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THE PUBLICATION LANDSCAPE OF GERMAN CORPORATE GOVERNANCE RESEARCH: A BIBLIOMETRIC ANALYSIS

M. Eulerich*, S. Haustein, S. Zipfel***, C. Van Uum******

Abstract

Although the importance and urgency of the corporate governance debate has increased in media, public and scientific literature after the financial crisis, there is no systematic and holistic approach to the phenomenon of corporate governance and the associated economic research in the German-speaking countries. Due to this, the literature on corporate governance research in the German-speaking area is examined by means of bibliometric methods and social network analysis in order to identify thematic clusters and the most influential documents and authors. Based on a co-citation analysis of over 10,000 references cited in 267 source documents, a map is constructed that depicts the landscape of corporate governance research in German-speaking countries. The analysis identifies a large body of accumulated corporate governance research, which is mostly based on the theoretical work from English-speaking scholars. Our findings and interpretations allow a new view on the German corporate governance research and on the particular understanding of corporate governance in the German-speaking research community. Today, around 10 years after the introduction of the German Corporate Governance Code, corporate governance research is a well-established segment of German business administration research characterized by diverse research focuses.

Keywords: Bibliometric Methods, Social Network Analysis, Corporate Governance Research, German-speaking Countries

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1. INTRODUCTION

Although the importance and urgency of the corporate governance debate has increased in media, public and scientific literature after the financial crisis, there is no systematic and holistic approach to the phenomenon of corporate governance and the associated economic research in the German-speaking countries. Hence, and despite its relevance, corporate governance research has not become the subject of a bibliometric analysis, yet. Means of bibliometric analyses and methods of social network analysis enable to represent the quantity of academic communication. Forms and structures of the research landscape can thus be illustrated. Although a few bibliometric studies exist focusing on German business administration, such as the extensive works of Schäffer et al. (2006), Schäffer et al. (2011), Binder & Schäffer (2005) and Wagenhofer (2006) on controllership, so far only a few authors consider it relevant. This study applies bibliometric methods and social network analysis to the area of corporate governance research in the German-speaking countries in order to evaluate the impact of publications and clusters representing thematic sub-fields.

The few publication and citation analyses on corporate governance research that exist are limited to English-language journals, which are covered by the Social Science Citation Index (SSCI) of the Web of Knowledge[1] (Huang & Ho, 2011; Durisin & Puzone, 2009). However, these publications cannot directly be transferred to the corporate governance research in German-speaking countries due to the different governance system and the distinct understanding of corporate governance. A detailed examination of the research development reveals different facets of the corporate governance debate and thereby creates not only a better understanding of the issues discussed, but also reflects the current research landscape. Since only 20% of journals relevant to German business research are covered by the Web of Knowledge, a citation database based on corporate governance research in the German-speaking countries was constructed manually (Schrader & Hennig-Thurau, 2009).

Thereby, the objective of this paper is both, to analyze the development of corporate governance research in German-language publications and to identify the structure and development of corporate governance research by means of citation and co-citation analysis. Additionally, the combination of individual analyses supports the identification of connections between different authors or subjects because single analyses cannot reveal these relations.

The use of citation and co-citation analyses intends to holistically reflect the structure and the development of corporate governance research in Germany and therefore aims at elaborating on the following four questions:

- Which publications were cited most frequently during the relevant period and how strong is the influence of the most frequently cited publications within the field of German corporate governance research?
- Which authors were cited most frequently during the relevant period and how do they influence the corporate governance research in the German-speaking countries?
- Which thematic clusters can be identified in corporate governance research by means of co-citation analysis? Where are thematic emphases and which authors and publications are central to these clusters?
- What other scientific areas are connected to corporate governance and to what extent have these connections evolved over time?

In order to examine these issues, different analytical methods were applied to documents published from 1995 to 2011. Given the first English publication in the mid-1970’s, the analysis on German publications begins in 1995, although there was no fundamental corporate governance discussion noticeable in Germany at that time, yet. German publications focusing on corporate governance topics can rather be observed since 2000.

In order to put the approach used by the citation, co-citation and cluster analysis into concrete terms, the following section illustrates the methodology of bibliometric methods in general and presents the methodology of this paper. The bibliometric methods applied to identify and map the publication landscape of corporate governance research in the German-speaking countries are explained below.

2. BIBLIOMETRIC METHODS

Citation analyses are based on quantitative methods and used for the evaluation of scientific communication structures. The following analysis of publications and citations aims at quantitatively recording developments in the scientific communication system and identifying lines of research within a region or between different areas (Winterhager, 1994, p. 14). This approach is based on the assumption that through a publication and subsequent citations, an information exchange can be observed in the scientific communication system, which allows reliable and valid conclusions about the trends and interdependencies in the overall system (Small, 1978; Garfield, 1979). A citation is therefore a reliable and applicable indicator for the exchange of information of the scientific community (Schäffer et al., 2006).

First bibliometric surveys, which mainly referred to the evaluation of references, were cited by publications of a discipline or sub-discipline in order to identify core journals for the management of library holdings by means of objective and quantitative methods (Gross & Gross, 1927; Archambault & Larivière, 2009). With the development of the SSCI by Eugene Garfield at the Institute for Scientific Information (nowadays Thomson Reuters) in the 1960s, which was the first database that recorded scientific literature on the basis of indexing citations, bibliometric analyses globally gained importance in scientific evaluation. By the systematic and regular collection of citations and references from scientific journal articles in the field of natural sciences, engineering, and medicine, a data basis was created that illustrated publication output, perception and communication structures. Today, the Thomson Reuters citation indices cover more than 12,000 scientific journals under the surface of the Web of Knowledge. In 2008 conference proceedings were added.

For the investigation of the relationship between citing and cited publications, it is relevant to initially define the concept of a citation. A reference corresponds to a document listed in the bibliography

[1] http://wokinfo.com

of a publication. From the perspective of the cited document, the reference is a citation (Stock, 2001). A citation analysis evaluates the influence of a distinct source or an author by the number of citations received (Gmür, 2003). Although the number of citations is commonly interpreted as an indicator for the performance and the acceptance of a publication, conclusions should not be deducted inconsiderately (Winterhager, 1994; Goldfinch et al., 2003; Jokic & Ball, 2006). The frequency of citations is therefore rather a measure of "visibility" than of its "quality", as citations are counted regardless of an affirmative or criticizing use of the reference. Therefore, the quality of a highly cited source is not necessarily high. The investigation of the bibliometric analysis is expanded using co-citation analysis. A co-citation can be conceived as a measure, which portrays the contextual similarity of several publications related to a theory, a topic, a methodology, or an empirical field (Price, 1965; Crane, 1972; Leivrouw, 1989; Small, 1980; Gmür, 2003). A co-citation exists, when two references of the same author are listed in one bibliography of a publication. Similar to bibliographic coupling, co-citation analysis is based on the assumption that two documents, which appear together in the reference list of a third document, have similar contents (Kessler, 1963; Marshakova, 1973; Small, 1973).

> "In measuring co-citation strength, we measure the degree of relationship or association between papers as perceived by the population of citing authors." (Small, 1963, p. 265)

The more frequently two documents are cited together by a third party, the greater the similarity of the contents of the co-cited documents. The inherent structure of a research area can be disclosed and examined by the analysis of co-citation. The results of co-citation analysis enable us to distinguish individual fields of research, schools, researchers' networks, or adjacent research areas and enable the identification of so-called "invisible colleges" in a network or cluster representation (Small, 1980; Gmür, 2003). Invisible colleges represent research networks, which despite a lack of formal organizational connection shape the research direction and focus through constant interaction (Crane, 1972; Lievrouw, 1989; Schäffer et al, 2006). Schäffer et al. note, "that the ascertained networks do not represent any actor-structures in the field of research" (Schäffer et al., 2006, p. 398). Co-citation networks rather represent the central connections as perceived in the context of an exogenous observation of a research field.

Co-citations are frequently analyzed in the medical and natural sciences where formal scholarly communication is covered by large citation databases such as Web of Knowledge and Scopus[2]. For the German publication output of business research, these databases are not suitable, since they only cover a fraction of the relevant sources. Due to this, the collection of citation and co-citation data for this paper is conducted manually based on the approach by Schäffer et al. (2006; 2011), Gmür (2007) and Roth & Gmür (2003).

2.1 Identifying the Citing Source Documents

To construct a network of co-cited documents within corporate governance research in the German-speaking countries, 267 relevant source documents are identified. The reference lists of these documents contain the required citation relations. No German journal is specialized in corporate governance research reclusively but articles are rather published in various journals. Therefore, relevant documents are retrieved from general business research journals, which were identified with the help of the 2008 "Jourqual" ranking.

Jourqual is a journal ranking by the German Academic Association for Business Research (Verband der Hochschullehrer für Betriebswirtschaftslehre – VHB)[3], which, in its 2008 edition, considers and rates 1,633 national and international journals relevant in business research on the basis of the judgment of over 1,000 experts in Germany, Austria and Switzerland (Schrader & Hennig-Thurau, 2009). Jourqual was initiated in 2003 in order to provide an alternative to the ISI Journal Citation Reports. The journal rankings based on the Web of Knowledge databasis limit journal quality to a mean citation rate, i.e. the impact factor, and cover only 20% of journals identified as relevant sources in business research in German-speaking countries (Schrader & Henning-Thurau, 2009).

The search for corporate governance publications was limited to the Jourqual categories "ABWL" (*general management*), "Organisation und Personal" (*organization and human resources*), "Rechnungswesen und Controlling" (*accounting and controllership*) and "Wirtschaftsethik" (*business ethics*). Among the journals in these four categories, the following are considered as German high-quality journals indicated by the quality index (JQI) of the Jourqual ranking, ranging from 1 (very low) to 10 (very high):

- „Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung" (zfbf) (JQI=7.21) including its English version „Schmalenbachs Business Review" (sbr) (JQI=7.20)
- „Zeitschrift für Betriebswirtschaft" (ZfB) (JQI=7.01)
- „Die Betriebswirtschaft" (DBW) (JQI=6.70)
- „Journal für Betriebswirtschaft" (JfB) (JQI=6.09)
- „Industrielle Beziehungen" (JQI=6.09)

[2] http://www.scopus.com

[3] http://vhbonline.org

- „Zeitschrift für Planung und Unternehmenssteuerung“ (JQI=5.90)
- „Zeitschrift für Wirtschafts- und Unternehmensethik“ (ZFWU) (JQI=5.89)

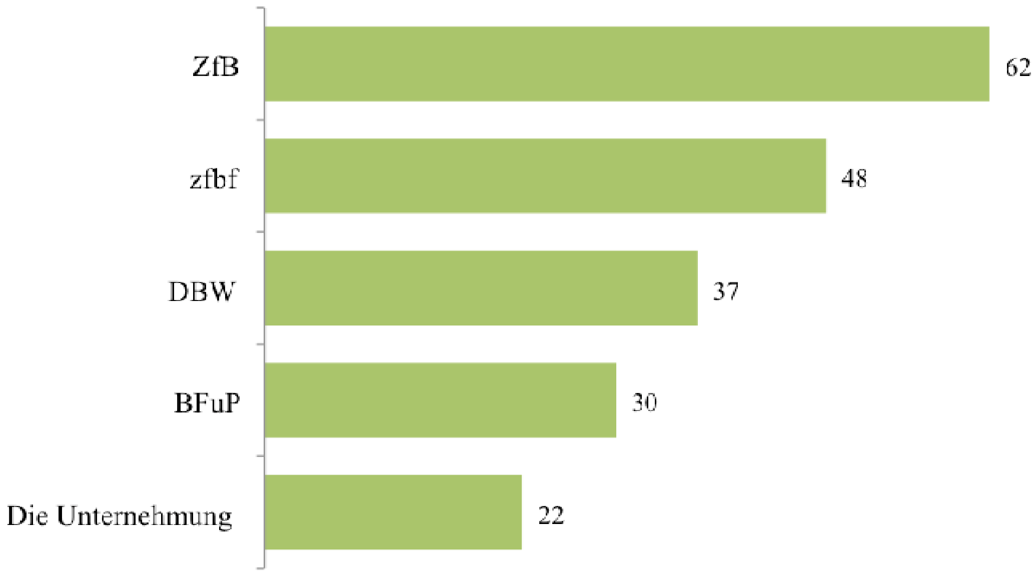
Due to their importance for the development of the discipline and their high prestige in the scholarly community, the following two journals were searched for relevant documents as well:

- „Die Unternehmung – Schweizerische Zeitschrift für betriebswirtschaftliche Forschung und Praxis“ (JQI=5.78)
- „Betriebswirtschaftliche Forschung und Praxis“ (BFuP) (JQI=5.57)

For the period from 1995 to 2011, 267 documents are considered relevant for the analyzed sub-discipline of corporate governance research. Overall, these 267 documents were published in 19 different journals, the five most frequent of which are shown in figure 1. Since corporate governance research is most frequently published in “ZfB”, “zfbf”, “DBW”, “BFuP” and “Die Unternehmung”, these sources can be described as the core journals of the sub-discipline.

Since the co-citation network analysis is based on the sources cited by the 267 source documents, the required citation data need to be extracted from the reference lists of the 267 articles. In total, 10,026 different references were cited 13,527 times. An asymmetric 267 by 10,026 matrix is constructed containing the directed citation links from the 267 source documents to the 10,026 cited documents. The cited references contain not only journal articles but all kinds of cited documents, such as books, proceedings papers and reports. By including all document types, it is assured that the research landscape is depicted completely and important publications are not excluded by a limitation to a certain document type as it is often the case in co-citation studies.

Figure 1. The five most frequently publishing journals with number of documents relevant to corporate governance research



2.2 Analysis of Direct Citations on the Document Level

Before document similarity and network structures are examined based on the co-citation data, direct citations are analyzed. As shown in table 1, the 267 source articles cite the following publications most frequently: Jensen & Meckling (1976), Shleifer & Vishny (1997), Murphy (1999), Jensen (1986), Hart (1995), Witt (2003), Berle & Means (1932) and Jensen & Murphy (1990). Citations are distributed among documents typically according to the Pareto principle stating that a few documents are cited commonly, while the majority of documents is cited less frequently. 80.8 percent of the 10,026 documents are only cited once.

It should be noted that a certain bias exists in terms of the number of citations and age of the documents. Since document age is not corrected, older documents have a longer period and thus a higher chance of being cited than younger ones. However, most documents are most frequently cited two to three years after publication and become obsolete afterwards. As it is the purpose of this study to reflect formal communication structures in corporate governance research in German-speaking countries during the period from 1995 to 2011, publication age is not normalized. The ranking in table 1 shows that 62, i.e. 23.2 percent, of the 267 source documents cited Jensen & Meckling (1976), indicating that it is still the most visible work, although it has been published over 35 years ago, whereas Witt (2003) is among the most influential documents in corporate governance research even though it was only published in 2003. Although this citation analysis is based on corporate governance research in the German-speaking countries, the most influential publications are written in English. Witt (2003), which is the author's professorial dissertation, is the only German publication among the eight most frequently cited sources.

Table 1. Documents cited most frequently by the 267 source documents

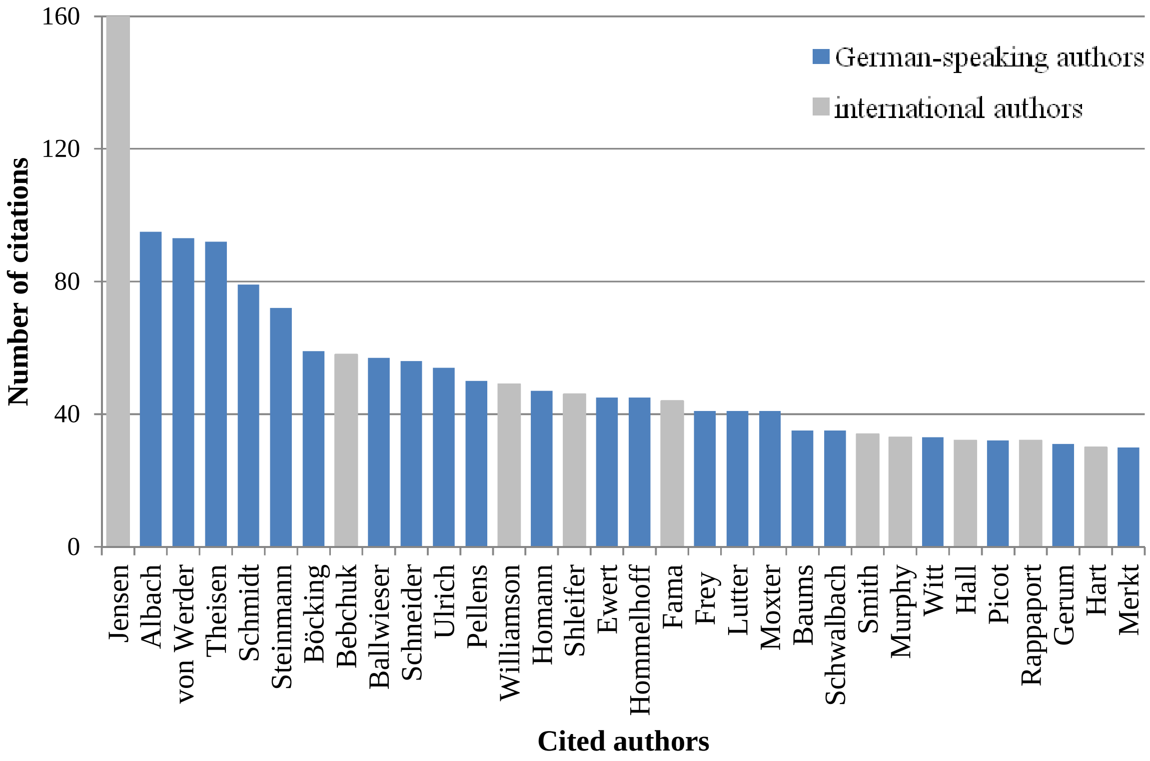
Cited document	Number of direct citations	Percentage of sources citing document
Jensen & Meckling (1976)	62	23.2%
Shleifer & Vishny (1997)	30	11.2%
Murphy (1999)	17	6.4%
Jensen (1986)	17	6.4%
Hart (1995)	17	6.4%
Witt (2003)	15	5.6%
Berle & Means (1932)	15	5.6%
Jensen & Murphy (1990)	15	5.6%

Overall, the eight documents represent a wide thematic range of corporate governance research. Known to be the 'intellectual fathers' of the corporate governance debate, Berle & Means (1932), laid the foundation with their well-known work „The Modern Corporation and Private Property", while Jensen & Meckling (1976) and Jensen (1986) focus on the principal-agent theory and identify resulting agency costs in general corporate governance research and various sub-disciplines. With their reviews of the corporate governance discussion from a theoretical and practical perspective, Hart (1995) and Shleifer & Vishny (1997) essentially contribute to the general understanding of the topic. Jensen & Murphy (1990) and Murphy (1999) focus on executive compensation, which has become increasingly important in international corporate governance research as well as in the German-speaking community as presented below. The debate about executive incentive compensation can be seen as a further development of the agency theory and examines the interests of principal and agent in terms of performance-based compensation. Witt (2003), who represents an innovative approach comparing the corporate governance systems of Germany, Japan and the USA, has become a central piece in the German-speaking community.

2.3 Analysis of Direct Citations on the Author Level

Direct citations cannot only be examined on the level of cited documents but can also be aggregated on the author level. Based on the first authors of the 10,026 references cited by the 267 source documents, 4,683 unique cited authors can be identified. Those authors cited at least 30 times are presented in figure 2. The most frequently cited and thus central authors in corporate governance research in the German-speaking countries are Michael C. Jensen, Horst Albach, Axel von Werder and Manuel R. Theisen. Again, a certain citation bias can be observed in favor of authors with a longer publication history as well as of those with a greater number of publications. Authors, who have been publishing a great number of documents for a long period of time are able to attract a greater number of citations compared to those who are at the beginning of their research careers. Since it is this study's aim to observe the overall influence of authors in corporate governance research in German-language journal articles from 1995 to 2011, this bias is not corrected for.

Figure 2. Number of citations per author for the 32 most frequently cited first authors, who were cited at least 30 times



As is shown in figure 2, the US-American Jensen is by far the author with the highest impact in the German corporate governance community. However, German-speaking researchers (indicated by the blue coloring in figure 2) dominate the list of most frequently cited authors. Overall, the 32 authors, who were cited at least 30 times, accumulate a total of 1,681 citations. Of those 69.2 percent (1,163) are German-speaking authors and 30.8 percent international authors.

2.4 Extracting Co-citation Data

The 267 by 10,026 matrix containing the direct citations by the source documents to their cited references is transformed into a co-citation matrix. A co-citation matrix is a special form of a co-occurrence matrix, which contains the number of co-citations for each pair of documents. Co-occurrence matrices are symmetric square matrices, meaning that the rows and columns are the same (in this case cited documents) and the matrix elements c_{ij} and c_{ji} are identical (in this case number of co-citations of documents i and j). The co-citation matrix based on the references of the 267 source documents consists of 10,015 cited publications[4] in rows and columns and the number of co-citations for each of the document pairs. This 10,015 by 10,015 co-citation matrix forms the database of the following cluster and network analysis.

2.5 Cluster and Network Analysis of Co-cited Documents

On the document level, co-citation data are supported by methods of social network analysis in order to analyze similarities and recurring structures, and to visualize the research landscape. As mentioned earlier, the greater the number of co-citations, the more the two documents are supposed to be related. In order to eliminate random co-citations, the co-citation matrix is diminished such that only co-citation values of 3 and above are considered. Since the majority of documents is co-cited only once or twice with each other, the co-citation matrix is reduced to a 463 by 463 matrix containing all documents, which have been co-cited at least three times with at least one other document. The density of the resulting co-citation network consisting of 463 vertices (co-cited documents) and 2,238 edges is 0.021. This indicates that of all 106,953 indirect connections possible between two vertices, 2.1% are realized. Counting the absolute number of co-citations, the strongest links exist between Jensen & Meckling (1976) and Shleifer & Vishny (1997), Berle & Means (1932) and Jensen (1986), respectively, and Sleifer & Vishny (1997) and Berle & Means (1932).

[4] 11 of the 10,026 cited publications were not co-cited together with another document, because they were the only document cited in the reference list. They were hence not included in the co-citation matrix.

As shown in table 2, these combinations of documents are most frequently co-cited, i.e. they occur together in the reference lists of 21, 13, 12 and 12 of the source documents, respectively. The high number of co-occurrences can be explained by the general thematic orientation of these publications. They are often cited together to describe the theoretical background of corporate governance research.

Table 2. Most frequently co-cited document pairs

Document pair		Number of co-citations
Jensen & Meckling (1976)	- Shleifer & Vishny (1997)	21
Jensen & Meckling (1976)	- Berle & Means (1932)	13
Jensen & Meckling (1976)	- Jensen (1986)	12
Shleifer & Vishny (1997)	- Berle & Means (1932)	12

Since the number of co-citations of two publications depends on how often these two are cited in total, similarities should not be computed on the absolute number of co-citations but on a relative value in relation to the absolute number of citations perceived by the two documents. Several similarity measures, such as the cosine or the Jaccard index, can be applied to compute normalized values reflecting the relative co-citation strength between two documents (van Eck & Waltman, 2009). This kind of normalization is especially important if documents are clustered, i.e. grouped, based on similarity values. Thus, absolute values inhibit that single clusters can be separated accurately. Documents with a small absolute number of co-citations and a small number of total co-citations will not be assigned to a cluster. Appropriate normalization solves this problem as the number of co-citations is put into relation to the total number of co-citation. This study applies the so-called 'association strength' to determine relative similarity values. Association strength is defined as

$$Association\ Strength = \frac{c_{ij}}{s_i s_j}$$

where c_{ij} represents the number of times the documents i and j were co-cited and s_i and s_j stand for the sum of all co-citation relations of i and j in the entire network. In contrast to other well-known similarity measures such as the cosine of Jaccard index, the association strength represents a probabilistic instead of a set-theoretic approach. The association strength proved to be particularly suitable for co-citation analysis (van Eck & Waltman, 2009).

While clustering groups of documents based on their similarities, social network graphs visualize complex network structures. Both methods clustering and mapping are combined in VOSviewer[5] providing a visualization of relations between and similarities of the co-cited documents. Based on the association strength and an adjustable parameter clusters can be computed and integrated into the network graph, which is presented in figure 3. The vertices reveal the 463 co-cited documents; the edges represent the 1,800 strongest of all 2,238 connections in terms of normalized co-citation values. Cluster allocations are indicated by color. Altogether, 32 clusters are identified, which comprise between 156 (cluster #01) and 2 (clusters #15 to #32) documents each.

The number of documents per cluster is shown in figure 4. The six largest clusters (#01 to #06) cover in conjunction 82.3% (381) of the 469 documents. The smaller clusters in the periphery of the co-citation network are not connected to the main component as connections are reduced to the 1,800 strongest co-citation values after normalization. These documents are only peripheral to corporate governance research in the German-speaking countries and are irrelevant to the field of research.

The following interpretation is focused on the three main clusters. Figure 4 pictures the six largest clusters and includes different sizes of vertices. The size of the vertices depends on the so-called degree, the number of the connections within the whole network. The more connections a vertex has in the network, the larger its size in the network graph as depicted in figure 5. Jensen & Meckling (1976) have the most connections. The authors were co-cited 479 times together with 208 of the 469 documents. Due to the high centrality degree the document occupies the central position in the network and has connections to all of the main clusters (#1 to #6). This structure certifies the impact and importance of this work for the entire corporate governance research.

[5] VOSviewer is a software for the visualization of clusters and network structures, which was especially developed for bibliometric co-occurrence data. The software is available for download free of charge at http://www.vosviewer.com.

Figure 3. Co-citation Network with 463 Documents and 32 different clusters. Cluster allocation is indicated by color. The six largest clusters (#01 to #06) are highlighted together with the most important document

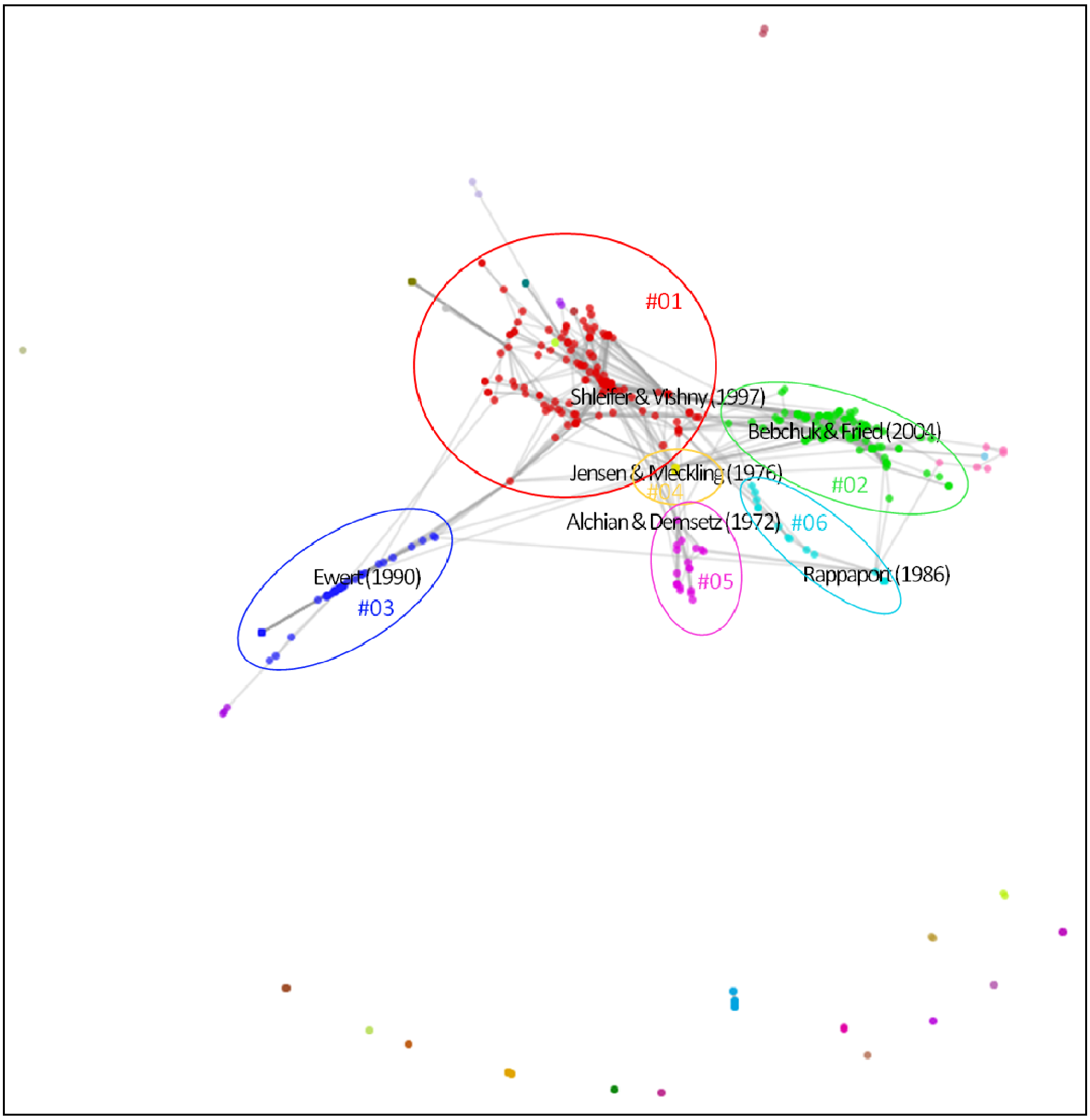


Figure 4. 32 clusters identified based on co-citation similarities with number of documents per cluster

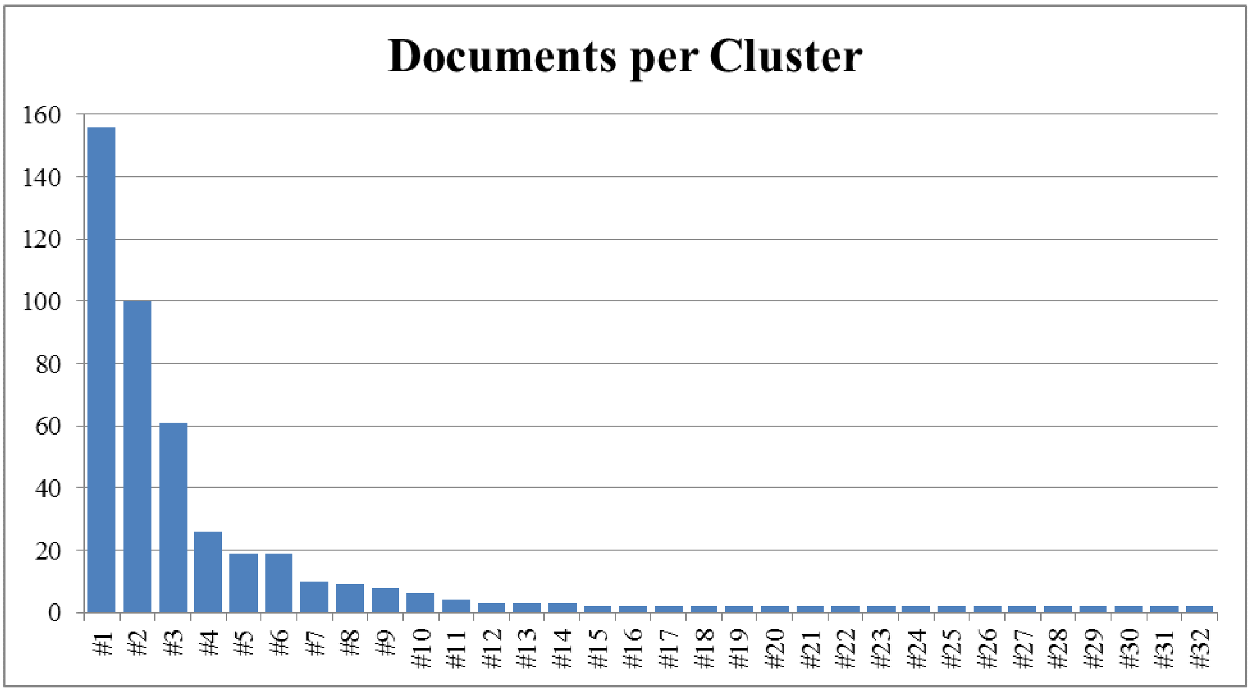


Figure 5. Largest component of the co-citation network including the six largest. Cluster allocation is indicated by color, size of vertices represents degree

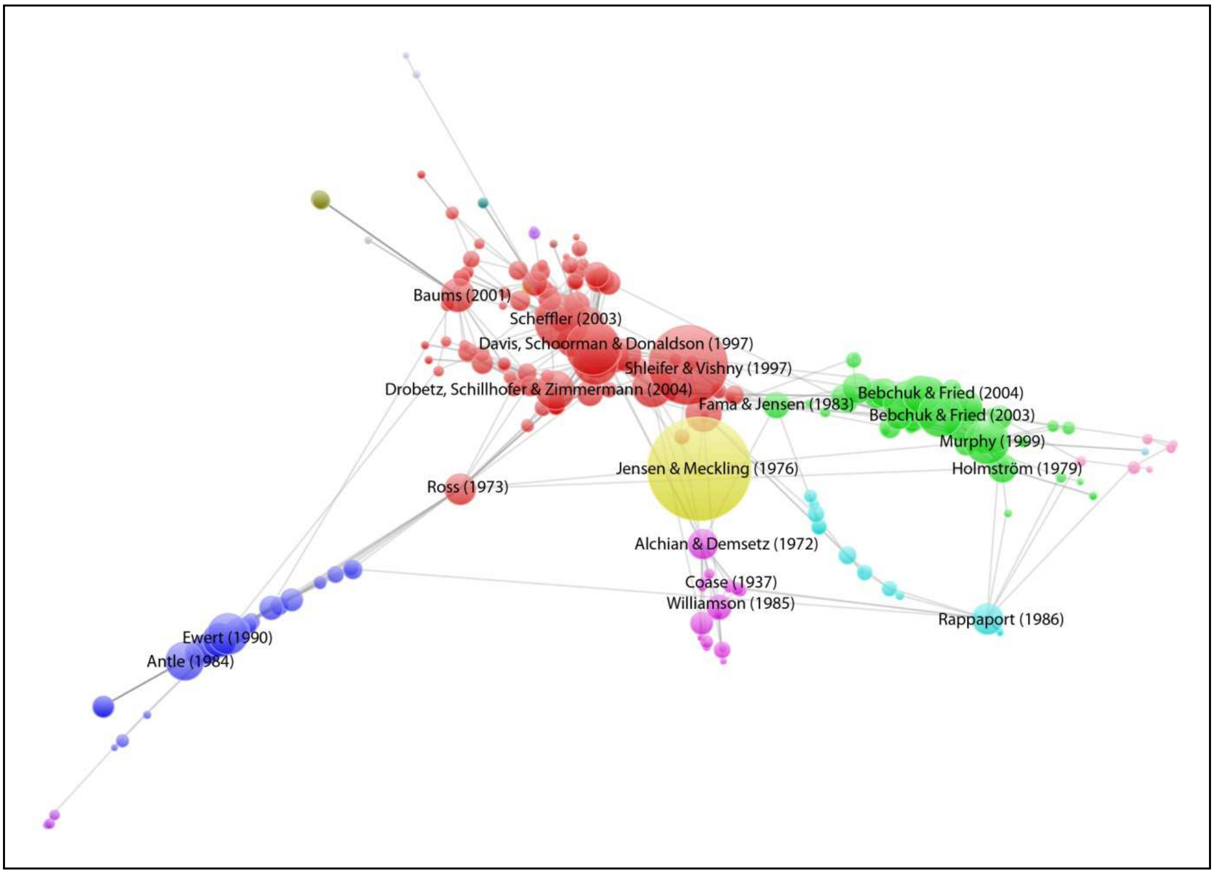
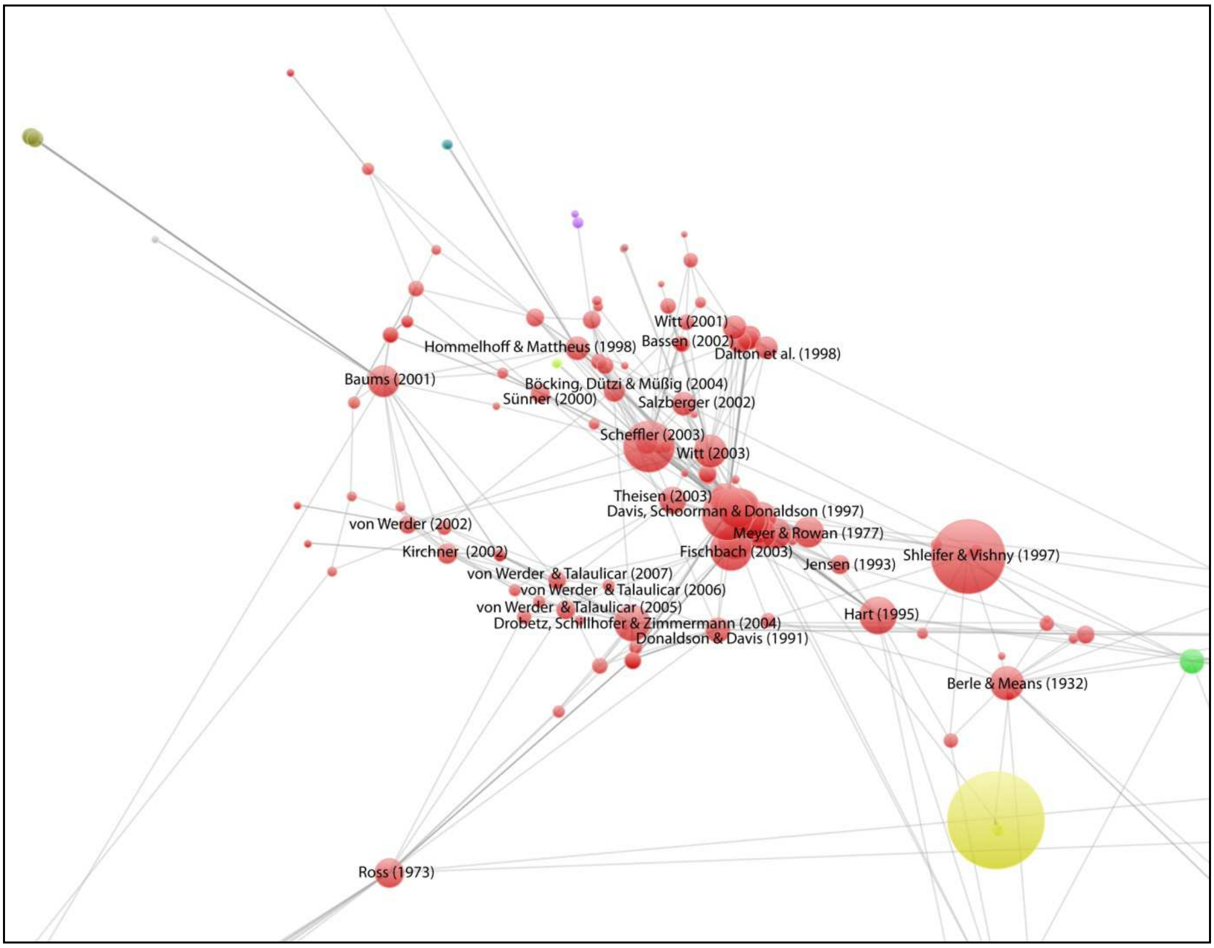


Figure 6 demonstrates a detailed representation of the whole network, which denotes cluster #01. The first cluster (#01) mainly visualizes the German-speaking community of corporate governance research and is illustrated in a separate figure due to its complexity and size (figure 6). Besides some fundamental papers from English-speaking countries numerous German authors are represented in this cluster, where the papers of Berle & Means (1932), Ross (1973), Shleifer & Vishny (1997) and Hart (1995) are the connecting points between German studies and the international discussion on corporate governance. The importance of these papers can be characterized as fundamental theoretical work for the entire field of corporate governance research. Additionally, the studies by Jensen (1993) and Meyer & Rowan (1977) are also two fundamental theoretic papers in the cluster, which explore the corporate organization and its impact on the governance structure.

The theoretical part includes furthermore the work of Davis et al. (1997) and Donaldson & Davis (1991) regarding the stewardship-theory as an opposite position to the classic principal-agent theory. Finally Dalton et al. (1998) and Baghat & Black (1999) analyze the board structure and the independence of the board members, which represents a connection of the different theoretical studies, on the one hand, and the origin for some German researches and their work, on the other hand.

The main German papers should not be analyzed singularly, but in a more holistic approach. Besides the habilitation (post-doctoral lecturing qualification) of Witt (2003) there are various papers, which elaborate on general as well as specific questions of the corporate governance discussion as a central theme, for example, Bassen (2002), Fischbach (2003) and Scheffler (2003) or Böcking et al. (2004). In addition to these mostly scientific approaches the studies by Baums (2001), Cromme (2002), von Werder (2002) and Theisen (2003) are the reference work for the implementation of the German Corporate Governance Code (GCGC), which was introduced in the years 2001 and finalized in 2002. Thereby, the position of the different papers by von Werder & Talaulicar (2007,2008,2009) should be explained. Their annual publications represent a periodic analysis of the compliance with the GCGC for the public listed companies in Germany and are often used as a reference for acceptance of the code. The work of Theisen (2003) and Hommelhoff & Mattheus (1998), all legal academics, show the close connection between the legal and business discussion within the field of corporate governance research. In summary, these fundamental papers form the German basic understanding of corporate governance.

Figure 6. Detailed view of cluster #01



The second largest cluster (#02) concentrates on executive compensation and incentives, which has started to develop in the early 1990s. The theoretical framework is based on the works of Holmström (1979) and Fama & Jensen (1983), and can be understood as a further development of the principal-agent theory and the work of Jensen & Meckling (1976). While Holmström (1979) focuses on the appearance and meaning of the moral hazard, Fama & Jensen (1983) review the importance of the board of directors and its function for efficient and effective corporate governance and the possibilities of useful controls. Murphy (1999) presents a general evaluation of the executive compensation as an agency problem, which was further determined as an integral part of corporate performance by Bebchuk & Fried (2003, 2004). Overall, the structure of this cluster could be described as homogenous, with few but strong vertices.

The third cluster (#03) covers subjects concerning auditing and accounting and is driven by the work of Antle (1984) „Auditor Independence“ and Ewert (1990) „Auditing and asymmetric Information“. These two studies integrate the principal-agent theory into accounting and auditing research and are the source for most of the German researches within these fields of interest. The external auditor acts as an additional control mechanism for the principal and shareholders, respectively, and supports the reduction of asymmetric information. Although the regulatory accounting, auditing and governance frameworks in the US or UK differ from that in Germany, the non-German papers are crucial sources for the German research community.

3. CONCLUSION AND FURTHER RESEARCH

Summarizing, the findings and interpretations allow a new view on the German corporate governance research and on the particular understanding of corporate governance in the German-speaking research community. Today, around 10 years after the introduction of the GCGC, corporate governance research is an established segment of German business administration research with many different specific topics. However the focus still lies on the new inventions from the US or UK, which are still the starting point for German scholars to explore the phenomena of corporate governance in Germany. Based on the fundamental theoretical and empirical Anglo-American work of different authors, the German studies are well connected. The chronological upstream of the English papers could be interpreted as an outcome of the long established capital markets and therefore an understanding of the separation of ownership and control. Although the separation of ownership and control could also be identified in Germany in general, most of the German research adopts the scientific problems, methods and approaches from the one-tier-system and adjusts them to the German two-tier-system. A detailed analysis allows the identification of non-German research topics and a transfer of these to the German system after a period of time. Especially the English studies with conceptual or theory-building contents are standard references for the German scholars. Only the publications of the Government Commission “German Corporate Governance Code” have a direct impact on the German research environment.

Some limitations of our paper are worth noting. Although the presented analyses allow a first overview of the German corporate governance research structure, some potential issues and dimensions are excluded. A country-specific view of the used references could be possible. This international perspective could be important to identify research networks of different scholars or institutions. Analyzing the keywords or the document types (e.g. journal article, book and dissertation) of the cited references could also be a possibility to reach another point of view. Additionally, a periodic analysis can be an interesting chance to identify a changing or non-changing research structure.

The aim of this paper was to identify and understand the German corporate governance research with the help of bibliometric methods. The applied citation and co-citation analyses were useful steps to characterize and structure the research field. Although English literature is still the dominant and important “anchor” of German researchers, some kind of “German school”, basically due to the different regulatory framework, can be identified.

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DEVELOPING ECONOMIES AND THE EMERGENCE OF NEW STAKEHOLDER GROUP: AN EXAMINATION OF STAKEHOLDERS IN THE CHINESE STOCK MARKET

Wen Qu, Judy Oliver***

Abstract

As a consequence of the development of the Chinese economy, there has been an emergence of "new" stakeholder groups for the Chinese listed firms. New stakeholder groups include creditors, regulatory agencies, private investors, professional associations and environmentalists. With the use of secondary data, a review was undertaken to explore the emergence of these new stakeholder groups and discuss their influence over listed firms in China. The stakeholder typology developed by Mitchell et al (1997) is used to identify stakeholder attributes of each stakeholder group and assess their stakeholder power. The changes of stakeholder power over the years mirror China's transition from a centrally planned economy to a more market oriented one.

Keywords: Stakeholders, Chinese Economy, Stock Market, Investors, Stakeholder Theory

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Introduction

Since the inception of economic reforms in 1979, China has had one of the world's fastest-growing economies. The economic reforms have allowed market prices and private investors to play a significant role in production and trade, and enabled the Chinese economy to become substantially integrated into the world economy (OECD, 2010). The establishment of the Chinese stock market is a direct outcome of the economic reform in China. The Shanghai and Shenzhen Stock Exchanges were officially opened in 1990 and 1991, respectively. Since its establishment, the Chinese stock market has been transformed from a fledgling, emerging market to the largest emerging stock market in the world. It is now the biggest stock market in Asia outside Japan, with 2,342 firms listed on two stock exchanges and a total market capitalization equivalent to nearly US$3 trillion at the end of 2011 (CSRC, 2011). At the same time, there were 165 million investor accounts in the A-share market, including 162 million individual investor accounts, or 98.18% of the total (CSRC, 2011). For over a decade, publicly-listed firms have benefited most from the fast expansion of the Chinese stock market, raising more than US$96.6 billion of capital funds from public investors (CSRC, 2009). As a consequence of the rapid development of the Chinese economy, the emergence of new stakeholder groups can be seen in China, most notably private investors, creditors and professional associations. This paper aims to discuss the changes that have taken place in the Chinese economy which has given rise to these new stakeholder groups, explore the attributes of each stakeholder group and assess their stakeholder power over listed firms in China.

Stakeholder Theory

The underlying theoretical foundation for this study is stakeholder theory and stakeholder typology developed from it. Stakeholder theory suggests that firms are not just a nexus of contracts; they should go beyond shareholders and be responsible for a range of stakeholders including customers, suppliers, employees, creditors and communities (Freeman, 1984). Stakeholder management is important for firms to survive and be successful in the longterm as each stakeholder group supplies the firm with critical resources or makes a contribution to the firm(Deegan, 2006). In exchange, each group expects its interests to be satisfied by inducements (March and Simon, 1958). As Hill and Jones (1992) described, investors provide the firm with financial capital. In exchange, they expect the firm to maximize the risk-adjusted return on their investment. Creditors provide the firm with finance and, in exchange, expect their loans to be repaid on schedule. Management and employees provide firms with time, skills and human capital commitments. In exchange, they expect fair income and adequate working conditions. Customers supply the firm with revenues and expect value for money in exchange. Suppliers provide the firm with inputs and seek fair prices and dependable buyers in exchange. Local communities provide the firm with locations, local infrastructures and perhaps favorable tax treatment. In exchange, they expect corporate citizens who enhance and/or do not damage their quality of life. The general public, as tax payers, provide the firm with a national infrastructure. In exchange, they expect corporate citizens who enhance and/or do not damage their quality of life and do not violate the rules of the game established by the public through their legislative agents.

As the ultimate goal of corporate decisions is market place success, good stakeholder-firm relationship management is instrumental to assure revenues, profits and, ultimately returns to shareholders (Pfeifer and Salancik, 1978; Berman et al., 1999). However, this does not mean that all stakeholders are treated in the same way by firms due to managers' time and cognitive constraints. In order to achieve the firm's strategic objectives, Roberts (1992), suggests that one of the major roles of corporate management is to assess the importance of meeting different stakeholders' demands because as stakeholder power increases, the importance of meeting stakeholders' demands increases accordingly. This view is supported by others who consider that given the constraints faced by managers they will give their attention to the more "powerful" stakeholders (Scott and Lane, 2000; Bailey et al., 2000; and Nasi et al., 1997). Power is viewed as a function of the stakeholder's degree of control over resources required by the firm, especially financial resources (Ullmann, 1985).For example, a study by Neu et al. (1998) found that firms were more responsive to the demands or concerns of financial stakeholders including shareholders, creditors and government regulators, than the concerns of environmentalists. Another challenge to corporate management is in relation to their operating and reporting behaviors because of the expectation and power relativities of various stakeholder groups changing over time (Friedman and Miles, 2002; Unerman and Bennett, 2004).

The rapid changes in the Chinese economy over the last thirty years and the growth and maturity of the stock market allows for the examination of how new stakeholder groups have emerged as a consequence of the changing market conditions and to examine the power relativities of each stakeholder group.

Methodology

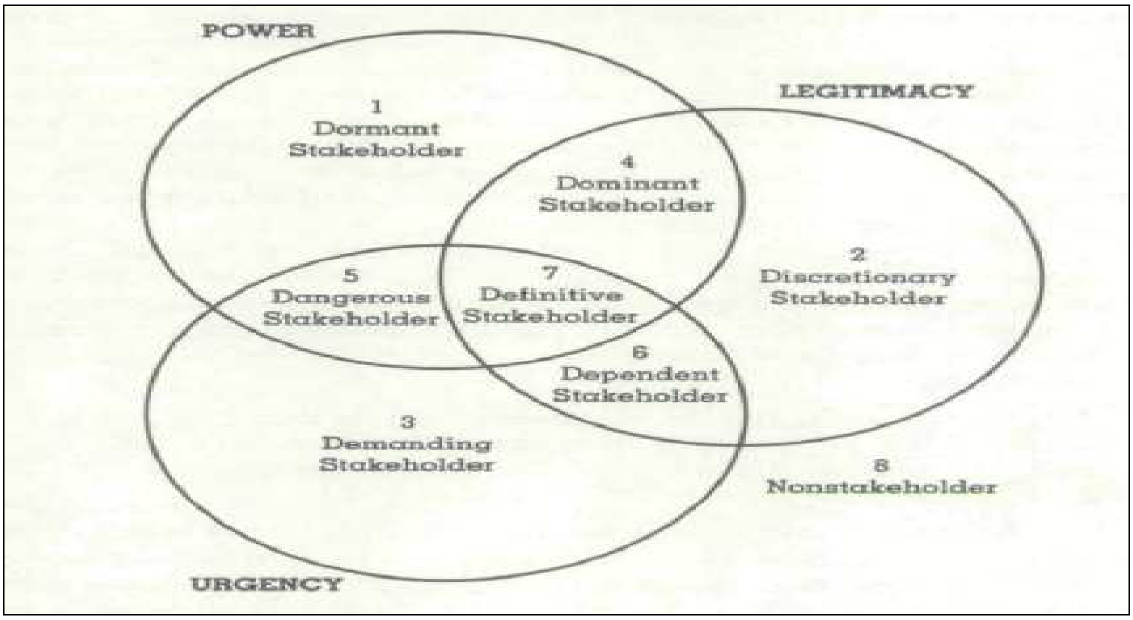
Secondary data sources will be used to identify major stakeholders and their attributes relating to the Chinese stock market. To assist with the analysis reference will be made to the stakeholder typology developed by Mitchell et al. (1997). The typology classifies stakeholders into latent stakeholders, expectant stakeholders and definitive stakeholders depending on the possession of one, two or all three relationships attributes: power, legitimacy and urgency. The power attribute refers to a stakeholder's power to influence the firm, and power is defined by Pfeifer (1981, p.3) as "a relationship among social actors in which one social actor, A, can get another social actor, B, to do something that B would not otherwise have done". The legitimacy attribute refers to the legitimacy of the stakeholder's relationship with the firm and, legitimacy in this context, is defined as a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially-constructed system of norms, values, beliefs and definitions. Legitimacy of a claim on a firm is based on contract, exchange, legal title, moral right, at-risk status or moral interest in the harms and benefits generated by company actions (Agle et al., 1999). Power and legitimacy are defined as core stakeholder attributes. The urgency attribute refers to the urgency of the stakeholder's claim on the firm, and urgency is defined as the degree to which stakeholder claims call for immediate attention. Agle et al. (1999) further explain that stakeholder urgency is a multidimensional notion that includes both criticality and temporality, with a stakeholder claim considered to be urgent both when it is important and when delay in paying attention to it is unacceptable.

Latent stakeholders are those possessing only one of the three attributes and include dominant (power), discretionary (legitimacy) and demanding (urgency) stakeholders. Expectant stakeholders are those possessing two attributes, and include dominant (power and legitimacy), dependent (legitimacy and urgency) and dangerous (power and urgency) stakeholders. Definitive stakeholders are those possessing all three attributes. Individuals or entities possessing none of the attributes are non-stakeholders or potential stakeholders.

As mentioned earlier there is a view that managers give their attention to certain stakeholders who are deemed more "powerful" and the theory of stakeholder salience predicts that firms do not respond to all stakeholders equally, rather, managers prioritize stakeholder relationships. Mitchell et al. (1997) define stakeholder salience as the degree to which managers give priority to competing stakeholder claims. For example, shareholders and creditors place emphasis on firms' profitability and wealth creation, while public interest groups, including environmentalists, focus on the impact of firms' operations on the environment. Stakeholder salience is positively associated with the cumulative number of the three stakeholder attributes (Mitchell et al., 1997). Stakeholder salience will be high where all three of the stakeholder attributes - power, legitimacy and urgency - are perceived by managers to be present. Stakeholder salience will be low where only one of the stakeholder attributes is perceived by managers to be present. The Mitchell et al. (1997) theoretical model of stakeholder salience is tested and confirmed by Agle et al. (1999). The empirical results of Agle et al. (1999) confirm that, in the minds of CEOs, the stakeholder attributes of power, legitimacy and urgency are individually and cumulatively related to stakeholder salience. Their findings suggest that these stakeholder attributes affect the degree to which top managers give priority to competing stakeholders.

The stakeholder typology developed by Mitchell et al. (1997)is shown in figure 1 below.

Figure 1. Stakeholder typology: one, two or three attributes present



Source: Mitchell, Agle and Wood, 1997, p. 874

Discussion

Prior to 1978, state-owned enterprises (SOEs) in China were rigidly controlled by the Chinese government with all equipment and raw materials supplied by the government. As part of the central planning system, the government determined the prices of material, products, suppliers and customers of SOEs. The control of China's enterprises rested primarily with the inside nominated managers who, in turn, were often controlled and supported in various forms by the Party and ministerial associates (Tam, 2002). The function of managers, who served as the Party's agents, was solely to supervise the production process and ensure the actualization of government plans (Lin and Tan, 1999). In terms of capital resources of SOEs, state funds were collected through fiscal and other means of revenue collection and siphoned off to SOEs. The government, therefore, placed little weight on commercial banking and the capital market as active players in financial intermediation (Suzuki et al., 2008). Due to the government being the sole stakeholder of the SOEs, the Chinese economy had stagnated for a long period of time. The government gained the profits but also bore the losses as the ultimate owner of the SOEs, and managers and employees had no incentives to maximize the profitability of the SOEs (Xu and Wang, 1999). As a consequence this bred a culture of low productivity in SOEs.

As part of the economic reform in China, SOE reforms were launched in 1978. The essence of SOE reforms was a gradual relaxation of state central planning, implementation of various kinds of profit sharing schemes and increased autonomy over decision-making conferred to SOEs, and especially to the managers of SOEs (Qiang, 2003; Ren et al., 2005). As a consequence of these reforms new stakeholder groups have emerged, in particular, creditors, public investors, regulatory agencies, professional associations and environmentalists. We devote the following sections to thediscussion of these emerging stakeholder groups' stakeholderattributes and relative power base by reference to the Mitchell et al. (1997) typology.

Creditor Stakeholder Group

In respect of financing the SOEs' operations, the Chinese government in 1983 transformed the state budget allocations into loans, which were funded by four state-owned commercial banks. The state-owned bank loans, therefore, replaced the government budget allocation and the major creditor stakeholder of SOEs was changed from the Chinese government to state-owned banks. Although banks were the main financial resource provider of SOEs, banks did not have any power over SOEs in terms of whether to lend funds to them. In fact, the government prevented banks from operating on purely commercial terms with revenue generating activities, by forcing banks to provide subsidized lending to SOEs.

Since the emergence of the capital market in China in the early 1990's, some SOEs have been transformed into shareholding companies, obtaining funds for further development and expansion from public investors. However, the majority of poorly-managed and inefficient SOEs in China still relied upon bank loans. To avoid the potential social unrest caused by a high unemployment rate, the government felt obligated to support unprofitable SOEs by requesting state-owned commercial banks to extend loans or even provide the SOEs with more funds, with little consideration given to the borrowers' repayment capacity (Xu, 2005). This situation led to the many non-performing loans (NPL) which the China Banking Regulatory Commission (CBRC) reported was the equivalent US$340 billion in NPLs in the financial system by the end of 2004. Pricewaterhouse Cooper's China NPL Investor Survey 2004, however, reveals a figure as high as US$500 billion (Xu, 2005).The Chinese government assisted state-owned commercial banks to "unload" huge non-performing loans from their books. In 1999, as a solution for tackling the NPL problem, the government established four financial asset management companies (AMCs) and transferred the equivalent of US$55 billion of non-performing loans to those companies (Xinhua Press, 2005). The function of AMCs is to focus exclusively on debt collection. In addition, the four AMCs are allowed to negotiate with the borrowing state-owned enterprises and conduct a series of debt-to-equity swaps. In this way, the debts are transferred into equities and the AMCs have gained control over some enterprises (China Daily, 2005). The massive disposal of NPLs to AMCs has dramatically reduced the NPL ratio of banks and financial institutions.

As a result of the World Trade Organization (WTO) agreement, China has opened the banking and financial service market to foreign financial rivals, with public listing one of the strategies to achieve these goals. This has led the banking and financial institution industry in China to be more independent, transparent and profit-driven. By the end of 2011 there were twenty-eight national and regional commercial banks listed in the Chinese stock market. The two most publicized public listings are the China Construction Bank and the Bank of China. The former was listed on the Hong Kong Stock Exchange in 2005 and the latter on the Shanghai Stock Exchange in 2006. The other two state-owned commercial banks, China Industrial and Commercial Bank and China Agrisocial Bank, were listed in 2007 and 2008, respectively.

The listing of commercial banks and the further opening up of the banking market to foreign financial institutions has led to some positive changes in the Chinese banking industry (Petkova, 2008). First, the Chinese banks began to adopt international practices regarding balance sheet criteria in which the capital ratios are based on the risk involved. Secondly, banks started to apply commercial lending criteria. In their lending activities, banks have been disconnected from the government-based policy and have shifted to lending based on generally accepted commercial banking techniques. To reduce NPLs, banks have strengthened the finances and management of SOEs. In 2007, the National People's Congress passed the new Bankruptcy Law, aiming to reduce the NPLs by ensuring better respect for creditors' rights. In the same year, some steps were taken to build national standards and networks for credit assessment. The central bank of China, the People's Bank of China (PBOC), has sought to develop a national credit information database and has urged banks to unify regulations. The China Securities Regulatory Commission (CSRC) has issued the Tentative Procedures for the Administration of Credit Ratings in the Securities Market (Petkova, 2008).

Therefore, the nature of the creditor for Chinese firms has changed significantly with the role overtime shifting from the government to private financiers. Financial Institutions have become one of the main sources of SOEs' capital when state-owned bank loans replaced the government's budget allocation in the early 1980s (Xu, 2005). As creditors for listed firms, the power possessed by this stakeholder group has changed during the past two decades. In the early stage of the economic reform, banks were under pressure from the government to provide "policy loans" to SOEs (Petkova, 2008). Banks, therefore, had no power to influence SOEs' performance and information disclosure. They also did not have an urgent claim over the actualization of their economic stake. Therefore, between the early 1980s and mid-1990s, creditors could only be classified as a discretionary stakeholder of SOEs. Factors such as the entrance of China into the WTO, the opening up of the Chinese banking market and the listing of several large commercial banks, have all contributed to the changes in the operation of the banking system in China. Now, profit-oriented banks provide firms with loans on commercial terms. Regardless of being state-owned or private, commercial banks were expected to earn interest revenue from borrowers and have their loans repaid. Creditors now have a stronger economic stake in listed firms. The power and urgency possessed by the state-owned banks over listed firms gradually increased with the disconnection between the government's loan policies and banks' commercial activities. Banks can now independently determine which enterprises they want to lend funds to and how to avoid non-performing loans (NPLs). Since the mid-1990s, the Chinese banks have developed stakeholder attributes of power and urgency. Therefore, financial institutions can nowbe classified as a definitive stakeholder of listed firms in the Chinese stock market.

Regulatory Agency Stakeholder Group

In the Chinese stock market, the regulatory agency group includes the Ministry of Finance (MOF), the China Security Regulatory Commission (CSRC) and the Shanghai and Shenzhen stock exchanges.By the use of the political process, regulatory agencies in China have political power (Freeman and Reed, 1983) over listed firms to ensure that the political stake of the Chinese government is actualized. The MOF has authoritative power over listed firms in terms of following accounting regulations and standards. The CSRC has power to regulate listed firms' conduct and information disclosure. The CSRC and both stock exchanges have employed a series of strategies and actions to achieve "investor protection". These actions include stipulating accounting and disclosure regulations, establishing a corporate governance régime, providing training for investors and independent directors, and imposing public sanctions against listed firms. These actions suggest an increased willingness by the Chinese leadership to subordinate the interests of controlling shareholders to the interests of other shareholders (Berkman, 2008). They have sent a clear and strong signal to listed firms over the years, that to legitimate their status in the Chinese stock market, listed firms need to devote themselves to protecting minority investors' interests by disclosing transparent information to investors.

Politically, a healthy capital market serves the government to further open up China's economy, enhance enterprise reform and attract more investments from both domestic and overseas investors. However, due to the problems of "one dominating state-owned share monopoly" and "insider control", the minority or public investors' interests have been expropriated by majority shareholders since the establishment of the stock market in China. Over the years, "investor protection" has been acknowledged by the regulatory agency group as one of the most important measures for supporting the steady growth of the Chinese stock market.In emerging markets with relatively weak legal systems, regulators can provide an effective substitute for ineffective judicial enforcement and provide an investor protection role (Glaeser et al., (2002; Chen et al., 2005; Berkman, 2008).In China, although the Chinese government has enacted the Company Law and the Security Law in recent years, the overall legal system is still relatively primitive by the standards of capitalist countries (Berkman, 2008). China's first civil compensation suit regarding a securities case reflects on one hand, the activism of the investment community in China. On the other hand, as Chen et al. (2005) suggest, one successful civil suit in the first 12 years of the Chinese stock market is a testament to the lack of legal redress in securities cases. Under the Security Law, a civil case against a listed firm can only be brought to the court after the CSRC has made an investigation. Class action lawsuits are not possible in China and so a lawsuit brought by an individual investor is very costly and has a low probability of success (Chen et al., 2005).

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

To enforce the Chinese accounting standards, the MOF, jointly with the CSRC, supervise financial accounting information disclosures made by listed firms on the Chinese stock market. The CSRC has the power to punish listed firms and their auditors if non-compliance with accounting standards and audit criteria or false financial information is found. Penalties for the CPA firms that do not apply appropriate standards can include cancellation of licenses, temporarily or permanently. By the end of 2004, the CSRC had completed the investigation of 851 cases and 953 related persons had been punished, most for disobeying the accounting standards and showing false information in their reports (CSRC, 2005).

The CSRC has also publicly pledged to improve the transparency of its own work to ensure the efficiency of capital market reforms and to curb corruption. In 2005, the CSRC further implemented the stock market reform plans mapped out by the State Council and steadily opened up the market. According to the chairman of the CSRC, strong protection of the interests of public investors is the priority for the reforms, and an accountability culture needs to be developed (CSRC, 2000). The CSRC has also increased its interaction with the media and the public investors, such as offering more detailed introductions of the new policies to investors and conducting more interviews with the media.

Under the close supervision of the CSRC, Shanghai and Shenzhen stock exchanges established their own listing rules in 1998 and strengthened their roles in supervising information disclosure. While endeavoring to provide facilities for the securities trading and monitoring thereof, the two stock exchanges also participated in championing the improvement of corporate governance, especially in respect of protecting investors' interests and the transparency of information disclosure. In 2003, the Shenzhen Stock Exchange issued the *Guidelines on Protection of Investor Rights and Interests for Small and Medium Enterprises Board*. Article 12 of this guideline stresses that listed companies should "truthfully, accurately, completely and timely disclose the information that may significantly impact the price of stocks and derivatives or the decision-making of investors, and such information must not contain falsehoods, misleading statements or material omissions. The person with disclosure obligation shall, based on the principle of good faith, voluntarily disclose other information that is not required by laws, administrative regulations and rules, as well as the rules of the Exchange. Listed firms shall ensure that investors have equal access to the information disclosed and shall not make selective disclosure". Article 13 emphasizes that "when making voluntary disclosure of forward-looking financial information, listed companies shall follow the internal audit procedures, issue risk warnings to investors stating the assumption basis for such forward-looking information and any uncertainty involved and, in accordance with actual conditions and in a timely manner, modify the information previously disclosed".

In addition to releasing and implementing rules to regulate information disclosure by listed firms and safeguard the interest of public shareholders, these two stock exchanges also take some action to maintain the sustained development of the stock market. They monitor the dominant shareholders' illegal use of funds of listed companies; in conjunction with the assistance of local governments, they enforce state shareholders to return funds to listed companies to ensure the capital resources raised from the stock exchange are used for legitimized purposes. The regulatory department within the Shanghai Stock Exchange has also released reports to expose the bad behavior of some security investment companies in the stock market. It is complementary to Chinese accounting standards that disclosure is reasonable and systematically and efficiently enforced. It also helps to ensure that the Chinese accounting standards are properly implemented. Taking a similar attitude as the CSRC in respect of investor protection, the two stock exchanges also undertake strong enforcement to promote transparent disclosure in the stock market.

Market reactions to the CSRC's actions are investigated by Chen et al. (2005) and Berkman (2008). Chen et al. (2005) provide empirical evidence on the impact of the regulatory agencies' enforcement actions on the valuation of listed firms. In their study, the authors identify 169 enforcement actions carried out by the CSRC in the period 1999-2003. Using event study research methodology, Chen et al. (2005) find that enforcement actions implemented by 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. Moreover, they find that firms have a greater rate of auditor change; a much higher incidence of qualified audit opinions; increased CEO turnover; and wider bid-ask spreads. The negative stock returns and the costly economic consequences for listed firms suggest that the regulatory agencies in the Chinese stock market have credibility and their actions have "teeth".

Berkman (2008) adopts an event study methodology to examine the stock market reactions to three newly-released regulations by the CSRC aimed at reducing expropriation from public investors by controlling shareholders. The three regulations were all introduced in the second quarter of 2000 and were partly motivated by China's successful attempt to gain entrance into the World Trade Organization (WTO). The first new regulation (released on May 18, 2000) substantially increased the rights of public investors at a firms' annual shareholders' meeting. The second regulation (released on June 6, 2000) prohibited the issuance of loan guarantees by a firm to its controlling shareholder, and the third regulation (released on June 26, 2000) improved the transparency and regulation of asset transfers to related parties. Berkman (2008) finds significant positive abnormal returns accrue to firms with weak governance, as proxied by the value of related-party transactions and a variety of less direct measures. These results are interpreted as evidence that securities market regulation can be effective in protecting public investors from expropriation in a country like China with weak judicial enforcement.

The regulatory agency group in the Chinese stock market has three strong stakeholder-attributes. This group legitimates its existence by establishing the regulatory framework of corporate disclosure in the Chinese stock market. The enforcement of the regulations and sanctions it has imposed show its power and urgency over listed firms in the stock market. If listed firms are de-listed by the stock exchange, not only do they lose an important source of capital, but also their reputation in society is damaged. Accordingly, the regulatory agency group can be identified as a definitive stakeholder for listed firms in the Chinese stock market.

Investor Stakeholder Group

Individual investors have emerged in Chinese society since the beginning of the 1990s, when stock exchanges were opened in Shanghai and Shenzhen. As part of the fiscal policy of the Chinese government, the interest rates in China have remained low which has led some investors to seek higher rates outside of traditional savings accounts. The prosperity of the Chinese stock market has attracted increasingly more residents to invest their savings in relatively high-risk income stocks, funds and other investment devices. As a result, many have withdrawn money from banks and given it to security companies in the form of cash deposits (People's Daily, 2005b). This is evidenced in a CSRC (2000) report which states that the Chinese stock market is primarily made up of individual investors, and who are segmented, segregated and with low shareholding ratios. As minority shareholders of listed firms, individual shareholders have, on average, no more than 0.3% of the seats on the board of directors or supervisory board, even though they are a group possessing approximately one-third of the shares (Xu and Wang, 1999). Various factors have restricted individual shareholders' participation in the management and significant decision-making of listed firms. These include low shareholdings by individual shareholders, geography and the time zone differences (CSRC, 2000). Thus, the absence of cumulative voting procedures has significantly enhanced the control rights of a firm's largest shareholder.

Chinese domestic investors have a reputation for seeking short-term trading profit rather than long-term dividend income and investment growth, which is evidenced by the short shareholding periods of 1-2 months in 1995, and 5.8 months in 2002, compared to the average 18 months share holding period in the US (Deng and Wang, 2006). Such short investment horizons indicate that small individual shareholders neither have the willingness nor the capacity to monitor the management of listed firms closely. After more than a decade of development in the Chinese stock market, the number of individual investor accounts has increased from 8.35 million in 1992 to nearly 162 million by the end of 2011. The individual Chinese investors are also increasingly interested in the performance of listed firms and macroeconomic development when investing in the Chinese stock market. The value-oriented investment ideology is becoming more acceptable; and traders have been reported as becoming more rational and mature.

The Chinese public investors have also progressively become aware that they can protect their interests through legal mechanisms. In 2001, nearly 900 compensation cases in relation to fraudulent financial statements, insider trading and market manipulation were lodged in the lower courts (People's Daily, 2001). In early 2002, two reputable law firms filed complaints in the court on behalf of 363 investors and 700 investors who suffered from financial losses caused by fraudulent financial information disclosed by two listed firms. In November 2002, eleven individual investors obtained compensation of RMB 224,096 Yuan (US$28,012) from Hongguan Shiye and a related security underwriting company after a lawsuit lasting nearly four years. This marks the success of the first civil compensation case in China over fraudulent financial information. The case reflects the attitude of government authorities and regulatory agencies towards further legal enforcement of various regulations in respect of listed companies (Shao, 2003).

Based on Mitchell et al. (1997) typology, the investor group has one strong attribute, namely, urgency. Investors can buy or sell their shares freely. If they can't have the management changed via their voting powers, they may sell their shares in the stock market and this action may lead to the devaluation of a firm's share price. As investors have equity stakes in listed firms, they expect firms to make transparent disclosures to assist them in making efficient decisions in terms of how to allocate their financial resources. This group, however, does not have strong power over listed firms. Although investors in China have begun to use legal mechanisms to protect their interests from exploitation by majority owners, their actions are only strong enough to put external demands and pressure on listed firms to make transparent disclosures, rather than imposing sanctions on firms directly (Chen et al., 2005). With strong urgency and legitimacy but weak authoritative power, the investor group can only be classified as a dependent stakeholder of listed firms in the Chinese stock market.

Accounting Profession

In ancient China, in an economy which was dominated by small scale family businesses, the role of accountants in respect of strategic management and decision-making in Chinese society was not well regarded.Traditional Chinese culture considers merchants and people related to industry as inferior to other professions. Confucian philosophy suggests that "the mind of the superior man is conversant with righteousness; the mind of the mean man is conversant with gain" (Gao and Handley-Schachler, 2003). However, the function of accountants has changed since the economic and enterprise reforms in China. The rapid growth of accounting firms during the past fifteen years is the consequence of the introduction of massive new accounting regulations, standards and the trend of international accounting harmonization. The important role that accountants can play in improving business management and corporate governance has been recognized and this recognition has led to the development of a certification process for the accounting workforce (Groom and Sims, 2005).

The establishment of the Chinese Institute of CPAs (CICPA) was a landmark event in the development of the CPA profession in China (Tang and Lau, 2000). The CICPA is a quasi-government organization and reports to the MOF. The CICPA's main responsibilities include registering CPAs and public accounting firms and conducting the entrance examination. In January 1994, the *People's Republic of China Registered Accountant Law* (Certified Public Accountants Act) was promulgated by the MOF. The Act defines the scope of a CPA's role, including external auditing as distinct from internal auditing and government auditing, and other accounting consultancy work such as the design of accounting systems, performing accounting projects for management and providing advice on taxation, business registration and staff training.

A further step in the development of an independent profession has been the de-linking of CPA firms from sponsoring agents, usually government departments and institutions, since 1998. With the growth of the market economy, the government's tight control over CICPA has become impractical and now accounting firms are formed as either independent partnerships or limited liability companies. The de-linking is a sign of the intention of the government to abandon direct control over CPA practices. CPA professional services have been subject to professional, legal and market discipline since then.

An important role has been played by the independent accounting and auditing firms in boosting investors' confidence in the Chinese stock market. In 1998, a survey was conducted by the CICPA among 773 listed companies as part of an "accounting and auditing market cleaning campaign" implemented between 1997 and 1999 in China. The results show that there was a significant improvement in respect of the quality of accounting and auditing work. Of the 773 companies, there were 38 companies that received qualified auditor's opinion, 55 companies were offered an auditing opinion with the attachment of an explanation. One auditing firm released a qualified auditor report to a listed firm and one auditing firm refused to issue an audit report to a listed firm. In total, 12.29% of auditing firms expressed their disagreement to the financial information provided by the listed firms. Prior to that, the issuing of a qualified auditor report to a listed firm by an auditing firm had never previously happened. The implication of these actions is that accountants in China have improved their professionalism and sense of responsibility to public investors. A survey conducted by Chinese media in June 1998 also showed that the public's confidence in qualified accountants had improved from 45% in 1994 to 81%. The image and creditability of independent accounting and auditing firms have gradually improved. However, the quality of services provided by domestic accounting and auditing firms is still far from satisfactory, especially in respect of professional ethics. In order to make higher profits, some accounting firms assist their clients to produce fraudulent financial information. Due to a lack of any sense of risk, these accounting firms do not seem to realize that public investors rely upon an auditor's opinion to make decisions regarding capital investment. The majority of corporate scandals including Hongguan Shiye and Qiongminyuan can be related to the deceptive role played by external accounting and auditing firms(Xiao et al., 2004).

This professional body has played a positive role in improving the quality of financial disclosure in the Chinese stock market. However, as one of the stakeholders of listed firms, CICPA only possesses one of the three stakeholder sorting criteria – legitimacy. CICPA doesn't have power and urgency over listed firms and CPA firms. Rather, it is the CSRC and the MOF that possess authoritative power over listed firms and CPA firms. As mentioned previously, it is the CSRC and the MOF that can impose a penalty on CPA firms that do not apply appropriate standards and such a penalty can include cancellation of a CPA firm's license, either temporarily or permanently. Therefore, by reference to the Mitchell et al. (1997) typology the CICPA can only be classified as a discretionary stakeholder of listed firms in the Chinese stock market, as it cannot threaten listed firms' capital resources.

Environmentalists

Another stakeholder group of listed firms are environmentalists and the environmental authority. The State Environmental Protection Administration (SEPA) has issued several regulations and provisions related to environmental disclosure and reporting. The *Management Provision on Reporting and Registration on Pollutant Emissions* (1992) was the earliest regulation, requiring enterprises to report to the government the details of the pollutants they are responsible for and how they are managed. The *Environmental Management Provision for Construction* (1998) requires enterprises that run construction projects to produce an Environmental Impact Assessment report (EIA). The *Bulletin on Information Disclosure for Corporate Environmental Performance* (2003) stipulates that non-compliant enterprises should disclose their corporate environmental performance to the public. Local environmental protection bureaux must release corporate non-compliance lists periodically to the public through newspapers and television. This regulation requires that listed firms must disclose their environmental performance information for the previous year by March 31st every year. Another regulation released in 2003, Regulations on the Environmental Inspection of Companies Accessing or

Refinancing from the Stock Market, aims to prevent environmental risk associated with listed firms from certain heavily polluting industries such as metal, chemicals, oil, coal, thermal power and construction materials. The CSRC requires firms wanting to be listed on the Chinese stock exchanges to include their environmental risk and how they meet environmental standards and environment-related measurements in their prospectus of Initial Public Offerings (IPO), application files for IPO and legal statement and working reports of lawyers for IPO.

The survey of annual reports of 1195 listed firms conducted in 2003 by Guo (2005) concludes that firms in China pay less attention to corporate environmental reporting and disclosure compared to some of their western counterparts. As most of the regulations in the Chinese stock market focus on improving corporate disclosure and reporting of firms' financial performance rather than social and environmental issues, environmental disclosure is not popular, and annual reports of listed firms rarely include environmental issues. Although possessing legitimacy attributes, environmentalists do not have strong power and urgency over the financial resources of listed firms and therefore can be classified as discretionary stakeholders of listed firms in the Chinese stock market.

Based on the discussion above concerning the emergence of new stakeholders and the changing power of particular stakeholder groups, Table 1 summarizes stakeholders and their attributes in the Chinese stock market.

Table 1. Stakeholders and stakeholder attributes in the Chinese stock market

Stakeholder group	**Power**	**Legitimacy**	**Urgency**	**Classification**
Creditor	High	High	High	Definitive stakeholder
Regulatory agency	High	High	High	Definitive stakeholder
Investor	Low	High	High	Dependent stakeholder
Accounting Profession	Low	High	Low	Discretionary stakeholder
Environmentalist	Low	High	Low	Discretionary stakeholder

Conclusion

As a consequence of the development of the Chinese economy, there has been an emergence of "new" stakeholder groups. New stakeholder groups include creditors, regulatory agencies, investors, professional associations and environmentalists. Applying Mitchell et al.'s (1997) stakeholder typology, the assessment of stakeholder attributes clearly shows the regulatory agency group is the most powerful stakeholder group for listed firms in the Chinese stock market. The MOF, the CSRC and the Shanghai and Shenzhen stock exchanges can be jointly identified as definitive stakeholders, as they possess three strong stakeholder attributes, namely, power, legitimacy and urgency over the capital resources of listed firms. Although the creditor group is also considered a definitive stakeholder, the regulatory agency group has political power which we consider gives this group the number one position. To be continuously listed in the Chinese stock market and obtain financial resources from shareholders, listed firms must follow the rules and regulations enforced by those regulatory agencies.In relation to the creditor group the changed banking environment in China has transferred this stakeholder group from a discretionary stakeholder to a definitive stakeholder. The creditor group now possesses three stakeholder attributes that are closely related to the economic stake creditors have in listed firms. Being profit-oriented itself, this group possesses power to control the capital resources relied upon by listed firms. Investors are dependent stakeholders and, due to relatively weak legal mechanisms, have limited power over listed firms. However, investors strongly exhibit one of the attributes, namely, urgency. They can take immediate actions by selling their shares when they feel their legitimate interests are not being served by the management of listed firms. The professional association, CICPA, exhibits strong legitimacy but lacks power and urgency over listed firms in the Chinese stock market, which makes it a discretionary stakeholder. Environmentalists have emerged as a stakeholder group more recently with the greater awareness given to corporate environmental performance and disclosure to the public. Like the professional associations, Environmentalists would be considered discretionary stakeholders as they only have the legitimacy attribute. Therefore, as a result of the economic reforms in China we can see the change in ownership structures of firms from state-owned enterprises where the sole stakeholder was the Government to a westernized capital market with listed firms and multiple stakeholders. This change will prompt the management of listed firms in China to be more aware of the need for stakeholder management to be successful into the future.

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THE IMPACT OF GUANXI ON AUDITOR INDEPENDENCE: PERCEPTIONS OF AUDITORS AND CFOS IN HONG KONG

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Abstract

Auditor independence has long been referred to as the cornerstone of the auditing profession. Guanxi refers to the networks of informal relationships and exchanges of favors that dominate all business and social activities that occur throughout China. This research will analyse the impact of guanxi and client size on the perceived independence of auditors in the setting of Hong Kong. Survey data is obtained from 524 questionnaire responses from Chief Financial Officers (CFOs), Big 4 and Non-Big 4 auditors. Two within-subjects independent variables: "guanxi" and the "client size", and one between-subject independent variable: auditors versus CFOs, are employed. Results indicate guanxi is a significant factor influencing perceived auditor independence in Chinese society, which has largely been neglected in the accounting literature. Independence is severely impaired when the duration of guanxi with clients reaches five years or more. Large client size has a negative influence on the perceived independence of auditors and this result contradicts an earlier U.S. study. The results indicate that the longer the guanxi when the auditor is associated a with large audit client, the greater the decrease in their perceived independence and this has implications for audit legislation. CFOs generate the lowest mean scores (greatest threat to auditor independence) for the perceived effects of all levels (durations) of guanxi among the three groups. This result supports the stewardship theory that asserts stewards (CFOs) motives are aligned with the objectives of their principals. CFOs consider the increasing levels of guanxi associated with the auditors are not in the best interests of their principals, and hence affect the reliability of the audited accounts. Though this study is conducted in the Asia Pacific region, western counterparts will find the results useful. Multinational corporations which have subsidiaries or headquarters established globally, should be aware that guanxi has implications for their Asian operations and their consolidated audited accounts. In view of the critical importance of the guanxi factor on the perceived auditor independence, standard setters in this region should consider devising ethical guidelines requiring mandatory rotation of public accounting firms.

Keywords: Guanxi, Auditor Independence, Client Size, Stewardship Theory, Rotation of Audit Firm

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1. Introduction

Auditor independence is regarded as one of the cornerstones in auditing theory (Mautz and Sharaf, 1961). The AICPA (2008) in its Principles of Professional Conduct sets down the following for auditors to observe:

> "*For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance.*"

Perceived independence of auditors is of critical importance both for the Profession and in auditing research. In view of the importance of perceptions of auditors' independence, researchers worldwide have been investigating dimensions of this issue over a considerable period of time (Ashton,1974; Firth 1980; Shockley, 1981; Johnson and Pany, 1984; Knapp, 1985; Pany and Reckers, 1987; Gul, 1989; Bartlett, 1993; Teoh and Lim, 1996; Beattie *et al.*, 1999; Majid *et al.*, 2001; Goodwin and Seow, 2002; Umar and Anandarajan, 2004; Lindberg and Beck, 2004; Lin and Chen, 2004; Jones and Chen, 2005; Cooper *et al.*, 2006; Law, 2008b; Daniels and Booker, 2009; Law and Yuen, 2010).

Many researchers have concentrated their effort in examining whether the influence of provision of non audit services (NAS) have had a negative influence on perceptions of auditors' independence, and this has particular relevance especially after the Enron debacle (Shockley, 1981; Hillison and Kennelley, 1988; Teoh and Lim, 1996; Beattie *et al*., 1999; Gendron *et al*., 2004; Lindberg and Beck, 2004; Alleyne *et al*., 2006; Carey *et al*., 2006; Richard, 2006; Law, 2008b), or whether it positively enhances independence (Bartlett, 1993; Emby and Davidson, 1998; Windmoller, 2000). Additionally, some researchers reveal NASs provisions have no influence on perceptions of independence (Sucher and Bychkova, 2001; DeFond *et al*., 2002; Ashbaugh *et al*., 2003; Chung and Kallapur, 2003; Quick and Rasmussen, 2005).

These studies had as a focus the monetary impact (provisions of non audit services) on auditor independence, however, considering the importance of *guanxi* in doing business in Chinese society this non-monetary dimension has considerable importance. Scant attention has been given however to research examining the *human impact* on auditor independence, like *guanxi*.

The research issue of *guanxi* is interesting and such a study can be of significant practical relevance to regulators and practitioners in addition to researchers in both accounting and management. In Western society, because of the close or strong ties in the network relations of organisations (Podolny & Page, 1998) a form of *guanxi* exits. This research takes the opportunity to extend the empirical study of these relations to the Eastern society, particularly in Hong Kong. The only prior research similar to this has been conducted by Hwang *et al*., (2008) using Taiwanese data.

Hong Kong was under the sovereignty of Britain for over 100 years until 1997 and western culture and accounting practice is understood in the region (Law and Hung, 2009). However it is appropriate to conduct an empirical study such as this in Hong Kong, because Confucian culture is still deeply ingrained in the Hong Kong society. Cohen *et al*., (1995) has indicated that there are international differences in auditors' ethical perceptions, and in an increasingly global environment accounting ethics and cross-cultural behavioral research is strongly recommended (Umar and Anandarajan, 2004; Cooper *et al*., 2006). This study is the first study in the Asia Pacific region using empirical survey data to examine the impact of *guanxi* on perceived auditor independence.

Three sample groups of are drawn: Big 4 auditors, non big 4 auditors and Chief Financial Officers (CFOs) from Hong Kong. Two within-subjects independent variables – the *guanxi* factor (duration) and the client size factor – and one between-subject independent variable – "auditors versus CFOs from Hong Kong – are examined. Given the lack of any theory used to explain the impact of *guanxi* on auditor independence, this research draws attention to stewardship theory in considering the goal convergence of shared collective interests with the contracted steward, i.e., the CFOs of corporations.

In Hong Kong, there is currently no mandatory enforcing of Auditing Standards to monitor the impact of *guanxi* or other perceived risks to independence. With increasing globalization, this study has practical implications for multinational corporations that have business in Chinese societies. It is hoped that the results of the research can assist regulators and standard setters in devising auditing standards and ethical guidelines in Hong Kong and their international counterparts.

Following this introduction the paper proceeds with a literature review, namely, importance of auditor independence, stewardship theory and *guanxi* from which hypotheses are developed. The data collection method of this research experiment is then discussed. This is followed by the presentation of results, discussion and finally a conclusion.

2. Literature review and hypothesis development

Importance of auditor independence

Auditor independence is an alleged factor attending recent corporate collapses and corporate scandals across the world, for example, Enron, WorldCom, and Sunbeam in the US (Bakar *et al*., 2005), HIH and OneTel in Australia, and Parmalat in Italy. Auditor independence has long been referred to as an essential component of the auditing profession (Mautz and Sharaf, 1961), and been seen as crucial to the validity of external audit (Sucher and Bychkova, 2001). It has been observed by the Chairman of the American Institute of Certified Public Accountants (AICPA) and embraced by the Hong Kong Institute of Certified Public Accountants (HKICPA) as indeed the cornerstone of the accounting profession and one of its most precious *values*. *Actual* independence and the *appearance* of auditor independence have thus been heralded within the major worldwide professional accounting bodies as matters of primary importance. The requirement for CPA auditors' independence from audit clients is well established in the professional standards of the accounting bodies such as the Institute of Chartered Accountants of England and Wales (ICAEW), American Institute of Certified Public Accountants (AICPA), The Institute of Chartered Accountants in Australia (ICAA), and CPA Australia. The Code of Professional Conduct (ICAA and CPA Australia, 2005) explicitly requires not only actual independence from audit clients, but also the maintenance of the *appearance* of independence to third parties.

In that context the International Standards on Auditing (ISA) 200 states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. If outside parties doubt the independence of the reporting auditors, then a number of possibilities could arise. Firth (1980) mentions the following three impacts:

1. Audits may be perceived to be valueless. Audit work and audit fees would disappear.
2. The Government may become more involved in auditing matters and could move towards a state-controlled audit board.
3. Other regulatory bodies such as Stock Exchanges may become more concerned with auditing matters. This may result in lower earnings for auditors and lessen the powers of the professional accounting bodies and CPAs.

Thus, it is generally argued as vital that auditors maintain their independence, to ensure high quality of audits are maintained at all times, and that without auditors' independence, the credibility of the audited financial statements would be reduced to the detriment of interested parties and, indeed, to the accounting and auditing profession generally (Bakar *et al.*, 2005).

Overall the pervading rhetoric appears to be that, when auditors discharge their responsibilities, independence both *in fact* and *in appearance* should always be present (Mautz and Sharaf, 1961; Firth, 1980; Shockley, 1981; EFAA, October 1998; Hussey and Lan, 2001). Indeed, in the wake of Enron and the subsequent demise of Arthur Andersen the future of the auditing profession was argued to be dependent upon the perceptions of auditor independence. In other words, once an auditor is perceived to lack independence, the audit work loses credibility and the value of the auditing function is severely impaired, if not lost (Firth, 1980; Koh and Mahathevan, 1993; DeFond *et al.*, 2002; Law, 2008b); an audit report is only beneficial if it contains reliable and unbiased information. When users of the audit report do not believe that the auditor is independent, reduced confidence is applied to the auditor's opinion in the audit report (Quick and Rasmussen, 2005; Law, 2008b).

Stewardship theory

Stewardship theory examines relationships and behaviors often discounted in organizational economic theories, emphasizing collective and contractual behavior in which a higher value is placed on goal convergence than on agent self interest (Slyke, 2006). Stewardship theory defines situations in which managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their principals (Davis *et al.*, 1997a). In contrast to agency theory, a steward places greater value on collective rather than individual goals, makes decisions he/she perceives to be in the best interests of his/ her principals (Davis *et al.*, 1997b). Stewards are motivated by intrinsic rewards such as trust, job satisfaction and mission alignment (Mayer *et al.*, 1995). The disposition of both the principal and the contracted steward is towards trust and the realization of collective interest, and this differs significantly from that of agency theory which is more distrusting of the intentions of the agent (Slyke, 2006). Hence, there is much less of a clear divergence between managerial and shareholder interests under the assumptions of stewardship theory. Though the accounting literature has attempted to use the stewardship theory to examine corporate competitiveness (Ho, 2005), the theory remains acknowledged but largely neglected and untested (Slyke, 2006; Pirie and McCuddy, 2007), particularly in application to auditor independence.

Guanxi

Guanxi describes the basic dynamic in the complex network of personal influence and social relationships, and is a central concept in Chinese society. China is often described as being a relational society involving mutual obligations' a long-term perspective and cooperative behaviour. By contrast, Western society and business environment is characterised by the short-term immediate benefit, highly transactional behaviour (Tsang et. Al., 1998).

In the Chinese language, "guanxi" is the term for a personal relationship. It refers to the network of informal relationships and exchanges of favors that dominate all business and social activities that occur throughout China (Lovett et al., 1999; Hwang and Baker, 2000). Sociologists have linked guanxi with the concept of social capital and it has been exhaustively described in studies of Chinese economic and political behavior (Wellman et al., 2002). Guanxi has been critically important to Chinese society since the time of Confucius (Hwang and Staley, 2005). Confucius promulgated five sets of healthy relationships with society: ruler/subject, parents/children, older/younger brothers, husband/wife, and friends (Hwang and Baker, 2003; Lovett et al, 1999). Researchers observe that business people cannot achieve their goals alone and thus must rely on social networking or guanxi with others, particularity in Chinese society (Hwang et al., 2008; Groen et al., 2008). In the Mao era, China emphasized collectivistic values like the alignment of individual and organizational interests, when performing well for the individual means performing well for the organization. Conflicts of interest are removed because of this collective interest.

Guanxi is embedded in the mindset of the Chinese and in their personal and organisational relationships (Park and Luo, 2001). Thus it ties in business partners by reciprocal exchanges of favours and obligations regularly and voluntarily (Alston, 1989). Once it is established between partners, one can ask a favour of the other, who can also expect it to be repaid in the future, in some way.

As China integrates herself into the world economy, mangers in Chinese organizations are now facing the challenge of having to compete with outsiders. They will have to come to terms with operating under a non-guanxi based environment. Similarly managers from the west with have to confront Chinese managers where a more Confucian environment prevails. This may be either inside or outside their corporate boundary, for example, managers operating a Division of a large corporation in China or in dealings with an external supplier from Asia.

In the Chinese business environment, it is unavoidable that an auditing firm will be exposed to guanxi (Hwang and Staley, 2005; Taormina and Lao, 2007: Law and Hung, 2009). The potential audit risk and violation of ethical standards that would impact audit firms when operating in a society of guanxi should not be overlooked (Hwang and Staley, 2005). As a result, guanxi has been widely used in the Chinese society; it is a strong social cultural concept. Individuals can obtain legitimate benefits from organizations but guanxi may also carry negative consequence including cronyism, corruption, violation of organizational procedures, erosion of trust and independence (Khatri et al. 2006; Hwung et al., 2008), hence, favour exchanges between close guanxi parties within an organization may negatively affect the welfare of the others (the non-guanxi parties).

Western and Eastern approaches to guanxi are quite different. Law and Hung (2009) found that the social networking factor is a key factor that influences CPAs to become entrepreneurial start-ups in Hong Kong. Chinese business people often rely on guanxi for business information, advice and problem solving (Hwang and Staley, 2005; Taormina and Lao, 2007; Hwang et al., 2008). Hwang and Staley (2005) observe that in China, business people first strive to build guanxi with a potential customer, and business development follows afterwards. It was also found that once guanxi has been established, marketing costs and bad debt expense are lowered (Hwang and Baker, 2000). Yeung and Tung (1996) noted in their research that guanxi was the only item consistently chosen as a key factor that contributes to business success in China. Likewise, Au and Wong (2000) indicated that the ethical judgments of Chinese CPAs are negatively affected by guanxi. From a western research perspective, Wright and Booker (2005) comment that a former auditor's prior relationship with the audit client would likely impair auditor independence. Another US study conducted by Bowlin et al., (2009) show that there are concerns when auditors become managers of their audited clients. In a qualitative study in Poland, MacLullich and Sucher (2005) found that ethical issues were thus presented to be a likely problem for Polish auditors. Auditors may be over familiar with clients for their built-in relationships, and thus the degree of thoroughness in the audit investigations may be lower, affecting the independence of the auditors. Auditor independence is further threatened by the very nature of the relationship between client management and the auditor (Windsor and Ashkanasy, 1995), Furthermore, prior studies have indicated that perceived auditor independence may differ very much in different countries (Cooper et al., 1994; Cooper et al., 1996; Patel and Psaros, 2000; Umar and Anandarajan, 2004; Cooper et al., 2006), therefore the importance of guanxi in Chinese society is worthy for our research.Hence in the context of the stewardship function and the above literature review leads to the following hypothesis:

H1: Guanxi has a negative influence on the perceived independence of auditors.

Client size

Generally though, studies which have investigated the association between client size and auditor independence have been infrequent. Shockley (1981) commented that in a highly competitive environment, competition for audit clients increased and this gave clients greater opportunities and incentives to replace incumbent auditors. Auditors' dependence on their clients may increase. Emby and Davidson (1998) commented that auditors were in a relatively weak position in disputes with their clients, compared to other professionals groups in society, that the existence of the competing audit firms in the audit market can provide a major source of power to clients. Reynolds and Francis (2005) agree that economic dependence clearly exists for large clients. This dependence is greater when a client is large relative to other clients in the accounting firm. They further comment that could lead to preferential treatment and favourable reporting by auditors. DeAngelo (1981) further found that economic consequences create strong incentives for accounting firms to be lenient and report favourably in order to retain large clients. Miller (1992) also reported that economic dependence could lead to favorably reporting for large clients. A subsequent study conducted in the U.S. found the impact of client size has a negative influence on the auditor independence (Carcello *et al*., 2000).

In order to make a classification of the definition of client size in this study, corporations which are constituents stocks of the Hong Kong Hang Seng Stock Index are classified as large corporations, while those not in the constituents stocks of the Hang Seng Stock Index are classified as small corporations. Thus the classification is consistent with the grouping categories in prior studies (Pany and Reckers, 1980; Knapp, 1985; Gul, 1989). In considering the impact of client size on the perceived independence of auditors, the above literature review leads to the following hypothesis

H2: Large client size has a negative influence on the perceived independence of auditors.

To determine the interaction effects between the independent variables of *guanxi* and the client size factors, the alternative hypothesis H3 is proposed.

H3: The influence of guanxi on the perceived independence of auditors depends on client size.

Between-subject independent variables: types of respondent groups

There have been several calls for cross-cultural behavioral and accounting ethics research (Umar and Anandarajan, 2004; Cooper *et al*., 2006). Cohen *et al*., (1995) suggest there is a need to explore international differences in auditors' ethical perceptions. Cooper et al., (1996) in their research found that there are differences in the ethical perceptions and operational practices of auditors in Hong Kong and those in Australia. Hong Kong was under British rule for over 100 years. Although it was handed back to China in 1997, Western culture and accounting practice remains prevalent through various channels, in television, movies, lifestyle, social activities, and the educational system (Law and Hung, 2009). The power of the West has been, and still is, rooted in the forms of social, economic and cultural patterns that prevail in the society (Schaper & Volery, 2004). Hence, both Chinese and Western culture in the Hong Kong environment create a unique environment for the study of *guanxi*. The study of perceived national cultural differences and the impact of these cultural differences on commercial behavior justify the selection of auditors and CFOs in Hong Kong as respondents for this research (Patel and Psaros, 2000).

Hence H4 and H5 are proposed:

H4: The influence of the guanxi factor on the perceived independence of auditors depends on the respondent sample groups.

H5: The influence of the client size factor on the perceived independence of auditors depends on the respondent sample groups.

The final hypothesis is formed to examine whether there are differences in the perceptions of auditor independence among the three groups.

H6: There are differences in the perceptions of auditor independence among the three respondent groups.

3. Data collection method

Given the exploratory nature of the research an experimental approach has been taken. Respondents are familiarized with the topic of the research through small vignettes of two Hong Kong companies one small and one large. Their views are then sought, through closed questions of the impact of *guanxi* on auditor independence. Different durations of guangi are then posed (1,3,5 and over 5 years) in order to explore the different possible impact of timescale.

250 Big 4 auditors, 250 non Big 4 auditors and 250 CFOs were randomly selected from the Directory of CPAs booklet (Dijk, 2000). Research assistants were employed to make phone calls to the selected participants, requesting their participation before sending off the questionnaires to them (Law, 2008b). The respondents were assured of anonymity and of the voluntary nature of their cooperation in the survey. The survey package together with a prepaid envelope was then sent to those who agreed to participate. The package consisted of a copy of vignettes, the questionnaire and a cover letter signed by the researchers. Prior evidence in Australia and Netherlands supports contacting the respondents before sending off the questionnaires and suggests response rates of 70% to 80% might be expected (Roberts, 1999; Dijk, 2000). Baruch (1999) observes an average response rate of 59% for surveys of professionals and that this is an acceptable level. Thus similar techniques were used in this study in the expectation of a satisfactory response rate (Sekaran, 2000; Desira and Baldacchino, 2005). Collis and Hussey (2009) suggest that the response rate would be increased by keeping the questionnaire as short as possible and using closed questions of a non-sensitive nature.

Measurement

The term '*guanxi*' was defined to the respondents and their attention focused on the relationship between auditor and client for the hypothetical small company, not registered on the HKSE. Attention was then turned to a larger size company which was registered on the HKSE. The respondents were asked to rate their perceptions of auditor independence in the vignettes on a five-point Likert scale ranging from 1 "*guanxi* seriously undermines independence" to 5 "*guanxi* strongly enhances independence." These perceptions dealt with the existence of and duration of *guanxi* between the auditor and client for each of one year, three years, five years and finally above five years.

Responses such as those required in this research are not unfamiliar to auditors. Pany and Reckers (1987) point out auditors often make repeated judgments in their daily work. Auditors are generally working on similar aspects of more than one audit during their daily work and repeated judgments are often required (Bamber, 1983). Therefore, these audit judgments are likely to be *like* within subject responses. Some researchers have commented there exists a possible 'demand' effect in the within-subjects repeated measures (Pany and Reckers, 1987; Chang et al., 2002). Demand effect implies instructions may induce the participants attention in a certain direction and this may occur especially in experimental design studies. Findings in psychological research suggest however, that there is little evidence to show the experimental demand effect actually exists (Weber and Cook, 1972; Berkowitz and Donnerstern, 1982).

Moreover, in this research, possible bias due to learning effects from the subjects are controlled for by printing the order of the vignettes and questions in the questionnaire in a random manner (Gul, 1987; Gul, 1989; Dijk, 2000; Chung and Monroe, 2000; Law, 2008b). Gul (1989) further concludes that based on his extensive reviews of the literature there is *no clear-cut* evidence on the existence of "demand effects" in the repeated measures design. Fuller and Kaplan (2004) state that the advantages of the within subjects design in the mixed ANOVA far outweigh the disadvantages.

A mixed ANOVA (within subjects and between subjects ANOVA) is conducted for analyzing the main and interaction effects. Shannon and Davenport (2001) point out that the mixed ANOVA entails a most useful analysis. In the auditing literature, the uses of within subjects repeated ANOVA analysis techniques are commonly used in examining behavioral issues, and in researching auditors' perceptions of independence (Ashton and Kramer, 1980; Shockley, 1981; Pany and Reckers, 1980; Pany and Reckers, 1987; Knapp, 1985; Gul, 1987; Gul, 1989; Dijk, 2000; Fuller and Kaplan, 2004; Law, 2008b).

To recap the experiment the two independent variables are:

1) existence and duration of *guanxi* with four levels, 1 year, 3 years, 5 years and more than 5 years relationships with the client, and

2) client size with two levels, large and small client.

The dependent variable is the perceived independence of the auditor in the auditor - client relationship, and the between-subjects independent variables are CFOs, Big 4 auditors and Non Big 4 auditors.

4. Results

There were 193 responses from the CFOs, 178 responses from the Big 4 auditors and 153 responses from the non Big 4 auditors, giving response rates of 77%, 71%, and 61% respectively. The items in the survey showed satisfactory levels of reliability, with a Cronbach's alpha of 0.84 and a normal data distribution. A test for non-response bias was carried out by comparing the first 30 responses and the last 30 responses of the second requests for the three groups respectively (Oppenheimer, 1976), but no significant differences in perceptions of independence were found and hence non-response bias was not considered a problem. For the CFOs sample, 69% of the respondents had 11-15 years of experience and 19% had more than 15 years of experience. Whereas for the auditors groups, 62% had 6-10 years of experience, 21% had 1-5 years of experience and 15% had 11-15 years of experience. The descriptive statistics for the means and standard deviations of the scores for the dependent variable, perceived auditor independence, are shown in Table 1.

Table 1. Descriptive statistics – perceived Auditor Independence by client size and Guanxi duration

Clients / Duration	Subjects (Types of samples)	Mean	Std. Deviation	N
Large clients, *Guanxi* with 1 years relationship	CFOs	3.01	1.34	193
	Big 4 auditors	4.57	.73	178
	Non Big 4 auditors	4.65	.77	153
	Total	**4.02**	**1.27**	**524**
Large clients, *Guanxi* with 3 years relationships	CFOs	2.29	1.25	193
	Big 4 auditors	2.90	1.73	178
	Non Big 4 auditors	3.35	1.52	153
	Total	**2.81**	**1.57**	**524**
Large clients, *Guanxi* with 5 years relationships	CFOs	1.58	1.13	193
	Big 4 auditors	1.63	1.05	178
	Non Big 4 auditors	2.28	1.24	153
	Total	**1.80**	**1.18**	**524**

Large clients, *Guanxi* with more than 5 years relationships	CFOs	1.11	.33	193
	Big 4 auditors	1.44	.93	178
	Non Big 4 auditors	1.71	1.09	153
	Total	**1.40**	**.86**	**524**
Small clients, *Guanxi* with 1 years relationship	CFOs	3.61	1.16	193
	Big 4 auditors	4.61	.80	178
	Non Big 4 auditors	4.63	.72	153
	Total	**4.25**	**1.05**	**524**
Small clients, *Guanxi* with 3 years relationships	CFOs	2.55	1.30	193
	Big 4 auditors	3.10	1.87	178
	Non Big 4 auditors	3.65	1.66	153
	Total	**3.06**	**1.67**	**524**
Small clients, *Guanxi* with 5 years relationships	CFOs	2.16	1.28	193
	Big 4 auditors	2.41	1.46	178
	Non Big 4 auditors	2.67	1.49	153
	Total	**2.40**	**1.42**	**524**
Small clients, *Guanxi* with more than 5 years relationships	CFOs	1.49	.96	193
	Big 4 auditors	2.12	1.42	178
	Non Big 4 auditors	2.68	1.56	153
	Total	**2.05**	**1.40**	**524**

Scores are from 1 guanxi seriously undermines independence to 5 guanxi strongly enhances independence

4.1 Within subject analysis

For hypothesis 1, the multivariate test reported in Table 2 relates to the first within-subject independent variable – *guanxi*. Green and Salkind (2001) recommend reporting the familiar Wilks' lambda value. The variable for *guanxi* has an F value of 996 at $p < 0.05$ and hence the result is statistically significant. As the variable is significant and has four levels, pairwise comparisons were undertaken using the Bonferroni comparison (Green and Salkind, 2001) to reveal where the differences exist. The pairwise comparison (Table 4) shows that all four levels of *guanxi* are significantly different from each other at a p value < 0.05. The mean score for *guanxi* with 1 year of relationship drops from 4.18 to 1.76 for *guanxi* after a relationship of more than 5 years (see Table 3) and therefore H1 is supported.

Table 2. Multivariate Tests of client size and *guanxi* duration

Effect		F	Hypothesis df	Sig.
CLIENT	Pillai's Trace	91.503(a)	1.000	.000
	Wilks' Lambda	91.503(a)	1.000	.000
CLIENT * TYPESAMP	Pillai's Trace	.082(a)	2.000	.921
	Wilks' Lambda	.082(a)	2.000	.921
GUANXI	Pillai's Trace	996.578(a)	3.000	.000
	Wilks' Lambda	996.578(a)	3.000	.000
GUANXI * TYPESAMP	Pillai's Trace	15.466(a)	6.000	.000
	Wilks' Lambda	16.087(a)	6.000	.000
CLIENT * *GUANXI*	Pillai's Trace	11.049(a)	3.000	.000
	Wilks' Lambda	11.049(a)	3.000	.000

A Exact statistic
The statistic is an upper bound on F that yields a lower bound on the significance level. Design: Intercept+TYPESAMP Within Subjects Design: CLIENT+*GUANXI*+CLIENT**GUANXI*

Table 3. Mean values of influence of *guanxi* on Auditor Independence by *guanxi* duration

GUANXI	Mean	Std. Error	95% Confidence Interval	
			Lower Bound	Upper Bound
1 year	4.179	.033	4.113	4.244
3 years	2.975	.052	2.874	3.076
5 years	2.123	.042	2.042	2.205
More than 5 years	1.757	.033	1.692	1.822

Table 4. Pairwise comparisons of influence of *guanxi* on Auditor Independence by *guanxi* duration

(I) *GUANXI*	(J) *GUANXI*	Mean Difference (I-J)	Std. Error	Sig.(a)	95% Confidence Interval for Difference(a)	
					Lower Bound	Upper Bound
1 year	3 years	1.204(*)	.055	.000	1.057	1.351
	5 years	2.055(*)	.052	.000	1.919	2.192
	>5 years	2.422(*)	.045	.000	2.303	2.540
3 years	1 year	-1.204(*)	.055	.000	-1.351	-1.057
	5 years	.852(*)	.063	.000	.684	1.019
	>5 years	1.218(*)	.060	.000	1.060	1.376
5 years	1 year	-2.055(*)	.052	.000	-2.192	-1.919
	3 years	-.852(*)	.063	.000	-1.019	-.684
	>5 years	.366(*)	.042	.000	.256	.476
>5 years	1 year	-2.422(*)	.045	.000	-2.540	-2.303
	3 years	-1.218(*)	.060	.000	-1.376	-1.060
	5 years	-.366(*)	.042	.000	-.476	-.256

Based on estimated marginal means.
* The mean difference is significant at the .05 level.
(a) Adjustment for multiple comparisons: Bonferroni.

For Hypothesis 2, the client size variable has an F value of 92 at $p < 0.05$ (Table 2) and the result is significant. The means and pairwise comparisons (Tables 5 and 6) show that both levels of the variable are significantly different from each other at a p value of < 0.05. The mean score for large client size (2.54) is significantly lower than that of small client (2.97), implying the larger client size has a negative influence on the perceived independence of auditors, thus H2 is supported.

Table 5. Mean values of influence of *guanxi* on Auditor Independence by client size

CLIENT	Mean	Std. Error	95% Confidence Interval	
			Lower Bound	Upper Bound
Large	2.543	.028	2.488	2.599
Small	2.974	.037	2.901	3.047

Table 6. Pairwise comparisons of influence of *guanxi* on Auditor Independence by client size

(I) CLIENT	(J) CLIENT	Mean Difference (I-J)	Std. Error	Sig.(a)	95% Confidence Interval for Difference(a)	
					Lower Bound	Upper Bound
Large	Small	-.430(*)	.045	.000	-.519	-.342
Small	Large	.430(*)	.045	.000	.342	.519

Based on estimated marginal means
* The mean difference is significant at the .05 level.
(a) Adjustment for multiple comparisons: Bonferroni.

For hypothesis 3, Client**Guanxi* has an F value of 11 at $p < 0.05$ (Table 2). The result is statistically significant, and thus H3 is supported. The mean scores of the interactions is shown in Table 7. Tests of within subject contrasts (Table 8) show that the difference lays in level 2 versus level 3. That is the mean score drops significantly from 3 years *guanxi* (2.85) to 5 years *guanxi* (1.83) (Table 7), indicating perceived independence is significantly impaired when duration of *guanxi* increases from 3 years of relationships with clients to 5 years of relationships in a large client environment.

Table 7. Mean values – client **guanxi*

CLIENT	*GUANXI*	Mean	Std. Error	95% Confidence Interval	
				Lower Bound	Upper Bound
Large	1 year	4.073	.044	3.986	4.160
	3 years	2.849	.066	2.719	2.979
	5 years	1.832	.050	1.734	1.930
	>5 years	1.419	.036	1.348	1.490
Small	1 year	4.284	.041	4.204	4.364
	3 years	3.101	.071	2.962	3.240
	5 years	2.415	.062	2.294	2.536
	>5 years	2.095	.058	1.981	2.208

Table 8. Tests of within-subject contrasts

Source	Client	*Guanxi*	Type III Sum of Squares	F	Sig.
Client	Level 1 vs. Level 2		96.082	91.503	.000
Client * typesamp	Level 1 vs. Level 2		.173	.082	.921
Guanxi		Level 1 vs. Level 2	752.193	471.163	.000
		Level 2 vs. Level 3	376.582	182.031	.000
		Level 3 vs. Level 4	69.628	77.794	.000
Guanxi * typesamp		Level 1 vs. Level 2	46.551	14.579	.000
		Level 2 vs. Level 3	24.638	5.955	.003
		Level 3 vs. Level 4	11.630	6.497	.002
Client * *Guanxi*	Level 1 vs. Level 2	Level 1 vs. Level 2	.860	.189	.664
		Level 2 vs. Level 3	56.853	9.722	.002
		Level 3 vs. Level 4	4.488	1.348	.246

Client level relates to large and small company clients
Guanxi level relates to duration 1, 3 5 and >5 years duration

4.2 Between-subject analysis

For hypothesis 4 the (*Guanxi** TYPESAMP) interaction has an F value of 16 at $p < 0.05$ (Table 2). The result is statistically significant, and thus H4 is supported. Test of within-subject contrasts (Table 8) show that the four levels (durations) of *guanxi* are significantly different from each other for the three groups.

It is interesting to note that the CFOs have the lowest mean scores (that *guanxi* more seriously undermines independence) for all levels among the groups, while non Big 4 auditors have the highest mean scores for all levels among the groups (Table 9). Overall CFOs consider the independence of auditors would be impaired under the different levels of *guanxi* relationships to a greater extent than the auditors. These results support the stewardship theory that the CFOs are concerned (as stewards) to give due regard to the the resources entrusted to the corporation under their control (Davis et al., 1997a; Slyke, 2006). This will be elaborated further in the following section.

Table 9. Mean values - Types of samples **guanxi*

Types of samples	*GUANXI*	Mean	Std. Error	95% Confidence Interval	
				Lower Bound	Upper Bound
CFOs	1 year	3.306	.055	3.198	3.413
	3 years	2.422	.085	2.256	2.589
	5 years	1.870	.068	1.736	2.005
	>5 years	1.301	.054	1.194	1.407
Big 4 auditors	1 year	4.590	.057	4.478	4.702
	3 years	3.003	.088	2.830	3.176
	5 years	2.022	.071	1.883	2.162
	>5 years	1.778	.056	1.667	1.889
Non Big 4 auditors	1 year	4.641	.062	4.519	4.762
	3 years	3.500	.095	3.313	3.687
	5 years	2.477	.077	2.326	2.628
	>5 years	2.193	.061	2.073	2.312

For hypothesis 5, the (Client * TYPESAMP) interaction has an F value of 0.08 at $p > 0.05$ (Table 2). Thus H5 is rejected. There is no significant difference between the respondent groups concerning the influence of client size on the independence of auditors. This is perhaps not surprising and indeed a somewhat reassuring dimension of the study, that there is some commonality of thinking between the different samples on this point.

For hypothesis 6, the between-subject ANOVA reveals that there are significant differences in the means among the three groups, F value of 140 at $p < 0.05$ (Table 10). Post Hoc tests also confirm the results (Table 12). The mean scores of the CFOs (2.2) are the lowest among the groups while non Big 4 auditors have the highest (3.2) (Table 11). Hence, H6 is supported. This confirms the impression created earlier (see Table 1) that the lowest score for 'undermining independence' are awarded by CFOs. Big 4 auditors and to a greater extent non-Big 4 auditors do not report as much concern about the undermining of independence.

Table 10. Tests of Between-Subjects Effects

Source	Type III Sum of Squares	df	Mean Square	F	Sig.
Intercept	3950.715	1	3950.715	12926.344	.000
Typesamp	85.904	2	42.952	140.535	.000
Error	159.235	521	.306		

Significant at the .05 level

Table 11. Mean values of Auditor Independence by subject

Types of samples	Mean	Std. Error	95% Confidence Interval	
			Lower Bound	Upper Bound
CFOs	2.225	.040	2.147	2.303
Big 4 auditors	2.848	.041	2.767	2.929
Non Big 4 auditors	3.203	.045	3.115	3.290

Table 12. Post Hoc tests

	(I) Types of samples	(J) Types of samples	Mean Difference (I-J)	Std. Error	Sig.
Bonferroni	CFOs	Big 4 auditors	-.6236(*)	.05745	.000
		Non Big 4 auditors	-.9779(*)	.05984	.000
	Big 4 auditors	CFOs	.6236(*)	.05745	.000
		Non Big 4 auditors	-.3543(*)	.06095	.000
	Non Big 4 auditors	CFOs	.9779(*)	.05984	.000
		Big 4 auditors	.3543(*)	.06095	.000
Hochberg	CFOs	Big 4 auditors	-.6236(*)	.05745	.000
		Non Big 4 auditors	-.9779(*)	.05984	.000
	Big 4 auditors	CFOs	.6236(*)	.05745	.000
		Non Big 4 auditors	-.3543(*)	.06095	.000
	Non Big 4 auditors	CFOs	.9779(*)	.05984	.000
		Big 4 auditors	.3543(*)	.06095	.000
Games-Howell	CFOs	Big 4 auditors	-.6236(*)	.05681	.000
		Non Big 4 auditors	-.9779(*)	.05847	.000
	Big 4 auditors	CFOs	.6236(*)	.05681	.000
		Non Big 4 auditors	-.3543(*)	.06455	.000
	Non Big 4 auditors	CFOs	.9779(*)	.05847	.000
		Big 4 auditors	.3543(*)	.06455	.000

Based on observed means. *The mean difference is significant at the .05 level.

5. Discussion and implications

This empirical study makes several contributions. First, the result in H1 indicates that *guanxi* has a negative influence on the perceived independence of auditors. Independence is severely impaired when the *guanxi* with the client reaches five years or more. In Hong Kong, there is currently no mandatory rule enforcing Auditing Standards or monitoring of the impact of *guanxi* or other perceived familiarity risks to independence. Likewise, Section 203 of the U.S. Sarbanes Oxley Act (2002) only requires the reviewing partner of the public accounting firm to be rotated off of the audit every five years. However, the impacts of *guanxi* on the perceived independence of other auditors in the audit firm are ignored in the Sarbanes Oxley Act (2002). Several bills with provisions dealing with audit firm rotation were heavily debated in the U.S., however nothing was enacted into law because the U.S. Congress decided further study was needed (Daniels and Booker, 2009). Though this empirical finding originated from Hong Kong, Umar and Anandarajan (2004) point out that many corporations (MNC) have operations globally. The unique Confucian culture ingrained in the Chinese society could have a significant influence on the perceived independence of auditors, and the fairness of the consolidated audited financial statements that emerge from regional operations. Standard setters could seriously consider drafting ethical guidelines requiring the mandatory rotation of public accounting firms when the duration of *guanxi* with clients reaches a certain number of years relationship. Though that may incur increased transaction costs (Williamson, 1981), the benefits could nevertheless outweigh the costs in the long run.

Second, the result in H2 reveals that large client size has a negative influence on the perceived independence of auditors. This result contradicts an early study conducted by Pany and Reckers (1980) in the U.S. Since this study is conducted in a society of Chinese Confucian culture, further research is recommended to validate this finding. H3 indicates that the longer the *guanxi* between the auditor and the large audit client, the greater the undermining of their perceived independence. The result in H3 reinforces the finding in H1, and confirms that *guanxi* is a significant factor influencing auditor independence particularly in Chinese society. Hence it is surprising that the effect of *guanxi* on auditor independence has largely been neglected in the accounting literature thus far.

Third, the result in H4 is interesting and contributing to the existing body of literature related to stewardship. It is promising to note that CFOs have the lowest mean scores for all levels of *guanxi* among the three groups. That is, they believe that *guanxi* more seriously undermines auditor independence. Results support the stewardship theory that asserts stewards' (CFOs) motives are aligned with the objectives of their principals (Davis *et al.*, 1997a). CFOs perceive that the utility gained from contractually aligned behavior is higher than the utility that can be gained through individualistic self serving behaviors, which are undertaken at the expense of the principal's goals (Davis *et al.*, 1997a).

The stewards (CFOs) place greater value on collective rather than individual goals, and consider the increasing levels of *guanxi* associated with the auditors are not in the best interests of their principals, and hence affect the reliability and fairness of the audited accounts. Further, H6 also indicates that there are significant differences for the impact of *guanxi* on the perceived independence of auditors among the three groups. The mean scores of the CFOs (2.2) are the lowest among the groups while non Big 4 auditors have the highest (3.2) (Table 11). Apparently CFOs give due regard to the resources entrusted to the corporation and this may result in lower perceptions of auditor independence than the auditors group. Nevertheless, there may be some other variables that contribute to the variation of perceived auditor independence between the groups and further research is recommended to explore this result. Such research may be based on interview, or case study and perhaps be of a longitudinal nature in the future.

Finally, whilst the sample groups held significantly different views on the effects of *guanxi* on auditor independence, they do not hold significantly different views on the impact of client size on auditor independence. Hence hypothesis 5 was not supported.

Conclusion

This empirical study draws data from Hong Kong to examine the impact of *guanxi* on auditor independence. It makes several contributions to further our understanding and the results are consistent with stewardship theory. Given the lack of prior empirical research using stewardship theory to examine the impact of *guanxi* on perceived independence, this research contributes to the existing literature. Though this study is conducted in the Asia Pacific region, western counterparts in the U.S or U.K. should also find the results beneficial. For example, MNCs nowadays have subsidiaries or headquarters established globally, the impacts of *guanxi* have possible implications for their Far East operations, the fairness of their regional financial statements and ultimately affecting the consolidated audited accounts. With the increasing globalization of doing business, this study contributes some practical implications for multinational corporations that have business in Chinese societies.

In view of the critical importance of the *guanxi* factor on the perceived auditor independence, standard setters should consider devising ethical guidelines requiring mandatory rotation of public accounting firms. Though that may involve transaction costs (Williamson, 1981), the benefits would nevertheless outweigh the costs in the long run. *Guanxi* is grounded in the Chinese community and the interpersonal relationships between friends and family members are not necessarily in terms of money. In Hong Kong, life and getting work done is all about connections. The impact of *guanxi* will determine the success of the business or what lengths a person must go to help the others. Hence, the non Chinese auditors working with Chinese managers should become accustomed to the practice of *guanxi*, if not this may result in misunderstanding, distrust, anger and even the end of a business relationship. No matter how much experience the non-Chinese management possess, the right *guanxi* can remove barriers when they encounter difficulties. Western auditors and CFOs have to consider the impact of *guanxi* on auditor independence, as we take this subject forward.

This research was exploratory in dealing with the impact of *guanxi* in a Chinese environment which are familiar with a Western notion of auditor independence. It sought the opinions of major players (subjects) in the audit process. *Guanxi* will be familiar to all respondents and in this research a single item variable was used to identify *guanxi* to the respondents and this has been used successfully in previous research (Lee and Humphreys 2007). However future research could attempt to deconstruct the *guanxi* characteristic into distinct elements. Additionally, case studies could be adopted to explain further the impact of *guanxi* using interviews and research of a longitudinal nature could occur to discover more about how it is founded, how it grows and its consequent impact.

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A MINI REVIEW OF THE CHINESE STOCK MARKET: FROM 1978 TO 2010

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Abstract

The Chinese economic reform, starting from 1978, facilitated the emergence and development of the capital markets. This paper provides a brief review of the Chinese stock market from various perspectives, such as the regulation, issuance of shares, shareholding structure and financial reporting of listed firms, and future development. It is expected that our paper could offer readers and researchers who are interested in the Chinese capital market, particularly in the area of accounting and finance, a general understanding of the market.

Keywords: Stock Market, Regulation, Issuance, Ownership Structure, Financial Reporting, China

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Introduction

Since the implementation of the "reform" and "openness" policy in 1978, China had achieved rapid economic growth over the past several decades. The Chinese stock market was established and developed during the period. There has been considerable empirical research concerned with the listed companies in the capital market (e.g. Ding and Graham, 2007; Liu and Liu, 2007; Liu and Shrestha, 2008; Huyghebaert and Quan, 2009; Cai et al., 2011). However, limited research provides an overall landscape as to the market. To fill the gap, we briefly reviewed the development and the characteristics of the market from various perspectives. The purpose of this paper is to inform the future empirical research relating to the Chinese stock market in the field of accounting and finance. It is expected that this paper could make readers and researchers, who are interested in the Chinese capital market, obtain a general understanding with regard to the market.

The paper is structured as follows. Section 2 describes the reasons and the process regarding the emergence of the Chinese stock market. In addition, two stock exchanges (Shanghai and Shenzhen) are introduced in this section. Section 3 presents how the Chinese government regulates the market through administrative and legal instruments. Section 4 demonstrates the evolution of the stock issuance system. The shareholding structure and the reporting framework of listed companies are detailed in section 5. Finally, section 6 draws some conclusions.

Emergence of the stock market

The economic reform paved the way for the emergence of the Chinese stock market (CSRC, 2008; Zhang et al., 2008). During the early 1980s, the Chinese government began to reform the state financial sector in order to fit in with the new economic situation. Some commercial banks[6] were established to replace the state planning budgetary system[7] as the main channels for Chinese enterprises to raise capital. It is apparent that borrowing from those commercial banks would generate high transaction costs for enterprises. Chinese enterprises, particularly those state-owned enterprises (SOEs), realized that they needed to diversity their funding channels rather than solely borrowing from the commercial banks or relying on the governmental grants or interest-free loans (CSRC, 2008; Seddighi and Nian, 2004). Meanwhile, the income of domestic residents grew rapidly commensurate with the country's rapid economic growth. However, they had to deposit their money in banks for minor interest rates owing to the shortage of investment channels (Liu and Shrestha, 2008; Yi and Davey, 2010). Some of them had attempted to seek new investment opportunities for higher rate of returns. Furthermore, the Chinese government attempted to attract capital

[6] Including Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and Agricultural Bank of China.

[7] In that funds and capital were centrally administered and allocated to enterprises.

infusion in the state-owned enterprises so as to restructure the firms as well as improve the performance of them (Seddighi and Nian, 2004; Zhang and Zhao, 2004). In these circumstances, the Chinese stock market started to develop.

In the beginning, some informal stock markets, mainly initiated by small state-owned and collectively-owned enterprises in urban areas, were founded around the country. In January 1985, the first public offering of standardised corporate equity was launched by Shanghai Yanzhong Industrial. Subsequently, two over-the-counter markets appeared in Shanghai and Shenyang in 1986. Until November 1990, the first stock exchange was established in Shanghai with the approval of the Chinese government. Several days later, the second stock exchange, namely the Shenzhen stock exchange, started to operate in December 1990. Since then, a formal stock market has been formed in (mainland) China. In recent years, the Chinese stock market has grown rapidly to be the largest emerging market in the world (Ding and Graham, 2007; Zhang et al., 2008).

Chinese stock exchanges

At present, there are actually three stock exchanges in China. Two of them – the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) – are in the Chinese mainland. Another one is Hong Kong Stock Exchanges and Clearing Limited (the full name of the Hong Kong Stock Exchange) located in Hong Kong. According to An et al. (2011, p. 109):

> *"Chinese (domestic) stock exchanges refer to the Shanghai and the Shenzhen stock exchange other than the Hong Kong stock exchange because Hong Kong is independent in economy although it has been a special administrative region of China since 1997. As a matter of fact, the Hong Kong stock market is defined as a developed market, whereas the Chinese stock market is regarded as an emerging market."*

In recent years, the two stock exchanges developed rapidly from both size and quality. The SHSE mainly focuses on large corporations. Until December 2010, there were a total of 894 companies listed on the SHSE with a total market capitalization of 17.9 trillion yuan[8]. The SZSE is concerned with not only large firms but also small and medium sized firms (SMEs). It set up a small and medium enterprise board in 2004 and a growth enterprise board in 2009 that allowed the SMEs with huge potential to raise funds in the capital market. The launch of the two boards facilitates the construction of a multi-tiered capital market in China. At the end of 2010, a total of 1169 firms, including 485 firms on the main board, 531 firms on the small and medium enterprise board, and 153 firms on the growth enterprise board, were listed on the SZSE, with a total capitalization of 8.64 trillion yuan.

Regulation

Regulation is defined by Mitnick (1980, p.5) as "the intentional restriction of a subject's choice of activity, by an entity not directly party to or involved in the activity". It is usually conducted by governmental agencies using legal weapons (e.g. laws, rules and regulations). The purpose of regulation is to protect both the public and the private interests. For the regulation of the Chinese stock market, it is carried out by a government-driven regulatory and supervisory framework and a legal framework, both of which are described as follows.

Regulatory and supervisory framework

As a formal stock market with two stock exchanges was launched in the early 1990s, the Chinese government attempted to establish a centralized regulatory and supervisory framework for the oversight of the market. The first initiative was setting up the Securities Supervision Office in the People's Bank of China (PBC, namely the central bank of China) in May 1992. Subsequently, the Securities Committee (SC) and the China Securities Regulatory Committee (CSRC) were established by the State Council in October 1992 so as to better oversee the market as well as work in accordance with international practices (CSRC, 2008).

In April 1998, the Chinese government consolidated the supervisory functions of PBC and SC into the CSRC, and made the CSRC become the solo regulator for the capital markets. Before long, the CSRC developed a regional supervision system by absorbing the provincial securities regulatory offices. With a total of 36 regional offices across the country (including 11 directly subordinated to the CSRC and 25 with independent planning status), a centralized regulatory and supervisory framework was constructed.

In 2004, the CSRC reformed the framework in that the regional supervision offices were reorganized into (36) provincial supervisory bureaus (refer to table 1), and supervisory responsibilities were decentralized to the local agencies. Meanwhile, CSRC also strengthened its coordination with local governments for the supervision of capital markets. It was acknowledged by CSRC (2008) that the introduction of the new system improved the regulatory and supervisory efficiency, and in turn facilitated the healthy and orderly development of the market.

[8] The unit of Chinese currency (RMB), one US dollar is approximately equal to six yuan.

Table 1. Provincial supervisory bureaus

Provincial supervisory bureaus (36)			
Beijing	Guangxi	Hainan	Chongqing
Guizhou	Gansu	Qinghai	Ningxia
Shenzhen	Xiamen	Tibet Autonomous Region	Fujian
Sichuan	Shanxi	Xinjiang	Yunnan
Tianjin	Hebei	Shanxi	Inner Mongolia Autonomous Region
Liaoning	Jilin	Heilongjiang	Dalian
Shanghai	Jiangsu	Zhejiang	Ningbo
Anhui	Shandong	Henan	Qingdao
Hubei	Hunan	Jiangxi	Guangdong

Moreover, the CSRC strengthened cooperation on market supervision with other international organizations (e.g. IOSCO, namely International Organizations of Securities Commissions) and its overseas counterparts. At present, it has been an ordinary member for all the committees (the President Committee, the Executive Committee, the Technical Committee, and the Emerging Markets Committee) in IOSCO. And since June 2006, Mr. Shang Fulin, Chairman of the CSRC has been the vice-chairman of IOSCO's Executive Committee. In addition, the CSRC had signed 43 bilateral Memorandums of Understanding (MOUs) with capital markets regulatory authorities in 39 countries and regions by the end of 2009. The cooperation contributes to the sharing of supervisory information, provides assistance on cross border investigations, and facilitates staff exchanges and cooperation on research (CSRC, 2008).

Legal framework

There are usually two elements for the construction of a legal system: first of all, the enactment of laws, regulations and rules; secondly, the enforcement of the laws, regulations and rules. In the following, the two elements for the construction of a legal framework for the Chinese capital market are described.

Laws, regulations and rules

Since the inception of the capital market, a number of laws, regulations and rules were issued by the Chinese government as instruments to regulate the market, including (under a chronologic order):

Laws

- *The company law* (implemented since July 1994): setting out specific provisions for the conditions of establishing a company, the organization of a company, share issuance and transfer, corporate bonds, liquidation procedures and legal liabilities; also setting standards of corporate governance for limited liability companies and joint stock companies, laying the legal foundation for the development of joint stock companies and in turn, the capital market.
- The purpose of the law: to protect the legitimate rights and interests of firms, shareholders and creditors; accelerate the restructuring of SOEs; and facilitate the economic growth.
- *The security law* (effective since July 1999): the first national law to regulate the issuance and trading of securities in (mainland) China; confirming the importance of the capital market and formalizing the legal status of the market.
- The purpose of the law: to protect the rights and interests of investors; maintain the healthy development of China's capital markets; safeguard the economy and public interests; and accelerate the development of the socialist market economy.
- Both laws were amended by the Standing Committee of the National People's Congress of the People's Republic of China in 2005 for the new development of the markets. [9]

Regulations and rules

- The *Provision Regulation on the Issuing and Trading of Shares* (effective in April 1993): to regulate share issuance and trading as well as the acquisition of listed firms.
- The *Implementation Rules on Information Disclosure of Companies Issuing Public Shares* (promulgated in June 1993): setting up standards for mandatory information disclosure of listed firms.
- The *Provisional Measures on Prohibiting Fraudulent Conducts Relating to Securities* and the *Circular on Prohibiting Securities Market Manipulation* (issued in August 1993 and October 1996, respectively): establishing the criteria for defining illegal trading activities and relevant supervisory sanctions.

The aforementioned laws, regulations and rules formed a fundamental legal framework for the

[9] However, the fundamental principles for both laws were not changed.

Chinese capital market, which significantly facilitated the take-off of the market, and laid a foundation for further improvement of relevant regulations and rules.

Enforcement

For the enforcement of laws, regulations and rules relating to the capital market, it was initially conducted by enforcement offices in the regional supervisory bureaus. In 2002, the CSRC set up a special securities crime bureau working together with the Securities Crime Investigation Bureau of the Ministry of Public Security (also established in 2002) to investigate crimes in the capital market (e.g. market manipulation and insider trading).

Until 2007, the CSRC established the Sanction Committee, Chief Enforcement Office and the Law Enforcement Task Force in Beijing, and reinforced its enforcement offices with a larger workforce in the regional bureaus. A centralized enforcement system was then established. In the system, the function of inspection and sanctions within the CSRC are separated, which avoids conflicts of interests as well as ensures professionalism, efficiency and justice in the law enforcement. The establishment of the law enforcement framework is very helpful to protect the interests of investors and ensure market integrity.

Issuance of shares

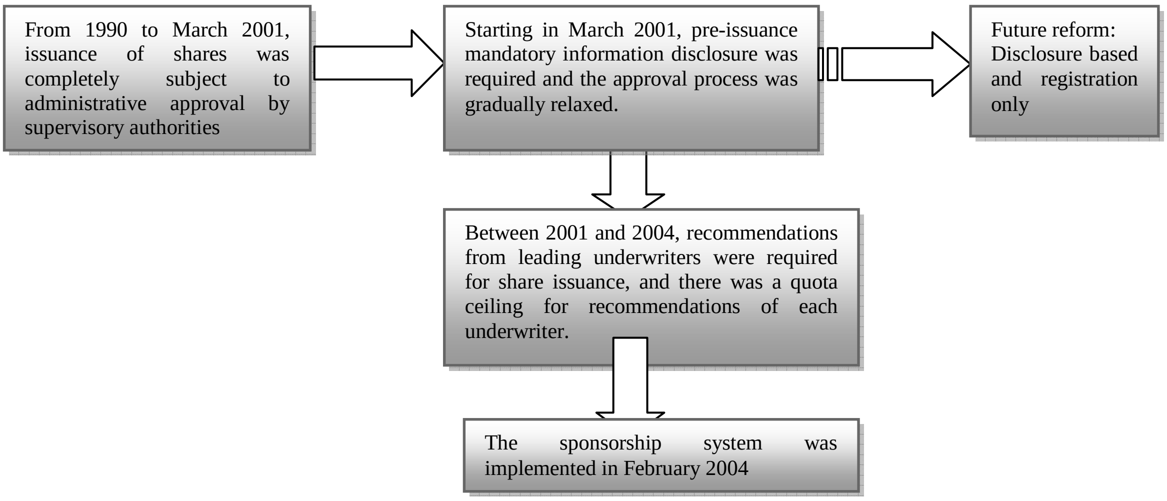
After the establishment of stock exchanges in the 1990s, stocks could be issued through public offerings to all investors around the country. However, the public offering of shares was subject to administrative approval from some governmental authorities. In the beginning, the CSRC along with the SPC (State Planning Commission) and the PBC (People' Bank of China) jointly undertook the administrative function. They imposed a quota for the new share issuance on an annual basis in order to curb the potential excessive (investment) demand in a pre-mature market where market participants had not obtained a profound understanding with regard to the market rules, their rights and obligations (CSRC, 2008; Huyghebaert and Quan, 2009).

The quota was then assigned to 29 industry supervising bodies and 32 provincial governments (including provinces, municipalities and autonomous regions) according to the distribution of the industry and production, and the regional economic development (Tian and Megginson, 2005). The industry supervising bodies and local governments would recommend enterprises for public offerings within the given quota on the basis of the firm-level performance, the attainment of the industry, and the local economic development objectives (Huyghebaert and Quan, 2009). The CSRC would make final decisions for the approval of public offerings through an internal committee (namely the Public Offering Review Committee). Once approved, initial public offerings (IPOs) of shares of enterprises were usually underwritten by leading firms in the security industry. The pricing of IPOs was determined by the profit after tax and a fixed price earning ratio set by the government.[10]

In March 2001, The CSRC introduced a new ex-ante review and approval system for public offerings of shares in that the pre-IPO mandatory information disclosure was required, and the approval process was relaxed gradually. In the meantime, leading underwriters, replacing the industry supervisory bodies and provincial governments, became referees for enterprises for the issuance of shares. However, they were limited in the number of recommendations. More recently, the CSRC reformed the issuance system again. A sponsorship system was introduced to replace the leading underwriter recommendation system. Under the system, sponsors (or representatives of the sponsoring institutions) should be qualified practitioners who come from securities firms or asset management corporations, with a license for underwriting IPOs. Moreover, one sponsor is required to work on one case (or enterprise) only at a time. Simultaneously, the pricing of IPOs was reformed in that a book-building process, principally supervised by the market, replaced the governmental approval for the share (issuance) price. Figure 1 demonstrates the evolution of the issuance system in the Chinese stock market.

[10] Issue price of a new share = profit after tax per share × price earning-ratio of the issue.

Figure 1. the evolution of the issuance system



Source: adapted from CSRC (2008, p. 219)

The recent reforms have accelerated the transformation of share issuance from being government-driven to being market-driven. However, compared with the developed markets in that public offerings are usually disclosure-based, and the registration is required by the supervisory authorities only, and the procedures for share issuance tend to be simple and standardized (with the share price determined by the market directly), there still leave spaces for China to further improve the share issuance system.

Listed companies

After initial public offerings, companies would be listed on the stock exchanges for public trading by investors. There are some unique features for Chinese listed companies. The most representative are the shareholding structure and the corresponding financial reporting framework. Both features are presented as follow.

Shareholding structure

The shareholding structure of Chinese listed firms is split. It is characterized by two general classifications of shares. The first classification includes circulation (or tradable) shares and non-circulation (or non-tradable) shares. Only circulation shares can be traded at stock exchanges under the regulation of the CSRC. [11] The second classification consists of domestic shares and foreign shares (refer to figure 2).

The domestic shares (namely A-shares) can be further classified into three classes, comprising state-owned shares, institutional (or legal person) shares and public shares, each of which accounts for one-third of the total approximately. The state-owned and the institutional shares are non-circulation shares that cannot be traded on the stock exchanges. But the institutional shares can be traded amongst institutions through Securities Trading Quotation System (an over-the-counter market). The public shares, so-called circulation A-shares, can be traded at both the Shanghai and Shenzhen stock exchanges. A-shares, denominated by RMB (Renminbi, namely the Chinese currency), are subscribed and traded in RMB, and only available to domestic investors until December 2002 when the Chinese government launched the Qualified Foreign Institutional investor (QFII) programme that allows licensed foreign institutional investors to trade A-shares in the secondary market.

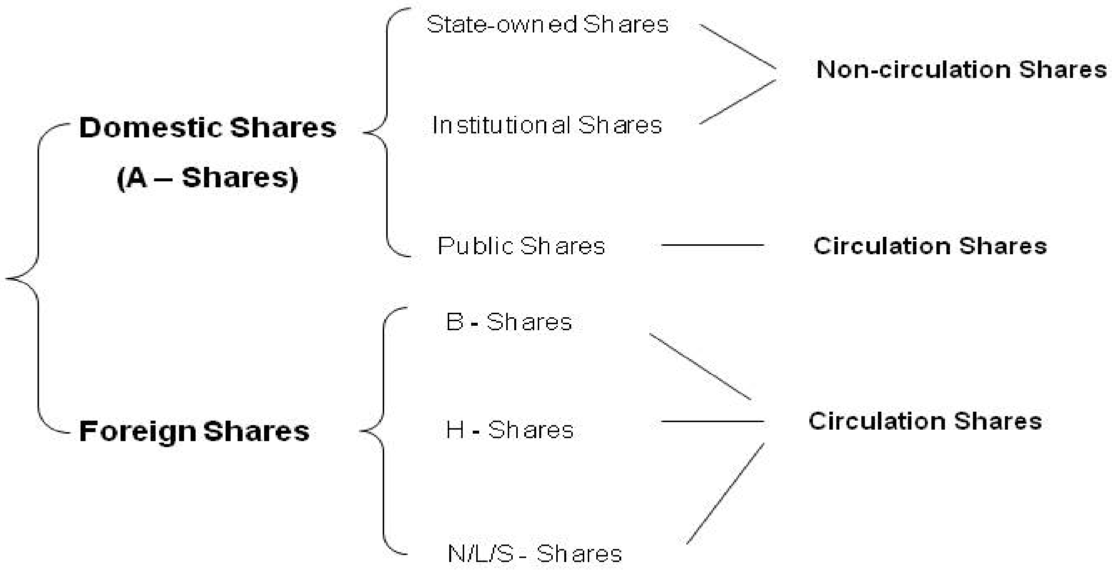
Foreign shares are composed of B-shares, H-shares, N-shares, L-shares and S-shares, all of which are circulation shares and primarily available for foreign investors.[12] B-shares are ordinary shares denominated in RMB but subscribed for and traded in either US dollars on the Shanghai stock exchange or Hong Kong dollars on the Shenzhen stock exchange. In February 2001, the Chinese government through the CSRC released the B-shares market in which individual domestic investors with legal foreign currency accounts were allowed to own and trade B-shares (Liu and Liu, 2007). According to Lu et al. (2007) and Hung (2009), the opening of the B-share market to domestic investors and the limited opening

[11] In 2005, the CSRC launched the non-tradable share reform in which non-circulation shares would be converted into circulation shares gradually. However, after the reform, only a limited number of converted shares are available to investors (Cheng et al., 2009).

[12] Since May 2006, the Chinese government, through the Qualified Domestic Institutional investors (QDII) programme, has allowed licensed domestic institutional investors to invest in foreign shares.

of the A-share market to foreign investors greatly enhance market efficiency.

Figure 2. Classifications of Chinese shares



Source: Yi and Davey (2010, p. 328)

H-shares represent shares issued by Chinese mainland companies but listed and traded on the Hong Kong stock exchange. Since the Chinese government authorized Chinese firms to be listed on the Hong Kong stock exchange in July, 1993, there have been 165 mainland firms issuing H-shares at present.[13] The other three types of foreign listings, comprising N-shares, L-shares and S-shares, represent shares issued by Chinese mainland firms, but listed and traded on the New York, London and Singapore stock exchange, respectively. There are very limited Chinese firms issuing N/L/S shares currently. The majority of (Chinese) overseas listed firms issue H-shares, which highlights the significance of H-shares for Chinese firms in attracting foreign investment (Cai et al., 2011).

Varied classes of shares are entitled by law to the equal rights (e.g. voting, dividend and cash flow claims) and bear the same obligations (Balsara et al., 2007; Bao and Chow, 1999; Cheng et al., 2009). Nevertheless, the pricing of them may be distinct. In accordance with Chen et al., (2001) and Tian (2007), there is a significant premium of A-share prices over B-share prices for the same company although it has been reduced after the release of the B-share market. Seddighi and Nian (2004) also state that A-shares issued by a listed company on the Shanghai stock exchange are usually traded at three times the price-earning ratio of the corresponding B-shares, and four times the ratio on the Shenzhen stock exchange.

Chinese enterprises are not permitted to be listed on both the Shanghai and Shenzhen stock exchanges at the same time. However, they can be dual-listed on either of domestic exchanges and foreign stock exchanges.[14] That is, a Chinese listed firm can issue both A- and H/N/L/S-shares (e.g. A+H/A+N/A+L/A+S). In reality, the majority of the dual-listed firms issue A-shares and H-shares (A+H) because of very limited Chinese firms listed on other foreign stock exchanges. By the end of 2010, there were 69 dual-list A and H share firms in China. Most of them are large corporations according to market capitalization as well as top performers in their sectors, and even in the national economy (Yi and Davey, 2010).

The segmented shareholding structure of listed companies is a unique feature of the Chinese stock market. According to CSRC (2008) and Li (2007), the segregation, on the one hand, strengthens control of the Chinese government over the market; on the other hand, it undermines market efficiency due to the restrictions to different investors. Therefore, the Chinese government needs to further reform the shareholding structure of listed firms so as to reduce market restrictions, and consequently enhance the market efficiency.

Financial reporting framework

Since 1993, the CSRC had issued many regulations regarding financial reporting issues of listed firms, such as the content and the format of prospectus, interim reports and annual reports. According to the

[13] By the end of 2010.

[14] In addition, Chinese companies can issue both A- and B-shares simultaneously on the same domestic exchange (Shanghai or Shenzhen), also called dual-listing. But in this research, dual-listed companies only refer to those listed on two stock exchanges (usually a domestic stock exchange and a foreign stock exchange).

regulations, annual reports of listed firms should be prepared within 120 days after the end of a financial year (31, December of each calendar year). Moreover, the annual report should be prepared in accordance with relevant accounting standards in terms of the shareholding structure.

As for firms issuing A-shares, annul reports should be prepared under the Chinese generally accepted accounting principles (GAAP) and mostly audited by local accounting firms.[15] Furthermore, they should be released in the designated journals by the CSRC. If a firm issues B-shares as well, the annual report should be also prepared according to the International Accounting Standards (IAS) and audited primarily by the big 4 international accounting firms[16] for the purpose of international comparison and credibility recognition (Liu and Liu, 2007). The firm should publish the English version of its annual report under the IAS for oversea investors. It is required by the CSRC that firms issuing both A- and B-shares should reconcile accounting information under the two accounting standards (Chinese GAAP and IAS). But the reconciliation information is only released to A-share investors rather than B-share investors. Annual reports of firms issuing H-shares or other foreign shares should be prepared in accordance with the IAS[17] and audited by the big 4 accounting firms. The firms usually release their annual reports through journals or newspapers in the region where they are listed.

There are some significant differences with respect to financial reporting between the Chinese GAAP and the IAS although the Chinese authorities have attempted to converge the differences as much as possible in recent years (Grant Thornton Hong Kong, 2004; Liu and Liu, 2007; Qu et al., 2012). For instance, there is a more restrictive policy for measuring inventory, investment, estimating bad debt expense, depreciation expense, and the recognition of related parties, under the Chinese GAAP (Bao and Chow, 1999; Liu and Liu, 2007). According to Bao and Chow (1999), three factors are primarily accountable for the differences: different accounting regulations; policy intervention by the Chinese government; and differences in professional judgments between domestic and international auditors, which reflect distinct institutional arrangements between the two standards.

Conclusion

In less than two decades, the Chinese stock market has undergone fundamental changes that have taken some developed markets many decades to achieve (CSRC, 2008). Now it has been the largest in Asia after Japan, as well as the largest emerging capital market in the world. By the end of 2010, there were totally 2063 companies listed on the Shanghai and Shenzhen stock exchange, including 1955 A-share companies, 108 B-share companies, 86 companies issuing both A-share and B-share, and 69 companies issuing both A-share and H-share. The total shares issued by listed companies were 3.32 trillion, and the total raised capital was RMB 54.56 trillion in 2010. Among the total shares, there were a total of 2.56 trillion tradable shares.

Meanwhile, the total market capitalization of Chinese listed firms was RMB 26.54 trillion that is equivalent to 67% of GDP[18]. However, the capitalization of tradable shares was RMB 19.31 trillion, around 49% of GDP. Despite the tremendous growth in recent years, the Chinese stock market still lacks the depth and maturity, as compared with the major developed markets in the world (Balsara et al., 2007). For example, the market capitalization of US listed firms over GDP was around 300-400 percent. Moreover, weak rule of law, inadequate institutions, lack of training for fund managers, weak corporate governance and internal control of listed companies, and inappropriate governmental interventions are also limiting future development of the market (CSRC, 2008; Zhang et al., 2008).

To address the barriers, the CSRC (2008, pp. 286-293) following *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets*[19] promulgated the following development strategies:

- Maintain a fine balance between the government and the markets, strengthen legal and regulatory framework, and build fair, transparent and efficient markets
- Create a fully multi-layered stock market to meet diverse needs
- Improve the quality of listed firms
- Encourage competition to foster a more globally competitive financial service industry in China
- Open up gradually and build up globally competitive capital markets
- Improve capital markets' culture and foster an environment suited to the sustainable development of capital markets.

These strategies appear to be practical and feasible, and it is expected to solve the legacy (structural)

[15] Since 2007, there has been great convergence of Chinese GAAP with the *International Financial Reporting Standards* (IFRS), through the issuance of *Accounting Standards for Business Enterprises* (ABSE 2007) by Ministry of Finance (Qu et al., 2012). However, there are still some differences between the two standards due to distinct institutional arrangements.

[16] Including Deloitte & Touch, Ernst & Yong, KPMG and PriceWaterhouseCoopers.

[17] The Hong Kong GAAP has fully harmonized with the IAS since 2005.

[18] The total GDP of China was RMB 39.798 trillion in 2010.

[19] Released by the State Council in January 2004 as high-level guidelines for further reform and development of the capital markets.

problems and facilitate further development of the market.

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THE IMPORTANCE OF CUSTOMER NEEDS AND EXPECTATIONS IN ACHIEVING TOTAL QUALITY MANAGEMENT: A STRATEGIC VIEW FOR FUTURE TRENDS

Patsy Govender*

Abstract

The study aims to assess the impact of customers (internal and external) on total quality management in a service organization. The measuring instrument, that is, questionnaires were distributed to three levels of managerial employees. Overall, whilst there is evidence of utmost focus on customer needs and expectations in this organization, there is also greater focus on external customers than internal customers. Yet, an added insight to the study is that internal customer needs and expectations are influenced by managers' current position. Hence the higher the managerial level, the stronger the perceptions that internal customer needs and expectations are met in this organization. In conclusion, the article reflects on scholarly views, recommends strategies and provides profound insight when probing into a similar field of study.

Keywords: Improvement Initiatives, Quality Focus, Customer Relations, Customer Requirements, Customer Expectations

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Introduction

A period of brutal recession, unemployment, the turbulence of change, customer demands, and competition compels a trend of customer-focused organizations. With a desperate surge in improvement initiatives, an organizational imperative is to continuously improve the quality, services and processes as customers evaluate both products and services. By balancing the focus on both internal and external customers, the resultant effect is organizational effectiveness.

The strategic intent of TQM provides a practical context for managing people (Schultz et al., 2003:12), to manoevre organizations to be effective and efficient (Schultz, Bagraim, Potgieter, Viedge & Werner, 2003) and emphasizes collaborations for process improvement and ultimate customer needs and satisfaction. By judgement, customers will favour products and services that reach high standards (Anyamele, 2005), as the broader definitions of quality is to meet requirements, including customer defined quality. This article unfolds a synergy of ideas so that contingency approaches can be taken when piloting processes. If one can improve a process, then the benefits of that process can be reaped each time a person performs that process (Canada, 2010). With a focus on "customers, continuous improvement, and teamwork" an opportunity for TQ success emerges as outlined in the "Baldrige National Quality Program Criteria for Performance Excellence" (Evans, 2005:415).

Literature Review

TQM is a set of guiding principles to meet and exceed the expectations of external and internal customers (Bradley, 1993; Pike & Barnes, 1994 cited in Steyn, 2000). TQM is a "360 degree continuous improvement program of metrics, information, training, analysis, discretionary investments, process improvements, change and controls, that involve the entire organization" (Internet 1:2). Customer perceptions on the quality of products and services is a core element for both customer and organizational benefits. TQM, an integrated approach meets quality at all organizational levels, including quality expectations as defined by the customer. This includes how well products and services meet deadlines and targets (conformance to specifications). In contrast to product development, the product of a service is intangible. Often, the quality of services are associated with perceptions and responding to customer needs.

TQM necessitates that employees see themselves as customers of, and suppliers to other employees to enable them to understand their contribution within the organization, to the final end product and ultimately, to external customer satisfaction. Internal customers (employees) receive goods or services from others in the organization. Internal customers make contribution to the organization's vision and mission and is dependent on the department's products or services in order to service consumers and external customers (Evans & Lindsay, 2005 cited in Brijball Parumasur & Govender, 2008). Accommodating their needs ensures external customer satisfaction (Bardakci & Ertugrul, 2004 cited in Okay & Akcay, 2010). Evans & Lindsay (1996) opine that any business consists of four goals: to achieve customer satisfaction, to obtain higher customer satisfaction than competitors, to retain customers and to gain market shares.

Employees are internal customers who receive inputs, goods or services from suppliers within the company. They contribute to the company's vision and mission and depend on the department's function to produce products or services to ultimately service consumers and external customers (Evans & Lindsay, 2005). From this viewpoint, an employer's task is to fulfil the needs of both internal and external customers, and failing to understand and meet the needs of the former can result in a product or service of inferior quality. This may have a detrimental effect on the external customer. Johnson (1993) found that a correlation exists between internal and external customers needs and that employees (internal customers) that are not treated correctly cannot be expected to treat external customers differently. With employee participation in the company's decision-making processes a positive attitude will surface. With job satisfaction, employees will perform better and treat customers better (Okay & Akcay, 2010).

When a customer complaints, the indication is that a requirement was certainly not met. Due to circumstances and events, customer needs may change. More companies do not give importance to internal customers (Okay & Akcay, 2010). If the aim is to keep external customers happy to increase their profits, then companies need to apprehend the internal customer concept better and make them happy (Simsek, 2004 cite in Okay & Akcay, 2010). Furthermore, competitors are soaring with improvement initiatives.

According to Hill and Wilkinson (1995) the three fundamental TQM principles are

- Customer orientation: The orientation of TQM is customer satisfaction (internal and external customers).
- Process orientation: Every process in the quality chain has a customer, extending from external customer to the many internal customers through the suppliers of the organization.
- Continuous improvement: Effective improvement occurs through the individuals who do the job to implement changes.

About 80 per cent of quality problems are due to poor management (Kelemen, 2003). Juran's methodology is commended for continuous improvement, the centrality of planning in the management of quality and acknowledging external and internal customers in the quality management process (Flood, 1993 cited in Kelemen, 2003). Internal customers who support the organization would be able to bring in new customers (Okay & Akcay, 2010), whereas external customers who are dissatisfied with the company may instigate negative propaganda (Taskin, 2000). Unless service employees are satisfied, customer satisfaction does not occur (Cinemre, 2005). Also, job satisfaction is complex with numerous 'affecting components' (Gui, Barriball & While, 2009), and it entails, for example, pay structures, working conditions and management, amongst others (Friday & Friday, 2003). If employees are not satisfied with these conditions, they will look elsewhere for better working conditions and environment.

Customer complaints indicate that a requirement was not met (Canada, 2010). Satisfying customer needs alone will not achieve success. Organizations must also keep and aim to keep abreast of the competition to exceed customer expectations. Hence, essential to high performing organizations, is the need for customer-driven quality and quality-driven leadership (Evans, 2005). To capture attention in a capitalist economy, customer needs and expectations must be identified and merged into action plans as part of the TQM approach to providing value for money, products and services. Companies may assess how well their products and services are satisfying customer needs. A simple approach is to ask customers directly (verbal response) or via a formal approach using imprint analysis, referring to a "collection of associations and emotions unconsciously linked to a word, concept or experience. The stronger the emotion, the stronger the imprint" (Evans, 2005:164).

Aligned with TQM principles, customer feedback via engaging employee participation who interact with them, and creating a culture of prioritizing customer needs and continuously improving these feedback channels. Secondly, feed back customer information into the design and features of the organization's products and services. The technique of quality function deployment may inform employees of how aspects of their products and services relate to customer satisfaction, thereby enabling them to make informed decisions about how their products may be improved. Evidently, collecting customer feedback on expectations and engaging in market analysis of needs and opportunities is insufficient. Instead, this information needs to be translated into strategies for improvement or even expanding the product line. Employees who interact with customers need to be recruited, selected, trained and empowered in order to fulfill and exceed the expectations of customers (Evans, 2005). With inconsistencies customers are frustrated, hence damaging the image of a firm (Evans, 2005). Juran's "quality planning map" consists of steps: identify who the customers are; determine their needs and translate them into company language; create a product that responds to customer needs; optimize the product features to meet company needs and customer needs; develop a process to produce the product; prove that the process can produce the product, and transfer the process to operations (Kelemen, 2003). Every process in the "trilogy (planning, control, and improvement) is universal (inherent in organizations focusing on quality)"; and of relevance are customer identification, establishing measurements, and diagnosing causes (Suarez, 1992:17).

With long-term customer-focused quality, organizations will be able to anticipate and prevent problems. Total quality is characterized by "doing things right the first time", continuous improvement, customer needs, and a host of "associated practices" (Snell & Dean, 1992:470). It is the mutual co-operation of people, including business processes to produce products and services which meet and exceed customer needs and expectation. The difficulty in defining quality is to translate the user's needs into measurable features. Juran's definition of quality is "fitness for use". An alignment between product features and products free from deficiencies is needed, and meeting customer expectations is Juran's strong viewpoint (Suarez, 1992).

The shift to a customer-driven organization created changes in manufacturing practices, such as, product design and supplier relations (Evans, 2005; Evans & Lindsay, 2005). Customer perceived service quality is considered one of the main determinants of business performance (Sureshchandar, Rajendran & Anantharaman, 2002). Customers are delighted and manufacturers are focused on improved design for attaining quality and business goals (Evans, 2005). Studies show that more than half of the customers will conduct business with the organization if their complaint is resolved; and it takes six times more to obtain a new customer than keeping a current customer (Evans, 2005). The SERVQUAL models and their extensions (Parasuraman et al., 1988 cited in Chatterjee & Chatterjee, 2005) have tried to indicate factors that influence customer expectations, including customer perceptions, including attempts to quantify customer satisfaction by using service performance gaps. Yet, both customer needs and performance standards are difficult to measure (Evans, 2005). The customer indicates formal specifications for a product but for a service customers are not required to provide formal specifications (Chatterjee & Chatterjee, 2005). Acceptance of the product by customers is quantifiable, whereas with services customer satisfaction is difficult to quantify due to the behavioural aspects linked with the service (Chatterjee & Chatterjee, 2005).

Also, a site's design for e-commerce must meet the customers' requirements, and not the company's (Evans, 2005). Dot-coms have promoted customer relationships, extending beyond traditional service organizations. Also, information technology can increase speedy service, but quality can be adversely affected when customer satisfaction is decreased with less personal interaction (Evans, 2005).

Table 1 reflects the core areas of TQM, followed by focus on external and internal customer needs and expectations.

Objective of the Study

- To assess the impact of internal and external customer needs and expectations on TQM in a service organization.

METHODOLOGY

Respondents

The population comprised of all managerial staff in a public sector organization in Kwa-Zulu Natal, South Africa. The population comprised of 400 managers and a sample of 202 was drawn using the stratified random sampling technique to get representation of the different strata of managers, that is, top managers, senior managers and middle managers. The majority of the sample are middle managers (54.4%),

Measuring Instrument

The study utilized questionnaires as the main instrument for the study. Section A focused on biographical information. Section B, consisting of 55 questions focused on the dimensions of TQM.

Research procedure

Ethical Clearance was granted for the larger study.

Administration of the Questionnaire

The questionnaires were administered by a Section Head of the target organization, followed by electronic copies to the three categories of managers.

Analysis

Descriptive statistics (mean, standard deviation) were used to analyze the data. The data from the questionnaires were captured using Excel (Version 5) and processed via Simstat.

RESULTS

Table 1. Descriptive Statistics: Key dimensions of Total Quality Management

Statistic	Customer needs and expectations	Monitoring and controlling quality	Participative management	Teams and teamwork	Continuous top management support, training and learning
Mean	3.2882	3.1729	3.1634	3.0760	3.5571
95% Confidence Interval for Mean Lower Bound	3.2038	3.0887	3.0701	2.9769	3.4806
Upper Bound	3.3726	3.2572	3.2567	3.1752	3.6335
Variance	0.355	0.354	0.434	0.490	0.292
Std. Deviation	0.5961	0.5951	0.6590	0.699	0.5400
Minimum	1.50	1.40	1.09	0.00	1.79
Maximum	4.82	4.45	5.00	4.33	5.00

In this study, when assessing the extent to which the organization is fulfilling the dimensions and sub-dimensions of TQM, it was found that utmost focus on customer needs and expectations was second out of the 5 dimensions determining TQM. This implies that there is evidence of utmost focus on customer needs and expectations in this organization. However, against a maximum attainable score of 5, customer needs and expectations (Mean = 3.2882) reflects that there is room for improvement. Essential to high performing organizations, is the need for customer-driven quality and quality-driven leadership (Evans, 2005). Hence, both internal and external customer needs are important in assuring quality. One of Deming's principles of quality management is that if you cannot recognize your customer, you do not know what you are embarking on and you cannot learn to improve (Deming, 1986 cited in Anyamele, 2005). On the contrary, Foster (2004) asserts that a difficulty in satisfying customer needs is that with dynamism in an environment, the needs of customers are changing continuously.

Further descriptive statistics were conducted for the dimension of customer needs and expectations (external and internal customers) (Table 2).

Table 2. Descriptive Statistics: Utmost focus on customer needs and expectations

Statistic		Customer needs and expectations: Utmost focus on external customer needs and expectations	Customer needs and expectations: Utmost focus on internal customer needs and expectations
Mean		3.3078	3.2400
95% Confidence	Lower Bound	3.2176	3.1473
Interval for Mean	Upper Bound	3.3980	3.3327
Variance		0.419	0.442
Std. Deviation		0.64706	0.66512
Minimum		1.38	1.17
Maximum		4.94	4.67

In terms of customer needs and expectations, the focus was on external customers and internal customers. Table 2 indicates that in this organization there is greater focus on external customers (Mean = 3.3078) than internal customers (Mean = 3.2400).

Frequency analyses were computed to obtain greater insight into managerial perceptions. With regard to utmost focus on external customer needs and expectations, 61.4% of managers agree and a further 9.9% strongly agree that their organization strives to be competitive by exceeding customer expectations. Furthermore, 63.4% agree and 4.5% strongly agree that employees who interact directly with external customers are carefully trained.

However, 3.5% of the managers disagree that the needs and expectations of customers are identified by using a formal approach. In addition, 14.4% of managers disagree and a further 2.0% strongly disagree that employees who interact directly with customers are carefully empowered.

In this study, utmost focus on external customer needs and expectations significantly relate to internal customers at the 1% level of significance. Similarly, the research findings of Johnson (1993) reflects that a relationship exists between internal and external customer needs and that employees (internal customers) that are not treated correctly cannot be expected to treat external customers differently. Furthermore, employee satisfaction is a prerequisite to attaining customer satisfaction (Freiberg & Freiberg, 1997 cited in Vora, 2004). However, Dale (2003) cautions that it is imperative to identify the 'customer chain or hierarchy', as each level will have certain 'needs and bias' and the needs usually reflect some aspect of conflict and 'a decision on a trade-off', if required, will need to be made.

Recommendation

In this organization, managers need to ensure that they use a formal approach to identify customer needs and expectations. Employees (internal customers) need to be empowered as they interact directly with customers.

A strategic point for managers is to use verbal or formal approach to assess how well products and services are satisfying customer needs and expectations. Improvement initiatives such as customer information can be fed back into the design of products and services. A compelling need is to empower employees who interact continuously with customers. In order to move into new domains organizations must take cognizance of internal and external customer needs.

The biographical data in this study reflects that internal customer needs and expectations are influenced by managers' current position. The higher the managerial level, the stronger the perceptions were that internal customer needs and expectations are met in the organization. Hence, of utmost importance is to communicate to lower levels of management and for them to understand that internal customer needs and expectations must be met because failing to understand and meet internal customers' needs can result in an inferior quality of product or service and this can have a detrimental effect on external customers. Managers need to empower employees to take ownership of weaknesses or opportunities and to institute improvements and decisions for long term organizational benefits. By focusing on the basic elements of improvement, quality focus and sustenance of the quality path will emerge despite ferocious competition. A salient point is that customer perceptions do change and with a strategic intent organizations can overcome obstacles in an environment dictated by ferocious competition.

Conclusion

Contemporary organizations are looking to produce more with less. Astute and effective managers need to communicate customer centric strategies, to monitor growth objectives and to engage in a customer-focused managerial philosophy. Customer focus is firmly anchored to TQM and the continuous monitoring of customer satisfaction leads to strategic goals and challenges. Inspiring superior performance in a climate that dictates quality and continuous improvement is imperative for any organization.

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LOOKING INTO THE EXPECTATION GAP - WHAT ARE GOING-CONCERN ASSUMPTIONS REALLY ABOUT?

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Abstract

The question of whether or not a company will be able to continue to do business is at the core of every audit. Despite the importance of this part of the audit, little is known about what triggers an auditor to issue a qualified opinion based on going-concern uncertainties. Previous research has suggested that the auditor might act strategically, using, e.g., ambiguous wording to avoid a qualification and negative consequences for the client and still communicate his concerns. Yet these studies failed to explain in what instances auditors use such strategies. We use a sample of 90 companies that were delisted from the Johannesburg Stock Exchange or received a qualified opinion, and show that the issuance of a qualified opinion is not correlated with the company's financial situation at all. We therefore suggest that the auditor's own risk assessment— whether or not he might risk a lawsuit if a due going-concern assumption is not issued—might explain much more about his decision than do specifics about the client company.

Keywords: Audit, Risk, Stock Exchange, Finance

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Introduction

External auditors provide assurance services to company stockholders and society in general. One of the main pillars of assurance services is the assumption as to whether the company to be audited will continue with its business operations or not. The going-concern assumption is fundamental in the preparation of a company's financial statements as it determines the basis on which the value of the assets and liabilities of a company is stated in the financial statements.. If the going-concern assumption is in jeopardy, this could result in the impairment of the company's assets (in order to reflect forced sale values) and also an upward adjustment of liabilities due to penalties for early settlement and/or breach of loan terms or covenants. An understanding about a company's ability to remain a going concern affects almost all steps of the audit, starting with client acceptance, planning the engagement, the actual audit procedures and in assessing the audit risk.

Despite its major importance for the audit, the Standards on Auditing (ISA) provide little guidance on how to assess a going-concern assumption. In fact, some of the example conditions listed in ISA 570 may only be identified or become apparent when it's "too late" in the eyes of stakeholders such as investors, lenders and auditors themselves. The quest for more insight into the possible future sustainability and development of companies has been strongly enhanced by various players, investors and creditors to name but a few. Particularly after high profile corporate failures, the quest forthe reasonswhy the auditors did not warn the public about the firms' failures is on (Tucker, Matsumura, & Subramanyam, 2003). The confusion of the auditor's role with a corporate failure prediction function is most likely one of the most prominent areas of the expectation gap.

Since Altman's famous z-score model (Altman, 1968)scholars have made interesting and promising advancements towards the prediction of bankruptcy. With the rise of these models the potential benefit that they could yield for auditors have been widely discussed. Indeed, research has demonstrated that statistical bankruptcy prediction models outperform auditors' going-concern judgement decisions when discriminating between bankrupt and non-bankrupt companies (e.g. Levitan & Knoblett, 1985; Kuruppu, Laswad, & Oyelere, 2003; Grant, Wheeler, & Ciccotello, 1998). However, there is a difference between the use of a creditor-based failure prediction model and the going-concern assumption of an auditor. A company with an unqualified audit report could still "go under" and a company with a qualified audit report could still continue operating as a going concern. Despite a long list of literature proving that corporate failure prediction models can help auditors to assess a company's going-concern status, these models are not mentioned by behavioural standards. Also, the latest ISA clarity project failed to provide specific guidelines on how to assess a going-concern assumption. Although there is a list of variables provided that gives the auditor some guidance on when to qualify, what finally triggers a qualification remains a mystery.

Background to the research problem

Research to date is inconclusive as to whether the qualification of the auditor has an information value at all for stakeholders of the company for which the financial statements are presented. Some studies suggest that the issuance of a going-concern opinion hold some explanatory power about company's likelihood to fail (e.g.,; (Hopwood, McKeown, & Mutchler, 1989), 1994; (Kennedy & Shaw, 1991); (Chen & Church, 1992)). Other works, however, focus on the market's reaction to a qualified going-concern opinion as a proxy for its information value (e.g. Dopuch, Holthausen, & Leftwich, 1986; Fleak & Wilson, 1994) and fail to provide a consistent answer as to the information value.

So far, the decision-making process to issue a going-concern assumption has been seen as two-fold. Firstly, the auditor gathers evidence to decide if the company really deserves a going-concern assumption and, secondly, decides whether or not to include a qualification. An interesting approach would be to add a third stage to this decision making, namely, the auditor's own strategic considerations. Once the auditor tells his or her client that he has decided to include a qualification, the client will try to fence it off. The auditor is therefore caught between professional duties to modify the going-concern assumptions and following her client's demands not to do so in order to avoid negative consequences. Arnedo et al. (2008) focused in their analysis on the wording auditors used in their reports on Spanish companies and found that ambiguity in wording is well suited to confuse the reader and thereby serve both ends. Interestingly, their attempt to correlate this ambiguity to explicatory variables like industry sector or the auditor-client relationship did not yield any results. Even when they looked at the financial situation of the client, they could not establish a relationship between the extent of ambiguity of wording and the likelihood of failure. This is remarkable, as one would certainly assume that a weaker financial situation would trigger a more ambiguous choice of words.

After groundbreaking works like Power's "The Audit Society" (Power, 1997), the auditing function came more and more under scrutiny from a socio-economic point of view. Questions were raised as to whether auditing might have taken on a myth-like appearance, a function mainly serving the profession's own needs. We are very interested in gaining a deeper understanding of the auditing function and how it feeds back into larger societal functions. Although we are fully aware of the fact that simple mathematical regressions will never be able to fully explain such a multi-facetted connection, we want to add to the Arnedo et al. (2008) work by continuing where they stopped, namely how to explore the auditor's strategic behaviour.

Hypothesis

The objective of this paper is to understand better what the going-concern assessment really is and on what it is based. As the assessment is a matter of professional judgement, it is not possible to observe the decision making process directly. The first assumption we want to test is if the going-concern assumption is based purely on considerations about a company's financial strength. In such a case, the decision-making process should take the same aspects of a company into consideration as any other corporate failure prediction. Therefore, we would expect to see a high correlation between corporate failure prediction models and the auditor's opinion making.

Hypothesis 1: the financial strength of a company and going concern related qualifying opinions are highly correlated

The auditor's main purpose is not to predict corporate failure but rather to assess if the financial statements are giving a true and fair view of the company's financial situation. A qualified audit opinion based on going-concern considerations might trigger a chain of events which might push a company out of business (e.g. Moizer, 1995). Although Citron and Taffler (2001)proved that the threat of a self-fulfilling prophecy doesn't pass the empirical test, other research suggests that it is a real consideration for auditors (e.g. Mutchler, 1984; Sikka, 1992, 1997). Therefore, the auditor might adopt a very prudent stance and try to avoid triggering a self-fulfilling prophecy by only qualifying companies in a very weak financial situation. Also the ISAs are quite supportive for a prudent approach in this regard. If prudence are indeed applied, some correlation between financial strength and going concern related qualifying opinions would be expected, but not necessarily a strong correlation.

Hypothesis 2: the financial strength of a company and going concern related qualifying opinions are correlated

A third possibility would be that auditors base their qualifications on completely different stimuli that have nothing in common with corporate failure prediction considerations. The auditor might be less concerned with the survival chances of a business than with her own risk-management considerations. If, for example, she did not qualify and the company were to fail, what would be the risk of her suffering financial losses in a subsequent litigation? In this case, we would expect to see no correlation at all between the corporate failure prediction models and the qualified opinions of auditors.

Hypothesis 3: the financial strength of a company and qualifying opinions show no correlation

Review of the literature

Up to now there have been a number of studies discussing the usefulness of corporate-failure models in assessing the going-concern status of a company (Kuruppu, Laswad, & Oyelere, 2003). The study by Stice (1991)looked at whether a company's financial condition, asset structure, and sales growth have an impact on the likelihood of a company issuing flawed financial statements. Stice (1991) used Altman's z-score to measure the financial conditions of the companies in the sample. The model proved effective in identifying high-risk audit engagements and auditors can therefore use this information as a basis for higher audit fees and audit hours that match up with the risk of litigation attributed to the client(Stice, 1991).

Other studies widened the mathematical-model approach and added other behavioural-orientated aspects. Hopwood et al.(1989) first use a log-linear approach to investigate the relationship between bankruptcy and audit report qualifications within the context of one univariate and two multivariate models. The second multivariate model (a ratios and audit opinion model) is based on audit opinion types and 6 ratios that were derived from Beaver (1966), Deakin (1972)and Libby (1975)studies.

In contrast to the Altman and McGough(1974) study, Hopwoodet al.(1989) considered consistency exceptions, the subject-to opinion issued for other than going-concern opinion reasons, and going-concern opinion qualifications. They argue that an audit-opinion-only multivariate model was the least-cost option in the last three years before a company goes bankrupt (Hopwood, McKeown & Mutchler, 1989).

Starting off by comparing the auditors' abilities to identify problems when using relevant cues to the accuracy of a mathematical model, Kida(1980)tested if ratios could provide auditors with useful information when making going-concern decisions. Auditors indeed were able to distinguish problem from non-problem firms, given only ratios, with an average accuracy rate of 83 percent compared to the 90-percent accuracy rate achieved by the discriminant model. Kida (1980) attributed the difference between auditor and model accuracy previously found by Altman and McGough (1974)to auditors' judgments of continuity qualifications, which is not the same as auditors' predictions of problem firms.

Anandarajan and Anandarajan (1999) applied the predictive power of two machine learning techniques (ArtificialNeural Networks (ANN), and Expert Systems (ES)) and Multiple Discriminant Analysis (MDA). Based on actual decisions of auditors, the ANN model achieved the highest predictive accuracy at 85.8% compared to the MDA and ES models, which achieved predictive accuracies of 74.1% and 69.1%, respectively. The results for the ANN model compared favourably to Altman and McGough's (1974) study, which was 82% accurate. Companies with non-going-concern problems were appropriately categorised at a rate of 90% for ANNs, 75% for ES and 81% for MDA, lower than Altman's original study, which achieved 97% accuracy for non-failed companies. Testing forms of going-concern uncertainty reports, the ANN model achieved a predictive accuracy of 80% for modified reports and 83.2 % for disclaimer reports, compared to 72.1% and 74.3% for MDA, and 66% and 60.3% for ES, respectively. Kuruppu et al. (2003) tested whether statistical corporate liquidation models are effective for assessing a company's going-concern status. Their corporate liquidation model outperformed Altman's bankruptcy prediction model in predicting company liquidations in their sample of New Zealand companies (Kuruppu, Laswad, & Oyelere, 2003).Other authors have stressed the usefulness of corporate failure prediction models for inexperienced auditors (Paquette & Laurence, 1996).

Research methodology

We take our empirical data from the Johannesburg Stock Exchange. To get a better understanding of the qualifying assumptions, we comprise a sample made out of (a) failed companies, where the going-concern assumption proved not to hold and (b) all those companies which indeed have received a qualified or modified opinion. The time period we covered ranges from Jan 1st 2000 to Dec 31st 2009. The JSE's Equity Markets and Continuing Obligations Divisions provided a list of 61 delisted and liquidated companies and a list of 168 companies of financial statements with qualified or modified audit opinions for the period. For the purpose of our research, we eliminated all companies delisted due to mergers, takeovers or similar transactions involving financially sound companies that delisted voluntarily. The sample of failed companies comprises 36 companies. Subsequently, we eliminated a further five companies that acted purely as shell companies, leaving a final list (a) of 31 companies

The original list of 168 companies' financial statements with modified audit reports includes companies that appear on the list more than once due to their audit reports being modified more than once during the period and includes companies whose audit reports were qualified for reasons other than going-concern uncertainties. Two companies with modified audit opinions were excluded from the sample. One such company did not have any assets and the second was excluded from the sample because it operated in hyper-inflationary environment and its financial statements were not prepared in compliance with international financial reporting standards. After clearing the list, the final list (b) comprised 63 companies with modified audit opinions. Each company was only included once in the final sample list (b) as only the "first-time" audit opinion qualifications were selected (Dopuch, Holthausen, & Leftwich, 1986).

In respect of list (a), we examined the last audited financial statements issued prior to the company being liquidated to determine both the legal status and the type of audit opinion. The period from last balance sheet date to liquidation date ranges from just under 10 months to just over 4 years and 8 months. All the modified audit opinions were either due to going-concern uncertainties only or going-concern uncertainties in combination with other issues. The legal status and the date of going into liquidation for each company were verified against the Cipro database.

As a proxy for financial strength of the companies we use Altman's z-score (1968)as there is a body of literature that backs its effectiveness and it has been tested in different geographical environments (Altman & McGough, 1974). The company financial data, including market capitalisations, for both the failed companies sample and the sample of companies with modified opinions was obtained from the McGregor BFA Research Domain. Once the financial data for the failed companies and companies with modified opinion was obtained, we calculated the variables (ratios) required for both the original Altman's z-score.

The original z-score used the following final discriminate function:

$$Z = 0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5$$

Where:

X1 = Working capital/Total assets

X2 = Retained Earnings/Total assets

X3 = Earnings before interest and taxes/Total assets

X4 = Market value equity/Book value of total debt

X5 = Sales/Total assets

Z = Overall Index

Source: (Altman, 1968).

The variables were calculated in line with Altman's z-score. The X3 variable calculated (Earnings before interest and tax/ Total assets for the original z-score and Operating income/ Total assets for the EM Score), was in certain instances not the same because of non operating income and or expenses being included in the "earnings before interest and tax" figure used for the original z-score.

Results

At first, we tested the accuracy of the z-score and the EMS score to predict corporate failure in the (a) sample of 31 JSE listed companies that have either been liquidated/dissolved or are in the process of being liquidated/dissolved. Nine companies were liquidated within 12 months of the last financial statement, 14 companies within 24 months and six companies after 24 months. Two more are in the process of being liquidated. In the sample of companies we identified as failed; only 4 companies received a qualified opinion.

In the (b) sample, we looked at companies that had received a qualified opinion, a total of 63 companies. We examined each of the companies' financial statements to confirm that the auditor's report was modified due to either going-concern uncertainties or going-concern uncertainties and other reasons. All companies were checked against the Cipro database to confirm their current legal status and, where applicable, the date when the company went into liquidation. Of the 63 companies which received a qualified opinion, only 23, or 37%, have subsequently been liquidated—although often years later. Of these companies, 40 companies were still in business. Interestingly, only one company went out of business within 12 months after the qualified opinion on going-concern. Four more companies ceased their activities within 24 months. Twenty companies ceased their activities later (and sometimes much later) than 24 months after they received a qualified opinion. To test our hypotheses formulated earlier, we pooled both subgroups together. Our sample contained 90 companies with their audit opinion (four companies appeared in both samples), the z-score and the information as to whether the company is still in business or not. To understand if the audit opinion is correlated with the likelihood of financial failure, we tested if the groups of companies which received a qualified audit opinion and the groups of companies which received an unqualified opinion would show significant differences in their z-scores. At first, we tested both groups positively for normality. Then, we applied a t-test to see differences between both groups in the means of the z-scores. In addition to the z-score, we divided our sample depending on their z-score into financially stronger companies (top 33%), financially average (mid 33%) and financially weak (lower 33%) companies.

Findings and Conclusions

Table 1.

Auditor opinion * financial strength Crosstabulation

Count

		finstr			Total
		weak	average	strong	
Audop	Q	19	23	21	63
	U	11	7	9	27
Total		30	30	30	90

Chi-Square Tests

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	1.270[a]	2	.530
Likelihood Ratio	1.278	2	.528
N of Valid Cases	90		

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 9.00.

Directional Measures

			Value	Asymp. Std. Error[a]	Approx. T[b]	Approx. Sig.
Nominal by Nominal	Lambda	Symmetric	.046	.073	.619	.536
		Audop Dependent	.000	.000	.[c]	.[c]
		finstr Dependent	.067	.104	.619	.536
	Goodman and Kruskal tau	Audop Dependent	.014	.025		.534[d]
		finstr Dependent	.007	.012		.534[d]
	Uncertainty Coefficient	Symmetric	.008	.015	.569	.528[e]
		Audop Dependent	.012	.020	.569	.528[e]
		finstr Dependent	.006	.011	.569	.528[e]

a. Not assuming the null hypothesis.
b. Using the asymptotic standard error assuming the null hypothesis.
c. Cannot be computed because the asymptotic standard error equals zero.
d. Based on chi-square approximation
e. Likelihood ratio chi-square probability.

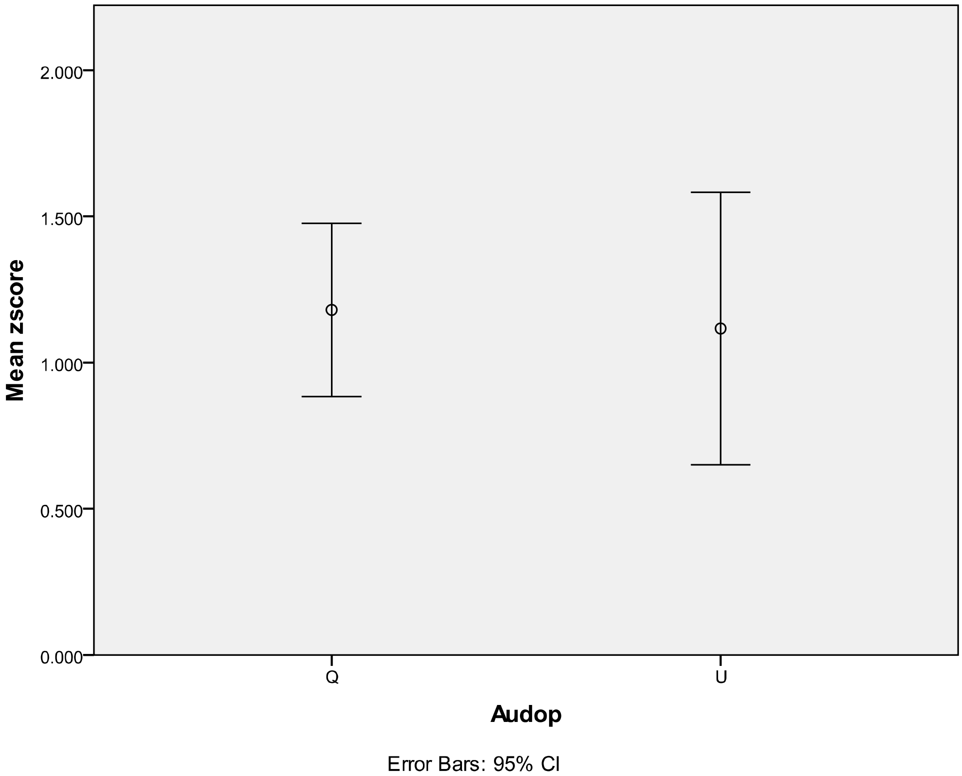
Interestingly, we see the qualified opinion equally distributed throughout all financial strength categories, similar to the unqualified opinion. From this cross table, it seems as if there is no connection of the audit opinion to the financial strength of a company. To test if this assumption holds, we performed an independent t-test to compare the means of the z-scores between both groups.

Table 2.

Group Statistics

	Audop	N	Mean	Std. Deviation	Std. Error Mean
zscore	U	27	1.11659	1.177460	.226602
	Q	63	1.18019	1.177200	.148313

Table 3.



The t-test performed on the z-score of companies showed no significant difference between companies that received a qualified opinion and such companies that received an unqualified opinion. In addition, the graphical presentation below underpins this finding.

Our analysis showed that both hypothesis 1 and 2 are rendered invalid, since the going-concern assumption is not associated with the financial strength of companies at all, leave alone a strong association. The statistical testing we applied did not support any significant difference between the z-scores of companies that received qualified opinions to those that received unqualified opinions. Neither could we prove that the auditors reacted prudently to avoid the risk of a self-fulfilling prophecy, which is in line with previous research that denied the existence of this phenomenon at all (Citron & Taffler, 2001).

If the decision on whether or not to qualify an audit opinion based on going-concern status is not influenced by the financial strength of a company, then what else drives this decision?

On one hand, auditors do have access to information that is exclusively accessible to insiders of the company. Managers might point out that the financial situation is not as dire due to expected positive future events. Yet, if these events are about to take place, it should improve the financial situation subsequently and the company should not fail at all. While this may explain why companies that received qualified reports never failed, it still does not explain why in our sample of 31 failed companies, only four companies received a qualified opinion. The same applies to the argument that auditors perform their work with a certain time delay between the end of the financial year and the actual audit and might have knowledge of additional events.

We suggest that there are other influential factors that are situated in the area of the auditing company itself. If we assume that the company under audit tries to avoid a qualified opinion at any cost, it will do everything possible to paint a positive picture of the company's financial outlook. The auditor will be tempted to believe and not to qualify—unless it would expose the auditing company to enhanced legal risks. Therefore, we suggest that the reason for qualifying a going-concern assumption is less likely to be found in the area of the audited company but more in the area of the auditing company.

As our findings suggest that there is no connection between the financial strength of a company and the audit opinion as to going concern, we doubt that there can ever be any true information value of a qualification of the audit opinion itself. If qualifications are, in fact, triggered by the auditor's own risk management considerations rather than financial considerations about the company under audit, this would also explain why previous findings about the information value or the market reaction of a qualification is so inconclusive.

Our findings themselves cannot dismiss the value of the auditing function nor do we attempt to do so. Yet, we would like to invite more research into how the going-concern opinion is explained. Which factors could the auditor use to estimate the risk of litigation and a potential loss resulting from it? Which potential problems that might lead to a company failure will easily lead to a litigation claim against the auditor if it wasn't picked up by the audit and which are easy to defend? Once these factors are established, it would be interesting to see if they can explain whether or not a company receives a qualification.

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CORPORATE OWNERSHIP AND INTERNATIONALIZATION: THE EFFECTS OF FAMILY, BANK AND INSTITUTIONAL INVESTOR OWNERSHIP IN THE UK AND IN CONTINENTAL EUROPE

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Abstract

While the role of corporate governance has been increasingly analysed during recent years, it is only very recently that the effects of corporate governance features on firm international strategies have been also considered. Using the Osiris database by Bureau van Djik we consider the potential role played by different kind of shareholders among the determinants of firm international level, distinguishing between the firms quoted in the UK from those listed in countries of Continental Europe (France, Germany, Italy, Poland and Spain). Overall our results confirm that different kind of ownerships affect with different degree of intensity the overall level of firm'sinternationalization. First, we find that ownership matter. Second, our results show that theeffects of ownership over firm's international strategies depend also on the context of analysis.

Keywords: Corporate Governance, Ownership, Investors, Europe, the UK

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1. INTRODUCTION

The role of corporate governance has been increasingly scrutinised in recent time. Corporate governance has been defined as the set of institutional and market rules that allow shareholders to monitor decision making in business firms (Shleiferand Vishny, 1997). Under the influence of classical financial theory and after the pioneering article of Jensen and Mecking (1976), corporate governance scholars have mainly focused their attention on the mechanisms that regulate the potential conflicts arising between managers and shareholders (Daily et al., 2003; Kochhar andDavid, 1996). Following this theoretical perspective some scholars have adopted theagency theory approach(Denis *et al*, 1997; 2002) in order to analyse the effects of corporate governance characteristics on firms strategy and on product diversification in particular. However, most of these studies have been focused on the analysis of the ownership structures investigating the potential effects of concentrate versus dispersed ownership. More specifically, these studies (Denis *et al*., 1999) explore under which conditions there will be leeway for management to exercise their discretion in order to pursue strategies that promote their own interestsat the expense of shareholders. Since managers derive various private benefits from product diversification they may have an incentive to diversify either because their compensation is linked to firm size (Baker et al., 988), because they derive power and prestige from being associated with a larger firm (Jensen, 1986), because their job security is enhanced (ShleiferandVishny, 1989), or because firm diversification reduces the risks attached to their undiversified personal portfolios (Amihud and Lev, 1981). It is only very recently, that this debate has also considered the relationshipthat corporate governance features, such as ownership have withfirms' international strategies (Sanders and Carpenter, 1998; Tihanyi*et al*, 2000; Tihanyi*et al*, 2003; Lien *et al*, 2005; Filatotchev*et al*, 2007)

In the classical theory of internationalization (Dunning, 1988)there is no room for corporate governance variables since this theory assumes that firms are profit maximizing agents regardless the identity of the owners. In this view all shareholders are just concerned with maximizing the value of the firm and therefore the shareholders characteristics do not impact on the level of international diversification. Given these assumptions, the level of international diversification is determined only by internal factors such as firm resources, the level of intangibles, asset specificity, international experience, R&D intensity or by external factors such as country risk, barriers to trade or the level of local knowledge

(Hennart, 2007). In the words of transaction costs economics it is the kind of resources that the firm managed and the level of perceived risk who determines whether or not international transactions are internalized or not. However, different kind of shareholders will have different perceptions of the risk surrounding any transaction because different types of shareholders will typically have different decision-making time horizons and different risk attitudes (Thomsen and Pedersen, 2000).Moreover, the kind of ownership will also influence the investments and the strategies pursued thus influencing firms' resources endowment (Shrader and Simnon, 1997). Therefore, we believe that within the framework of internationalization theory there is room for further deeper analysis of the impact of the ownership characteristicsand corporate governance on firm international strategy. Somerecent papers have started to explore the relationship focusing on some specific aspects of corporate governance such as the ownership structure and type(FernándezandNieto, 2006; Bhaumik*et al*, 2010; Hautz*et al*, 2013; Oesterle*et al*, 2013) the role of foreign shareholders (Filatotchev*et al*, 2008) and the independence of the Board of Directors (KorandMisangyi, 2008).

The present paper intend to contribute to this debate. The objective of the paper is twofold. First, using a European sample of listed firms, we intend to assess if and how different shareholders typologies affect the firms' degree of internationalization when we consider different facets of internationalization that allows us to provide a deeper understanding of the phenomenon. Second, distinguishing between the firms quoted in the UK from those listed in countries of Continental Europe (France, Germany, Italy, Poland and Spain) we intend to investigate if the different characteristics of the corporate governance systems in the two regions have a different impact on firms' internationalization levels.The structure of the paper is as follows. In the next section we review the extant literature on corporate governance and on its effects on international diversification and formulate our research hypotheses. In section 3, we explain how we have operationalized the variables in the model and we detail the data sources. Moreover, we present descriptive statistics on these variables and we outline the estimation methodology and the statistical tests used. We present and discuss the regression results in section 4 that partially confirm our hypotheses. The final section concludes and describes the main limitations of the paper suggesting avenues for further research.

2. THEORY AND HYPOTHESIS DEVELOPMENT

The relationship between owner identities and international diversification strategies appears an underdeveloped topic in the corporate governance literature. So far few studies have analyzed the differences among various types of owners in pursuing the diversification strategies and more specifically the internationalization strategies (George et al, 2005; Hautz et al, 2012; Osterle et al, 2013; Majocchi and Strange, 2012;Fernando and Nieto, 2006; Pedersen and Thomsen, 1997; Thomsen and Pedersen, 2000; Zahara, 2003). While the research on corporate governance characteristics and internationalization promises to enlarge our understanding of the firms and of their strategic decisions, very often this research has been conducted in empirical setting limited to one country. Thus it appears that previous literature has ignored that the firms' ownership structure and its impact depend also by the institutional context (Bhaumik et al, 2010; Osterle et al, 2013). In Europe two different models of capitalism coexist, the Anglo-Saxone mode and the German model, where not only the institutional setting is different but also where firms ownership types are unevenly distributed (La Porta et al, 1999). We use a data set of European listed manufacturing firms to understand how different types of owners, families, banks, institutional investors will differ in the level of internationalization.

The study of therelationshipbetween family ownership and internationalizationis rapidly growing but until now it provided mixed evidences(Kontinen and Ojala, 2010; Sciascia et al, 2012).

There are few studies, (Zahra, 2003) that, based on the assumption of altruism within the family context, hypothesize a positive relationship between family ownership and internationalization. According to this view, family loyalty and support lengthen the investments payoff time horizons. This owners long term view allowsmangers to realize those investments that are necessary in order to enter in the foreign markets assuming the higher risks associated with international expansion. However, the large majority of the studies on the topic show that family firms are reluctant to internationalize compared to non-family firms (Fernándezand Nieto,2006; Gomez-Mejia et al, 2010). The main arguments behind this position stress the negative effects that the combination of ownership and control generate respect to the international growth of family firms.Family-owned firms are particularly averse to the risk of losing the control of their business. Owners of family firms tend to manage companies on behalf of family interest rather than for the benefit of the firm compromising the firm growth at the expense of other shareholders. This attitude is reinforced by the strong focus on wealth preservationwith the goal of leaving the firm to descendants (James, 1999). These motivationsnegatively affect the level of international involvement (Hautz et al, 2012) by family owned firms. Moreover, internationalization requires often to collect capital by taking on more debt, increasing the financial risk of the firm, or by enlarging the equity base of the firm.In both cases the leverage of capitaldilutethe control of the family over their business (Demesetz, 1983) with the result that family-owned firms are less prone to pursue internationalization strategies.

For the same reasons family owned firms are less likely to collect expertise and resources by third parties,a requirement practically inescapable to internationalize the firms.Family shareholders tend to appoint members of the family to the top management positions rather than experienced and qualified professionals to maintain the control of the firm (Carney, 1998).Following these arguments we also posit a negative relationship between family ownership and internationalization but, compare to previous studies we additionally consider possible different measures of internationalization such as the level of foreign sales, its distribution and foreign direct investment (Carrillo, 2007; Rogers et al., 2008). We refer our hypotheses to the all sample since family-owned firms seems to have similar characteristics regardless the institutional context.Thereforeour first hypothesis is:

H1: Family–owned firms present a lower level of internationalization than non-family-owned firms.

Because of different national settings, corporate governance systems considerably vary across nations. The literature (La Porta*et al*. 1999) historically differentiates two opposite models of capitalism: (1) the Anglo-Saxon model, which is market-oriented and characterised by a strong influence of institutional investors with an emphasis on shareholder-value, and (2) the German model that is predominated by a logic of cooperation and partnership, resulting in close relationships between industrial firms, banks, and social partners (Eckert andMayrhofer, 2002; Pedersen andThomsen, 1997; Porter, 1992).

The first model is generally referred to as the Anglo-Saxon model, and is mainly identified with the United Kingdom and the United States. The second model is mainly identified with the countries of Continental Europe. Even if De Jong (1997) has established some distinctions between the German-speaking and the Latin countries (France, Spain and Italy) - with the latter system characterised by a higher degree of direct ownership concentration and with prominent shareholders that are mainly private, families or the State - Continental Europe shares some common characteristics that differentiate it from the UK and the US. The main feature that distinguishes all the corporate systems of Continental Europe from the Anglo-Saxon system is the very weak level of control from external capital markets. In Continental Europe the weakness of the financial market control leads firms to be less influenced in their decision making from direct market pressures. On the other side, indirect market pressures, such as those linked to interest rate policies adopted by banks, may significantly influence the decision making of firms. In Germany and in the rest of Europe a monitoring role over firms' management is typically played by banks, which generally hold important stakes in their client capital. In this model, the banks not only supply short-term finance but also long-term capital, often in the form of equity, and typically contribute to shape the company policies and to select the top management team. Therefore, in the European context banks tend to consider their investments in firms as a portfolio of different debt and equity assets. Since equity is a riskier investment than debt bank tend to influence firms policies compensating the additional risk generated by the equity with more conservative policies that lead to lower internationalizations. Therefore, we posit that:

H2: Firms listed in Continental Europewith a bank as first shareholder have a lower level of internationalization than other kind of firms

On the contrary in the Anglo-Saxon model, financial markets play a crucial role in monitoring and disciplining managerial behaviour, whilst banks limit their role to the supply of short-term finance and do not have direct interest in the firm. In this system, firms have a broad shareholder base with both private and financial institutional owners such as pension funds or private equity institutions (De Jong, 1997) playing a leading role in financing the growth of the firms but a more limited direct role in the management of the firm. In this context institutional investors are likely to be particularly active investors in firms, as they will typically have the financial interest, the independence and the expertise to monitor the firm's management and policies. There is some evidence (Hoskisson et al, 1994; Young et al, 2008) that institutional shareholders promote good governance, with a resultant improvement in firm overall performance in general and in internationalization in particular (Tihanyi et al., 2003). Such firms have become in the Anglo-Saxon markets not only a significant player holding a large share of corporate equity listed in the markets but also gaining influence on corporate strategic decision through increased activism (David et al., 2001). These investors are likely to be those that are most actively seeking foreign expansion. The equity participation of such financial institutions may well provide the firms with access to the institutions' networks in overseas markets, and thus facilitate internationalization (Filatotchev et al, 2008). Moreover, in this context the top management team is typically made of autonomous and well trained figures. Control is exercised through the market and if managers do not perform well, a takeover bid for the firm is likely. This threat provides a strong incentive for managers to behave in the interests of the financial shareholders. In this context institutional investors such as professional investorst, pension funds and private equity firms – different from banks – have a strong incentive to promote growth and internationalization in order to increase the market value of the investments.

So our last hypothesis is:

H3:Firmslisted in the UK with institutional investorsas first shareholder have a higher level of internationalization than other kind of firms

3. METHODOLOGY AND DEFINITION OF VARIABLES

3.1 The sample and the variables

The sample was chosen in order to provide a representative view of thelisted firms in Europe. We include the UKas a significant market thatrepresents the Anglo-Saxon corporate governance system and Germany, France, Italy, Spain and Poland to represent Continental Europe. We deliberately omitted small countries due to the natural orientation of their firms to internationalize and we concentrate on European countries with the larger domestic markets. All the data were collected from the Bureau Van Djik Electronic Publishing's database "Osiris" with the exception of the geographical distribution of sales that was manually extracted by firms' annual reports. Since we were interested in measuring international diversification both through export and foreign salesand foreign investments we deliberately omit services firms. This becausefor service firms production and consumption tend to coincide (Clark et al., 1996) affecting negatively .the significance of exports as a measure of internationalization for these industries-

Adopting these criteria to the Osiris database we selected 1316 firms, 454 in the UK, 341 in Germany, 300 in France, 121 in Italy, 51 in Spain and 49 in Poland. After dropping firms with key missing data the first overall sample consisted of 880 firms. The descriptive statistics of the sample are reported in Table 1.We define three different measure of internationalization. The first two measures refer to the scale and scope of internationalization through foreign sales while the last one is a proxy of the scope of internationalization throughforeign direct investments. In order to measure the dimension of salesin foreign markets we use the ratio of foreign sales to total sales(Katsikeas*et al,* 2000; Majocchi *et al*, 2005), a variable that we named *"Forsal_int"*. This measure gauges the ability of firms to enter foreign markets, but does not consider the geographical distribution of sales. As Rugman&Verbeke (2004) point out, foreign sales intensity is not a fully satisfactory measure of geographical diversification since it does not take in account the distribution of sales and whether or not they are geographically well-balanced in the main world markets. For example, using the export-to-sales ratio, two firms can be considered identical in term of geographical diversification even if one is exporting only in one country while the other has significant sales in all the main world markets. Consequently, since the requirements of the IAAS/IFRS standards oblige listed firms to reportdetailedinformation on the geographical distribution of their sales we collect and elaborate this information from the firms' annual report as reported in the firms' web sites. We classify (export and overseas) sales into six areas: the domestic market and five additional regionsthat coincide with the main continents: Europe, Asia, Africa, Americaadding a residual region called the 'Rest of the World' that collect both Oceania and undefined data. Using this classification, our measure of international diversification is calculated using the Jacquemin and Berry (1979) entropy index. This measure was initially developed in order to quantify the degree of product diversification, but has also lately been adapted to measure international diversification (Kim, 1989; Kim *et al.* 1989; Hitt*et al*, 1997). The variable, that we named "*Forsal_entropy*", measure is defined in the following way:

$$\text{Entropy measure} = \sum_{J=1}^{6} x_j \ln\left(\frac{1}{x_j}\right)$$

The subscript *j* defines one of the six geographical areas, and x_j is the percentage of sales realised in the market *j*. The natural logarithm of the inverse of the sales realised in every market is the weight given to each geographical segment. The entropy measure will equal 0 for firms that have all their sales concentrated in one area, and will theoretically reach a maximum value of 1.79 for firms with exactly the same share of sales in each of the six defined areas. In our sample the average value of the entropy measure is 0.73, with a minimum value of 0 and a maximum value of 1.64. The last measure, named *"Country_subsid"* is a proxy for the geographical scope of international activities.Following previous studies (Tallman & Li, 1996; Morck&Yeung; 1991), was measured as the number of foreign countries in which a company had subsidiaries. The average number of countries in the sample is 6.11 (s.d. is equal to 11.02) with minimum value of 0 and a maximum value of 126.

In order to test our hypotheses we define three ownership variables according to the nature of the first shareholder: first shareholder family (*FirstSH_Fam*), first shareholder bank (*FirstSH_Bank*) and first shareholder institutional investor (*FirstSH_II*). The three variables are dummy variables that take the value of one whenthe first shareholder is respectively a private, a bank or an institutional investor.Osiris defines sixteen different shareholders' types. While family and bank are considereda shareholders typology, we had to develop the construct of the variable shareholder institutional investor (*FirsSH_II*) aggregating five different types of shareholders considered in the database. The five categories included in the item*institutional investor* were: financial company, insurance company, mutual & pension fund/nominee/trust/trustee, venture capital and hedge fund. In order to correctly specify the model we consider additional variables already tested in previous empirical works (Hitt*et al.,* 2006).

The list of the control variables is the following:age (*Age*) (DeliosandHenisz, 2003) measured as the number of years from foundation,size (*Size_log)* as measured by the natural logarithm of the firms' employees (VerwaalandDonkers, 2002), the debt/equity ratio (*Leverage*) (Kochhar, 1996) and, drawing on the classical theory of internationalization (Hennart, 1982 and Buckley andCasson, 1976), two measures of intangible intensity measured by the ratio of intangible assets over total assets (*Intang_intensity*) and by the ratio of R&D costs over total sales (*ReD intensity*) (NachumandZaheer, 2005).Recent literature (Herrmann andDatta, 2005; Majocchi and Strange, 2012) has also highlighted the role and the importance of top executives and members of the board features in promoting internationalization. Therefore, we insert three variables specifying the board and the top managers characteristics: a dummy variable named *(Ceopresid)* that takes the value of one when a member of the controlling family is either the CEO or the President of the firm, a variable that measures the resources of the board that is the count of its members *(Boardsize)*(Sander andCarpenter, 1998)anda measure of the international vocation of the boards measured with the percentage of foreign directors over the total number of the members (*For_board*). Finally, we include a series of industry dummies to capture intra-industry differences and – just for the all sample – country dummies.

3.2 The model

Sullivan (1994) has clearly showed that the concept of internationalization is typically a multi-faced concept and that from the theoretical point of view, it is appropriate to measure internationalization with indexes that replicate that complexity of the concept. We decide to run our regressions using the three different measuresof internationalization described above: the foreign sales intensity (*Forsal_int*), the foreign sales entropy (*Forsal_entropy*) and the foreign direct investment scope(*Country_subsid)*. The overall level of correlation between these three dependent variables is quite low with the only exception of the correlation between the entropy and the foreign sales intensity measures which is 0.6. However, the results of the regression run using these two variables are different in some key coefficients confirming that we are not just replicating regression model with slightly different dependent variables. Since all the three dependent variables are left-censored we adopted a Tobit methodology (Greene, 2000). It should be noted that Tobit regressions are nonlinear and therefore the coefficients should be interpreted with care and do not measure the real causal effect on the dependent variable. This effect is correctly measured only by the marginal effect. However, the coefficients maintain the significance and the sign of the marginal effects so that we can rely on the regression coefficients to test our hypotheses that are relative to the sign of the estimated coefficients (Bowen and Wiersema, 2004).

Using the procedures with the Intercooled-STATA 11 statistical package we run Tobit maximum likelihood estimates on the threedifferent measures of internationalization that we included in our analysis for three different samples. The first sample, the overall one, comprises a total of 880 firms listed in Germany, France, Italy, Poland, Spain and the UK. Then we split this sample in two sub-samples one for Continental Europe, with 602 observations, and one for the UK, with 286 observations,in orderto test our hypotheses concerning the different effects of corporate governance in the different contexts. It should be noted that, given the existence of missing data in our foreign salesvariables, the size of the samples of the regressions with the foreign salesintensity and with the entropy measure as a dependent variable are smaller than the sample with the number of countries with a subsidiaries.

4. RESULTS

In Table 1 we report means, standard deviations and correlations for the variables used in our models. Correlation between the (continuous) variables is negligible suggesting that multicollinearity is not a concern in our case.

Table 1. Descriptive statistics and correlation between continuous variables

	Average	SD	Age	Size_log	Intang intensity	Leverage	R&D intensity	Boardsize	For_board
Age	55.89	58.11	1						
Size_log	6.44	2.218	0.326	1					
Intang_intensity	.157	.189	-0.130	0.070	1				
Leverage	.536	2.047	-0.009	0.072	0.066	1			
ReD_intensity	.198	.2864	-0.030	-0.086	-0.001	-0.003	1		
Boardsize	6.82	4.30	0.171	0.475	0.109	0.029	-0.006	1	
For_board	.0642	.157	-0.037	0.057	0.066	-0.018	0.033	0.078	1

Table 2 reports our results for the full sample of European firms. All the threeregressions show comforting values for the overall indexes of goodness of fit (χ^2 and Pseudo-R^2), suggesting that the overall specification of the model is good. The first hypothesis predicts that family ownership present a lower level of internationalization compared to non-family-owned firms.The first hypothesis is partially confirmed in two out of three definitions of internationalization. The coefficients are significant and negative in the models 1 and 2 suggesting that family ownership is a negative determinant of the scale and the scope of internationalization through foreign sales while it is not significant the result about family ownership and the scope of foreign direct investments.

Table 2. Tobit regressions results for the all sample†

VARIABLES	Forsal_int	Forsal_entropy	Country_subsid
Age	-0.0003*	-0.0002	0.0105
	(0.0002)	(0.0003)	(0.0070)
Size_log	0.0624***	0.104***	4.251***
	(0.0067)	(0.009)	(0.224)
Germ	-0.0629*	-0.005	-1.555
	(0.0342)	(0.045)	(1.112)
Esp	-0.002	0.117*	-3.268**
	(0.051)	(0.071)	(1.616)
UK	0.0348	-0.144	-5.124***
	(0.0327)	(0.0460)	(1.083)
Italy	0.0683	0.0952*	-2.639 **
	(0.0412)	(0.0577)	(1.310)
Poland	-0.180***	-0.111	-13.947***
	(.0527)	(.0735)	(1.977)
Intang_intensity	0.0824	0.0752	6.770***
	(0.0644)	(0.0915)	(2.141)
Leverage	0.0123*	0.0002	0.0212
	(0.0066)	(0.0108)	(0.1624)
ReD_intensity	0.0112**	0.0114	0.231
	(0.00545)	(0.0111)	(0.176)
Ceopresid	0.0389	0.0727	3.454 ***
	(0.0386)	(0.0542)	(1.274)
Boardsize	0.0016	0.005	0.332***
	(0.003)	(0.004)	(0.096)
For_board	0.387***	-0.054	7.138***
	(0.0752)	(0.107)	(2.422)
FirstSH_Fam	-0.060*	-0.090**	-0.899
	(0.0344)	(0.0485)	(1.157)
FirstSH_bank	-0.01355	-0.0290	-1.224
	(0.040)	(0.0573)	(1.377)
FirstSH_II	-0.0399	-0.0379	1.0145
	(0.0283)	(0.0395)	(0.926)
Constant	0.183***	0.2181***	-24.546***
	(0.050)	(0.0694)	(1.668)
Uncensored Obs.	850	751	692
Left-censored obs	81	93	196
LR chi^2(38)	318.96	330.19	751.09
Pseudo R-squared	0.3959	0.2462	0.1243

†= industry dummies included but not reported in the table
Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Our second hypothesis refers to firms listed in Continental Europe and predicts those with a bank as first shareholder have a lower level of internationalization compared to other firms.This hypothesis has just been tested with regard to firms listed in Continental Europe where bank ownership is a relevant phenomenon. The regression results for the subsample are reported in Table 3. The results show that H2 is confirmed only with regards to the foreign salesintensity dependent variable.Therefore, overall our second hypothesis is only partially confirmed.In the European context bank ownership negatively affect the level of internationalization in term of foreign salesbutwe cannot state that bank ownership affects the distribution of foreign sales because the coefficient it is not significant. Contrary to our prediction the coefficient of the bank ownership dummy is positive and significant in the third model with the number of countries with a foreign subsidiary as a dependent variable. These contrasting results confirm our assumption that the definition of the concept of internationalization is critical for any empirical analysis that intends to address the determinants of internationalization. The findings suggest that scholars should clearly specify which kind of aspect of the concept of internationalization is under investigation and that any discussion about internationalization *per se* without further specification remains too general.

Table 3. Tobit regressions results for Continental Europe ° †
°(France, Germany, Italy, Poland and Spain)

VARIABLES	Forsal_int	Forsal_entropy	Country_subsid
Age	-0.0003	-0.00006	-0.0151*
	(0.0002)	(0.0003)	(0.008)
Size_log	0.0544	0.0941***	4.776***
	(0.0787)	(0.011)	(0.278)
Intang_intensity	0.267***	0.319***	13.732***
	(0.089)	(0.127)	(3.119)
Leverage	0.014**	0.0017	0.181
	(0.006)	(0.0109)	(0.235)
ReD_intensity	-0.024	0.189	-2.626
	(0.103)	(0.160)	(1.912)
Ceopresid	0.029	0.098	5.291***
	(0.041)	(0.0587)	(1.455)
Boardsize	-0.003	0.005	0.311***
	(0.002)	(0.004)	(0.092)
For_board	0.189*	-0.121	1.684
	(0.101)	(0.143)	(3.625)
FirstSH_Fam	-0.010	-0.081	-1.194
	(0.037)	(0.052)	(1.285)
FirstSH_bank	-0.109*	-0.0105	6.029***
	(0.0563)	(0.079)	(2.028)
FirstSH_FI	-0.066**	-0.059	-0.892
	(0.0323)	(0.045)	(1.118)
Constant	0.152***	0.226***	-29.986***
	(0.054)	(0.075)	(1.951)
Uncensored Obs.	529	528	491
Left-censored obs	51	51	111
LR $chi^2(36)$	205.36	211.61	510.81
Pseudo R-squared	0.4551	0.2521	0.1200

†= industry dummies included but not reported in the table
Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Finally we test our third hypothesis with regard to the UK subsample.Results are reported in Table 4.

Table 4. Tobit regressions results for the UK sample†

VARIABLES	Forsal_int	Forsal_entropy	Country_subsid
Age	-0.0003	-0.001*	0.022*
	(0.0004)	(0.0006)	(0.012)
Size_log	0.055***	0.0959***	2.318***
	(0.0126)	(0.0181)	(0.359)
Intang_intensity	0.038	-0.096	1.427
	(0.093)	(0.139)	(2.793)
Leverage	0.011	-0.0431	0.042
	(0.024)	(0.035)	(0.208)
Red_intensity	-0.008	-0.0179	-0.0459
	(0.006)	(0.137)	(0.168)
Ceopresid	0.0834	0.038	1.019
	(0.0845)	(0.120)	(2.563)
Boardsize	0.026**	0.020	0.805***
	(0.010)	(0.015)	(0.306)
For_board	0.326***	0.007	11.351***
	(0.117)	(0.176)	(3.311)
FirstSH_Fam	-0.224***	-0.070	1.587
	(0.079)	(0.113)	(1.420)
FirstSH_bank	-0.0120	-0.0467	1.463

	(0.0691)	(0.099)	(2.080)
FirstSH_II	-0.025	-0.070	3.493**
	(0.061)	(0.087)	(1.785)
Constant	0.203**	0.169	-22.246***
	(0.094)	(0.136)	(2.923)
Uncensored Obs.	240	223	201
Left-censored obs	30	42	85
LR chi^2(33)	176.27	148.48	242.25
Pseudo R-squared	0.5291	0.3098	0.171

†= industry dummies included but not reported in the table
Standard errors in parentheses*** p<0.01, ** p<0.05, * p<0.1

The regression results of the UK firms show some interestingdifferences with the results obtained for Continental Europe.Our third hypothesis states that in the UK market firms with the institutional investors as first shareholderhave a higher level of internationalization than other kind of firms. Thehypothesis is confirmed only with regards to the scope of foreign direct investments suggesting that the institutional investor's involvement in ownership in the UK context is relevant when firms realize growth plan through foreign direct investments. Contrary to our findings with regard to the European subsample the coefficient of the bank dummy is not significant confirming the different role played by these financial institutions in the Anglo-Saxon and in the Continental European context.

Concerning the other control variables size plays an important role – as measured by the log value of the number of firms' employees – which is consistently significant and positive confirming, once more, the positive relationship between resources and internationalization (Leonidou, 1998; BalabanisandKatsikea, 2003; DhanarajandBeamish, 2003). With regards to firms' resources our models identify fourdifferent measurements of intangibles resources that are typically considered in literature (Delgado-Gomez *et al.*, 2004) as factors which promote internationalization: the share of intangibles assets over total assets (*Intang-int*), the share of sales that is devoted to R&D (*ReD_int*), the dimension of board size (*Board size*) and the percentage of foreign board members (*For_board)*. The share of intangible assets on total assets positively affects all three measures of internationalization in Continental Europe while forUK firms the relationships are not significant. The R&D intensity has been typically considered as a channel through which firms generate innovation that lead to better export performance (OzcelikandTaymaz, 2004; Roper andLove, 2002; CassimanandGolovko, 2011) and to higher internationalization through FDI (Buckley andCasson, 1976; Rugman, 1981; Hennart, 1982). However, our results do not fully confirm these conclusions. The size of the board and the share of foreign directors are additional resources that promote internationalization according to the most recent literature (Tihanyi*et al.*, 2000; Nielsen, 2010). For example directors can bring to the firm specific knowledge regarding foreign markets or relationships with overseas clients thus promoting the firm overall internationalization. These variables have an effect also in our model suggesting that the role of board in promoting internationalization is a promising field of research that deserve further and deeper analysis.

Finally, the variable that catches the involvement of family members in the management of the firm (*Ceopresid)* is significant only in the sample representing Continental Europe for foreign direct investment scope. This result is surely interesting and deserves further analysis. The different results emerging from the twosamples suggest once more that the factor affecting internationalization in the twocontexts, the UK and Continental Europe, may be different and that conclusions drawn from one context cannot be easily generalised.

5. DISCUSSION AND CONCLUSIONS

In the traditional theory of internationalizationfirm ownership has been scarcely considered. In the classical view of transaction costs (TC) theory (Buckley andCasson, 1976; Rugman, 1981; Hennart, 1982) the level of internationalization is the result of a comparison between the costs and the benefits of coordinating international transactions internally rather than externally through market prices. If the hierarchical solution is a more convenient choice than the arms-length solution then the level of internationalization of the firm will increase. Thus the overall level of internationalization is determined by the factors influencing the choice between the alternative methods of governance such as the level of specificity of the asset, the frequency of the transactions or the overall risk surrounding the transactions. To the extent that the resources to be exploited involve tacit knowledge,buyer uncertainty or indeterminate bargaining situations then the chosen governance method is likely to be internal to the firm and therefore promote further FDI internationalization (Majocchi and Presutti, 2009; Presutti et al., 2007). Alternative explanations of internationalizationrely mainly on a resource-based view of the firm (Lippman and Rumelt, 1982; Wernerfelt, 1984; Barney, 1986, 1991; Peteraf, 1993; Teece*et al*, 1997) where firm is considered as a heterogeneous bundle of valuable, rare and non-imitable resources.From the RBV perspective, international diversification is viewed as a means by which the firm can both exploit and increase its resources (Luo, 2002). In this view, (Mahoney and Pandian, 1992) when excess capacity, of physical assets, knowledge andhuman expertise exists firm tend toexploit these underused resources by entering foreign markets. This view explains why firm with valuable resources will have higher level of international export and international involvement. On the other hand, the firm may choose to enter in foreign markets in order to have direct access to new resources (Barkema and Vermeulen, 1998). In this case firms will growth internationally mainly thorough FDI in order to gain control of these resources.Overall,neither TC economics nor the RBV consider the ownership type as a determinant of overall firm internationalization.

Following recent literature (see, for example, Fernandez andNieto, 2006; Tihanyi*et al*, 2000; Tihanyi*et al*, 2003; Lien *et al*, 2005; Filatotchev*et al*, 2007; Bhaumik*et al*, 2010; Hautz*et al*, 2013; Oesterle*et al*, 2013) which has incorporated different governance variables in their analysis we have challenged this view. Our research has considered the potential role played by different kind of shareholders among the determinants of firm international level. Overall our results seem to confirm our main assumptions. We believe that these findings do not contradict the existing theories of internationalization but suggest that internationalization theories should not consider firms just as a value maximizing tool regardless the owners of the firm. Different owners have different risk attitudes and bring to the firm different resources (Carrillo, 2007; Rogers et al., 2008). Therefore, it well may be that similar firms, in the same industry sector but with different owners will have different degree of internationalization. By this point of view, we believe that our main conclusion is that family ownership lead to lower international diversification levels can contribute to a refinement of both RBV theory and TC economics. Studies about family firms show that in these firms shareholders tend to appoint executives considering also family links rather than just on the basis of proven managerial experience and expertise (Carpenter andWestphal, 2001; Enriques and Volpin, 2007). Consequently the overall management contribution to the development of resources which are valuable, rare and non-imitable is constrained. This in turn explains why the general relationship between family ownership and foreign sales is negative. However, our results show that the effects of ownership over firms' international strategies depend also on the context. Our results highlighted the fact that the much-discussed distinction between the Anglo-Saxon and the European approach to corporate governance is relevant in this context. Our findings suggest that previous results on the role of shareholders should always be consider with caution and interpreted with reference to the specific institutional context of the firms analysed. Given these cautionary notes we show that the attitude towards internationalization of financial institutions can differ sharply when the corporate governance rules and habits are different. Following our second hypothesis, partially confirmed by our data, we can state that, in the European context, firms with bank as first shareholder have lower level of internationalizationcompared to other firms even if we cannot state that bank ownership have any statistically significant impact on the distribution of export. Moreover bank ownership has a positive effect on foreign direct investments scope. On the contrary, confirming similar findings by Tihanyi et al. (2003), we found that, in an Anglo-Saxon context, institutional investors promote internationalization even if mainly through foreign direct investments.

Even if these findings add new light to the growing field of research that analyses the relationship between corporate governance, ownership and international diversification, we are aware that there is scope for further refinements and research. Our results should be interpreted with caution. First, we could not include in our analysis variables measuring the attractiveness of the different country, the relative weight and the overall, cultural, institutional and economic distance between the source and the target country. The importance of foreign activities for firms is probably also affected by these variables and future research should also control for them. Moreover,we did not consider in depth the role played by the corporate board in mediating between shareholders and mangers. The role of the board directors in monitoring managers on behalf of shareholders vary accordingly to the characteristics of the board and surely this aspect should be considered in order to have a complete view of the effect of corporate governance on international diversification. Another important extension to the present work could be made by lagging dependent variables so to avoid potential problem of endogeneity. Given the lack of data we could not address this issue in the present version of the paper but we count to improve our analysis gathering new data in the near future. Finally, it could well be that our findings on the Anglo-Saxon corporate governance system depends on country specific factor. An inclusion of US data in the sample would surely improve the reliability of our analysis. However, we are confident that one clear result emerges from our analysis and it is that the institutional context is an important determinant of the relationship between ownership and internationalization.

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