Discussion of “Public Enforcement of Securities Laws in Weak Institutional Environments: Evidence from China”

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Theme

- "China presents a unique setting for an out-of-sample investigation of the efficacy of U.S. style public enforcement without a well-developed institutional framework."
- Why unique? absence of private enforcements in China:
  - Few securities litigation
  - Shareholding voting (controlling shareholder dominance)
  - No strong-form price efficiency
  - Absence of sophisticated market participants
- "There is a lack of academic research on how developing and emerging economies fare when importing laws from advanced economies."
- "We fill a void in the literature by using China as an important case study to gain insights into public enforcement of securities laws in a weak institutional environment."

Results

- Do the regulators find bad firms?
  - 5-day announcement period return is -2.2%
- Any real effects on accounting afterwards?
  - No change in earnings management practice and transparency subsequently
    - Accruals management and small positive earnings
    - Disclosure quality – number of numbers and length of text
    - 2 measures of bid-ask spread

Results, cont’d

- If firms are bad, are they subject to more market discipline?
  - No change in market discipline
    - Cost of debt and equity
- If firms are bad, are they more likely to be sanctioned alter?
  - More likely to receive CL and be subject to CSRC sanctions in future

Motivation and tension

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- The tension in the paper
  - Ineffective: absence of private enforcements
  - Effective: regulator's enforcement serves as a substitute for the poor private enforcements
- Need a stronger motivation
  - Past research has looked at adoption of western accounting and auditing standards in emerging economies / China
  - These papers found surprising outcomes and link those outcomes to the unique institutions of the emerging economies
  - This paper needs to explain why they have these outcomes, and directly link those outcomes to certain unique institutions

Past research on adoption of western standards

- Ball, Robin, and Wu (2003)
  - Adoption of western accounting standards but accounting properties do not exhibit strong TLR (implying “low” quality)
  - Why? Family control and relational contracting, which lead to opacity.
  - Incentives more important than standards
- DeFond, Wong, and Li (2000)
  - Adoption of international auditing standards. Modified opinions increase by 9 times, but firms start to hire non-Big 10 auditors which are less stringent
  - Why? SOEs have no strong incentives to hire Big 10 auditors to signal accounting quality.
- He, Wong, and Young (2012)
  - China adopted IFRS in 2007 (more convergence than adoption)
  - Firms use fair value accounting to manage earnings.
  - Why? China has many related party transactions and markets are not well-developed. Fair value approach can lead to earnings manipulation.

Can CSRC provide effective regulations in the absence of law?

- Pistor and Xu (2005) argue that in the absence of law, China developed its stock markets, which ranked among the largest stock markets in the world.
- Their approach is called "administrative governance".
- Instead of relying on the court system to go after bad firms, they used the quota system for IPOs.
- Each provincial leader is given quota to list firms in the stock markets and these leaders are held accountable for their performance.
- These political leaders have incentives and local knowledge to monitor the firms.

What exactly are the possible reasons for the ineffectiveness in the use of CL in China?

- The paper needs to link the outcomes to China's unique institutions
  - Dig deeper into the regulator's and firms' incentives based on China's institutions
- Different from the first badge of the papers on finding emerging market firms not reaching western level of accounting quality after adopting western standards.
  - Those papers focus on firms' incentives
  - This paper has to look at both the regulators and the firms.
- From the firms' perspective, why isn't there an improvement in accounting quality after the CL? Why isn't there market discipline if the firms don't improve? Is the market that inefficient and the investors that naive? Or is there another reason behind it?
- The paper needs to explore more the incentives of the regulator. Pistor and Xu (2005) find that China's administrative governance can be effective.
  - If the Chinese government really wants to go after the crooks, they can

Are the objectives of the government the same as those of the U.S.?

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- Is the Chinese government just picking firms with poor disclosure?
- Is it trying to fulfill political objectives or consider political incentives while making the enforcement e.g. selective enforcement
  - Do more with the SOE results?
- The Chinese government may have different standards for quality from those of the U.S.
  - Firms that engage in earnings management, e.g. smoothing will not be sanctioned because this is accepted in a relational economy
- We need to understand more about the government's objectives and standards before we draw any comparison with the U.S. and make statements about its effectiveness.
  - I understand CSRC did talk about quality but we should also understand the Chinese market is dominated by state firms and controlled by the government. These forces are not there in the U.S.

Are accruals management and bid-ask spread a good measure of the government's enforcement outcomes?

- Firms in relational economies smooth their earnings to maintain stability among stakeholders (Ball et al., 2000 also find this in code law countries).
- Olympus case in Japan – they smooth earnings to protect stakeholders such as the employees, suppliers, and banks
- Japanese government and the public are sympathetic towards Olympus in smoothing earnings
- Perhaps the Chinese government is also not catching firms that smooth earnings or have low transparency
- Accruals earnings management and bid-ask spread are not the appropriate KPI for the Chinese regulator

Why is there no market discipline?

- Hung, Wong, and Zhang (2015) find that when firms are sanctioned by CSRC (accounting related violations), firm value drops by 15% (2-year CAR around the scandal).
- US accounting scandals are associated with a 41% drop in CAR (Karpoff et al., 2008)
- Chinese firms that are involved in scandals that disrupted their relationships with government, the drop in CAR is 35%.
- Perhaps CLs are minor issues and the market has anticipated them
- Those more serious ones will lead to sanctions. Some can be very serious while others may not be, i.e. not disrupting relationships.
- It is interesting to note that many of the CLs are about related party transactions. CSRC does pay attention of the underlying relationships of the accounting transactions.

Content of comments letter may give you the clue

- CSRC seems to care a lot about earning recognition
- What causing concerns to CSRC is the relationships in the transactions (these are relational contracts)
- What do they want to clarify?
- How do the firms respond?
- What are the firms trying to hide and why?

CLs before and after 2014

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1. The paper uses SSE data (2015-2017) for stock return tests, which find negative results, and the large sample (2013-2017) for all other tests, which find nothing.
2. Are results different between 2013 to 2014 and 2015 to 2017?

Panel A: CLs over time and from different sources

Year	SSE	Corporate announcements			CLs (Yes or No)	No. of SSE firms	% of SSE firms receiving CLs
	(1) CLs	(2) CLs	(3) Responses	(4) Supplemental announcements	(5)	(6)	(7)
2013	0	3	76	25	104	950	10.95%
2014	0	1	119	14	134	1,005	13.33%
2015	76	49	9	3	137	1,077	12.72%
2016	124	31	0	3	158	1,217	12.98%
2017	126	72	0	0	198	1,404	14.10%
Total	326	156	204	45	731	5,653	12.93%

Predicting CL and Sanctions

$$Sanction_{it} = \beta_0 + \beta_1 CL_{it-1} + \beta_2 CL_{it-2} + \beta_3 lnMarketCap_{it-1} + \beta_4 M/B_{it-1} +$$

$$\beta_5 Leverage_{it-1} + \beta_6 CFO_{it-1} + \beta_7 InstitutionalOwnership_{it-1} + \beta_8 SOE_{it-1} + \beta_9 Loss_{it-1} +$$

$$\beta_{10} ForeignListing_{it-1} + \beta_{11} Big4_{it-1} + Industry\ and\ Year\ fixed\ effects + \varepsilon_{it}. \quad (6)$$

- Need to control for fixed effects.
- Certain firms can be more prone to receiving CLs and sanctions.

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All the best