



Is Confucianism a Panacea for Improving Financial Reporting Quality? Evidence from China

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Abstract. The study breaks the inherent perceptions of Chinese Confucianism and discovers the shackle effect of Confucianism on financial reporting quality. Further analysis suggests that Confucianism intensifies the manipulation of actual business activities. The shackle effect of Confucianism is more prominent in state-owned enterprises, firms with poor internal control, less developed regions and western areas. The complement effect of culture and regulatory mechanism deepens the theoretical understanding of the economic consequences of Confucianism and provides implications for corporate governance in countries with the same cultural background.

Keywords: Chinese Confucianism · financial reporting quality · corporate governance · informal institutions

1 Introduction

Accounting information distortion seriously damages the interests of investors and is not conducive to the effective operation of capital markets. Existing literatures try to mitigate this issue. However, the capital market lacks effective judicial institutions and the framework of investor protection at the national level is not perfect in China (Du, 2013) [2]. Hence, there is not an exact conclusion that whether formal institution could effectively reduce earnings management. When formal institutions fail to function effectively, researchers turn to informal institutions. Confucianism is the most influential informal institution. Most relevant studies believe that Confucianism increases the moral binding force of managers, thereby, reduces opportunistic behavior and ensures the authenticity and reliability of financial information. However, any culture or religion has multiple dimensions (Chen et al., 2019) [1]. Fan and Xu (2022) [4] reveal that auditors' Confucianism damage the independence of auditors and increase bad news hoarding of listed firms. Is Confucianism a panacea for improving the quality of financial information? In other East Asian countries, public firms are characterized by highly concentrated ownership structure in China. As the ruler, the controlling shareholder holds the dominant power in the listed company. Confucianism enhances a norm that ministers will not overstep rulers' authority. The thought inevitably strengthens the power of controlling

shareholders and weakens the internal power checks and balances of public firms and intensifies opportunistic behavior. Therefore, with regard to firms surrounded by strong Confucianism atmosphere, it is difficult to establish an effective internal governance mechanism to reduce earnings management and ensure the high quality of financial information.

2 Background, Theory and Hypothesis

Confucianism contains profound hierarchical thoughts. China is a high-power distance society that is unlike western countries (Wang et al., 2021) [5]. The thoughts of the Ritual System and Loyalty to the Monarch of Confucianism emphasize that the subject have absolute respect and obedience to the ruler. Monarchy and patriarchy progressively become the basis of interpersonal relations that highlights this moral hierarchy. In essence, Confucian society is built on a hierarchical basis and everyone has a definite position. Every member is tightly bound by their responsibility and obedience to others. People under where are more likely to accept a hierarchical structure and demonstrate tremendous respect for the position, age, or authority than those in low power distance cultures (Zhang, 2013) [7]. Chinese people are attentive to hierarchy and authority figures, spare no effort to maintain a good relationship with high power and accept the power hierarchy to a high degree.

An obvious feature of Chinese listed companies is concentrated ownership. The agency conflict between controlling shareholders and minority shareholders and the phenomenon of One Share Dominating Exclusively is common in Chinese listed companies. The controlling shareholders hold a large number of shares is accompanied by the dominant power in public companies. Following the logic of the moral hierarchy, the controlling shareholders are the ruler and the minority shareholders are the subject. The controlling shareholders are more powerful and with higher moral hierarchy. Thus, minority shareholders tend to ideologically comply with the controlling shareholders even if their interests are damaged. In other words, Confucianism enhances the power of rulers, causing an imbalance of power in public companies, thus, it is difficult to play the role of the internal governance mechanism effectively and exacerbates agency conflicts.

In summary, Confucianism increases the power of rulers and weakens internal power checks and balances, and thus it is rough to ensure high-quality financial reporting of public companies. Hence, we formulate the hypotheses as follows:

H: Confucianism may reduce FRQ.

3 Research Design

3.1 Sample

We select relevant financial data of Chinese A-share listed firms from 2009 to 2019 as samples, covering 12 industries classified by China Securities Regulatory Commission (CSRC). To ensure the accuracy of the results, we processed the selected data as follows. First, excluding relevant data from banking, insurance. Secondly, removing ST (special treatment), and *ST (suspension from trading) of listed firms. Third, eliminate missing, discontinuous, or abnormal data. Excel and Stata17.0 were used to process the data. All continuous variables are winsorized at the 1% and 99% percentiles.

3.2 Variables

3.2.1 Independent Variables

Inspired by Du (2014) [3], we utilize the number of Confucian Institutions within 200 km of the official address of listed firms as the proxy variable of Confucianism (*Conf_200*).

3.2.2 Dependent Variables

Following Yang et al. (2022) [6], we employ discretionary accruals to measure financial reporting quality (*FRQ*).

3.3 Model

We use the following regression model to test the above hypotheses:

$$FRQ = \alpha_0 + \alpha_1 Conf_200 + \alpha_2 Control + \sum Industry + \sum Year + \varepsilon_{i,t} \quad (1)$$

In Model (1), FRQ is the dependent variable. The independent variable is the geographic-proximity-based variables of Confucianism with the label of *Conf_200*.

4 Results

4.1 Descriptive Statistics

Table 1 presents the descriptive statistics. The maximum value of *Conf_200* is 3.830 and the minimum value is 0.690. The mean and median of *Conf_200* are 1.43 and 1.390 respectively. The data suggests that there is a gap in the number of Confucian Institutions among public companies. The maximum value of FRQ is 1.490 and the minimum value is 0.000. The FRQ mean is 0.25, meaning that there is little difference in the level of accrued earnings management among A-share listed companies. Significantly, the median of *FirstRate* and *Top10Share* are 32.650 and 57.300. It means that the shareholding ratio of the first largest shareholder is up to 32.65% and the shareholding ratio of the top ten shareholders is 57.30% in half of A-share listed companies.

4.2 Benchmark Tests

In Table 2, the coefficient of *Conf_200* is significantly positive, which is consistent with our prediction. The result supports the point that any culture or religion has multiple dimensions and suggest that Confucianism is not a panacea for improving the quality of financial reporting. Therefore, we should understand the role of Confucianism in the development of contemporary business from a critical perspective.

Table 1. Descriptive statistics.

Variable	Obs	Mean	Std.Dev.	Min	Median	Max
Conf_200	10305	1.440	0.700	0.690	1.390	3.870
FRQ	10305	0.250	0.240	0.000	0.180	1.470
Lev	10305	0.440	0.200	0.0100	0.430	1.350
Growth	10305	0.830	13.690	-4.640	0.150	922.400
FirstRate	10305	34.470	14.550	3.000	32.830	89.990
Board	10305	9.650	2.370	4.000	9.000	25.000
Dual	10305	1.760	0.430	1.000	2.000	2.000
FourCom	10305	3.870	0.420	0.000	4.000	4.000
TobinQ	10305	2.080	1.510	0.150	1.640	31.400
Top10Share	10305	56.950	14.510	8.970	57.240	101.200
Size	10305	22.240	1.270	18.160	22.080	28.180

Table 2. Confucianism and FRQ.

Variables	(1)	(2)	(3)
	FRQ	FRQ	FRQ
Conf_200	0.012*** (3.46)	0.011*** (3.26)	0.008** (2.46)
Control	Yes	Yes	Yes
Cons	0.228*** (42.57)	0.268*** (4.93)	0.537*** (8.14)
Industry	No	No	Yes
Year	No	No	Yes
R ²	0.001	0.017	0.113
N	10305	10305	10305

Notes: The numbers in parentheses are t-statistics. *, ** and *** indicate significance at the 10 and 5 and 1 percent level, respectively. The standard errors are robust to heterogeneity.

4.3 Robustness Tests

Since the modified Jones model ignores the influence of intangible assets and other long-term assets on non-discretionary accruals, we use the residual of the Jones model of intangible assets as the alternative variable of FRQ. In Table 3, column (1) displays the results of the alternative dependent variable, which is consistent with the hypothesis. In addition, we narrow the scope of Confucian Institutions to a radius of 150 km around

Table 3. Alternative variables result.

Variables	(1)	(2)
	FRQ(IA)	FRQ
Conf_200	0.008 [*]	
	(1.94)	
Conf_150		0.001 ^{**}
		(2.35)
Control	Yes	Yes
Cons	0.514 ^{***}	0.485 ^{***}
	(6.12)	(7.85)
Industry	Yes	Yes
Year	Yes	Yes
R ²	0.125	0.133
N	10305	11486

a firm's official location. Column (2) shows the result of the alternative independent variable, and the conclusion holds again.

4.4 Additional Tests

4.4.1 Internal Governance Factors

A weak corporate governance is likely to encourage managers to distort financial information. As the part of internal governance, internal control aims to avoid and identify errors or fraud that could result in a misstatement of the financial statements. Therefore, we investigate whether the negative impact of Confucianism on FRQ could be affected by internal control. In Table 4, column (1)–(2) indicates the negative impact of Confucianism on FRQ is prominent in firms with poor internal control.

4.4.2 Political Factors

It is easier for state-owned enterprises (SOEs) to obtain long-term bank loans in China because their controlling shareholder is government. Compared with SOEs, non-state-owned enterprises (NSOEs) rely more on the high quality of financial reporting for funding from the capital market. Therefore, we deduce that the ownership differences of listed firms may affect the benchmark results. In Table 4, column (3)–(4) reveals that the negative impact of Confucianism on FRQ is more significant in SOEs. The result supports the view that SOEs are not dependent on the quality of financial reporting for funding.

Table 4. Additional test results.

Variables	(1)	(2)	(3)	(4)
	Internal Control		Political Connection	
	High	Low	SOEs	NSOEs
Conf_200	0.006*	0.044**	0.023***	-0.002
	(1.82)	(2.55)	(4.01)	(-0.40)
Control	Yes	Yes	Yes	Yes
Cons	0.556***	-0.103	0.403***	0.516***
	(8.21)	(-0.26)	(3.64)	(5.87)
Difference:	4.55**		11.38***	
Industry	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes
R ²	0.120	0.170	0.165	0.132
N	9609	696	6113	6018

Notes: The numbers in parentheses are t-statistics. *, ** and *** indicate significance at the 10 and 5 and 1 percent level, respectively. The standard errors are robust to heterogeneity.

5 Conclusion

This paper examines the influence of Confucianism on the quality of financial reporting from a critical perspective, using a sample of Chinese listed companies from 2009 to 2019. The results imply that the shackle effect of Confucianism played a prominent negative role on financial reporting quality and intensifies the manipulation of actual business activities. The negative impact of Confucianism on the quality of financial reporting is prominent in SOEs, firms with poor internal control and less developed regions.

The research limitation is that the measurement of the influence of Confucianism based on geographical proximity may not be accurate enough. The geographic distance between a firm and Confucian Institutions is currently the most common method to measure the influence of Confucianism. Although we try to improve the measurement method of Confucianism, the accuracy remains to be verified in future studies.

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