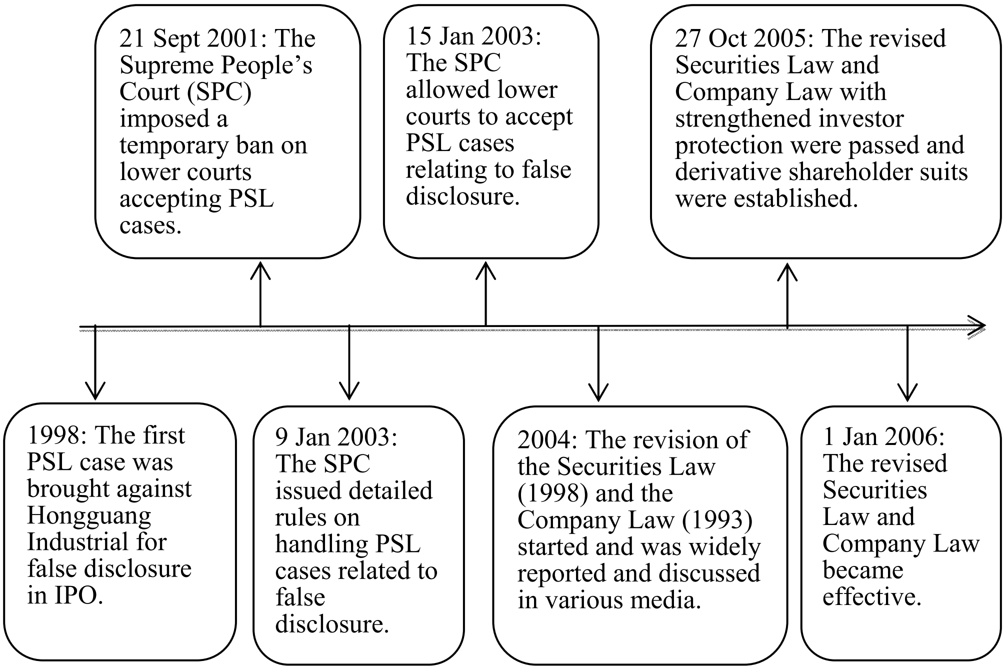
The evolution of laws and regulations in the past decade has exposed Chinese firms to a higher litigation risk. While the evidence on private enforcement in the form of minority shareholder action is scarce in China, some studies have indirectly tested this litigation risk by examining the firm's purchase of directors and officers legal liability (D&O) insurance. In China, directors and managers are required by the CSRC to seek shareholders' approval for purchasing D&O insurance. Zou *et al*. (2008) identify 53 such cases during 2000-2004 and find that firms with more acute controlling-minority shareholder incentive conflicts are more likely to consider purchasing D&O insurance. Figure 2 presents a timeline of the important laws and regulations associated with firms' litigation risk.

5.1 Financial reporting: Accounting standards reform and firms' disclosure behaviours

Given the ownership structure of Chinese privatised firms and the weak legal environment, the financial reporting incentives of Chinese managers are more influenced

Figure 2 Timeline of the laws and regulations regarding litigation risk

Figure 2 presents the series of laws and regulations across the timeline that exposed firms to higher litigation risk, aiming to enhance the level of investor protection.



by accounting's contracting role than its information role. Specifically, contractual terms in government regulations create strong incentives for firms to manage earnings to maintain their listing status relative to incentives to provide investors with transparent information. For example, several studies document the phenomenon that firms manage their earnings to meet the regulatory ROE benchmark for rights issue (Chen and Yuan, 2004; Haw *et al*., 2005; Yu, Du, and Sun, 2006). Moreover, the delisting regulation that states that a firm will be delisted if it reports a loss for three consecutive years gives managers another strong incentive to manipulate earnings upward.

Firth, Rui, and Wu (2011) examine the causes and consequences of falsified financial statements by studying the firms that make restatements in China. They find that firms with high debt and that plan to make equity issues are more likely to manipulate their earnings and thus have to restate their financial reports in subsequent years. They also find that restating firms suffer negative abnormal stock returns and have higher cost of capital, wider bid-ask spreads, greater frequency of modified audit opinions, and greater CEO turnover. From another angle, Cheung, Jiang, and Tan (2010) apply the OECD Principles of Corporate Governance to assess the transparency of 100 major Chinese listed companies. They find that investors do desire transparency in Chinese listed companies and reward companies for more voluntary disclosure. This finding raises another important research question: What factors affect management's voluntary disclosure? Using a unique regulatory setting regarding the voluntary disclosure of the pricing method of related-party transactions,[6] Lo and Wong (2011) find that earnings

[6] Chinese listed companies are mandated to disclose various details of their related enterprises as well

management and its incentives, board composition, and ownership structure significantly influence the voluntary disclosure decisions of managers.

Another important feature of Chinese firms' financial reporting environment is that different accounting standards are applied to firms in different segments of the market. B-share firms have historically been required to follow IFRS, while A-share firms follow the Chinese Accounting Standard (CAS), which has converged with IFRS progressively in four phases: 1992, 1998, 2001, and 2006. Peng and Smith (2010) examine the development of Chinese accounting standards since 1992 with the goal of identifying the convergence process of CAS with IFRS. They find that China's Ministry of Finance (MOF) converged the CAS with IFRS, with the level of convergence going from 20% in 1992 to 77% in 2006. The convergence has been achieved both through the direct import of standards from the IFRS and through progressive changes to the CAS.

Although Chinese accounting standards have moved towards IFRS, the value relevance of IFRS in China is still debated and the empirical evidence is mixed (Ding and Su, 2008). For example, Liu *et al.* (2009) provide empirical evidence that accounting quality has been improved through decreased earnings management and that the value relevance of accounting information has increased since 2007. On the other hand, He, Wong, and Young (2012) examine the unintended consequences of applying fair value accounting (FVA) to trading securities and debt restructuring. They find that earnings management, smoothing activities, and weak institutions (e.g. a poor legal environment and/or heavy government involvement in the economy) compromise the benefit of FVA for trading securities and debt restructuring that is intended to provide investors with more relevant and transparent information.

While asset impairment reversals are practised in many jurisdictions, empirical evidence is rare. Regulation changes on asset impairment reversals in China provide researchers with a unique opportunity to examine the determinants and consequences of impairment reversals. Prior to 2007, the CAS, following IFRS, allowed firms managerial discretion over impairment reversal. However, effective from 2007, the new impairment reversal regulation imposes restrictions on impairment reversals. Chen, Wang, and Zhao (2009) examine the value relevance of impairment reversal information using a sample from 2003-2006. They find that the value relevance of reversal information appears to be negatively affected by regulatory-motivated earnings management. Zhang, Lu, and Ye (2010) also focus on the new impairment reversal regulation and find that this regulation, which is closer to the US GAAP than to IFRS, constrains earnings management and increases the value relevance of impairment reversal information.

VI. The Development of Auditors and Financial Intermediaries

6.1 Auditors

Unlike in the US where the vast majority of public companies are audited by Big *N* firms, China's audit market is much less concentrated. In 2001, the concentration ratio for the Top 4 and Top 8 auditors was 30.32% and 44.7%, respectively (Xia and Lin, 2003), and the average market share of the Big 5 (now the Big 4) auditors in the statutory audit market between 1995 and 2003 was 26% (Chen, Su, and Wu, 2007). At the end of 2006, there were 73 audit firms qualified to audit approximately 1,400 listed companies, which means that on average, one qualified firm had less than 20 listed clients. This has created

as the types and amounts of all their related-party transactions in the notes to financial statements. However, the disclosure of transfer pricing methods is a voluntary management decision in China. This offers an excellent setting to investigate managers' decisions on transfer pricing disclosures.

a buyer's market where auditor independence is widely challenged. In assessing the value relevance of auditors' reports in China, Chen, Su, and Zhao (2000) find a significantly negative association between modified audit opinions (MAOs) and cumulative abnormal returns, suggesting the monitoring role of independent auditing as an institution.

Several structural changes in China's auditing market have given rise to research opportunities. The merger wave among China's certified public accountant (CPA) firms was activated by both market-based incentives and regulatory reasons. After China's accession to the WTO, large international accounting firms were allowed to be directly involved in China's audit market. Therefore, it became a rising concern whether domestic firms, which generally remained small in scale, would be able to compete with large international accounting firms. On the other hand, the Chinese Government increased the qualification for a CPA firm to obtain a licence to audit listed firms: for example, in 1997, a CPA firm with eight individual qualified CPAs was eligible to apply for a licence to audit listed companies, but in 2000, only a CPA firm with more than 20 qualified CPAs or with more than 8 million RMB revenue generated in the previous year was allowed to provide audit services for listed companies. The merger wave among CPA firms exogenously increased audit firm size without increasing audit firm competency and thus created a natural experiment to examine the relation between firm size and audit independence. Using this setting, Chan and Wu (2011) show a positive relation between firm size and audit independence.

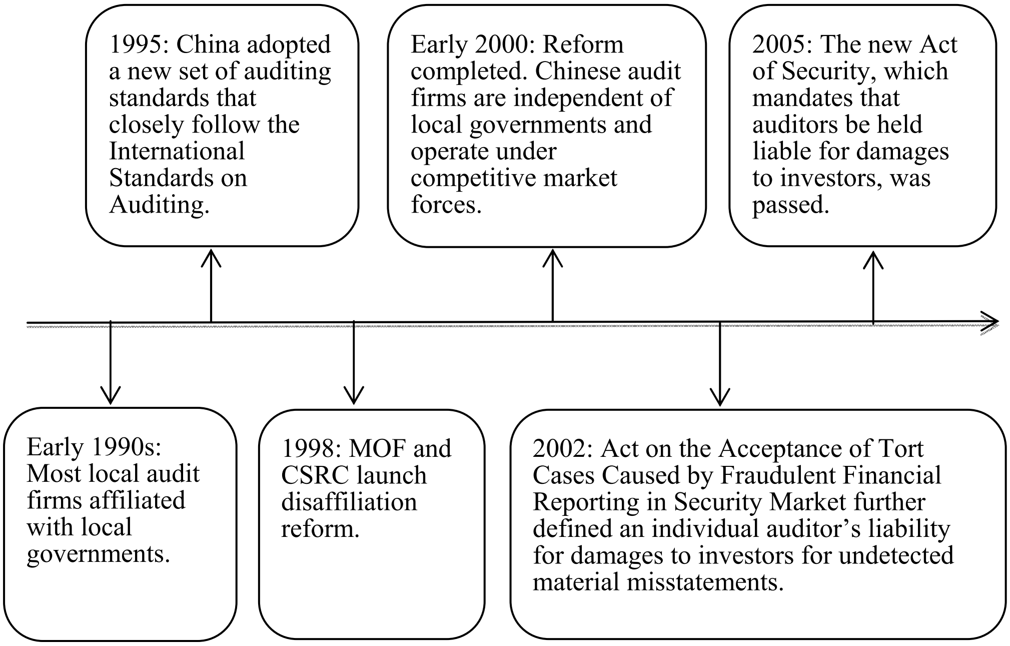
In sharp contrast to developed economies, the accounting and auditing profession in China is not only regulated but also administered by government agencies. To improve audit independence, the Chinese Institute of Certified Public Accountants (CICPA) initiated a disaffiliation programme in 1998-1999. This disaffiliation programme required disaffiliated CPA firms to be registered in the form of either an unlimited liability partnership or a limited liability company. This provides another policy experiment for researchers to investigate empirically the association between the organisational form of (CPA) firms and the reporting conservatism of auditors in China. Audit partners in an unlimited liability partnership firm share liabilities jointly and severally with other partners in the firm, whereas the liabilities of audit partners in a limited liability audit firm are limited to their personal contribution to the capital of the CPA firm. Therefore, auditors in partnership firms have a higher potential risk and liability exposure than auditors in limited liability firms. Consistent with this hypothesis, Firth, Mo, and Wong (2012) find that partnership CPA firms are more likely to issue modified audit opinions (i.e. more conservative) than limited liability firms.

The institutional changes shown in Figure 3 indicate the gradual improvement of audit independence in China. DeFond, Wong, and Li (1999) find that the adoption of enhanced auditing standards in 1995 by China's MOF led to an increase in MAOs, but this was followed by a decline in audit market share among large auditors. Chen, Sun, and Wu (2010) find that China's Private Securities Litigation Rules enacted by the Supreme People's Court in 2003 increased auditors' litigation risk and thus increased their propensity to issue MAOs. Aiming to improve audit quality for SOEs ultimately controlled by the central government (CSOEs), China's State-owned Assets Supervision and Administration Commission (SASAC) issued two rules in 2004: (1) SASAC assigns auditors for CSOEs and (2) management are required to retain auditors for a tenure fixed at 2-5 years. These two rules limit management influence over auditor choice and thus give rise to more MAOs (Chi *et al.*, 2013).

6.2 Institutional investors and sell-side analysts

Figure 3 Institutional changes aimed at improving audit independence

Figure 3 presents the gradual improvement of audit independence in China through a series of institutional changes across the timeline.



There has been a dramatic increase in institutional investors in the past decades. According to the CSRC, institutional investors, including mutual funds, insurance companies, QFIIs, and other general institutional investors, held about 48.8% of total market capitalisation at the end of 2007, up dramatically from 5% in 2002. At the end of 2011, 64 fund companies managed about 900 mutual funds, with total net assets of CNY2.17 trillion (US$341.1 billion). Along with the growth of institutional investors, sell-side analysts have been playing an increasingly important information production role in the market. According to the Securities Association of China, at the end of 2011, 92 brokerage firms employed more than 2,067 financial analysts, with more than 1,777 of them issuing research reports (Gu, Li, and Yang, 2013).

Institutional investors can be either quasi-insiders or outsiders depending on the nature of their ownership and the horizon of their trading behaviour (Bushee, 1998). One strand of literature argues that the frequent trading and short-term focus of institutional investors encourages managers to engage in myopic investment behaviour or to trade on insider information. Tong, Zhang, and Zhu (2013) provide significant evidence that relative to a benchmark period, institutional investors bought more event firms' shares in the last two trading days prior to announcement, pointing to concerns about the efficacy of the law enforcement of the insider trading regulations.

Another strand of literature argues that the large shareholdings and sophistication of institutions contribute to the better monitoring of corporate governance and allow managers to focus on long-term value rather than on short-term earnings. The Chinese Government has put a lot of regulatory effort into promoting the development of financial institutions, especially for mutual funds.[7] As institutional ownership has increased rapidly, so the role of institutions as shareholders has evolved. Motivated by the Chinese Government's expectation that mutual funds in China can monitor corporate decisions and counter speculative behaviours by individual investors, Yuan, Xiao, and Zou (2008) explore the effect of mutual fund ownership on the performance of Chinese listed firms and find that equity ownership by mutual funds has a positive effect on firm performance, lending support to the view that mutual funds play monitoring role in corporate governance.

In light of the short history of financial analyst forecasts in China, whether analysts in China perform their role as monitors and information producers is a major concern. Exploiting a unique set of analyst rating data produced by China's New Fortune magazine, Xu *et al*. (2013) confirm the general conclusion of a positive association between analyst coverage and stock return synchronicity measured by a firm's R-square documented by Chan and Hameed (2006) using data from 25 emerging markets, suggesting that analysts in emerging markets are generally not able to produce firm-specific information. However, the findings on star analysts show that star analyst coverage actually decreases stock return synchronicity, suggesting that star analysts are able to do a better job in producing firm-specific information given their superior human capital.

On the other hand, Gu, Li, and Yang (2013) point to a source of analyst bias which has been little explored in literature but is a wide concern among regulators and the investment community: institutional investors pressure financial analysts through trading commission fees to issue optimistic opinions in support of their stock positions. Specifically, with a unique data set that identifies mutual fund companies' allocation of trading commission fees to individual brokerages, they show that for stocks in which the fund companies have taken large positions, analysts are more optimistic in their stock recommendations when their brokerages receive trading commission fees from these fund companies. The relationship is stronger when the commission fee pressure is greater.

VII. Conclusions

Scholarly interest in Chinese stock market research has been on the rise in the past few decades, with an increasing number of papers published in top accounting and finance journals. In this survey, we have reviewed 95 articles using data on Chinese publicly traded firms that were published in major accounting and finance journals. We focus on the structural changes and salient features of the Chinese stock market. China's unique institutional background and the Chinese Government's intensive regulations provide a laboratory to test many important theories and hypotheses that are widely debated in the accounting and finance literature. As we have shown, in the past 15 years, many important works on China's stock market have exploited the regulatory shocks that affect stock market participants. Given the transitional nature of China's economy, many authors highlight the distinctiveness of Chinese listed firms compared with their counterparts in the West. These distinctiveness includes the effect of a firm's state ownership and political connections on managerial incentives and firm-specific behaviour.

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[7] For example, in 2000, the Chinese government made a strategic decision to cultivate the 'pillar role' of mutual funds among other financial institutions in the domestic stock markets (CSRC, 2000). Mutual funds are now encouraged to invest in listed companies in the expectation that they can monitor corporate decisions and counter speculative behaviours by individual investors (e.g. free-riding problems).

Despite the interesting empirical findings on China, it is still unclear to what extent these findings cast light on some fundamental accounting and finance questions in the West: What is the most appropriate measurement of accounting qualities? Do accounting numbers and qualities have a first-order effect on firm value, and does this effect differ between China and the West? How important is the stock market to private sector firm growth as well as the country's economic growth? As Allen *et al*. (2005) argue, China is an important counter-example to the findings in the law, finance, and growth literature. We believe the richness of the Chinese economy potentially offers the opportunity to not only duplicate the findings in Western accounting and finance studies but also to build new theories (e.g. Xu, 2011; Song, Storesletten, and Zilibotti, 2012). Finally, we would like to stress that the research opportunities suggested here are not limited to China and its counterpart transitional economies. After the recent financial crisis, there was a substantive rethinking on Western financial institutions and their systemic risks. In this context, more in-depth knowledge on China's stock market and its connection to the world's financial institutions has the potential to provide some useful insights to the West.

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