The Evolution of Corporate Governance in China
The effects of ownership on Chinese listed companies

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Executive summary

This thesis examines the evolution of corporate governance in China through the transition process. As corporate governance reform in China is an integral part of a program of wider economic reform, a general stakeholder perspective that accounts for the role of external investors, the political system and the role of the State was adopted.

In order to provide a theoretical perspective, the paper reviews key literature pertaining to corporate governance systems, internal and external governance mechanisms, and specific features of transitional economies such as high ownership concentration, weak institutional environments, and the prominent role of State-owned enterprises that are likely to affect the implementation of good corporate governance practices. The specific case of China is then examined both in terms of its historical development and current situation. Chinese social and cultural traditions, the role of the stock market and Chinese institutional reform were identified as areas of attention that may play a role in implementing a functioning corporate governance system in China. In light of the significant role the restructuring of SOE’s plays in China’s economic reform and development of a corporate governance system, the paper proceeds to examine empirically the affects of ownership on the performance of Chinese listed companies. Although the study produces inconclusive results, it does provide some insight as to the perceived importance of ownership to private investors.

The paper finds ultimately that China has made significant progress in its pursuit of a functioning corporate governance system. The reform of former SOE’s is continuing with the gradual transfer of non-tradable State shares to tradable shares, although the rights of minority shareholders must continue to be strengthened and protected. Increased stock market liquidity will also allow the market for corporate control to develop as an effective external governance mechanism in the future. The Chinese legal and institutional environments have been strengthened greatly in recent years including the introduction of laws pertaining to information disclosure. Finally the paper notes that due to the important social role of SOE’s and the ruling party’s traditional opposition to private property rights, the State may find it hard to give up full control. In this way, conflicting interests are likely to persist in Chinese listed companies and provide a significant barrier to implementing good governance practices.
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1.0 Introduction

1.1 Introduction

Studies in corporate governance have traditionally been based on advanced market economies until the 1997/98 financial crisis highlighted the importance of corporate governance systems in developing and transition economies. Many issues relating to the practice of good corporate governance transcend national borders, however in emerging and transition economies there are likely to be challenges, priorities and solutions that are specific to the individual countries stage of development/transition and historical background.

The People’s Republic of China\(^1\) is currently the world’s third largest economy, and largest transition economy. China is also a working example where corporate governance is evolving. China’s economy is essentially in a state of transformation, where it is simultaneously growing, developing and being transformed from a command to a more market-based economy. Although China’s transition from a command economy began in the late 1970’s, it has only been in the past few years that corporate governance reform has gained prominence – owing to a series of high-profile corporate scandals that highlighted the need to review the corporate governance system.

The program of ‘corporatisation’ started by the Chinese authorities in 1993 required the restructuring of largely inefficient State-owned enterprises\(^2\), along with the development of supporting institutions and the establishment of new capital markets. SOE’s are themselves strategically very important to the Chinese economy. Many of the key industries of the Chinese economy, such as power, oil, chemicals, steel, construction and machinery are controlled by large SOE’s. Furthermore SOE’s have traditionally been part of a social system that provided social security for the employees. The success of China’s SOE reform is therefore a significant factor in its future economic growth, and its ability to manage social issues.

China’s continual growth and social stability crucially depend on the success of its economic reforms, and the program to reform SOE’s is one of the key remaining issues in China’s

\(^1\) The People’s Republic of China will for the remainder of this thesis be abbreviated to China  
\(^2\) State-owned enterprises will for the remainder of this thesis be abbreviated to SOE’s
transition to a market-based economy. The consequence of the corporate structures selected will therefore be considerable, especially as the country’s market economy gains impetus.

The paper aims to contribute to the ongoing body of work in the field by providing a comprehensive review of corporate governance literature overall, and also in relation to China in particular. The paper also brings ownership studies of Chinese listed companies up to date through an empirical analysis of the effects of ownership on the performance of former SOE’s. Numerous surveys of Chinese corporate governance have been published in the last few years, however since corporate governance in China is evolving rapidly, the paper aims to provide an overview of Chinese corporate governance that is up-to-date and complete as possible by including the high growth period between 2003 and 2007. The importance of ownership as a corporate governance mechanism in China is also considered in relation to other governance mechanisms, and discussed in the context of the overall Chinese corporate governance system, and how it is likely to develop in the future. The research objectives of this paper are encapsulated in the following research questions:

1.2 Research questions

1) How has the corporate governance system in China evolved in the light of recent economic reform?

2) Can ownership concentration and structure help explain the performance of Chinese listed companies?

3) How is this likely to affect the future development of the Chinese corporate governance system?
1.3 **Demarcation of the paper**

The thesis is divided into seven chapters. The structure being as follows:

Chapter 1 is an introduction to the paper where the background and motivation for the study are presented and the research objectives defined. The structure of the paper and its methodology are also outlined.

Chapter 2 provides a literature review of pertinent works on the subject of corporate governance that discuss theory relating to corporate governance models and national corporate governance systems. The framework presented by Liu (2005) is thereafter used to sub-divide and review a number of internal and external governance mechanisms. Finally the corporate governance in emerging and transition economies is considered, along with the role of State-owned enterprises.

Chapter 3 provides first a historical review of Chinese economic development through the transition process, and thereafter an overview of current economic reform. Specific areas of attention have also been highlighted in relation to the continuing Chinese economic reforms.

Chapter 4 examines current corporate governance practices in China, in the context of the internal and external mechanisms framework outlined in Chapter 2.

Chapter 5 is the empirical study of the ownership and performance of Chinese listed companies. The results of the study are also presented.

Chapter 6 presents an analysis of the findings from the empirical study. These findings are also discussed in relation to other Chinese corporate governance mechanisms, and how they are likely to impact the future development of corporate governance in China.

Chapter 7 provides some concluding remarks.
1.4 Methodology

The paper aims to provide insight into the Chinese corporate governance system both through the use of established theory and empirical analysis. As corporate governance reform in China is an integral part of a program of wider economic reform, it was decided that a general stakeholder perspective that accounts for the role of external investors, the political system and the role of the State be adopted for the paper. As the scope of the paper is relatively broad, it was also decided that a qualitative approach would be most applicable, except for the analysis of ownership concentration and ownership structures, where a quantitative study can be applied.

The intention is to take a dynamic perspective of the evolution throughout the transition period focusing on how key elements have evolved and what were the drivers of change. Firstly, the paper will review key corporate governance literature as it pertains to national corporate governance systems and their component mechanisms. Specific features of emerging and transition economies that may affect the introduction of effective corporate governance are also explored, as China is expected to share similarities with them. In relation to China specifically, both the historical development of the economy through the transition period, and the current situation are examined. The historical development is included as many of the current struggles with corporate governance are rooted in China’s past. Although this section is somewhat descriptive, it is highly relevant for the thesis and for the understanding of the overall research. In the overview of the current situation, both internal and external factors of corporate governance are explored.

On the basis of the important role the restructuring of SOE’s plays in the establishment of a functioning corporate governance system in China, an empirical study of ownership as a particular corporate governance mechanism is conducted. The analysis will attempt to determine if ownership concentration and ownership structure of Chinese listed companies can be used to explain their performance. This analysis will be based solely on published and readily available data. Finally, a discussion of the findings from the empirical study, combined with the findings relating to Chinese corporate governance reform and current practices is presented. The discussion will focus on key areas such as the restructuring of SOE’s and institutional development in China, in the context of their current and future development paths.
2.0 Literature Review

2.1 Defining Corporate Governance

The influential 1992 UK Cadbury Report defines corporate governance fundamentally but somewhat simplistically as “the system by which companies are directed and controlled” (Cadbury report, 1992). Whilst Milhaupt (1998) describes corporate governance as pertaining essentially to the relationship between shareholders and management, although the author noted that this was not without debate.

The OECD Principles of Corporate Governance (2004) outlines non-binding standards, principles and good practices for corporate governance. It also provides guidance for the implementation of standards and principles. The report describes corporate governance as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined” (OECD Principles of Corporate Governance, 2004).

Good corporate governance serves many important objectives. It enhances the quality of listed companies, forms a scientific constraint and incentive mechanism that motivates managers to maximise returns on investment, and effectively protect the interests of investors. Furthermore, it creates fairness, transparency and accountability in company business activities. In short, good corporate governance is an actuator for good company performance; as it effectively reduces risks and decision mistakes. Good corporate governance is also a firm foundation for healthy securities markets in the long run. It reduces speculation and violations of market rules, and thereby helps ensure stability in the financial markets. This heightens public confidence in firms as well as playing an important role in attracting foreign investment.

2.2 Models of Corporate Governance

2.2.1 The Shareholder Model

The identification of the separation of ownership and control as a source of conflicting interests between owners and managers can be traced back to Berle and Means (1932). Jensen and
Meckling (1976) developed the theory in an agency context, where the agent (manager) acts on behalf of the principle (owner), but differing objectives of the owners and managers, incomplete information on the managers’ behaviour, and incomplete contracts give rise to the principle-agent problem. Particularly, incomplete contracts as a source of agency problems have been discussed by many authors, such as; Coase (1937), Fama and Jensen (1983) and Hart (1995).

Much conventional corporate governance thinking is focused on arrangements to solve this agency problem and ensure the firm is operated in the interests of the owners (shareholders and creditors). In line with this thinking, Shliefer and Vishny (1997) define corporate governance as “dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”.

There has been a great deal of critique relating to this ‘conventional’ view of corporate governance. Firstly, this perspective overlooks the diversity of the stakeholders within the principal-agent relationship and thus ignores the game around an enterprise, which is performed by multiple stakeholders with varying degrees of conflicting interests among themselves. Secondly, this perspective focuses too narrowly on the bilateral contract between owners and managers, and ignores the interdependencies and interactions among stakeholders. It is also criticised for treating managers as opportunistic agents that are driven by individual utility maximisation. Opponents of the shareholder model stress that the interests of all of the stakeholders’ interests must be accounted for. If the emphasis is solely on shareholder value maximisation, there are externalities that are imposed on other stakeholders of the corporation. This critique is the foundation of the corporate governance stakeholder model advocated by many theorists.

2.2.2 The Stakeholder Model

Stakeholders in a corporation include, but are not limited to suppliers, employees, customers, governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees, prospective customers and the general public. Various stakeholder models and definitions are advocated by scholars. Allen (2005) suggests that corporate governance concerns arrangements to ensure that firms are operated in a way that society’s resources are used efficiently, and that competition and reputation should also be
included as mechanisms to deal with in addition to the conventional ones. The model used by Allen suggests that when managers and employees reach full consensus and cooperate, the Pareto efficient outcome can be achieved.

Allen’s model however, is too simple to be used for analysing complex realities, especially when the role of different stakeholders is to be considered. Tirole (2001) advocates that corporate governance consists of institutions that induce or force management to internalise the welfare of stakeholders. Based on this approach, a stakeholder model is designed in which there is a broader mission of management, and management in turn is sharing control with stakeholders. The former suggests that management should aim at maximising the sum of stakeholders’ benefits, and incentive systems should then be designed with the purpose of achieving this aim. In this model, control is shared between stakeholders in the form of generalised codeterminations. This model is more elaborately designed, but it is based on the assumption of optimal contracting among stakeholders. This assumption is however considered unrealistic as there are a range of institutional setting restrictions on the contracts among stakeholders, for example, government intervention is an important factor that is prevalent in many emerging economies.

Berglof and von Thadden (1999) define corporate governance as the “set of mechanisms that translate signals from product and input markets into firm behaviour.” Based on this approach, the authors are proposing a broader corporate governance paradigm. Firstly, the model consists of multilateral negotiations and influence-seeking among stakeholders, shareholders and other groups – both inside and outside the firm. Secondly, the model includes different institutions providing mechanisms, and influencing the transmission of signals. In addition to the legal and financial systems, the model also includes facets such as the product, input and labour markets. In the case of intense competition in the product and input markets, firms’ investment decisions are under pressure from consumers and suppliers as well as shareholders, and managers must focus on running the firm effectively in order to remain competitive. Thus, the competitive situation of the firm is of particular significance for consumers and suppliers, as increased competition leads to stronger protection of their interests.

Employees make up another group which can monitor managers’ decision making, and the labour market is important for the role of employees. The presence of a highly mobile workforce and strong unions means that employees are in a strong position, and can greatly influence firms’
decisions. Finally, stakeholders and institutions are also influenced by national and local government. This model also accounts for the political system and the role of government having influence on the transmission of signals, either directly or indirectly through the external framework it provides.

The stakeholder model proposed by Berglof and von Thadden (1999) is broadly designed. It recognises both the diversity of stakeholders, and the multilateral interactions between them. The model also accounts for the important interactions between governance arrangements and national political, legal, and financial systems, and provides a number of checks and balances between stakeholder groups and their institutional constraints.

### 2.3 Corporate Governance Systems

National corporate governance systems can be distinguished in terms of the degree of ownership concentration, and the control and identity of the controlling shareholders. A widely dispersed ownership structure is a feature of outsider systems (e.g. US and UK), while concentrated ownership is characteristic of insider systems (e.g. Germany and Japan). Outsider systems are characterised by having independent boards, dispersed ownership, transparent information disclosures, well-developed stock markets, well developed legal systems, and a competitive market for corporate control. Insider systems are characterised by concentrated ownership structure, widespread cross-shareholding, limited information disclosures, and reliance on family finance or banking systems (Shleifer and Vishny 1997). The insider system emphasises the function of banks and legal persons, which have great influence over the firm’s long-term development. As majority shareholders, banks and corporations play a tremendous financial role and thereby directly impact corporate governance. In the insider system, it is minority shareholders that are in the weaker position.

The various corporate governance systems that exist globally have emerged in an ad-hoc manner (Sison, 2000; Shleifer and Vishny, 1997). Firms and economies have been shaped simply by following conventions, or by the environment, worldview and culture, legislative and political frameworks in which they operate. Over time they have evolved into today’s corporate governance systems, although it is certain they continue to evolve. Besides the political and legal influence, systems have been influenced by “culture, democratic representation and
accountability, the distribution of power, and the protection of property rights and equality” (Sison, 2000, p181). Other influencing factors include the level of media freedom and the intensity of competition amongst firms (Zingales, 2000). The essential point however, is that the national corporate governance system typically evolves in an ad-hoc manner, without being designed specifically to achieve maximum efficiency, economic benefit, or shareholder protection or wealth. Corporate governance systems are instead driven by a number of combined forces.

Some authors suggest that the political process, rather than maximising social welfare, accommodates the most powerful and influential players in the economy. For instance, Roe (1994) contends that in US politics, it is not economic efficiency which has shaped corporate America, as the law actively discourages large investors. Institutions such as banks, mutual and pension funds, and insurance companies are all precluded from exercising any real control or influence over corporations. The consolidations that occurred during the takeover wave of the 1980s were met with an adverse political reaction, which was largely seen as a continuation of anti-large policies (Grundfest, 1990; Jensen, 1993). The very distinct development of legal protection for small shareholders in the US is suggested by some to be a response to the suppression of large investors, at least in part (Bhide, 1993; Coffee, 1991; Douglas 1940). Roe (1994) concludes that as large investors are discouraged, the US system is far from efficient.

This assertion of the dominating political process also applies to the insider systems of Germany and Japan. During the period of rapid economic development of the late 19th century, these countries forged their systems of powerful banks with healthy State support (Gerschenkron, 1962). Furthermore, German banks discouraged initiatives such as disclosure rules, insider trading prohibitions and increased minority shareholder protection. These initiatives ensured that minority shareholders never became dominant enough to protect their rights, and that the banks maintained a powerful position. These legal systems thus developed to accommodate the banks as the predominant economic power.

The evolution of national corporate governance systems thus sheds some light on the issues involved in the process. The arguments show clearly that there are many kinds of influences behind the search for the optimum corporate governance system. These influences have also had a number of policy implications, particularly for emerging and transitional economies.
The US, UK, Germany, and Japan have some of the best corporate governance systems in the world. The advanced market economies of these countries have solved their governance problems better than many other countries, however this in no way implies that these systems are perfect solutions and governance mechanisms cannot be improved. In less developed countries, corporate governance systems are practically non-existent (Shleifer and Vishny 1997). In emerging and transition economies, corporate governance mechanisms must be developed and implemented in order to improve the overall quality of corporate governance.

2.4 Corporate Governance Mechanisms

Corporate governance mechanisms consist of a combination of economic and legal institutions that ensure the flow of external financing to the firm, aligns the interests of owners (investors) with managers and other stakeholders, and guarantees a return to investors.

Corporate governance mechanisms are defined and categorised by different authors in different ways. Shleifer and Vishny (1997) identify five categories; (1) incentive contracts, (2) reputation considerations by managers and investor’s optimism, (3) legal protection, (4) large investors and (5) specific governance arrangements, such as the debt/equity choice, LBO’s, co-operatives and State ownership.

Maher and Anderson (1999), on the other hand, recognise three broader mechanisms; (1) executive compensation plans, monitoring by boards etc., (2) legal protection of shareholder rights, prohibition of insider dealing etc., and (3) indirect control over managers through capital markets, managerial labour markets, and markets for corporate control (e.g. takeovers).

Liu (2005) identifies two typical governance mechanisms that address the conflicts of interest between shareholders and managers, and between majority and minority shareholders. The first is an internal mechanism consisting of the ownership structure, the board of directors, executive compensation, and information disclosure and transparency. The second is an external mechanism consisting of a market for corporate control, product market competition, good legal
infrastructure and rigorous law enforcement\textsuperscript{3}. The Liu (2005) categorisation will hereafter be used as the framework to present and discuss corporate governance mechanisms.

\subsection*{2.4.1 Internal Mechanisms}

\textbf{Ownership structure}

The agency problem originates from the separation of ownership and control, which creates information asymmetry and agency costs (Fama and Jensen, 1983). Managerial behaviour does not necessarily serve the best interests of shareholders (Shleifer and Vishny, 1997), and management decisions can reflect the manager’s personal interests rather than the shareholders interests. It has been found however, that even a modest concentration of ownership is sufficient to provide large investors an incentive to monitor managers, and provide managers with the incentive to work harder (Jensen and Meckling, 1976; Shleifer and Vishny, 1986).

Alternatively, highly concentrated ownership may be a sign of poor investor protection. In this case, controlling shareholders have strong incentives to monitor management and thereby maximise profits, but minority shareholders are not protected from expropriation by the controlling shareholders and management (La Porta et al., 1998). In this case, the conflict of interest lays not only between shareholders and management, but now also between the controlling shareholder and minority shareholders. A well designed ownership structure therefore is one of the most important governance mechanisms in terms of value maximisation.

La Porta et al. (1998) define the following five types of controlling shareholders: 1) a family or an individual, 2) the State, 3) a widely held financial institution such as a bank or an insurance company, 4) a widely held corporation, or 5) miscellaneous. Countries with poor shareholder protection such as emerging and transition countries experience most of the above mentioned types except the ‘widely held corporation’.

A good corporate governance system should combine legal protection and a somewhat concentrated ownership structure (Shleifer and Vishny, 1997). The legal protection of shareholders (especially minority shareholders) determines ownership concentration. Research

\textsuperscript{3} This is based on recent Corporate Governance research, e.g. CLSA, S&P 2001, OECD Principles of Corporate Governance 2004.
finds that highly concentrated ownership is a result of weak legal protection for investors (La Porta et al., 1998). This would explain why ownership structures in the US and UK companies are widely dispersed. Good legal protection means that shareholders are less fearful of being expropriated, and are willing to reduce their ownership and divest shares.

In emerging and transition countries with weak legal protection, controlling shareholders are able to expropriate the firm’s assets at the expense of minority shareholders. This phenomenon is often referred to as ‘tunnelling’. Johnson et al. (2000) use the term “tunnelling” to describe the transfer of assets and profits out of the company for the benefit of its controlling shareholders. Controlling shareholders are easily able to transfer company’s resources for their own benefit through self-dealing transactions. Such transactions include “outright theft or fraud, which are illegal everywhere though often go undetected or unpunished, but also asset sales, contracts such as transfer pricing advantageous to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporate opportunities, and so on.” Johnson et al. (2000)

The Board of Directors

The board of directors is a crucial internal mechanism of the overall corporate governance system. It is the critical link between owners and management, and sets the rules of governance. Solutions to corporate governance problems can be initiated by boards. Although shareholders are the ultimate owners of a company, they do not have the virtual power to control either the daily operations or the long-term policies. The board of directors are instead the key players in terms of decision-making. Boards are sanctioned by the shareholders, and are responsible for providing strategic guidance, effective supervision of management and ensuring the maximisation of shareholders’ interests.

Board Structure

Outsider countries (e.g. UK and US) have a one-tier board structure whilst insider countries (e.g. Continental European/Japan) use a two-tier model. In the two-tier structure, there are three governing bodies, the supervisory board; the management board the general shareholder meeting. The essential difference between the one-tier and two-tier structures is the absence of the supervisory board in the one-tier structure. In the two-tier structure, the supervisory board has
the duty of supervising both management and the board of directors (management board). One advantage of the two-tier structure is that the supervisory board has independence from executive directors. However, it is often so far removed from the company business operations that it lacks important information necessary to carry out its function. The advantage of one-tier structure is that the board is composed of independent directors to provide objectivity, and executive directors that are familiar with the company business. The disadvantage of the one-tier structure however, is that it is easier for the board to be manipulated internally or ‘captured’.

There is no definitive answer to the question of which board structure is superior. Different board structures are implemented to suit different economic and market systems. The present trend throughout the world however, is moving in favour on the one-tier structure (OECD Principles of Corporate Governance, 2004).

**Board Composition**

The composition of the board is an important aspect that helps guarantee the effectiveness of board operations. A modern board consists of individual executive directors (such as the finance or the marketing directors) who deal with a particular function within the company. The board will also consist of non-executive and independent directors.4

Existing evidence suggests that independent directors are able to help protect the interests of shareholders in specific circumstances when there is an agency problem (Byrd and Hickman 1992; Lee et al., 1992). Furthermore, independent directors monitor management more efficiently than executive directors.

Large public companies usually set up special sub-committees under the board. For instance, a compensation committee composed of entirely independent directors determines the remuneration level of senior management. Kesner (1988) finds that the most important board

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4 The U.S. National Association of Corporate Directors (1996) pp 9-10 defines an independent director as one who (a) has not been employed by the company in an executive capacity within the last five years, (b) is not affiliated with a company, that is an adviser or consultant to the company, (c) is not affiliated with a significant customer of or supplier to the company, (d) has no personal services contracts with the company or with a member of the company’s senior management, (e) is not affiliated with a not-for-profit entity that receives significant contributions from the company, (f) has not had any business relationships with the company other than service as a director within last five years, (g) is not employed by a public company for which an executive officer of the company serves as a director, (h) has not had any of the relationships described above with any affiliate of the company, and (i) is not a member of the immediate family of any person described above. 

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decisions result from such sub-committees. Vance (1983) further argues that the audit, executive, compensation, and nomination committees have a great influence over company activities. Particularly the audit committee, consisting of independent directors, is generally expected to be an effective monitoring body (Klein, 1998). Davidson et al., (1998) find that whilst overall board composition appears to be unrelated to company performance, the structure of the finance and accounting committees appear to be considerably more influential.

Other Board Considerations

The size of the board, along with the frequency of board meetings appear to be related to company performance. The evidence on the optimum size of the board however, is inconclusive. Yermack (1996) and Eisenberg et al. (1998) argue that smaller boards may be more functional and could provide better financial reporting supervision, whereas larger boards may possess a greater depth of knowledge and experience. A board that meets more often should be able to devote more time to company issues. Vafeas (1999) find that frequent board meetings can improve a firm’s financial performance.

In summation, effective board performance helps ensure that company objectives are realised, resources are allocated efficiently, and the interests of shareholders are reflected in management decisions.

Executive Compensation

Providing executives with a highly contingent, long term incentive-related contract is another way to influence behaviour and align management interests with those of shareholders. Incentive contracts are comprised of various elements, including salary and bonuses, share ownership, stock options, and (in the case of poor performance) the threat of dismissal (Jensen and Meckling, 1976; Fama, 1980). The optimal incentive contract is determined by how well it influences management’s performance, e.g., the degree of risk aversion and effectiveness of decision-making (Mirrlees, 1976).

Research shows that there is a positive relationship between remuneration and performance and thus rejects the extreme hypothesis of complete separation of ownership and control (Murphy, 1985). The sensitivity of pay to performance is broadly similar in the US, Germany and Japan.
According to Jensen and Murphy’s (1990) research conclusions, there appears to be a direct correlation between pay and performance, and it is found that executive pay rises/falls by around US$ 3 per every US$ 1000 change in value to shareholders.

It is important to note that excessive executive compensation is a form of expropriation from shareholders. Further and more serious problems may arise from high incentive contracts. Stock option plans, as a main form of incentive contract for executives, has become increasingly controversial. The main argument in favour of stock option plans is that they provide good incentives for managers to act in the best interests of the shareholders. The argument against them however, is that they can create opportunities for self-dealing by management, especially if the board of directors is an inefficient monitor (Shleifer and Vishny, 1997). Yermack (1997) finds that managers often receive stock options shortly before an announcement of favourable news, and likewise delay issuing them until after bad reports are released. It was for example, the increased use of stock options (and direct ownership) that led executives at Enron and Worldcom to manipulate accounting figures, and in turn artificially inflate the share price (Cassidy, 2002; Madrick, 2003).

Frydman and Saks (2007) reviewed the development of US executive compensation in the period 1936-2005, and found that incentive pay, including stock option plans, form an increasing part of executives total remuneration packages. Compensation policy is a very important tool in creating a successful company, and stock ownership is the most powerful link between executive value and shareholder value. Thus, Jensen and Murphy (1990) argue the problem is not how much remuneration executives receive, but rather in what form it is received.

**Information Disclosure and Transparency**

Information disclosure is: “releasing the company’s financial and non-financial information completely, accurately, timely, and openly to shareholders and stakeholders for the purpose of enhancing their participation and protecting their interests”\(^5\).

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\(^5\) This is a part of good governance and a key factor in emerging and transition economies. Reliable and timely information disclosure affects decision-makers outside the company shareholders, investors and potential investors, and stakeholders, who decide where to place their capital. Providing adequate financial reporting is one of the primary responsibilities of management. Auditors should be accountable for their audit reports.
Healy and Palepu (2001) argue that the reasons for a company to volunteer information are three-fold; to reduce the cost of capital, increase the liquidity of their shares and to increase their following by financial analysts. In particular, reducing the cost of capital and operating costs, and minimising risks are very important factors. Timely and comprehensive information disclosure can help ease investors’ concerns over a possible risk of default. The quality and amount of information firms disclose affects the capital market, thus affect the firms cost of capital. When asymmetric information exists between investors and management, moral hazard and adverse selection problems can arise. Management has first-hand access to company information, where investors do not. Speculative managers may therefore focus more on their own personal interests. Improving the quality of information disclosure could eliminate such asymmetry and reduce the cost of capital (Verrecchia, 2001).

Controlling shareholders that control more seats on the board have less incentive to disclose information at board level, and likewise may also make use of their information advantage to manipulate disclosure to investors in their own interests, thus lowering the quality of information delivered (Shleifer and Vishny (1997).

2.4.2 External Mechanisms

The Market for Corporate Control

The market for corporate control is defined as the market in which managers compete for the control rights over company resources. It is often referred to the ‘takeover’ or ‘divestiture’ market. A takeover can enhance shareholder value through mergers and acquisitions, tender offers, proxy contests, hostile takeovers, and often a combination of these are involved (Jensen and Ruback, 1983).

Mergers are negotiated directly with the management and approved by the board of directors of the target company, before being voted on by target shareholders. Mergers or tender offers occur when the bidding firm offers to purchase shares of the target firm at a price higher than the official market value. Proxy contests occur when an insurgent group, often led by dissatisfied former managers or large shareholders, attempts to gain enough backing amongst shareholders to

Management may deliver information through annual reports, quarterly reports, financial analysts, corporate website, press conference, news releases or analyst meetings (Chen and Jian, 2006).
appoint a majority of board members (Jensen and Ruback, 1983). A hostile takeover is a form of takeover which runs against the wishes of the target firm’s management and board. In a typical hostile takeover, a bidder makes a tender offer to the dispersed shareholders of the target firm, and thus can be viewed as a particular mechanism for ownership concentration (Shleifer and Vishny, 1997).

A takeover can increase the combined value of the target and acquiring firm, usually evidenced through the stock price appreciation of the target firm (around 20-30% depending on the type of transaction) after the attempted takeover announcement (Jensen and Ruback, 1983). Takeover targets are in many cases poorly performing companies (Mørck et al., 1989). If the takeover is successful, inefficient managers are usually removed (Martin and McConnell, 1991). Jensen (1986) argues that takeovers solve the free cash-flow problem, as they usually lead to the distribution of the firm’s profits to investors over time. The market for corporate control is widely regarded in outsider countries as a critical external corporate governance mechanism; one in which managerial discretion is effectively controlled. The market for corporate control is therefore often quite dynamic, and its functions are effectively displayed.

**Product Market Competition**

Product market competition is an important external mechanism in as it affects management incentives, and thereby the efficiency of the firm. Table 2-1 describes the effects of product market competition on performance and other incentive mechanisms in corporate governance. Even in a weak governance environment, strong product market competition can act to align managers’ goals to the aim of efficient productivity (Allen and Gale, 2000). Competition encourages management to operate more efficiently and reduce costs in order to avoid bankruptcy.

Evidence on the influence of product market competition on performance however, appears inconclusive. Based on a survey of Norwegian companies, Klette (1999) finds the relationship between competition and firm performance to be negative. Scharfstein (1988) shows that increased product market competition leads to managerial slack, however Hart (1983) finds the opposite to be true.
Strong product market competition may in turn create other problems. Milgrom and Roberts (1992) find that competitive pressure may exacerbate the moral hazard problems in the US savings and loans (S&L) industry. In order to survive in an environment of fierce competition, S&L executives must gamble on risky investments. Shleifer (2004) argues that competitive pressure can lead to a variety of unethical practices, e.g., child labour, corruption, excessive executive pay, and earnings manipulation.

**Table 2.1 Effects of Product Market Competition on Performance and other Incentive Mechanisms**

<table>
<thead>
<tr>
<th>From Product market competition to corporate performance</th>
<th>Strong product market competition forces managers to focus on better financial performance, as bankruptcy and redundancy may be the ultimate result (Scherer, 1980; Hart, 1983).</th>
</tr>
</thead>
<tbody>
<tr>
<td>From Product market competition to ownership structure</td>
<td>Financial institutions that compete intensely in their own product markets (e.g. Savings and Loans) may have stronger incentives to demand better financial performance on their own equity investments, than a financial owner that does not face strong competition in their own product markets.</td>
</tr>
<tr>
<td>From Product market competition to incentive based compensation</td>
<td>Product market competition heightens the incentive effect of the remuneration system, as it allows remuneration to correlate relative to the performance of close competitors rather than relative to the market (Nalebuff and Stiglitz, 1983; Shleifer, 1985; Hermalin, 1992).</td>
</tr>
<tr>
<td>From Product market competition to performance monitoring system</td>
<td>Higher product market competition makes it easier to measure the performance of a firm as close competitors act as a benchmark (Nalebuff and Stiglitz, 1983; Shleifer, 1985). It is also easier to ascertain how much of a firm’s profit is determined by monopoly pricing. In order to find the social efficiency of the firm, this must be subtracted from net profit.</td>
</tr>
</tbody>
</table>

*Source: Table adapted from Encycogov (produced by ViamInvest)*

Shleifer (2004) argues that if a firm treats honesty as a normal good, then the demand for honesty will be lower in more competitive environments, since competition reduces operating profits. If a
company uses unethical or illegal ways to gain competitive advantage, then competition may not lead to socially desirable outcomes.

These inconsistent conclusions may be partially due to the research ignoring the interaction between competition and the enterprise institution. Based on the analysis of (listed) Chinese manufacturing firms, Li and Niu (2006) find that if ownership is either moderately concentrated or relatively dispersed, the interaction between competition and firm governance is complementary. This means that firms are more productive in a competitive environment. Alternatively, if ownership is highly concentrated, competition and governance become substitutes, meaning that firms become less productive in a competitive environment. Li and Niu (2006) also find product market competition to be complementary to board efficiency and the effectiveness of executive compensation.

### Legal Infrastructure and Law Enforcement

There is no doubt that a robust corporate governance system is supported by a well-functioning legal infrastructure, and law enforcement. The most important legal rights of shareholders are voting on the major issues facing the firm, and the appointment of directors (Manne, 1965; Easterbrook and Fischel, 1983). The legal environment of a country has a significant effect on the size of the capital market. La Porta et al. (1997) conclude that a good legal environment protects investors against expropriation by managers, and increases their willingness to invest in equities. In this way, the scope of capital markets becomes broader and more valuable.

The legal environment, measured by both the character of laws on the books and the quality of law enforcement, plays an important role in preventing the expropriation of minority shareholders by controlling shareholders. La Porta et al. (1998) find that countries with poor legal protection of minority shareholders have more concentrated ownership structures and smaller capital markets. Measured by the efficiency of the judicial system, the rule of law, corruption, the risk of expropriation and the possibility of contract repudiation by the government, law enforcement is found to be better in richer countries than poorer countries.

The difference in legal protection for investors also helps explain why firms are financed differently across countries. In the US, both large and smaller minority shareholders are protected by an extensive legal system that emphasises the protection of minority rights,
facilitates share transfers, maintains the independent election of directors and provides shareholders with the power to sue directors for violations of fiduciary duty, including through class action suits (Shleifer and Vishny, 1997). Class action suits are however, not permitted outside of the US and Canada (Romano, 1993).

Improving the legal infrastructure and enforcement is the most obvious strategy to reduce the agency conflict between controlling shareholders and minority shareholders. It is clear that legal infrastructure and law enforcement are fundamental elements of corporate governance. Legal protection of investors and concentration of ownership are also complementary approaches to the improvement of corporate governance.

2.5 Corporate Governance in Transition Economies

Corporate governance has been a prominent part of policy agendas in developed market economies for some considerable time. In emerging and transition economies, it has taken longer to become integrated into policy debates. However, since the Asian financial crisis of 1997/98 it has become a much more prominent issue.

The main area of focus for much corporate governance literature has traditionally centred on the conflicting interests of weak, dispersed shareholders and self-interested management. However, La Porta et al. (1999) and Barca and Becht (1999) have shown that widely held firms are only common in countries with high levels of investor protection such as the UK and US, and are not the norm globally. Furthermore, the assumption made by most corporate finance theory that firms operate under a functioning civil or common-law justice system is not the case in many transitional economies (Berglöf and von Thadden, 2000). Many of the findings for developed countries should therefore not be considered absolute in relation to emerging or transition economies. In transition economies there are challenges, priorities and solutions which are different from those in developed economies, and this is an important consideration for transition countries seeking to implement alternative governance models.

Firms in transitional economies are more likely to use internal resources to fund expansion projects rather than seeking external financing. Fama and French (1989) find that the risk premium for external funds is often high due to weaknesses in investor protection, enforcement and transparency. A reliance on internal funds however can restrict firm growth, if the firm is
starved of capital in order to fund expansion (Perotti and Gelfer, 2001). The liquidity constraint can be lessened however, by redirecting resources among the firms in a business group (Berglöf and von Thadden, 2000), especially if it is a hierarchical group that is led by a bank (Perotti and Gelfer, 2001). Bank credit is the most common source of external capital in transition economies, and plays an important role in supporting economic growth (Perotti, 1993). If traditional financing channels are disrupted before new and reliable ones are able to be created, financial sector reform could damage existing production (disorganisation), leading to a large decline in output (Blanchard and Kremer, 1997). This is potentially a serious problem in transitional economies. At the start of the transition process, a basic banking system is generally in place whilst functioning equity markets are almost non-existent. It is therefore likely that the development of creditor rights might have a priority over those of minority shareholders. In this way, creditor rights are expected to develop ahead of shareholder rights in the context of legal reform (Carlin and Mayer, 1998; Pistor et al, 2000).

Important common features of transitional economies are a large dominating sector of former SOE’s that requires restructuring, and a need for new enterprises in underdeveloped parts of the economy, especially the service sector (Berglöf and von Thadden, 2000). In addition transition economies commonly inherit a dysfunctional legal system, with many other basic institutions such as capital markets typically having to be built up from scratch (Berglöf and von Thadden, 2000). The limited power and scope of both private and public enforcement can prevent investors from bringing lawsuits and there is often great uncertainty over their rights (Berglöf and Claessens, 2004). Improving investor protection is likely to be crucial for most transition economies (La Porta et al., 1998; Berglöf and Claessens, 2004).

Transitional economies typically face the further problem of soft budget constraints. This problem often stems from former SOE’s that are losing money, but remain dependent on the government for continued refinancing (Berglöf and Roland, 1998; Schaffer, 1998). Soft budget constraints are also likely to impede the development of the banking sector, as the requirement for external finance is reduced. As a result, soft budget constraints lead to inefficient governance structures remaining unchanged, with no pressure to reform. Tougher budget constraints in contrast, are more likely to produce better investment decisions. The elimination of soft budgets therefore plays an important role in improving the efficiency and performance of former SOE’s.
In order to mitigate the effects of weak investor protection, transition economies tend to have relatively high levels of ownership concentration (La Porta et al., 1999; Berglöf and Claessens, 2004). Higher levels of ownership concentration and poor investor protection both impair the liquidity of equity markets. Equity markets not only provide financing to firms, but also provide owners with a market for ‘divestiture’ and the ability to diversify systematic risks. A lack of liquidity also effectively nullifies the market for corporate control, which is a fundamental problem in many transitional economies. Firms wishing to raise capital through issuing equity may also face problems in transition countries due to poor minority investor protection, even if those countries are developing rapidly (Singh, 1995). Profitable investment opportunities that are foregone from lack of equity financing may in turn lead to large social costs (Claessens et al., 1999).

In terms of financing during the transition process, when legal and financial systems and institutions are all underdeveloped, substitutes for standard corporate governance mechanisms and financing channels play a more prominent role. The concerns managers have for their reputation and the prospect of access to capital markets help promote proper firm conduct (Shleifer and Vishny, 1997), until the necessary and formal investor protections have been established and institutional frameworks are in place (Gomes, 2000). During the economic development of the transition process, investors depend more on the reputational concerns of managers for their protection, whereas in the longer run legal protection takes over as the dominant form of investor protection. Financing is also able to be obtained in environments with only weak investor protection because of investor over-optimism, where investors are excited about companies and finance them without much thought about getting their money back, instead simply counting on short-run share appreciation (Shleifer and Vishny, 1997). This helps to explain the enormous volumes of equity financing in East Asian economies prior to the 1997/98 financial crisis. In short, the reputational concerns of managers and investor over-optimism offer some explanation as to how firms can acquire external financing in environments that offer only limited investor protection.

The problem of soft budget constraints must be addressed, and steps taken to improve the legal system and reduce corruption. The strengthening of investor protection is also fundamentally
important as it will encourage outside finance, and hasten the restructuring process. The EBRD\textsuperscript{6} Transition Report (1996) finds that outside investors are essential in bringing about active and deep restructuring. Central issues in a many transition countries are also law enforcement (Berglöf and Claessens, 2004) and unyielding government support for economic reforms (Dewatripont and Roland, 1997). Berglöf and Claessens (2004) also conclude that private sector efforts to enhance enforcement are also an important and necessary requirement in implementing reform.

2.5.1 The Role of State Ownership

State ownership became very common in many countries around the world after the great depression and World War II, with the State assuming an enormous role in production (Shleifer and Vishny, 1998). More recently however, evidence has begun to confirm the inefficiency of SOE’s, question the motivations of bureaucrats and highlight the social costs of favouring specific constituencies. As many of the arguments in favour of State ownership have become eroded, more recent years have seen a move globally towards mass privatisation, with public enterprises being replaced by private ones in most sectors.

State ownership of firms can be justified in that they are considered more efficient when other ownership structures do not adequately account for the interests of stakeholder groups. This general argument is often applied where there are concerns regarding matters such as monopoly power, externalities or social welfare (Bennet and Maw, 2003). Stakeholders are able to realise objectives other than profit maximisation, as they have control over areas such as quality and services provided (Hart, 2003).

In practice, State ownership is generally inconsistent with this stakeholder argument of greater efficiency. Some possible exceptions however are the police and prisons (Hart, Shleifer and Vishny, 1997). In SOE’s, the public manager faces relatively weak incentives to reduce costs, improve quality or innovate, because the manager is not the residual claimer and hence gets only a fraction of the return (Shleifer and Vishny, 1998). Highly inefficient SOE’s are also a drain on the overall economy, as their losses are a heavy burden on the State treasuries (Boycko et al., 1995; Kikeri et al., 1994). It also appears that SOE’s do not necessarily serve society the best. In

\footnote{EBRD (European Bank for Reconstruction and Development)}
many countries for example, State owned rather than private enterprises are by far the worst polluters. In many transition countries, the most severe cases of polluting the environment can be directly attributed to SOE’s (Grossman and Krueger, 1995). A possible explanation for this could be that, due to their inherent inefficiencies, SOE’s have a much higher cost for reducing pollution.

Based on the evidence of extreme inefficiency, along with the continual disregard for social objectives, the behaviour of SOE’s appears to be in conflict with the justification for their continuation. Many of the problems of State ownership are grounded in the grabbing hand model of State ownership (Frye and Shleifer, 1997). Heavy burdens are placed on the economy, such as SOE’s that expend economic prosperity policies, laws and taxes that hinder investment, corruption and often having the most talented people involved in unproductive pursuits (Shleifer and Vishny, 1998).

In theory, SOE’s are controlled by the public, in practice however, State bureaucrats have the de-facto control rights, which are in reality extremely concentrated. Bureaucrats have almost complete control-rights over State firms, and are able to use this control to pursue the political objectives of the ruling government. In some cases bureaucrats can even pursue their own private agendas (Duckett, 2001). Regardless, it would be reasonable to assume that these bureaucrats have scant regard for profit maximisation, as they themselves are not the beneficial owners. As the cash flow ownership of SOE’s is effectively dispersed amongst the taxpayers, the bureaucrats have no significant cash flow rights. Furthermore, the politically motivated objectives of the State bureaucrats are often very different from social welfare interests (Shleifer and Vishny, 1994). There is also evidence that bureaucrats are influenced by groups such as public employee unions which resolutely support State ownership (López de Silanes et al., 1997).

State ownership could therefore be described as a case of consolidated control, with no cash flow rights and objectives that are often socially detrimental. In order to address the inefficiencies of SOE’s, many countries have embarked on programs of privatisation (Megginson and Netter, 2001). Demands for increased public expenditure across a wide range of countries have tended to raise the opportunity cost of finance, resulting in pressure to reform or divest SOE’s to alleviate the drain on treasuries (Yarrow, 1999). Changes to ownership structures that are relatively more efficient generally result in substantial performance improvements (Megginson et al., 1994). On
this basis, private ownership appears more desirable than State ownership, however there is still debate over the optimal pace of privatisation (gradual or mass privatisation), and the sequence of the reform process.

2.6 Sectional summary

Corporate governance is a set of mechanisms, both institutional and market based, that deal with the conflict of interests between shareholders and management, and between majority and minority shareholders. In this chapter, we have introduced both internal and external governance mechanisms, including ownership structure, board of directors, executive compensation, information disclosure, the market for corporate control, product market competition and legal infrastructure and enforcement. All these mechanisms were found not to be independent of each other but they are closely interlinked making the structures fluctuating and difficult to analyse.

To assist transition economies in their policy decisions regarding corporate governance, it has been suggested that the traditional market-based approach should be broadened to address the trilateral conflict between managers, minority shareholders and large controlling shareholders. The identity of the large shareholders may also be an important factor, along with who monitors them and their incentives for doing so.

The risk of expropriation is the major agency problem in large public corporations. It is also important to consider if, and to what extent, the firm and its stakeholders are constrained by the legal framework in which they operate. The interaction between corporate governance and the political and legal systems must be considered in relation to the problems faced by transitional countries, such as weak capital markets and the need to restructure SOE’s. This new expanded framework provides a better foundation to analyse and understand the policy decisions of transitional economies in relation to corporate governance.
3.0 The Development and Characteristics of the Chinese Economy

3.1 Introduction

Since 1949 when the Chinese Communist Party (CCP) came to power, the Chinese economy has been transformed dramatically. In order to examine the present governance system in China, it is first necessary to review some of the historical developments which have taken place to the Chinese economy. The period since 1949 can be divided into three stages:

- The Command Economy Period (1949 - 1978)
- The Transition Period (1978 - 1993)
- The Corporatisation Period (1993 - present)

The review of the two initial stages (the Command economy period, and the Transition period) will only proceed to discuss issues relating to the current Corporatisation period and corporate governance. In addition to a general review of the three aforementioned periods, particular attention has been paid to certain key features pertaining to the Chinese governance system, namely:

- Social and cultural traditions in Chinese society
- Stock market establishment and development
- Chinese Institutional reform

3.1.1 The Command Economy Period

During the initial command economy period (the first 30 years of CCP control), all production was in theory owned by the people of China. The State was constituted and mandated by the Chinese people to manage and control the production sector. Chinese people were educated to work in the interests of the country and the CCP only, which in official language was referred to as working for the “common good”. Under the communist ideal, the existence of diverging

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7 Except where otherwise noted, this section is based on the following three sources: Broadman (2001); Tenev et al. (2002); Schipani and Liu (2003).
interests was uncommon and not tolerated, and in this way conflicts of interests did not exist. A ‘governance system’ in the western sense was therefore considered unnecessary. The traditional Chinese governance model was thus a “State-owned, or a State-owned-and managed model” (Schipani and Liu, 2003). This model provided the State with ownership of all assets as well as control over all managerial power. The ‘State-owned-and managed model’ has been recognised as depressing the growth of the private sector (the private sector did not actually exist), and depriving SOEs of economic and legal independence.

During the command economy period all power was provided to the public sector under a centrally planned system, in which terms such as ‘corporation’ and ‘legal person’ did not exist. SOE’s were simply referred to as danwei, meaning ‘work units’. These work units were considered to be government affiliates that were responsible for certain defined functions within the broader overall system. The danwei model was a political structure that extended the control and influence of the State (CCP) down to grassroots level. SOE’s (danwei) were controlled by the State through a dual control system consisting of a State-appointed general manager (technical appointment) and a party secretary (political appointment). In certain situations, the general manager served in both roles, but generally the two functions were separated. This dual-control system was comparable to the CCP system of local government, with both a mayor and a party secretary at the top of the hierarchy. In both the cases however, the party secretaries were the more powerful players and consequently, control over both local government and SOE’s were in the hands of politicians and bureaucrats rather than professionals (Tenev et.al, 2002).

Under the danwei system, managers of SOE’s were required to fulfil production quotas stipulated by the State, and did not have profit maximisation as an objective. SOE’s received target production quotas, but were also provided with guaranteed distribution channels for their production. SOE’s were also provided with the resources necessary to reach production targets. Any excess financial surplus (profit) was then remitted back to the State. Under the danwei system, the western concept of ‘banking’ did not exist in China. Banks served effectively as

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3 Ibid. page 6
State financial distributors, providing the required financing to SOE’s for them to carry out the production and distribution of goods and services according to State production targets (Tenev et. al, 2002). In this way, the governance structure of SOE’s was an integral part of the broader governmental concern. Managers of SOE’s were appointed and dismissed by government agencies in the same way as any other government official. Managers were not evaluated by the financial performance of the SOE, but instead by their ability to meet production quotas set out by government agencies.

The traditional model ultimately served as an allocator and coordinator of economic resources and activities. The system was not only an economic tool that bound State bureaucracy, SOE’s and employees together; it was also a social system that provided social security for employees. In this sense, SOEs were both production units and social security units. SOE employees received an ‘iron rice bowl’ for life, receiving a salary, housing, medical entitlement and a guaranteed State pension. The SOE function as a provider of social welfare not only helped ease concerns over the shortage of goods and services inherent in the command economy model, but also reinforced employee’s dependence on the danwei system. Social pressures caused by a stagnating economy were balanced by the prospect of permanent employment and social security. The natural consequence of the system however, was that SOE’s did not innovate or invest in new production technologies, and thus remained uncompetitive in the context of the Western economic model (Tenev et al., 2002).

### 3.1.2 The Transition Period

The transition period of economic reform began in 1978, when Party leader Deng Xiaoping led a movement within the CCP to modernise the mainland Chinese economy. In the 15 year period between 1978 and 1993, new ideas and laws were gradually introduced to reform the operation and function of Chinese SOE’s. The period of transition in China had thus begun, from a planned economy into a new and more Western like economic system. This is also referred to as China’s adoption of the ‘contracting’ model. Instead however of the transition model implemented by many Eastern European countries, where transition entailed a fundamental shift from a planned to a free-market economy with the large-scale, co-ordinated privatisation of SOE’s, the CCP was not yet ready to relinquish control, and sought to create a ‘free-market’ model under the auspices of the State. The main focus during transition was therefore to introduce market forces within the
domain of direct State ownership and control. Market forces were introduced alongside CCP central plans and administrative orders. A key element of the reform was that the managers of SOE’s were to be made responsible for the financial position of the firm and thereby encouraged to expand production and focus on profits.

From 1979, the government began to allow SOE’s to retain part of their profits (after fulfilment of government production quotas) in order to provide incentive to expand the economic activities. This system was formalised in 1983 through the introduction of a tax scheme where SOE’s were levied a uniform tax rate of 55 percent. Under this system however, profits were heavily distorted through the government’s influence over pricing and competition, resulting in high variations of profits across firms and sectors. Market distortion was further accentuated through an individual and adjustable company tax, which depended upon the importance of the individual firm to China’s economy, along with the bargaining power of the SOE’s management.

In order to replace State budgetary grants and subsidies, bank loans gradually introduced from 1979. The People’s Bank of China (PBOC) was formally established by the government in 1983 as the country’s central bank, by removing its commercial banking activities. Four specialised State owned banks were instead created to take over the financing of enterprises, and thus the role of the banks as creditors was formally established. The Agricultural Bank of China (ABC), the Bank of China (BOC), China’s Construction Bank (CCB), and the Industrial and Commercial Bank of China (ICBC) were established, reflecting the State’s perceived importance of these sectors to the overall economy. As State owned financial institutions however, the banks’ loan policies and decisions ultimately remained under governmental control. Although these moves were a clear signal of China’s intent to reform the banking system, it was also clear there remained much work to do.

A landmark event during the transition period was the introduction of the “State-owned Industrial Enterprises Law” (SOE Law) of 1988. This new law established a corporate governance framework with three specific features. Firstly, managers of SOE’s were given the basic power of management control, including the power to act as legal representatives of the enterprise. SOE managers could thus exercise managerial functions that are an integral part of the Western economic model. Officially, managers of SOE’s had become legal persons enjoying full management authority and responsibility for the companies’ financial position. This feature
thus initiated the separation of ownership and management in SOE’s. Secondly however, the SOE Law ensured that local government continued to oversee the implementation of the CCP’s guiding principles and policies. Even though the separation of ownership and management had thus been initiated, this provision still left the State with significant political influence over the management and operation of SOE’s. Thirdly, enterprises were permitted to introduce a more democratic management philosophy (e.g. through the employees’ congress and trade unions). Unions were permitted to represent and protect the interests of employees, although the hierarchical structures of SOE’s with a high concentration of power at management level seldom provided employee organisations the possibility being a significant management partner.

Under the new SOE Law, performance contracts were also introduced. These contracts were made between the overarching governmental agency and the SOE, represented by the CEO. CEO’s were permitted to pay bonuses to employees, and to hire temporary labour in the form of contract workers, who could in principle have their employment terminated at the end of their contract. This development effectively put an end to the ‘employment for the life’ or ‘iron-rice bowl’ system which had been in place since 1949.

A Bankruptcy Law pertaining directly to SOE’s which was enacted in 1986 also became effective in 1988. This law was followed by the Civil Procedures Law of 1991, which introduced rudimentary provisions for the bankruptcy of legal persons in general. Companies that have performed poorly could in principle be ordered into bankruptcy; however the management often went unpunished, even if the situation was caused by conduct stemming from the lack of a governing legal framework regulating the conduct of managers.

The SOE Law itself failed to define clearly the ownership of assets and the boundaries of firm, and thus a certain amount of expropriation of State assets for personal benefit of managers took place. As profits were not retained in the enterprise for development purposes and innovation, enterprise expansion possibilities were effectively null and void. The changes relating to SOE reforms were undertaken gradually, and aimed at resolving the central problem of the lack of efficient incentives in the planned economy system. The early reform stage took place within the framework of State ownership and control. Profit retention and the introduction of a certain

10 The Provisional Regulations on Contracting Management System in SOE’s §14 (1988)
amount of decision making autonomy were the first steps. By the end of the 1980’s, there were
over 6600 industrial SOEs, accounting for 60 percent of total industrial output and 70 percent of
total profits, that had instituted some form of profit retention (Tenev et al., 2002). The uniform
income tax system of 1983 provided SOE’s with more responsibility for profits and losses, and
put them on an equal footing with regards to market competition. In practice however, the
enterprise specific ‘income adjustment’ tax provided room for negotiation and bargaining in
relation to profit remittance. The tax system was thus highly arbitrary in nature.

Although the State did begin to commercialise SOE activities and introduce incentives to
managers, it did not initially make any large-scale changes to the ownership structures. Instead, it
gradually allowed new forms of ownership structure to develop over time, and the competition
that evolved out of these new ownership forms began to elicit a certain degree of market control
over SOEs. The introduction of new ownership forms combined with growing State enterprise
autonomy created the basis for the hybridisation of State and non-State enterprises. This
hybridisation became a distinct feature of China’s market-oriented reforms. The hybridisation
process happened through breaking up existing enterprises to form new “secondary legal
entities” (or subsidiaries), often disguised as collectives; joint ventures with foreign and/or
domestic partners; limited liability companies; and joint stock companies (Broadman, 2001)\textsuperscript{11}.

In general, the transition model and the new contracting system failed in its attempt to provide
the much needed reform to SOE’s, and majority State ownership allowed State planning to
remain a decisive component in SOE operations. SOE’s were still commonly regarded as
government affiliates rather than independent legal entities. Continuing State influence meant
that poorly performing SOE’s were not penalised; and continued to be subsidised through soft
loans from State banks, and subsidies from local governments that controlled the majority of
SOE’s. The positive effects of financial discipline were also eroded through negotiable profit
retention schemes or special tax rates for medium and large SOE’s. In this way it was very
difficult to define the amount of SOE profits eligible to be paid to the State.

\textsuperscript{11} This has been one of the favoured ways for SOE managers to gain autonomy from supervising government agencies
The contracting system was successful in that it increased the autonomy of enterprises and was at least the first step towards the separation of ownership and control. The main problem however, remained the combination of government and corporate management. The State continued to have almost unlimited responsibility for the survival of enterprises, resulting in turn with continuous soft-budget constraints. The careless behaviour of firms was perpetuated, with the tendency to over expand in good periods and re-negotiate profit remittance in bad periods. Both banks and the legal system were not developed as efficient external SOE monitors nor partners, neither did they work as monitors of SOE management. As the primary focus of the reform process was SOE’s, other forms of ownership and newly established businesses were not well regulated. The lack of understanding of other managerial systems would lead to unequal treatment of other forms of enterprises. These problems led to a new wave of SOE reform being initiated in the early 1990’s, reflecting a desire to build a modern enterprise system compatible with the market economy model. Chinese policy makers now began to look to the modern corporate model in the Western world for possible solutions.

3.1.3 The Corporatisation Period

The Corporatisation period emerged from the previous series of reform’s failure to achieve the necessary and desired results, and in turn signified important changes to China’s overall approach to reforms. From 1993, Chinese political planners returned to the philosophy on the corporate structure as it existed prior to 1949. The new proposals were for a return to the corporate form, a relatively ideology-free concept which the central government found useful for redefining the overall relationship between economic players, including between autonomous economic entities and the State\(^\text{12}\). This re-emergence of the corporate form was to be accompanied by further ownership diversification, rapid development of the capital markets, and the beginning of equal treatment for State and non-State entities – a move that simultaneously established the requirement of a new legal and regulatory environment in China.

During the previous Transition stage, both central and local governments increasingly felt the need to find more radical solutions to address the problem of stagnating SOE’s. The new wave of Corporatisation began with President Deng Xiaoping’s visit to southern China in 1992, where he

\(^{12}\) Tenev et al. (2002), p.16
called for a ratcheting-up of the reform effort. In November 1993, at the 14th Party Congress, the assembly voted on issues pertaining to the establishment of a ‘socialist’ market economic structure. The new structure was to include two key provisions. Firstly, a ‘modern enterprise system’ based on the principle of corporatisation was to be established with the full separation of the State’s ownership rights from the legal person property rights of enterprises, and secondly, support for the growth of diversified forms of enterprise ownership including privately owned, individually owned, foreign-invested, and jointly owned types of enterprises\textsuperscript{13}.

The series of new reforms were initiated with the intention of separating the ownership of the State from its property rights in enterprises, and in turn promoting market behaviour and good management incentives. Small SOE’s were privatised into various kinds of ownership such as privately, collective or foreign owned enterprises, whilst medium and large SOE’s underwent a program of corporatisation\textsuperscript{14}. The corporatisation program involved the establishment of the SOE as an independent legal entity with the State as the majority shareholder, but within the remit of commercialisation so as their operations were governed by commercial laws the same as private enterprises (Lin, 2001). The assets of the SOE’s were audited, registered and attributed to their owners, the various State agencies. Following this, firms could decide either to be transformed into limited liability companies or joint stock companies where they would be listed on the stock exchange.\textsuperscript{15}

3.2 Current Overview

It is clear that China has adopted a ‘gradualist’ approach to economic reform, by which incremental reforms based on their success at local level, have been implemented to provide a replacement for central planning. Rather than embarking on the massive, co-ordinated privatisation of SOE’s as with many other centrally planned economies, the Chinese government allowed a range of different ownership forms, including collectively owned organisations (owned by local governments), foreign-invested firms and new private start-ups (Luo and Peng, 1999). Even though International investors are able to purchase ‘B’ shares of Chinese listed

\textsuperscript{13}Tenev et al. (2002), p.16
\textsuperscript{15}Procedures for SOEs Corporatisation available at the official website of the National State Asset Administration Bureau: www.sasac.gov.cn
firms in Shanghai and Shenzhen, ‘H’ shares in Hong Kong, or even domestic ‘A’ shares via various other International markets or large institutional investors, ownership provides virtually no control rights to these investors. This is due to most large former SOE’s remaining under State control through majority shareholding, with only minority outside ownership (Peng, 2000). The Chinese market in this way remains one of the least accessible to International investors.

The key objective of economic reform is to implement a system of real ownership, and in the process rectify distortion in the price system caused by soft budget constraints. These two aspects are interdependent, and cannot be separated. Other aspects of the reform process include establishing product factor markets, restructuring the financial and social security systems, and implementing an effective legal framework. Economic reform on this scale is thus a difficult process both to implement and manage.

The corporatisation process has brought about significant changes to Chinese enterprises. Firstly, these enterprises now have access to a new financing vehicle, in that they are now able to raise capital on the stock market, and secondly different ownership structures are now able to be implemented. For the first time now in China, firms are able to have several owners jointly sharing finance and control in addition to the State. Although it is still unclear whether corporatisation has yet achieved its desired goals, some studies including Aivazian et al. (2005), have found supporting evidence that corporatisation has improved enterprise performance.

Within the context of this apparent success, several points should be examined more closely. Firstly, the new joint-stock companies listed on Chinese stock exchanges are largely reformed SOE’s or subsidiaries of SOE’s. Ownership forms of SOE’s, together with their government and parent affiliations are largely determined upon their foundation. Secondly, Chinese corporatisation is occurring within the context of the ‘socialist’ market economy. The term ‘socialist’ inherently implies that public ownership remains a basic property right within the system. However the term ‘market economy’ also implies that free market mechanisms which do not conflict with this ideology will be utilised to a full extent. Therefore, although the proportion of State ownership can be reduced, it is likely that the State will maintain some degree of ownership and control, especially in key industries.
Holdings in enterprises that remain under State control after corporatisation, are gradually sold off to institutional investors or transformed to tradable ‘A’ shares under China’s Split-Share structure reform program of 2005, a process that is still far from complete. These facts suggest that, State ownership, State control and government affiliation remain present in many Chinese listed companies. It is therefore clear that even after a long process of economic reform in China, there remains more work to do. The key reasons for this are now discussed.

3.2.1 Social and Cultural Traditions in Chinese society

Social values and economic principles built on traditional Chinese culture and the recent history of the planned economy are likely to have an impact on corporate governance practices in China. Power distances between the Chinese people and the ruling Party chiefs have always been long, and still today Chinese society can be characterised as authoritative and hierarchical. The hierarchical nature of society can be illustrated through the presence of a ‘father figure’ which exists in nearly all social groups (and corporations). In a Chinese corporation, the father figure could typically be a powerful government official or the head of the largest shareholder. The decisions of the father figure are followed explicitly and are seldom questioned. In corporations with such a figure, there is often little in the way of internal monitoring of decision making and actions. The former Party Leader Deng Xiaoping is a good example of a father figure in Chinese society. His calls for further development of the Chinese economy in 1992 had a profound impact even though power had officially been transferred to Jiang Zemin in 1989.

Chinese decision makers are traditionally used to operating in secrecy or in a ‘black box’¹⁶, and Chinese people are generally not used to receiving information from those who have higher social or establishment positions. The problems in information transparency are accentuated by the hierarchal social system and large power distances. A good example is the corruption scandal surrounding the powerful listing evaluation committee of the China Securities Regulatory Commission (CSRC)¹⁷. The fact that the members of the committee and the evaluation process are not publically known facilitates insider dealing and corruption. It is a necessary prerequisite

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¹⁷ Wang Xiaoshi, a deputy director of the CSRC, was arrested on corruption charges on November 12th, 2004. For a fee, Wang had been illegally providing companies seeking stock market listing with the names of those in charge of listing approval so that these individuals could be lobbied. “CSRC arrest causes investor jitters”. South China Morning Post, December 6th, 2004.
for corporate governance mechanisms to function effectively that all interested parties have access to relevant and timely information.

An enduring shadow of the socialist system and the command economy era is the lack of individual property rights. Since 1949, individual property rights were largely ignored or were even made illegal. It was not until 2003 that private ownership and property rights were legally recognised, when private property rights were officially drafted into the Chinese constitution. Chinese corporations are not used to clearly distinguishing rights over property and assets, and it is therefore not surprising that there is little respect shown towards minority shareholders, who in many cases are private investors. Furthermore, ownership and control rights themselves are often not clearly defined.

Finally, a deep-rooted characteristic of Chinese society is the importance of personal relationships, and the fact that business deals are frequently dependent on this. This social occurrence often creates problems in the transactions between Chinese corporations. The priority that is given to personal relationships, or ‘guanxi’, is also likely to impact other facets of corporate governance, such as law enforcement and the exploitation of minority shareholders.

### 3.2.2 Stock Market establishment and development

The corporatisation phase of Chinese economic reform was accompanied by the establishment and development of the Chinese stock markets as a necessary facilitating vehicle. This however, has led to new agency problems and generated new conflicts of interest among stakeholders in the corporation, and therefore in turn demanded a new corporate governance system.

The Chinese stock markets are a relatively new phenomenon, and they are required as much for enterprise reorganisation as procuring external financing. There are presently two national stock exchanges in mainland China, the SHSE (Shanghai Stock Exchange) founded on 26th November 1990, and the SZSE (Shenzhen Stock Exchange) founded on 1st December 1990. They are themselves independent legal entities, but operate under the auspices of the CSRC, providing venues for the trading of securities such as stocks, bonds and warrants. When the two stock exchanges were established in 1990 there were initially a total of only 10 listed companies.

In spite of the regional differences, the total number of listed companies in mainland China increased from 1990 to 2007\(^{19}\), however considerable swings in total stock market capitalisation have occurred since 2001, indicating shifting public confidence brought on by corporate scandals.

Since their inception, over fifteen hundred large SOE’s have been privatised, or partially privatised through listing on the Chinese stock exchanges. Enterprises that are to be listed on the stock exchanges are prepared accordingly. Typically, ‘modern’ management practices are introduced, including incentive based remuneration. These enterprises are given a greater level of autonomy and restructured. Accounting systems and disclosure practices are improved in order to align with International Accounting Standards (IAS), along with other aspects required to meet ultimate listing requirements set out by the CSRC. Amongst these other requirements, firms must be able to present three years of accounting profit, and be valued in excess of RMB 50 million (Aharony et al., 2000; Neoh, 2000). In many cases, particularly for the larger SOE’s, the preparation process is largely superfluous. The organisational form, culture and internal processes of many newly listed SOE’s, have not fundamentally changed.

In an effort to maintain political control of the privatisation process, China originally employed a quota system to determine which SOE’s should be privatised and the order in which it should take place. The CSRC thus set an annual capital quota for the total value of shares that could be issued. Neoh (2000) states that the best performing companies were never listed on the stock exchange, as the quota system controlled access to capital markets. Many of the better performing SOEs were retained by government agencies to serve as cash cows, and those in need of capital urgently were privatised. As quotas were under the control of the local authorities, it was for them to decide which enterprises should be listed. Local authorities therefore tended to put forward the enterprises under their control that required capital, without necessarily considering their future viability (Neoh, 2000). The quota system also restricted the choice for investors, as the most viable firms were often not listed. Problems also arose from SOE’s preparing to be listed. Misleading accounting practices could be used for example, to produce a three-year profit record and comply with listing requirements. These enterprises thus falsely

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presented positive performance records that enable it to be listed (Neoh, 2000). The system thus appeared arbitrary and unreliable, and there was the sense that the State-controlled and State-supervised selection process furthered the vested political interests of the well-connected firms, or those in sectors favoured and promoted by the government than it did the economic interests of the investing public. The quota system was eventually abandoned in 2000 (Business Week 2001).

It is clear that the Chinese stock markets have continued to expand rapidly since they were established in 1990, and with the ongoing restructuring progress of Chinese enterprises, more shares are becoming tradable and offered through the exchanges. By 2007, China’s mainland stock markets had a total market capitalisation of RMB 32.71 trillion\(^{20}\) (approximately USD 4.8 trillion), making it one of the largest stock markets in the world, and behind only Japan in Asia. Direct financing through equity issues has had a profound impact on Chinese economic growth in recent years, and there remains enormous potential for Chinese enterprises going forwards. Improvements in corporate governance practices are likely to allow the securities market to play a larger role in the financial sector.

### 3.2.3 Chinese Institutional Reform

Institutional reform is required in conjunction with the Corporatisation process, in order to deepen economic reform and develop the Chinese ‘socialist’ market economy. An important milestone was reached at the 15\(^{th}\) Party Congress in 1997 when the ruling Party issued a report declaring that that an oversized government with a large number of employees blurred the line between government and business, imposed bureaucracy and hindered the expansion of reform and economic development. The report also stated it to be detrimental to the relationship between the Party and the Chinese people.

Chinese government institutions were considered to have many failings. Firstly, the inadequate separation of government and enterprises functions, making government directly involved in management of SOE’s. A process of scientific policymaking was never able to be applied, leading to confusion over responsibilities and policymaking in government departments. In essence, the situation prevented the market playing its fundamental role of the efficient allocation of resources.

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of resources. Secondly, the management of the national economy and related social matters were undertaken primarily as a matter of administration. In this way, issues that would ordinarily be handled through the judicial system or through social intermediaries were instead dealt with by assigned government departments or institutions. The government therefore shouldered the entire burden of social responsibility. Finally, existing government institutions were excessively large with overlapping responsibilities. This situation fostered excessive bureaucracy, and also corruption and other questionable activities. Furthermore, large central government with many overstuffed institutions is also a financial drain on the treasury through high fiscal expenditure.

The number of employees in party and governmental agencies and non-profit organisations was almost 36 million in 1995, almost a quarter of the total number of State employees. In addition, around 10 percent of the employees of SOE’s (about 11.36 million) were working in Party organisation and administration. The essence of the State council institutional reform should be to reassess or eliminate the special departments that are directly involved in economic management, and to bolster the departments involved in macroeconomic supervision and control. Departments such as electrical power, coal power, chemical industry, metallurgy, machinery, electronics, domestic trade and forestry should no longer be maintained under central control.

Many institutional reforms have already been implemented in China, albeit with only a minimal degree of success. The main reason for this is that the separation of the government function and enterprise management function is still not fully realised. Government organisation has been traditionally orientated towards a planned economy with all facets controlled by the State. When the government managed SOE’s directly, governmental organisation had to be both compatible with the task and large in scale. The fundamental goal of China’s institutional reform therefore must be to amend SOE ownership structures, realise the separation of government and enterprise management and develop channels for external financing. The task of separating government from enterprises and capital is undoubtedly a complex one, and requires coordinated reform.

3.3 Sectional summary

Over the last 60 years the economic landscape in China has changed dramatically from a planned economy to ‘socialist’ market economy. Under the command economy SOE’s were simply work units that formed part of a wider system that also provided social welfare. However, without
profit maximisation as an incentive, SOE’s remained stagnant and uncompetitive. SOE’s were gradually given more autonomy during the transition stage, however despite these reforms the separation of ownership and control was not achieved and this allowed the problem of soft-budget constraints to continue. Limited success with a number of reforms introduced during the transition period led the State to embark on a more radical process of corporatisation, where SOE’s were transformed either into limited liability companies, or joint-stock companies where they would be listed on the newly established Chinese stock exchanges. The process of corporatisation was also to include further ownership diversification by the State and the development of Chinese capital markets. Corporatisation also requires functioning legal and regulatory systems grounded in a strong enforcement environment. Throughout the period of corporatisation, China has implemented reforms in an incremental manner based on their successful application at local level. However, Chinese corporatisation is also occurring in the context of ‘socialist’ market reforms, and the State continues to maintain a large degree of control over listed companies.

Three areas of attention have been highlighted in relation to the continuing development of Chinese economic reform. Social and cultural traditions are likely to play a role as high power distance and information opacity are engrained in Chinese society, and the notion of property rights is a relatively new concept. Business is also conducted through personal relationships which is detrimental to the enforcement environment. The role of the stock markets is also fundamentally important. The Chinese stock market was established to facilitate corporatisation; however this has bought with it a new set of conflicting interests, those between majority and minority shareholders. The rights of minority shareholders must be strengthened and protected in order for the stock markets to continue to function as a source of external finance. Institutional reform is also a critical aspect of the corporatisation process. Institutional reform facilitates the restructuring of SOE’s, the separation of government and enterprise management, and the development of external financing channels. Institutional reform in the context of a ‘socialist’ market economy is a complex task, and any moves towards it are only likely to be moderately successful until the separation of the government and enterprise functions are fully realised.
4.0 Corporate Governance Practices in China

4.1 Introduction

This chapter examines how the previously discussed internal and external corporate governance mechanisms are currently applied in the case of China, and the overall Chinese corporate governance system. Particular attention is paid to the role of individual mechanisms and how they are affected by the context of Chinese economic reform.

4.2 Ownership Structures

A distinguishing feature of the Chinese stock markets is that, whilst all shares of Chinese listed companies are identical in respect to cash flow rights and voting rights\(^{21}\), they are classified as who they can be owned by and whether they are tradable\(^ {22}\). Shares are essentially classified as ‘A’ shares\(^ {23}\), ‘B’ shares\(^ {24}\), ‘H’ shares, ‘N’ shares, ‘L’ shares and ‘S’ shares\(^ {25}\).

4.2.1 Sub-classification of ‘A’ shares

‘A’ shares are tradable shares of mainland Chinese companies that are listed on either the Shanghai or Shenzhen Stock exchanges. ‘A’ shares are generally only able to be owned by

\(^{21}\) Tenev et al. (2002) p.73
\(^{22}\) There is sometimes confusion in the literature as to how the Chinese share classification system is structured, and the precise definitions of individual share types. This is due to the system not being codified in either Chinese Company Law or Securities Law. This paper is consistent with how the classification system is most commonly described. For example: Tenev et al. (2002) p 76-80; Liu and Pei (2003); Wang (2004).
\(^{23}\) ‘A’ shares are issued in mainland China and quoted in Chinese RMB by domestic investors. Foreign investors generally restricted from buying ‘A’ shares except through the Qualified Foreign Institutional Investors (QFII) system which was established by the CSRC in 2002 (Kim et al. (2003) p.44, Box 1 presents the requirements a foreign institutional investor must meet to become a QFII). A QFII can own a maximum of 10% of the shares of a listed company, and collectively QFII’s are permitted to own a maximum of 20% of the outstanding shares of a particular listed company (Provisional Measures 2002, Article 20).
\(^{24}\) ‘B’ shares are issued in mainland China but quoted in foreign currencies such as USD or GBP. These shares are traded mostly by foreign investors, including overseas Chinese citizens and investors from Hong Kong, Taiwan, and Macau. However, since February 2001, domestic Chinese investors have also been permitted to invest in ‘B’ shares. The main difference now therefore between ‘A’ and ‘B’ shares is that ownership of ‘A’ shares is prohibited to most foreign investors, and where ‘A’ shares are traded in Chinese RMB, ‘B’ shares are traded in hard currencies. Chinese investors however, are subject to certain foreign exchange restrictions which mean that ‘B’ shares are still usually only traded by foreign investors (Kato et al. (2004) p8).
\(^{25}\) ‘H’ shares, ‘N’ shares, ‘L’ shares, and ‘S’ shares are those issued by Chinese companies in Hong Kong, New York, London, and Singapore respectively. These shares are traded by foreign investors, and are often collectively referred to as ‘H’ shares.
mainland Chinese citizens; however some conditional foreign ownership is permitted through the tightly-regulated Qualified Foreign Institutional Investor (QFII) system introduced in 2002. ‘A’ shares are further classified into the following four sub-types, namely; State shares, legal person shares, tradable shares and employee shares. ‘A’ shares thus are in this way different from ‘B’ or ‘H’ shares which are always tradable.

**State shares** are those held by the central or local governments in the form of State asset management companies or financial bureaus, or by another SOE. It is however the newly established State-owned Assets Supervision and Administration Commission of the State council (SASAC) which is generally perceived as being the ultimate owner of these shares. State shares are not tradable, although a direct transfer is possible between domestic institutions upon the approval of the CSRC established in 1992.

**Legal person shares** are those held by domestic non-individual legal entities or institutions. Chinese domestic institutions are defined as (non-bank) financial institutions such as securities firms, investment companies, financial trusts and mutual funds. A further sub-type of legal person shares is State-owned legal person shares. These are Legal person shares that are held by institutions in which the State is the majority shareholder, but not the 100% owner. State-owned legal ownership is the most common form compared to non-State legal ownership. As with State shares, legal person shares cannot be openly traded, but are transferable between domestic institutions on the approval of the CSRC.

** Tradable ‘A’ shares** are essentially those held by domestic individuals, although institutional investors are also permitted to hold them. Companies that are listed on either the Shanghai or Shenzhen stock exchanges are required to offer a minimum of 25% of the total share floatation to the general public in the form of tradable ‘A’ shares.

**Employee shares** are those listed companies issue to their employees, although not all listed companies offer such a scheme. These shares must be held for a period of 6-12 months, where after with the workers permission, the company can apply to the CSRC for permission to sell them to the general public.

The State therefore owns shares directly through central and local government, and through a array of local channels, which include; the State asset administrative bureaus, State asset
management companies, security or investment companies, banks, industrial enterprises, transportation, power or real-estate companies (Tenev et al., 2002).

Chinese companies can be categorised as private enterprises, collective enterprises, foreign companies and SOE’s. Foreign ownership is however, restricted as Chinese Company Law restricts foreign ownership to 25% of a firm’s total equity, with a maximum of 20% for a single investor (Hua 2005, Stefan and Yi, 2006).

The largest group of legal person shareholders are industrial SOE’s. State and legal person shares account for around 65% of the total ‘A’ shares on the Shanghai and Shenzhen stock exchanges26. The remaining 35% are tradable shares, which are held by institutional investors and individuals. Differential voting rights in the form of preferred stock is not permitted in China, with each share type carrying equal cash flow rights. The use of a single share class was originally intended to create a simple and transparent shareholding environment and thereby prevent the controlling class from abusing the rights of others. However, Tenev et al. (2002) suggest that the failure to acknowledge different classes of shares and the different rights associated with them may be detrimental to the interests of minority shareholders, as it hinders the establishment of a basis upon which minority shareholders providing different value can be recognised and protected.

A typical Chinese listed company has a mixed ownership structure with the State, legal person and domestic individual investors as the three primary shareholder groups. Chinese listed companies have a particular ownership structure, with State and legal person shares not being permitted to trade openly in the market. Chinese listed companies have on average 61% of shares concentrated in the top 10 shareholders27. Such high share holdings are likely to influence internal governance procedures and external supervision.

Although State and legal person shares are not tradable, they can be transferred between domestic owners upon the approval of CSRC. The transfer of State shares required the authorisation of the Chinese Ministry of Finance, whereas the transfer of legal person shares requires only the approval of the Stock exchange where the shares are listed, and is hence much

26 Data comes from China Listed Company Report 2003, CSRC.
27 Data obtained from the empirical analysis conducted as part of this thesis
easier to obtain\textsuperscript{28}. The transfer of State shares is usually between government departments as part of an ongoing reorganisation effort. These shares are transferred directly and do not involve any cash payments\textsuperscript{29}. The more common transfers of legal person shares however, usually take the form of a cash sale between the parties involved.

### 4.2.2 The Effect of Chinese Ownership Structure

Chinese ownership structures are characterised as being highly concentrated, with the majority of shares being State owned and non-tradable. The State therefore controls, directly or indirectly, the majority of listed companies. The pattern of concentrated ownership found in China is similar to that found in many Western European and East Asian countries\textsuperscript{30}; however the essential difference is that where the controlling shareholder in China is the State, the controlling shareholders in Western economies are institutional investors, families and individuals.

As the controlling shareholder, the Chinese government is in a position to appoint key personnel to the listed companies, and as such exert its political will over the firm’s business activities. In this way, many of the economic (and foreign) policies of central government are absorbed into the operations and strategies of listed companies, and resources of these companies utilised in the pursuit of a political rather than value maximising objective. China’s listed SOE’s are consequently extremely inefficient, and ‘insider’ managers perform poorly in terms of practicing good governance.

Statistics have shown that the largest shareholder in Chinese listed companies holds 36.12\% of total shares on average\textsuperscript{31}. This clearly shows that the largest shareholder on average has considerable discretionary power over the company’s resources. Of these companies, 78.9\% also belong to a specific sub-set that has a parent or other (legal person) company as the controlling shareholder (Liu, 2005). The 2003 CSRC listed companies report shows that cross-holding or pyramidal type ownership structures are common among Chinese listed companies. A listed company and its parent are often present in the same business sector where they may either be

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\textsuperscript{29} Green (2003): China’s Stock market, p 146

\textsuperscript{30} Ownership is concentrated in many Western European countries such as the largest shareholder in Austria on average holds 82.2\%, 59\% in Germany, 56.8\% in France, 52.3\% in Italy, 38.3\% in Spain, as well as in East Asian countries, for instance, 48.2\% in Indonesia, 33.5\% in Philippines, 30.3\% in Malaysia, 20.4\% in Korea, (ADB, 1999).

\textsuperscript{31} Data obtained from the empirical analysis conducted as part of this thesis
competitors, or have a co-operative business relationship. A listed subsidiary may depend on its parent or group for the distribution of its products or the supply of inputs/raw materials. Senior management may also work for both the listed subsidiary and the parent, creating a lack of independence in regards to operational decision making. Controlling shareholders are thus in a position to easily transfer firms assets back to the parent or to another group company.

The pyramidal type ownership patterns that are prevalent amongst Chinese listed companies, means that the role of the State as a controlling shareholder is often greater than it would initially appear. A listed company for example, may be majority-owned by a legal person institution which is in turn majority-owned by the State. The State therefore has indirect control of the listed company. In order to ascertain the full extent of State control, it is necessary to undertake the complex task of analysing all of the pyramidal ownership structures of listed companies and tracing back the ultimate beneficial owners. In reality, most large legal person institutions are State-owned or controlled enterprises. This means that the State effectively controls most listed companies in China, even though relatively few are majority-owned by a shareholder holding “State shares”\textsuperscript{32}. Liu and Pei (2003) suggested that 84% of listed companies were State-controlled. Public listing of SOE’s should theoretically reduce State involvement through the introduction of private investment; however Clarke (2003) argues that the opposite may be true. As the State usually (directly or indirectly) maintains control of the newly listed company, the total pool of assets under State control actually increases as a result of listing (Clarke, 2003).

In many cases, listed companies have a State-owned or controlled parent from which they are spun off. This is a special characteristic of Chinese listed companies that is derived from a policy of partial privatisation. The former parent company, which is typically an SOE, frequently remains the majority shareholder of the listed company. The State therefore remains in control of the listed subsidiary. The control and influence of the State inherent in these types of ownership structure may result in increased financial and operational risks to Chinese listed companies, and the perceived benefits of ownership concentration must be considered in relation to the drawbacks involved. Prior studies have shown ownership structures to have a direct relationship

\textsuperscript{32} Clarke (2003) p.497: “As a former senior policymaker recently boasted, with an equity stake of a mere 6%, the state controls the 94% of ‘social capital’ in the Guangzhou Light Industrial Group, and the enterprise is classified as ‘state controlled’”.

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with corporate governance, and hence be an effective internal governance mechanism. This is at least part of the issue behind SOE reform in China.

**Tunnelling**

La Porta et al. (1999) find that a controlling shareholder has a strong incentive to use the listed company’s resources to maximise its own benefits rather than shareholder wealth, as long as the rights of minority shareholders are not well-protected. La Porta et al., (2000) use the term “tunnelling“ to describe this phenomenon. Tunnelling is a serious problem in China. For example, the controlling shareholder of Sanjiu Pharmacy (a once blue chip in China) was found to have tunnelled away RMB 2.1 billion (USD 255.4 million) from the company, which equalled around 96% of the firm’s total equity. According to a 2002 CSRC report, the controlling shareholders of 676 listed companies occupied huge resources of their listed subsidiaries. In some cases tunnelling occurs in the form of outright theft or fraud (Johnson et al. (2000), however in the majority of cases it occurs through self-dealing transactions, such as sales of assets to listed companies at distorted prices (Tenev et al., 2002).

It has also been found that controlling shareholders use loan guarantees as a method of tunnelling away assets of listed companies. Here the controlling shareholder (parent) uses the listed company (subsidiary) to guarantee its own loan to a third party (usually a bank). The controlling shareholder thus gains both through being able to borrow at a more competitive interest rate, and also having the option to default on the loan (Berkman et al., 2007).

**Trends in the Government Policies**

In general, the Chinese State or CCP appears reluctant to fully relinquish its massive ownership of shares in domestic listed companies, due possibly to the fact that State involvement is fundamentally linked to the official policy of developing a “socialist market economy”33. It is therefore unlikely that the widespread mass privatisation of State-controlled listed companies will be implemented unless it is accompanied by ideological and political change. The commitment to retain overall State control is especially strong in certain key industries, for

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33 Sun and Tong (2002), p. 185. Some authors have suggested that the Chinese policy of retaining control of SOE’s emanates from a deep-rooted suspicion of private wealth. Clarke (2003), p.496: “a government that bans un-authorised fishing clubs and associations for the study of antique furniture and paper cutting is unlikely to welcome the unbridled blossoming of organisations whose purpose is to make real money.”
example ones that are related to national security, high-technology and those providing important goods and services to the public.

In the long term however, the State does appear to be moving towards developing the Stock markets and introducing more diverse ownership structures. This should in turn mean that Chinese listed companies will gradually become more independent and subject to market discipline. At present however, the State continues to limit the decision rights of SOE managers and as such remains the decisive control power.

In order to help establish the groundwork for fully functioning capital markets, China has embarked on a program of share reform that centred on the relaxation of the ownership constraints, and allowing the sale of State-owned shares. In September 2005, the CSRC issued the “Administrative Measures on the Split-Share Structure Reform of Listed Companies”\(^3^4\). The document outlines rules pertaining to converting non-tradable shares to tradable shares. Under the new legislation, State and legal person shares can be converted to tradable shares held by domestic institutions on the approval of the CSRC. Furthermore, foreign companies are given the possibility of increasing their holdings to a maximum of 49% of domestic asset management companies (Stefan and Yi, 2006).

There are a number of reasons to believe that the ‘Split-Share Structure Reform’ program will play an important role in the development of Chinese listed companies. Firstly, better governance ensues when all shares become tradable, as minority shareholders are able to play an increased role in management decisions. Secondly, privatisation will be facilitated through secondary equity issuances, curbing political interference in listed companies and boosting operating performance. Thirdly, better liquidity in the company’s stock will result from a substantial increase in the free float. Finally, reduced uncertainty over the timing of the reform process is likely to have a positive effect on valuations (Beltratti and Bortolotti, 2006).

Although these reforms take a long term perspective and are likely to take many years, they are likely in some way to solve the governance problems of China’s listed companies and the highly volatile stock markets. The reforms will ultimately shift the balance of shares (and thereby the

\(^3^4\) See details in the CSRC’s website: [http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069846.html](http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069846.html)
balance of power) from the government to the public, and in this way improve the overall quality of corporate governance practices in Chinese listed companies.

**Advantages and Disadvantages of Centralised Ownership**

The literature investigating the impact of large shareholders on corporate performance is ambiguous, due to the use of different samples of firms and different empirical strategies (Grosfeld, 2006). Authors’ findings are thus often difficult to compare and can show positive as well as negative effects of large shareholders on firm’s performance. Ownership by large shareholders provides strong motivation to actively monitor management and thereby prevent problems of moral hazard (Jensen and Meckling, 1976). Large shareholdings however could also lead to the lack of management initiatives (Burkart et al., 1997). If monitoring is excessive, it may restrict the discretionary powers of management and in this way also have a detrimental effect on company performance.

Studies have shown that ownership structures, both in terms of mix and concentration, significantly impact the performance of listed companies. Firstly, authors such as Xu and Wang (1997) have shown that the performance of Chinese listed companies is negatively correlated with State shares, but positively correlated with legal person shares. Secondly, Du Yajun (2003) finds that the effect of ownership concentration on firm’s performance has a greater impact in legal person companies than in those dominated by State. Finally, Chen and Chen (2000) found a positive correlation between firms profitability and the proportion of legal person shares, but a negative (or zero) correlation with the proportion of State shares and tradable ‘A’ shares.

**4.2.2 International Comparison of Ownership Concentration**

<table>
<thead>
<tr>
<th>Country</th>
<th>Largest</th>
<th>2nd largest</th>
<th>3rd largest</th>
<th>4th-10th largest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>82.2</td>
<td>9.5</td>
<td>1.9</td>
<td>6.5</td>
</tr>
<tr>
<td>China</td>
<td>47.0</td>
<td>8.0</td>
<td>3.0</td>
<td>-</td>
</tr>
<tr>
<td>France</td>
<td>56.0</td>
<td>16.0</td>
<td>6.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Italy</td>
<td>52.3</td>
<td>7.7</td>
<td>3.5</td>
<td>5.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>28.2</td>
<td>9.2</td>
<td>4.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Spain</td>
<td>38.3</td>
<td>11.5</td>
<td>7.7</td>
<td>10.3</td>
</tr>
<tr>
<td>UK</td>
<td>14.0</td>
<td>8.3</td>
<td>6.1</td>
<td>9.2</td>
</tr>
<tr>
<td>Country</td>
<td>Largest</td>
<td>2nd &amp; 3rd largest</td>
<td>4th &amp; 5th largest</td>
<td>6th – 10th largest</td>
</tr>
<tr>
<td>-----------</td>
<td>---------</td>
<td>------------------</td>
<td>-------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Belgium</td>
<td>55.8</td>
<td>6.9</td>
<td>0.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Germany</td>
<td>59.7</td>
<td>8.6</td>
<td>2.6</td>
<td>0.3</td>
</tr>
<tr>
<td>United States</td>
<td>22.8</td>
<td>9.5</td>
<td>7.5</td>
<td>3.8</td>
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</table>

<table>
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<tr>
<th>Country</th>
<th>Largest</th>
<th>1st – 5th largest</th>
</tr>
</thead>
<tbody>
<tr>
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<td>67.5</td>
</tr>
<tr>
<td>Rep. of Korea</td>
<td>20.4</td>
<td>38.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>30.3</td>
<td>58.8</td>
</tr>
<tr>
<td>Philippines</td>
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<td>60.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>28.5</td>
<td>56.6</td>
</tr>
</tbody>
</table>

Source: Tenev et al. (2002), Table 4.4, p81

Table 4.1 shows the average percentage of shares held by various shareholders according to the size of their holding. With ownership concentration in China being higher than the US and UK but lower on average than many Western European countries, its position is somewhere around the middle.

A further feature of Chinese listed companies is that they have a disproportionately high concentration of control in the hands of the largest shareholders. A high concentration of control rights are even found in listed companies with a relatively dispersed ownership structures. There are three primary reasons for this pattern. Firstly, a significant proportion of listed companies are subsidiaries that have a parent company or group that remains in control through extensive contractual and management ties after listing. Continuing involvement in spun-off listed companies is often evidenced through the parent company’s active control of the new listed companies’ boards, and maintaining control is often a prerequisite for the parent listing the subsidiary in the first place. Secondly, as previously discussed, a given level of control in a listed company is often extended and multiplied through complex pyramidal type ownership structures. Thirdly, the rights of minority shareholders remain weak under the present political and legal system in China, and this is particularly true when the State remains the controlling shareholder of the former SOE35.

4.2.3 General Shareholding Meeting

According to Chinese company law, the annual general shareholder meeting (and extraordinary shareholder meeting) is the supreme decision-making authority in listed companies. As the most powerful decision making body, the annual general shareholder meeting (AGM) has an important role to play regarding corporate governance. Chinese company law dictates that shareholders are provided with a number of comprehensive decision-making powers at the general shareholder meetings. These include:

- To make decisions regarding corporate policies on business operations and plans for investment
- To examine and approve the reports tabled by the management board and board of supervisors
- To examine and approve the financial reports and budgets, as well as the final accounts plans
- To examine and approve the proposed corporate profit distribution and loss coverage plans
- To propose resolutions on a possible increase or reduction of the registered capital
- To make decisions on corporate mergers, company dissolution or liquidation
- To undertake amendments to the corporate memorandum of association

According to Chinese company law an annual general shareholder meeting must be convened, with any extraordinary shareholder meetings also being held a maximum of two months after a predefined specific condition has been met. Conditions include a request to convene by any shareholder with at least a 10 percent holding in the company, with meeting agendas being circulated a minimum of 30 days in advance.

Despite the statutory power of the general shareholders meeting making it the supreme decision making body in Chinese listed companies, in reality meetings are usually just an opportunity to
“rubber stamp” the actions and requirements of the majority shareholders. In practice, there is very limited opportunity for minority shareholders to have their voices heard or influence proceedings in any way.

In 2000, the CSRC introduced a new regulation designed to increase the rights of minority shareholders at a firm’s annual general shareholder meeting by prohibiting shareholders that are involved in related party trading from voting on such trading. Chinese company law stipulates that resolutions proposed at the shareholder meeting require a majority of votes, by shareholders present at the meeting, to be passed. In 2004, the CSRC issued a guideline for public tradable shareholders to attend general shareholder meetings with the aim of promoting minority shareholder participation. However, the participation of minority shareholders in the general shareholder meetings remains very low. Hua (2005) found that only eleven percent of the individual shareholders participate in the annual shareholder meetings.

Several possible reasons could explain the reluctance of minority shareholders to attend and participate at the general shareholder meetings. A key reason is that minority shareholders are often private individuals and not institutional investors, and as such lack the professional interest in monitoring business activities. Additionally, the costs involved in terms of time and travel expenses (investors may have to travel long distances) may be too great for minority shareholders. Furthermore, majority shareholder and the management often appear indifferent to the concerns of the minority shareholders, and as such they do not believe their presence will make a difference.

4.3 Board of Directors

China has adopted a two-tier structure of board governance, consisting of both a supervisory and management board. Chinese company law stipulates that the number of directors must total between 5 and 19 in a listed company. Similar to the German system, the management board is the main decision-making authority, whilst the supervisory board acts as a monitor. Tenev et al.

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(2002) describe China’s Supervisory board structure as a mixture of the German-style supervisory committee and China’s traditional concept of employees as masters of enterprises’.

4.3.1 The Supervisory Board

The advantage of the two-tier structure theoretically is that the supervisory board is independent, and performs a monitoring role for both the board of directors and the management. Employee representatives should also be present on the supervisory board. In China however, the supervisory board is quite ineffective. Around half of the supervisory board members are appointed by shareholders, but key positions such as Chairman and Vice-chairman are usually appointed by the larger legal person shareholders (Tenev et al., 2002). Furthermore, the Chairman and vice-chairman are normally CCP representatives\(^\text{38}\), suggesting a strong political orientation. One of the requirements for the company to be listed is the establishment of a two-tier board structure, and thus most appointments to the supervisory board occur at the time of listing and have usually been working in the parent company.

The 2002 ‘Code of Corporate Governance for Listed Companies’ in China (hereafter the 2002 code) requires that the supervisory board implement a system of financial supervision for the company, including for directors and senior managers. However in practice, the supervisory board usually lacks necessary skills and experience to perform such a function. The primary channels of information for the supervisors originate directly from the management board and senior management. Furthermore, Chinese company law does not require the management board to report regularly to the supervisory board - and a lack of timely information about the company also hinders the supervisory board’s effectiveness in a monitoring role. Overall, the lack of professional experience, combined with the lack of information on which to base decisions, means that the supervisory board in China exists as primarily as a ‘rubber-stamp’ committee.

4.3.2 The Management Board

As the highest authority body of Chinese enterprises, the management board plays a significant role in corporate governance. Management boards in China however, have relatively weak influence over the decision-making of listed companies. Instead it is the State and securities

\(^{38}\) SOE’s traditionally have internal Party representation
regulators that enjoy significant power. Tenev et al. (2002) show that Chinese boards have full
decision making authority in only around 20% of listed companies, however boards in China are
generally requesting more autonomy from shareholders.

The CFA Institution Centre for Financial Market Integrity (hereafter the CFA) conducted a
survey of Chinese corporate governance in April 2007. The survey clearly shows that special
committees rarely exist in Chinese listed companies, whilst the ones that do exist are usually
investment/finance committees and strategy committees. Committees such as the nominating
and compensation committees are particularly rare in Chinese listed companies, with many not
even having a system in place for their establishment. The monitoring and auditing functions of
such committees in Chinese listed companies are under-developed.

In Chinese listed companies, 57% of directors are selected by the large legal person shareholders,
with 34% being selected by the management board, 6% by the Chairman of the board and 3% by
existing directors (Lu, 2003). As with appointments to the supervisory board, most executive
directors are appointed prior to the company being listed and are from the parent company. The
nomination and compensation review process of such appointments is handled either by the
management team or directly by the State. Tenev et al. (2002) find that many directors believe
there to be an internal selection criteria for appointing directors, based on factors such as
professional expertise, reputation, and interpersonal connections. The presence of such a
selection procedure, suggests that the board may be working in the interests of the majority
shareholders. This in turn suggests that control of Chinese enterprises, like ownership structure,
is also highly concentrated.

In an effort to address the lack of board independence in Chinese listed companies, the CSRC
stated that all boards must consist of at least one-third independent directors and include at least

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39 From August to September 2006, the CFA Institute Centre conducted a study of corporate governance practices
in China with CFA charter holders and CFA Institute members in Hong Kong and China who have investments or
interests in Chinese companies. The survey received 475 responses. The main objective if the survey was to obtain
opinions and views on: issues relating to corporate governance and financial disclosures among Chinese
companies; the effectiveness of recent reforms made by China to improve corporate governance practices; and
ways to further improve corporate governance practices in China.
one accounting professional director. The CSRC further stipulates that independent directors must be given the sufficient time (minimum 15 hours per year) and information necessary to perform their duties. Independent directors (at least 2 in number) should also have the power to call an extraordinary shareholder meeting if it is deemed necessary, and they must sanction any related-party transactions. The effort to bolster the position of independent directors is designed to protect the rights and interests of (minority) shareholders.

Although all Chinese listed companies must now comply with the CSRC regulations and have at least one-third independent directors appointed, the effectiveness and independence of the board is still not guaranteed. In many cases listed companies hire independent directors specifically to meet CSRC requirements. Of these independent directors, many are former advisors to the companies and some are scholars and researchers, with limited practical experience in the company’s operations and management (Hua, 2005). By increasing numbers of independent directors on the management board, the role of the supervisory board becomes more unclear. This type of board structure is a combination of those proposed by the Anglo-Saxon model and German model with overlapping functions. The duplication of the monitoring function across two boards is likely to increase the agency costs for the listed company.

Figure 4.1 describes the changes of the board composition, structure, and mechanisms for the three years prior to 2007. ‘Skills and experience of management’ can be seen to have improved the most, however the relatively high score is understandable as most directors (both independent and executive) hold a graduate degree. As control in the listed companies still remains in the hands of the State or controlling shareholder all the other issues receive a lower average rating for change over the period. Tenev et al. (2002) find that the role of Chairman and CEO has been separated in around 45% of total listed companies however it remains questionable that the separate roles work efficiently. Furthermore, the Chairman and CEO are usually appointed by the State or controlling shareholders and the Chairman is therefore able to manage board meeting as a representative of the largest shareholder. Management is likewise unlikely to resist government invention in business operations. In this case, even with the separation of the role of

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40 In August 2001, the CSRC issued specific guidelines on the qualifications of independent directors of listed companies, namely the ‘Guideline on Establishment of Independent Director System in Listed Companies’. These guidelines apply to all companies listed on the Chinese stock markets, but not Chinese companies listed overseas.
chairman and CEO being stipulated by the CSRC, it will not make a significant difference. The separation of the roles of Chairman and CEO therefore receives a lowest grade over the period.

**Figure 4.1 Board Composition, Structure, and Mechanisms: changes for the three years prior to 2007**

![Diagram showing board composition, structure, and mechanisms changes from 2004 to 2007.]

Source: CFA Institution Centre survey (2007)

### 4.4 Executive Compensation

The 2002 code (Chapter 5) discusses the incentive and disciplinary system for executives. The system should be designed to attract qualified personnel and maintain the stability of management. Listed companies should establish a reward system linking management compensation to firm’s performance and to individual’s work performance. Most directors and managers in China however, are underpaid in relation to Western standards.
In China, the compensation package for top executives is usually a fixed-salary plus a bonus linked to the company’s performance during the year (Liu, 2005). Most executives (including directors and senior managers) are paid on average less than RMB 50,000 (US$ 6,250) per annum, with the top three executives in a listed company receive about RMB 97,000 (US$ 12,000) per annum on average (Kato and Long, 2006). Independent directors usually receive less than RMB 50,000 (US$ 6,250) per annum. Executive directors usually receive benefits including a company car and housing subsidy, with independent directors also receiving some allowances. Non-executive directors however, do not receive benefits from the listed company.

The lack of strong performance linked incentive mechanisms means that the behaviour of SOE executives may be different from private company executives. The government evaluates SOE’s based on their social responsibilities, welfare functions, total profits and taxes paid. SOE executives may be more sensitive to the performance evaluations by their politically appointed superiors, and may be inclined to overstate profits in order to fulfil political expectations.

The 2002 code requires that executives publicly report details of their remuneration at the annual shareholder meeting. Full disclosure is required on the decision-making surrounding compensation packages for directors, supervisors and senior managers; total annual remuneration payment for executives, including bonuses, allowances and expenses; and the total compensation of the three highest paid directors and managers. The CSRC disclosure requirements however, are somewhat inadequate. Detailed information on the composition of executive remuneration packages should also be disclosed. In 2007, the CSRC released “Regulations of Information Disclosure of Listed Companies”, designed to shore up the 2002 code, however the new regulation did not even touch on the subject of remuneration disclosure.

The CFA survey shows there has been no significant change over the three years prior to 2007 regarding the adequate disclosure of directors and executive compensation (Figure 4.2). Tenev et al. (2002) show that in Chinese listed companies, non-executive directors tend to hold the most shares, while independent directors hold the least on average. Senior managers tend mainly to hold employee shares issued to them when the company was listed.

A recent amendment to the original 1998 Securities Law has focused on encouraging the use of stock option plan among listed companies. The use of stock options has thus begun to play a
more important role in aligning the interests of shareholders and managers, and thereby improving firms’ performance. The trend of executives’ shareholding has tended to increase in recent years, and the survey shows some improvement in the alignment of executive compensation and company performance throughout the period.

**Figure 4.2 Executive Compensation: changes for the three years prior to 2007**

![Bar chart showing changes in executive compensation and company performance](source: CFA Institution Centre survey (2007))

With the exception of some foreign-invested companies, stock option programs are still relatively new to Chinese companies, with only around 15% of total listed companies implementing them in some form. The State-owned Asset Supervision and Administration Commission (SASAC) first allowed overseas (Hong Kong) listed SOE’s to adopt stock option plans in early 2006 on a trial basis, on the premise that if it was successful mainland national and regional SOE’s would be allowed to follow suit.

The use of stock option plans, as a particular form of executive compensation however, is not a perfect governance mechanism; especially in developing markets Core et al. (2003) argue that if markets do not reflect managerial actions in equity prices, then the effectiveness of equity compensation must be in question. In these cases it would cause deeper agency problems rather than properly aligning incentives. In China, the immature legal system may allow the use of stock options to be abused. In order to ensure a positive relationship between executive compensation and firm’s performance, the Chinese legal system must be improved, with heavy penalties introduced for insider trading and the manipulation of share prices.

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Even though the use of stock options is becoming greater, not all Chinese employees will necessarily be familiar with them. Furthermore, even if they are familiar with them, they still may not necessarily be interested as the compensation is delayed. The year-end bonus has traditionally been the way of rewarding employees (Chiu et al., 2002), and thus Chinese employees may prefer shorter vesting periods.

The use of stock options however is continuing to gain ground overall. Depending on the employee, stock options can be a useful method – among others – to encourage employee performance and improve retention (Gross and Minot, 2008). Evidence suggests that stock options are now being received more favourably amongst Chinese employees. (Xiu and Ming, 2008) have found that especially amongst overseas listed SOE’s, barriers to exercising stock options have been overcome and some senior managers have received substantial rewards and have been cashing in on them. One major mainland Chinese company that has implemented options is CITIC Securities (Gross and Minot, 2008). The Chinese government has also initiated a new plan which allows (with prior approval of the government) for foreign exchange purchases for the purpose of stock options in foreign companies. Procter & Gamble China was the first to participate in this new program in February 2008 (Gross and Minot, 2008).

It is clear that the Chinese authorities recognise the importance of executive compensation as an incentive mechanism and consider it an important element of enterprise reform. Conyon and He (2008) have found CEO equity incentives in China to be positively correlated with firm size and risk profile. These findings imply that China’s corporate governance regulations have succeeded to some extent in aligning managerial interests with those of shareholders.

**4.5 Information Disclosure and Transparency**

The 2002 code (Chapter 7) describes information disclosure as the ongoing responsibility of listed companies. The report requires that a listed company must truthfully, accurately, completely, and timely disclose information as required by law, regulations, and the company’s own articles of association. Listed companies are required to publish the audited annual, interim and quarterly reports that have been approved by the management board. It is not however

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43 CITIC Securities is engaged in the securities brokerage, investment banking and asset management activities, and is part of the larger CITIC group in China
necessary for these reports to be made available on the internet. In addition to the mandatory information disclosure requirements, companies are also encouraged to disclose other information in a timely manner. This includes details of management and supervisory board members compensation packages, executive performance assessments, executive compensation and the holding of the controlling shareholder. It is also a CSRC requirement that a company seeking listing must have three years of financial statements prepared prior to being listed.

In an effort to improve the information disclosure level of listed companies, the CSRC released “Regulations on Information Disclosure of Listed Companies” in February 2007. The new regulation specifically addressed the required disclosed content, disclosure procedures, responsible persons on disclosure, and the punishments on the violation of disclosure rules. Furthermore, the new regulation not only applies to the listed company and its directors, supervisors and management, but also other stakeholders such as the controlling shareholder, potential buyer of the companies, investment advisory companies and the media, who may play a role in the listed company’s information disclosure process. In order to ensure true and complete disclosure, the 2007 regulation has specified that the Chairman, CEO and board secretary together are responsible for the authenticity accuracy completeness, immediacy and fairness of the disclosed information. The new regulation also introduces a ‘fair disclosure’ principle, meaning that the listed company cannot selectively disclose information to particular investors or the media. In relation to ownership disclosure in particular, the new regulation also attempts to disentangle the complex pyramidal ownership structures of Chinese listed companies by requiring that the controlling structure must be made available in a diagram which clearly identifies the controlling shareholder or shareholder group.

The Chinese government has also released a series of disclosure standards and ordinances aimed at improving the quality of accounting practices. The Finance Ministry has for example issued 38 new Basic Accounting Standards for Business Enterprises (ASBE) which is applicable to all listed companies from February 2006. The new ASBE standards are designed to improve the quality of financial information, to be in line with International Financial Reporting Standards (IFRS). Furthermore, the Finance Ministry has also issued 48 new Auditing Standards for

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Certified Public Accountants (CPAs). These in turn are expected to bring China’s audit rules more in line with International standards, and improve the overall quality of domestic CPA’s.

Investors are willing to pay a premium for companies with sound governance, and full and timely information disclosure is the best way of ensuring investors that this is the case. Information disclosure in China’s capital markets is however still in relatively short supply to both investors and analysts. As a result, markets are not well-appointed to monitor auditing and accounting professionals, or the disclosure practices of listed companies. The CFA survey shows the information disclosure practices of Chinese listed companies to be incomplete. More information relating to business segments and cash flows should be disclosed in the company’s financial reports. The survey also finds companies disclosure practices are more geared towards meeting the requirements of the authorities, rather than the needs of private investors. Consequently, this may increase the risk of the falsification of financial information.

**Figure 4.3 Information disclosure: changes for the three years prior to 2007**

![Bar chart showing information disclosure changes]

Source: CFA Institution Centre survey (2007)

Figure 4.3 shows the development of information disclosure practices in China over the three year period. Unsurprisingly, it is the completeness of information disclosed that received the lowest rating. This indicates only a slight improvement over the three year period. Although the CSRC has issued new regulations and standards pertaining to information disclosure, these ratings are relatively low and suggest there remains much room for improvement.
The multiple standards that are currently in use for the preparation and auditing of financial statements in China also affect the quality of disclosure. Some listed companies follow the International Accounting Standards (IAS), some the American General Accepted Accounting Principles (GAAP), and yet others follow domestic standards such as ASBE or industry-specific rules (Tenev et al., 2002). It is even the case that some parent companies follow ASBE principles, whilst their subsidiaries use industry-specific accounting systems. The same problem also exists regarding auditing standards. As a result of using multiple accounting and auditing standards, it is often difficult for investors and analysts to compare financial information between companies.

China has worked to improve both the standards of Accounting education and the number of students that study accountancy, however despite this the country is still presently lacking a large number of qualified accounting professionals\(^{45}\), with most domestic accountants working without formal education or training. Many Chinese accountants therefore lack knowledge of International accounting standards and practices. In relation to the large International accounting firms, the quality of China’s Certified Public Accountants (CPA’s) is much lower, especially amongst the smaller firms. Chinese CPA’s are well below International standards in areas such as management, qualifications of personnel and services offered. Furthermore, they have no proper process to perform risk assessments, and rarely carry out any internal control assessments as part of their audit work.

Market competition within the accounting industry in China is also fierce. There are approximately 5000 accounting firms competing to service around 1500 listed companies in China\(^{46}\). Intense competition as a market characteristic does not encourage firms to improve on professional quality. Many firms instead compete on price in order to increase their market share, instigating a ‘race to the bottom’ in terms of audit quality. CPA’s have been known to collaborate with listed companies in producing financial statements, and there have been many cases of fraud in China involving the questionable practices of CPA’s (Lin, 2004). As with many other industries in China, the accounting industry has not been fully opened up to international competition, however the government does encourage cooperation between foreign and domestic

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\(^{46}\) Data from: [http://www.cicpa.org.cn/](http://www.cicpa.org.cn/)
accounting firms. Many Chinese listed companies hire international firms as their external auditor, in spite of their charges being far in excess of domestic Chinese firms. These are primarily overseas listed companies where the presence of a reputable auditing firm is essential in order to raise capital internationally.

4.6 The Market for Corporate Control

In China, the presence of highly concentrated ownership structures with large blocks of non-tradable shares, combined with inadequate information disclosure, regulatory barriers and inexperienced management (Lin, 2004) suggest that the market for corporate control remains under-developed and ineffective.

Prior to the ‘Split-share structure reform’ of 2005, releasing large blocks of previously non-tradable shares on to the market, the agreed transfer of State/legal person ‘A’ shares was the most operable method of obtaining control rights of listed companies in China. In agreed transfer transactions, shares were usually traded or exchanged at a price lower than in the open market. If a buyer was able to find a controlling shareholder willing to sell their block of non-tradable shares, the price was usually lower compared with purchasing the same shares on the open market, resulting in different markets for different classes of shares. The resulting price differential has in some cases allowed non-listed companies to acquire listed companies, when the valuation of the listed companies ‘A’ shares usually provided strong economic rationale for the acquisition to occur in the other direction. From the listed company’s perspective, M&A’s occurred for different reasons. The listed company may have had to sell off some of its assets to meet the profit target stipulated by the government, or otherwise generate exceptional profits to meet the 10% ROE required for it to issue new shares (Tenev et al., 2002).

The fact that the majority of State-owned shares of Chinese listed companies could not be traded proved to have a negative impact on the market’s development. Chinese authorities attempted on two previous occasions (1999 and 2001) to sell off State-owned shares, however fears that share prices would plunge as supply increased caused these plans to be put on hold. These concerns of the minority shareholders (holders of tradable shares) were partially addressed in the ‘Split-share structure reform’ of 2005, where they were given more power over the process itself. The government has also stipulated a phased introduction of the newly tradable shares onto the
market. The non-tradable share reform has provided more liquidity to Chinese corporations, thus expanding takeover activities (Samsung report, 2006).

The total number of corporate control transactions in China has been increasing year on year since 1998. The total volume of transactions however remains relatively small by Western standards, although the average volume is growing rapidly year on year (Table 4.2). Stricter supervision of listed companies led to the growth of corporate control transactions slowing and stabilising after 2002, however the Split-share structure reform of 2005 has since facilitated a dramatic increase in M&A activity.

**Table 4.2 Number of Control Rights Transactions for listed companies 1998-2007**

<table>
<thead>
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<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
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<td>Amount</td>
<td>70</td>
<td>84</td>
<td>103</td>
<td>119</td>
<td>168</td>
<td>170</td>
<td>161</td>
<td>266</td>
<td>1411</td>
<td>1700</td>
</tr>
</tbody>
</table>

*Source: Jing Wang, 2008 and PriceWaterhouseCoopers Asia-Pacific M&A Bulletin, 2008*

The trend of merger activity in China has also begun to shift from those between financially troubled companies, to those between financially sound companies. Previously, it was more common for large companies to take over small ones, but as globalisation accelerates, better performing companies are merging with other financially sound companies to develop into globalised multinational corporations (Samsung report, 2006).

The high rate of M&A activity in Europe and the US markets is attributed essentially to a mature market-based system and supporting institutional environment. In China however, the majority of M&A deals involve the subject of State-owned property rights, thus creating a corporate control market with unique ‘Chinese characteristics’.

Apart from capital investment, external factors such as facilitating policy environment are decisive in determining the activity in China’s corporate control market. As part of an increased effort to reduce direct involvement in the M&A process, the Chinese government has established a number of new M&A regulations. The CSRC for example has unveiled an M&A memorandum of listed companies, as well as guidelines to manage direct transfers, as a facilitating vehicle for transactions between companies (Samsung report, 2006).
Merger activity is serving a crucial role in the Chinese government’s reform of SOE’s. The government’s permission for foreign investors’ acquiring stakes in Chinese SOE’s is facilitating the absorption of foreign capital and technological capability into the country that the government is itself failing to provide (Samsung report, 2006). Furthermore, the gradual conversion of non-tradable to tradable shares combined with the continuing acceptance of private capital and foreign direct investment, the corporate control market is likely to play a more prominent role in China in the future. An active corporate control market can be an effective external governance mechanism for Chinese listed firms. However, despite rapid growth in recent years, the market in China is still in its infancy and it is likely to take more time for M&A activities to scale-up and become more effective.

4.7 Product Market Competition

Product market competition can be a particularly effective governance mechanism as management must strive to make the company more efficient and thus avoid bankruptcy. In China however, the threat of bankruptcy has traditionally played a limited role. Furthermore, a study by Chan et al., (2002) found that firms in China operating in more competitive markets are likely to hire executives that are more profit-oriented, and these executives are more concerned with guanxi\(^\text{47}\) and less concerned with business ethics. In relation to this, Cai et al. (2005) find that when firms are able to use unethical behaviour as an instrument to gain competitive advantage, competition may actually encourage unethical behaviour.

China’s original bankruptcy law pertaining to SOE’s was passed in 1986, with the Civil Procedures Law introducing preliminary provisions for the bankruptcy of legal persons in 1991 (Tenev et al., 2002). The original 1986 bankruptcy law had a number of problems. The law was established during the command-economy era which was characterised by strong government intervention. In order to file a bankruptcy petition, creditors required the permission of the local government before it could be heard in court. The previous bankruptcy law had been initially implemented on a trial, and the lack of restructuring made the old law impractical in dealing with the new market-orientated economy\(^\text{48}\). The original bankruptcy law was eventually superseded

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\(^{47}\) Guanxi can be defined as a special type of relationship which contains trust, favour, dependence and adaptation (Wong, 1998), and often leads to insider-based decision making in the business world.

by the new ‘Enterprises Bankruptcy Law of the People Republic of China’ in 2007\textsuperscript{49}. Before the
new law was passed, there was not a single case of bankruptcy of a Chinese listed company. This
is not however evidence of efficiency or the successful exploitation of a competitive advantage;
some loss-making listed companies have in reality been very close to insolvency.

The new 2007 bankruptcy law is designed to make bankruptcy a market-driven rather than a
purely administrative process. With the implementation of new bankruptcy law, a large number
of unprofitable or insolvent listed companies are likely to be de-listed. These companies will
require restructuring, otherwise they will be declared bankrupt and face liquidation. The
successfully restructured companies are naturally re-listed on the exchange. There are currently
around 200 Special Treatment (ST) companies on the Chinese stock markets (over 10\% of total
listed companies). The new 2007 bankruptcy law will ultimately force the inefficient companies
to address their business problems. Furthermore, the new law involves the considerable
strengthening of creditors’ rights in the case of default, along with greater options for banks in
the reorganisation of client companies.

The Institute of Industrial Economy Research of the Chinese Academy of Social Sciences
released the ‘Competitiveness of Chinese Enterprises’ monitoring report in 2005\textsuperscript{50}. The report
shows the competitiveness of Chinese listed companies to be lower than that of non-listed
companies. Access to capital markets appears to have relieved some of the pressure for listed
companies to employ capital efficiently, as more capital can be raised through issuing stocks.
This is seriously detrimental to listed companies competitiveness.

\textbf{4.8 Legal Infrastructure and Law Enforcement}

There are currently five main laws pertaining to Chinese listed companies. These are the Basic
Accounting Standards (1992), Company Law (1993), Securities Law (1998), the Code of
Corporate Governance for listed companies in China (2002) and the Bankruptcy Law (2007).
These laws are primarily based on Western legal systems governing free-market economies. The
2002 code, for example is based on the OECD Principles of Corporate Governance (Hua, 2005).
The State Council Securities Commission (SCSC) is the highest authority for capital market

\textsuperscript{49} Information from http://business.sohu.com/7/0604/41/column220664192.shtml (Google translation)
\textsuperscript{50} Information from http://news.xinhuanet.com/fortune/2005-10/25/content_3680434.htm
supervision, for which the CSRC is the executive arm and is responsible for supervisory and regulatory duties.

As previously discussed, a well-functioning legal system and good law enforcement are critical for economic growth. The legal infrastructure and enforcement environment in China, however, are relatively weak and are lagging well behind market development. The Chinese constitution requires the courts to independently exercise judicial power in accordance with the law, and not be subject to the interference of government organs, social groups, and individuals. In reality, local authorities have appointive and financial power over judicial and law enforcement departments (Yang, 2000). As such, Chinese courts are heavily influenced by central or local government, and inter-provincial investment in China has been compromised through local biases in the judicial system.

The legal infrastructure and enforcement environment in China are generally too underdeveloped to ensure transparent and effective capital markets. Private enforcement of investor rights and public enforcement of contractual disputes are both in an extremely weak position. Under the current Chinese legal system concerning securities civil compensation, it is difficult for the investors to sue in court. For instance, there are no provisions for civil compensation concerning insider trading and the manipulation of share prices in the Securities Law. Some authors argue that increasing the amount of institutional investors in China will help improve governance practices. However, Lin and Li (2006) argue that without solid legal infrastructure, the introduction of institutional investors to the stock market will increase speculation, as the accumulation of large amounts of capital may be used to manipulate stock prices.

The CSRC maintains investor protection to be a top priority however present regulations do not provide any significant power to minority shareholders. For instance, a shareholder with at least a 5% holding in a company is usually able to nominate independent directors. However, under the current system in China, it is only the largest and second largest shareholders that have the right to elect independent directors. Independent directors nominated by controlling shareholders may suggest that their independence is doubtful, and as such they are unlikely to safeguard the interests of minority shareholders.

As part of the greater goal of economic reforms, the Chinese government has been focusing in recent years more on streamlining and reforming the legal system. The Chief Judge of the Supreme People’s Court in China, has stated that judicial reforms intend to create a fair, open, effective, honest and well functioning judicial system, in particular, to enhance an independent judiciary process and reduce interference from outsiders\textsuperscript{52}. It is reasonable to assume that an environment with better legal infrastructure and enforcement mechanisms will provide a fair and standardised market environment for competition, in which even listed companies with a highly concentrated ownership structure may perform better.

4.9 Sectional Summary

This chapter has detailed corporate governance practices in China through the external and internal mechanisms discussed in chapter 2. As an internal governance mechanism, ownership was found to be highly concentrated in China with a high prevalence of non-tradable State shares. In terms of board structure, China operates a two-tier system with both supervisory and management board functions. Chinese boards however are relatively weak as the use of independent directors on management boards confuses the role of the supervisory boards. Chinese boards also lack independence as it is the largest shareholder that appoints many key positions. In terms of executive compensation, Chinese managers have traditionally been paid a fixed salary plus bonus; however the Chinese authorities do recognise executive compensation as an effective governance mechanism and thus an important part of enterprise reform. The alignment of executive compensation with firms’ performance appears to be improving over recent years, which may be due to the increased use of equity based compensation in Chinese companies. Improving information disclosure and transparency is an effective governance tool, and the Chinese authorities have made important moves in this direction through the 2007 “Regulations on information disclosure of listed companies”. However the Accounting industry in China is still in its infancy with a lack of skilled professionals and a fiercely competitive operating environment.

Highly concentrated ownership structures, with large blocks of non-tradable shares has traditionally meant that the market for corporate control has played a limited role as an external

\textsuperscript{52} Information from: http://chinaperspectives.revues.org/document274.html
governance mechanism. The “Split share structure reform” of 2005 however has begun facilitating the conversion of non-tradable to tradable shares, in turn providing more liquidity and helping to expand takeover activities. As a governance mechanism, product market competition in China is likely to play a more prominent role through the removal of soft budget constraints associated with State ownership, and the introduction of the 2007 “Enterprises bankruptcy law of the People’s Republic of China” which makes bankruptcy a more market-driven process. Measures designed to promote healthy competition however may not have the desired effect if they are not implemented in a strong legal and regulatory environment. Effective legal infrastructure and law enforcement are an extremely important external governance mechanism and are crucial to economic development. The legal infrastructure and enforcement environments in China are relatively weak and slow to develop as part of the new ‘socialist-market’ economy. As a result capital markets are not efficient, and the rights of minority shareholders remain weak.
5.0 Ownership effects on the performance of Chinese listed companies

5.1 Introduction

As part of the examination of corporate governance in China, and the fundamental role played by the restructuring of the SOE sector. The paper will continue with an empirical study of the effects of ownership concentration and ownership structures on the performance of Chinese listed companies. Chapter 5 details the empirical analysis applied in this paper. The topics covered in relation to the study are its importance and benefits, aim and expected outcomes, theoretical motivation, methodology, hypotheses, descriptions of variables, data selection and descriptive statistics.

5.2 Research motivation

Literature on the subject of ownership structures has been influenced by the different analytical approaches taken and different parameters used. These approaches include the type of economy analysed (developed or emerging/transition), as well as the type of owners (State, institutional, management, employee or private investors). Some authors also believe that the time frame for the analysis may also play an important role in identifying any possible relationship. Research thus far does not appear to provide a definitive answer as to whether a relationship exists between ownership and firms’ performance, although the general conclusion in most cases suggests that a direct correlation cannot be proven.

Chapter 2 (section 2.4.2.3) discussed the importance of legal protection against controlling shareholders’ and managerial expropriation (La Porta et al., 2000). In the case of weak legal environments (such as in transition economies), large shareholders may be an important means of monitoring management and improving performance (Shleifer and Vishny, 1996). International studies also find evidence that large shareholders play an active and important role in corporate governance (for example Denis and Serrano, 1996 (US); and Edwards and Fischer, 1994 (Germany)).

During the 1990’s, privatisation was generally considered as the keystone of the transition process. The arguments were derived from the experience of developed economies, in which it
was generally found that private ownership improved enterprise efficiency (Megginson and Netter, 2001). Likewise many previous corporate governance studies have found that companies that have a relatively high level of ownership concentration, but are otherwise identical, enjoy a higher level of economic performance. This conclusion is particularly relevant to transitional economies where significant differences, such as State versus private ownership, may endure (Claessens and Djankov, 1999b; Xu and Wang, 1999). Alternatively, Demsetz and Villonga (2002) suggests that neither concentrated nor diffuse ownership structures have a measurable effect on firms’ performance, but rather the interplay with market forces is the determining factor for success in changing ownership structures. Estrin et al., (2008) finds that despite the expectation of the positive effect of private ownership, the post communist countries of CEE (Central and Eastern Europe) and CIS (Commonwealth of Independent States) went through a deep recession during the first three to eight years of their transition. Research at the company level also suggests that concentrated private ownership (especially foreign ownership) has a stronger positive effect on economic performance than dispersed ownership in the CEE and CIS.

Studies of emerging and transition economies often include an analysis of ownership structures and ownership concentration, for example the study of the Czech Republic by Claessens and Djankov (1999b). The findings of these studies are also mixed. Kocenda and Svejnar (2002) conclude that private ownership appears to be linked to superior performance in the case of some indicators whilst not in others. In a study of corporate governance in China, Hovey (2006) found that private, along with institutional and offshore ownership, positively impact the performance on listed firms. Mattlin (2007) however finds that Chinese firms with the best performance are presently found in sectors of the economy controlled by SOE’s (for example the oil, petrochemical, energy and metal industries). Chen and Gong (2000) and Xu and Wang (1999) also include the study of ownership concentration and ownership structures in their studies of China, with mixed results.

The review of empirical work in this section thus appears to show conflicting research results depending on the method and time period used in the analysis. The evidence from all the research is that ownership and performance may be related, but the relationship is more complicated than many researchers had expected.
5.2.1 Empirical approach
As previously discussed, China did not conduct its economic transition with the large-scale ‘mass’ privatisation of SOE’s associated with CEE and CIS transitions. Neither did it significantly loosen the degree of government control over SOE’s. However, China has managed to avoid the ‘transition recession’ associated with the aforementioned transitions. At first glance it appears that China has made a successful economic transition, however the lack of studies and data pertaining to it, make it too soon to draw any firm conclusions. The approach taken by this paper is to evaluate what has been learned to date regarding the effects of ownership structures from the findings over the recent years, and combine it with our own empirical analysis of Chinese listed companies. The focus of the empirical work conducted in Chapter 6 of this thesis is thus based on the effect of ownership concentration and different ownership forms on the performance of listed firms in China.

5.3 Methodology
In formulating the methodology to be used in this section of the paper, it was found that an empirical analysis aimed at describing, explaining and making predictions through observations would be the best possible way forward. The study of the effects of ownership on firms’ performance is thus based entirely on the empirical analysis of published and readily available data. The empirical analysis is also founded in a comprehensive literature review on models of corporate governance worldwide as well as studies of the SOE’s in China. Particular focus has been given to corporate governance and reforms in transition economies as documented in the academic literature.

5.4 Data Selection
For the analysis, the dataset has been constructed from readily available databases. The dataset is a ten year track record of performance variables for all companies listed on the SHSE and SZSE stock exchanges in 2007. The sources of information are listed as follows;

(2) Thomson One Banker databases. Data relating to ownership status, accounting ratios and accounting figures used in the estimation of Tobin’s Q are gathered and/or calculated from these databases.

(3) ISI Emerging Markets database. Concentration ratios for the largest shareholder (T1) and ten largest shareholders (T10) for each listed company was gathered from this database.

The data was then prepared for the empirical analysis. Much of the work was carried out manually utilising Excel functions to achieve the format applicable for the statistical software. Finally, the dataset was imported into the SPSS statistical program to analyse. Overall, it was a time consuming and labour intensive task to create the required dataset for the study.

The study is ultimately based on a dataset of Chinese listed on both the Shanghai and Shenzhen stock exchanges from the end of 2007. This provided an initial sample of 1563 companies. Market values, accounting and ownership data was then gathered for each of the listed companies for the previous 10 years, creating a track record from 1998-2007.

The pooled dataset therefore consisted of 15630 potential observations. Naturally, some observations are missing for some firms, and thus when the model was run these were dropped. The results show the number of observations in each case. A dataset of 8033 full observations was then available over the 10 year period. Finally, a total of 13 extreme observations were excluded from the ROE, Tobin’s Q and revenue growth variables as it was conceivable that these erroneous observations may unduly drive the results. Ultimately, this resulted in a working dataset of 8020 observations that constitute the basis of the analysis.

5.5 Hypothesis

This study follows the tradition of empirical work in corporate governance. In exploring ownership concentration and ownership structure in relation to the performance of Chinese listed companies, a simple Ordinary Least Squares (OLS) linear regression procedure is employed. Two hypotheses are proposed, the first tests the significance of ownership concentration in relation to firms’ performance. Hypothesis one will be tested at two levels of ownership concentration, where the relationships between the single largest shareholder (T1) and performance, and the top ten shareholders (T10) and performance will be investigated.
Hypothesis two relating to ownership status will test the significance of private or State ownership on firms’ performance. Both hypotheses will be tested by using the accounting measure (ROE) and the market measure (Tobin’s Q) as the performance variable, in order to distinguish between any actual and perceived relationship. In both hypotheses, corporate governance measures are specified as independent variables that have theoretical validity. In using Q as a performance variable, the paper assumes the market value of firms is a fundamental component of the measure of performance, and that the market is capable of discerning between firms with different ownership characteristics.

5.5.1 H1 Ownership concentration and Firm Performance

The effect of ownership concentration on the performance of Chinese listed companies is studied to ascertain if the performance of these firms can be significantly explained by ownership concentration. The approach taken is to examine the relative importance in Chinese enterprises of ownership concentration in predicting the performance of the firm. A null hypothesis of ownership concentration is tested. In the case of the hypothesis not being accepted, fluctuations of firms’ performance with ownership concentration can be investigated.

The null hypothesis is therefore stated as:

**Hypotheses 1**: (The irrelevance of ownership concentration) Ceteris paribus, in any regression of performance, the coefficient of T1/T10 (ownership concentration) is insignificant.

1) \[ \text{ROE} = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T1) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

2) \[ \text{ROE} = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T10) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

3) \[ \text{Q} = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T1) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

4) \[ \text{Q} = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T10) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

In expressions (1) - (4), \( \alpha \) represents the intercept, \( \beta \) the regression coefficients and \( \varepsilon \) is an error term. \( \text{Q} \) and ROE represent the dependent variables Tobin’s Q and Return on Equity.
respectively. Independent variables are represented by SIZE (market capitalisation); GRW (revenue growth); T1 (percentage of stocks held by the largest shareholder; T10 (percentage of stocks held by the ten largest shareholders combined). Finally, IND (industry dummies) were included to control for the industry in which the firm is active, and TIME (time dummies) to control for the year in which the results were obtained.

The ownership concentration of the top shareholders was taken from the ISI Emerging Markets database without identifying ownership characteristics. The ISI Emerging Markets database lists the percentage ownership of the firms’ largest shareholders. From this, the percentage ownership of the top one (T1) and top ten (T10) were derived.

Two independent variables that were deemed to have explanatory power when examining firms’ performance and corporate governance were the size and growth rate of the company.

Firstly, the natural logarithm of market capitalisation will be proxy for the size effect. Literature suggests that larger SOEs are subject to more government control and thus evoke bureaucracy and agency problems (Xu and Wang, 1999). In the context of China therefore, size becomes a proxy to explain bureaucratic inefficiencies brought about due to the size of the company. In this way it is expected that the variable SIZE be negatively correlated to firms’ performance (Sun et al., 2002; Xu and Wang, 1999).

The second independent variable is revenue growth. In this study, growth of revenue will be proxy for the growth rate of the firm, and it is expected to be positively correlated to firms’ performance.

**5.5.2 H2 Ownership Structure and Firm Performance**

Following the preliminary studies of hypothesis one, further data was compiled for hypothesis two. Hypothesis two is essentially the primary focus for the empirical analysis in this thesis. The effects of ownership structure on the performance of firms are studied to ascertain if the financial performance of Chinese enterprises can be significantly explained by the firm being in State or Private hands. If ownership structure is irrelevant, the equity ownership fraction (EO) is expected to be insignificant in regressions of performance.
Thus, the null hypothesis is stated as:

**Hypothesis 2**: (The irrelevance of ownership structure) Ceteris paribus, in any regressions of performance, EO (equity ownership fraction) is insignificant.

Hypothesis 2 is tested by estimating the following equation;

\[
5) \quad ROE = \alpha + \beta_1\text{SIZE} + \beta_2\text{GRW} + \beta_3\text{EO} + \beta_4\text{IND} + \beta_5\text{TIME} + \epsilon \\
6) \quad Q = \alpha + \beta_1\text{SIZE} + \beta_2\text{GRW} + \beta_3\text{EO} + \beta_4\text{IND} + \beta_5\text{TIME} + \epsilon
\]

In expressions (5) and (6), \(\alpha\) again represents the intercept, \(\beta\) the regression coefficients; \(\epsilon\) is an error term. \(Q\) and \(ROE\) again represent the performance variables Tobin’s Q and Return on Equity. The independent variables are represented by \(\text{SIZE}\) (market capitalisation); \(\text{GRW}\) (revenue growth); and \(\text{EO}\) (equity ownership fraction). Once again \(\text{IND}\) and \(\text{TIME}\) are included as dummies.

**5.6 Variables**

The models outlined previously contain a number of variables that will now be justified and defined in greater detail. The simple model outlined above indicates the need to identify observable variables that relate to ownership concentration, structure and performance. Thus, variables have been chosen by virtue of their potential to measure firms’ performance against ownership concentration and ownership structure.

**5.6.1 Dependent Variables**

**Performance Variables**

In the corporate governance literature, commonly used performance variables in assessing the relationship between firm’s performance and ownership structure are Tobin’s Q, and Return on Equity (ROE).

Tobin’s Q is an extensively used measure of firm performance in the corporate governance literature. The first significant study to use this measure was Mørck et al. (1988), whilst other studies have included Claessens (1999 and 2000). Tobin’s Q is designed as a market-based
measure of corporate performance, equal to the ratio of the market value of the firm (market value of equity and debt) divided by the replacement costs of total assets. Firms with a Q value greater than 1 are considered to be using scarce resources effectively. Likewise, those with a Q value less than 1 are considered to be using resources poorly.

ROE is also an extensively used as an accounting measure of firms’ performance in the corporate governance literature. Xu and Wang, (1997, 1999) and Qi et al. (2000) have used ROA and ROE in their study of Chinese listed firms. ROE is also the performance measure specified by the China Securities Regulatory Commission for rights issuing and delisting purposes (Haw et al., 1999).

ROE and Tobin’s Q differ in two important ways. Firstly in terms of the time perspective, and secondly in terms of those that are measuring performance. The time perspective for accounting based measures such as ROE are retrospective, whilst it is forward looking for Tobin’s Q. In terms of who measures performance, ROE is determined from the company perspective whilst Tobin’s Q is determined by the ‘market’. It should be noted that although Tobin’s Q is not a perfect measure of performance as it is often measured in proxy form, it remains one of the most widely used performance measures in empirical studies of corporate governance. The performance variables used in the analysis are therefore:

1. **Tobin’s Q ratio**

Very few Chinese listed companies issue publicly traded debt, and as such it is impossible to estimate a market value for their debt. The total book value of liabilities is therefore used as an approximation of the replacement costs of total debt; and likewise the book value of total assets as a proxy for the replacement costs of total assets. Thus the Tobin’s Q is calculated as:

\[
Tobin’s \ Q = \frac{Market \ Capitalisation - Total \ liabilities}{Total \ Assets}
\]

Market capitalisation, total assets and total liabilities for each listed company were collected from the Thomson One Banker database and used to estimate the Q value.
2. Return on Equity

Return on Equity (ROE) is a commonly used accounting measure of firm’s performance. ROE provides information to management and the board about the performance of the firm, and is thus an important performance measure. Furthermore, the China Securities Regulatory Commission also specifies the use of ROE for rights issuing and delisting purposes (Haw et al., 1999). ROE is also a common accounting performance measure in much corporate governance literature. On this basis it has been adopted for this analysis. ROE is calculated as:

\[
ROE = \frac{Net \ income \ after \ tax}{Shareholder \ equity}
\]

ROE for each listed company was collected from the Thomson One Banker database.

5.6.2 Independent Variables

The following independent variables are included by virtue of their explanatory power in the various regressions. The independent variables are as follows:

**SIZE (Market capitalisation):** this is measured by using the natural logarithm of the number of outstanding shares multiplied by the share price at the end of each year over the period.

**GRW (Revenue growth):** this is measured by the average annual growth of revenue over the ten year period.

**T1 and T10 (Ownership concentration):** the fraction of shares held by the single largest shareholder (T1) and the largest 10 shareholders (T10) at the end of each year over the period.

**EO (Equity Ownership categories):** Shareholdings are classified into two categories:
• State – where the proportion of shares owned directly by the State ≥30% of total shares

• Private - where the proportion of shares owned directly by the State does not equal or exceed 30% of total shares

In this way, EO also becomes a dichotomous ‘dummy’ variable where listed companies are either assigned a ‘0’ or ‘1’ depending if they are considered State owned or Private according to the above criterion.

**IND (Industry dummies):**
Nine industry classifications are used in the study. Industry groups are numbered from 1-9 and are used as dummy variables in the statistical analysis (see appendices 3 & 4 for industry groupings). The industry dummies are dichotomous in that they are noted as 1 if the firm is in the industry or 0 otherwise. One dummy variable was omitted arbitrarily in order to avoid the “dummy variable trap” as described by Greene (2000). Industry dummy 1 (mining) was removed, leaving industry dummies 2-9 for use in the analysis.

**TIME (Time dummies):**
A total of ten time classifications are used in the study. Time classifications are numbered from 1998-2007 representing each year under investigation in the study. The time dummies are again dichotomous in that they are noted as ‘1’ if the year is included, or ‘0’ otherwise. As was the case with industry dummies, one time dummy is again omitted to avoid the collinearity problem described above. The 1998 dummy was removed, leaving 1999-2007 for use in the analysis.

### 5.7 Descriptive Statistics
Descriptive statistics are provided in Table 5.1 for the dependent and independent variables. As observed in Table 5.1, the mean of Tobin’s Q is 1.058 with a standard deviation of 2.0159. The mean value of just over 1.0 suggests that the market values the average Chinese listed company slightly in excess of its book value. The mean return on equity is 0.03982 (around 4%) with a standard deviation of 0.522379.
<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity (%)</td>
<td>10998</td>
<td>-18,786</td>
<td>8,358</td>
<td>.03982</td>
<td>.522379</td>
</tr>
<tr>
<td>Tobin’s Q</td>
<td>8890</td>
<td>-40,4</td>
<td>38,1</td>
<td>1.058</td>
<td>2.0159</td>
</tr>
<tr>
<td>Market Cap</td>
<td>8872</td>
<td>4,274</td>
<td>14,376</td>
<td>7.62184</td>
<td>1,101512</td>
</tr>
<tr>
<td>Revenue Growth (%)</td>
<td>10934</td>
<td>-1,000</td>
<td>86,365</td>
<td>.33888</td>
<td>2.250497</td>
</tr>
<tr>
<td>Ownership Status</td>
<td>11540</td>
<td>0</td>
<td>1</td>
<td>.33</td>
<td>.469</td>
</tr>
<tr>
<td>Own. Concentration T1 (%)</td>
<td>11761</td>
<td>.004</td>
<td>1,000</td>
<td>.41794</td>
<td>.171277</td>
</tr>
<tr>
<td>Own. Concentration T10 (%)</td>
<td>11578</td>
<td>.020</td>
<td>1,000</td>
<td>.60982</td>
<td>.140647</td>
</tr>
<tr>
<td>Valid N (listwise)</td>
<td>8020</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Of the independent variables, market capitalisation has a mean value of 7.62184 with a standard deviation of 1.101512. Revenue growth has a mean value of 0.33888 (around 34%) with a standard deviation of 2.250497, reflecting the relatively high growth rate of Chinese listed companies over the period. The ownership status mean of 0.33 shows that one third of Chinese listed companies are privately owned, whilst the remainder remain under State control. Ownership Concentration (T1) has a mean value of 0.41794 with a standard deviation of 0.171277, and likewise (T10) has a mean of 0.60982 with a standard deviation of 0.140647. These figures represent the relatively high ownership concentration of Chinese listed companies, with the top shareholder owning 42% of the average firm, and 61% of the shares being controlled by the top ten shareholders. The relatively low standard deviation of T1 and T10 show some consistency in these results.

Table 5.2 shows the correlation matrix for the variables used in this analysis. The matrix generally shows a positive correlation between the performance variables (ROE and Q) and the control variables, with the exception of small negative correlations between ROE and ownership status, and between Tobin’s Q and ownership concentration (T1). The most significant correlations
Table 5.2 Correlation matrix

<table>
<thead>
<tr>
<th></th>
<th>Return on Equity</th>
<th>Tobin's Q</th>
<th>Market Cap</th>
<th>Revenue Growth</th>
<th>Ownership Status</th>
<th>Ownership Concentration T1</th>
<th>Ownership Concentration T10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity</td>
<td>Pearson Correlation</td>
<td>1</td>
<td>,060**</td>
<td>,151**</td>
<td>,049**</td>
<td>,021*</td>
<td>,036**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td>,000</td>
<td>,000</td>
<td>,000</td>
<td>,041*</td>
<td>,000</td>
</tr>
<tr>
<td>Tobin's Q</td>
<td>Pearson Correlation</td>
<td>1</td>
<td></td>
<td>,270**</td>
<td>,067**</td>
<td>,066**</td>
<td>- ,028**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td></td>
<td>,000</td>
<td>,000</td>
<td>,000</td>
<td>,010</td>
</tr>
<tr>
<td>Market Cap</td>
<td>Pearson Correlation</td>
<td>1</td>
<td></td>
<td>,025*</td>
<td>- ,098**</td>
<td>,163**</td>
<td>,123**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td></td>
<td>,020</td>
<td>,000</td>
<td>,000</td>
<td>,000</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>Pearson Correlation</td>
<td>1</td>
<td></td>
<td>,016</td>
<td>- ,026**</td>
<td>- ,003</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td></td>
<td>,132</td>
<td>,009</td>
<td>,750</td>
<td></td>
</tr>
<tr>
<td>Ownership Status</td>
<td>Pearson Correlation</td>
<td>1</td>
<td></td>
<td></td>
<td>- ,426**</td>
<td>- ,244**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td></td>
<td></td>
<td>,000</td>
<td>,000</td>
<td></td>
</tr>
<tr>
<td>Ownership Concentration T1</td>
<td>Pearson Correlation</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>,588**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>,000</td>
<td></td>
</tr>
<tr>
<td>Ownership Concentration T10</td>
<td>Pearson Correlation</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
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</tbody>
</table>

**Correlation is significant at the 0.01 level (2-tailed)  *Correlation is significant at the 0.05 level (2-tailed)

are those between Market Capitalisation and the performance variables (ROE and Q). Between the independent variables the most significant correlation appears to be between the two ownership concentration variables (T1 and T10). By their nature, some degree of correlation is to be expected between these variables, and it was judged that a figure of 0.588 would not present a problem of multicollinearity and significantly impact the explanatory power of the models.
Chapter 6 Empirical findings and discussion

6.1 Introduction

Chapter 5 introduced the models, defined variables, offered descriptive statistics and a correlation matrix, and proposed two hypotheses regarding the effect of ownership on firms’ performance. Chapter 6 continues the study of corporate governance in China by testing the two hypotheses relating to ownership concentration and structure proposed in the previous chapter, and interpreting the findings. These findings from the statistical analysis are also discussed in relation to other Chinese corporate governance mechanisms, and how they are likely to impact the future development of corporate governance in China.

Chapter 6 is organised as follows. The findings of hypothesis one, which considers ownership concentration and the performance of Chinese listed companies is first addressed. Hypothesis one (H1) is the preliminary study of this thesis. Secondly, the primary study of the thesis hypothesis two (H2) is addressed, which analyses the effects of ownership structure on the performance of Chinese listed companies. Finally, a discussion is presented that considers the empirical evidence concerning ownership together with the current position of corporate governance in China presented in previous chapters.

6.2 H1 Ownership concentration and Firm Performance

The effect of ownership concentration on the performance of Chinese listed companies is studied to ascertain if the performance of these firms can be significantly explained by ownership concentration in the hands of the largest and ten largest shareholders. The approach taken is to examine the relative importance of ownership concentration in predicting the performance of Chinese enterprises. A null hypothesis of the irrelevance of ownership concentration is tested. In the case of the hypothesis not being accepted, fluctuations of firms’ performance with ownership concentration can be investigated. Full results for the regressions pertaining to this section are included in appendix 1.
Table 6.1 Results ROE (T1)

<table>
<thead>
<tr>
<th>Coefficients(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
</tr>
<tr>
<td>Market Cap</td>
</tr>
<tr>
<td>Revenue Growth</td>
</tr>
<tr>
<td>Ownership Concentration T1</td>
</tr>
</tbody>
</table>

\(^a\) Dependent Variable: Return on Equity.

Industry and time dummy variables included.

Table 6.2 Results ROE (T10)

<table>
<thead>
<tr>
<th>Coefficients(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
</tr>
<tr>
<td></td>
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<tr>
<td>1 (Constant)</td>
</tr>
<tr>
<td>Market Cap</td>
</tr>
<tr>
<td>Revenue Growth</td>
</tr>
<tr>
<td>Ownership Concentration T10</td>
</tr>
</tbody>
</table>

\(^a\) Dependent Variable: Return on Equity.

Industry and time dummy variables included.

The results in Table 6.1 and 6.2 show the results of expressions (1) and (2) that test whether ownership concentration in the hands of the single largest and ten largest shareholders has any explanatory power in relation to ROE. As expected, Market Capitalisation and Revenue growth are both statistically significant. However, it is also clear that no significant relationship exists between ownership concentration and the performance of Chinese listed companies based on the accounting measure of performance ROE employed in this study. This appears to be the case both in relation to the single largest shareholder (T1) and the ten largest shareholders (T10).
Table 6.3 Results: Tobin’s Q (T1)

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
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<td>-6,102</td>
<td>,000</td>
</tr>
<tr>
<td>Market Cap</td>
<td>.234</td>
<td>.021</td>
<td>.129</td>
<td>11,060</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>.043</td>
<td>.008</td>
<td>.052</td>
<td>5,353</td>
</tr>
<tr>
<td>Ownership Concentration T1</td>
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<td>.122</td>
<td>-.018</td>
<td>-1,700</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Tobin’s Q
b. Industry and time dummy variables included.

Table 6.4 Results Tobin’s Q (T10)

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
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<td>.254</td>
<td>-7,450</td>
<td>,000</td>
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<tr>
<td>Market Cap</td>
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<td>.021</td>
<td>.108</td>
<td>9,255</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>.043</td>
<td>.008</td>
<td>.052</td>
<td>5,322</td>
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<tr>
<td>Ownership Concentration T10</td>
<td>.805</td>
<td>.142</td>
<td>.059</td>
<td>5,688</td>
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</table>

a. Dependent Variable: Tobin’s Q.
b. Industry and time dummy variables included.

The results in Table 6.3 and 6.4 present the results of expressions (3) and (4) respectively, that test the explanatory power of the two levels of ownership concentration in relation to Tobin’s Q. Market Capitalisation and Revenue growth again both have significant explanatory power. However, unlike the with the accounting measure ROE, the results in relation to the market measure Tobin’s Q suggest that ownership concentration may have some explanatory power in the performance of Chinese listed companies. At the T1 level, a figure of 0.089 suggests that ownership concentration is significant at the 10% level, whilst at the T10 level; ownership concentration appears to become a significant explanatory factor.
The findings from expressions (1) and (2) show ownership concentration to have no explanatory power in relation to performance as measured by ROE. In relation to Tobin’s Q (expressions 5 and 6) however the concentration of ownership in the ten largest shareholders (T10) becomes significant, whilst the concentration of ownership in the single largest shareholder (T1) becomes significant at the 10% level.

The significance of the (T10) ownership concentration in relation to Tobin’s Q appears to support Shleifer and Vishny’s (1986) findings, in that large shareholders may help reduce the free-rider problem of small investors, and hence are value-increasing. This explanation however, should be taken with caution, as the ten largest shareholders of the Chinese listed companies are often State government agencies and legal persons.

The results of the set of OLS regressions in expressions (1) to (4) have therefore yielded inconclusive results; in that it has not been possible find any significant explanatory power of ownership concentration in determining the performance of Chinese listed companies. On this basis we must therefore accept Hypothesis 1, and judge ownership concentration to be irrelevant in predicting firm’s performance. A clear distinction appears to have emerged however, between the results observed for the two performance variables.

In terms of the accounting measure ROE, the results clearly show both ownership concentration to be irrelevant in predicting performance. In terms of the market measure Tobin’s Q however; the findings are consistent with Xu and Wang (1999) in their 1995 study of Chinese listed companies. Their findings suggest a positive relationship between ownership concentration and performance. Whilst Xu and Wang (1999) acknowledge that their conclusions may have been premature, they also note that these findings challenge the popular notion that the free market, Anglo-US style of corporate governance is the most efficient. Chen and Gong (2000) also include the study of ownership concentration and structures in their studies of China, with mixed results.

6.3 H2 Ownership Structure and Firm Performance

On the basis of the result of hypothesis one, further data was compiled for hypothesis two. Hypothesis two is essentially the primary focus for the empirical analysis in this thesis.
The effects of ownership structure on the performance of firms are studied to determine whether the financial performance of Chinese enterprises can be significantly explained by the firm being in State or Private hands. If ownership structure is irrelevant, ownership fractions would be expected to be insignificant in any regression on performance. A null hypothesis of the irrelevance of ownership structure is therefore tested. Full results for the regressions pertaining to this section are included in appendix 2.

Table 6.5 ROE (ownership structure)

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>-.517</td>
<td>.094</td>
<td>-</td>
<td>-5.491</td>
</tr>
<tr>
<td>Market Cap</td>
<td>.077</td>
<td>.007</td>
<td>.149</td>
<td>11.536</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>.010</td>
<td>.003</td>
<td>.042</td>
<td>3.852</td>
</tr>
<tr>
<td>Ownership Status</td>
<td>-.009</td>
<td>.013</td>
<td>-.007</td>
<td>-.660</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return on Equity
b. Industry and time dummies included

Table 6.6 Tobin’s Q (ownership structure)

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>-1.654</td>
<td>.303</td>
<td>-</td>
<td>-5.453</td>
</tr>
<tr>
<td>Market Cap</td>
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<td>.021</td>
<td>.128</td>
<td>10.904</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>.043</td>
<td>.008</td>
<td>.053</td>
<td>5.285</td>
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<td>Ownership Status</td>
<td>.208</td>
<td>.043</td>
<td>.050</td>
<td>4.860</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Tobin’s Q
b. Industry and time variables included
The results in Table 6.5 and 6.6 show the results of expressions (5) and (6) that test hypothesis two (H2), the irrelevance of ownership structure as a determinant of the performance of Chinese listed companies. The adjusted R²s for the regressions are 0.023 for expression (5) with ROE as the performance variable, and 0.182 for expression (6) based on Tobin’s Q. Once again both Market Capitalisation and Revenue growth are statistically significant in relation to both the accounting measure (ROE) and the market measure (Tobin’s Q). With regards to ownership structure however, a difference emerges between the results for the two performance variables. In relation to ROE, a figure of 0.510 shows clearly that ownership structure has no explanatory power in terms of performance.

Findings from expression (5) show that in terms of the accounting measure (ROE), the type of owner does not help to explain the performance of Chinese listed companies. In terms of the market measure (Tobin’s Q) however in expression (6), the type of owner once again becomes significant. These findings are in line with Hovey (2006), where he finds private, along with Institutional and offshore ownership, to positively impact the performance of Chinese listed companies. In contrast to these results however, Mattlin (2007) finds that Chinese firms with the best performance are presently found in sectors of the economy controlled by SOE’s (for example the oil, petrochemical, energy and metal industries).

The results of the OLS regressions in expressions (5) and (6) have therefore again yielded inconclusive results. The conflicting results based on the two performance variables mean that the explanatory power of ownership structure in determining the performance of Chinese listed companies cannot be proven. Therefore on this basis, we must also accept Hypothesis 2 and judge ownership structures (SOE or Private) to be irrelevant in explaining the performance of Chinese listed companies.

Although both Hypotheses 1 and 2 have been confirmed, in that ownership concentration and structure are irrelevant in predicting firms’ performance, a clear distinction has emerged between the results observed for the two performance variables. In terms of the accounting measure ROE, the results clearly show both ownership concentration and structure to be irrelevant in predicting performance.
In terms of the market measure Tobin’s Q however, the results appear to show that ownership does in fact help to explain firms’ performance. As a retrospective performance measure employed by the firm itself, the results relating to ROE can be linked directly to the actual position of the firm. Tobin’s Q however is a forward looking performance measure that incorporates a high degree of market expectation. In this way, the market appears to perceive ownership concentration and structure to be an important determinant of the performance of Chinese listed companies.

6.4 Discussion on Internal and External Governance Mechanisms

As with many transition countries, the weak institutional environment in China makes traditional corporate governance mechanisms less effective, and it is difficult for firms to ‘commit’ to their stakeholders (particularly external investors). A concentration of ownership is the natural consequence in these environments. Although ownership concentration is often found to improve corporate governance, it also has potential costs which at the firm level include; entrenchment of managers, poor performance, limited risk diversification, liquidity costs and the expropriation of minority shareholders. At the macro level, these costs risk undermining the development of both capital markets (resulting in lower growth) and corporate governance rules.

In China, unique economic, cultural, political and legal characteristics have also evolved which have influenced the ownership structures of listed firms. The ownership of listed firms revolves around five categories of shareholding (see Chapter 4.2), with the majority of shares held by the State and legal persons (see Chapter 4.2.1), and account for around 65% of total outstanding ‘A’ shares on the both stock exchanges. Furthermore, State power is bolstered by Party officials being appointed to key positions on the supervisory boards of listed firms (Chapter 4.3.1). State control is then typically used to further the political agenda and government policies, rather than simply improving firm performance. Jensen and Meckling (1976) suggest that performance improvements can be realised through attention to the ownership distribution of the firm. In China however, ownership structures are primarily determined by State authorities or agencies rather than the market or alternative motivations such as private benefits.

The strategic importance of the former SOE’s cannot be underestimated. There are a great number of them, providing employment and social security for a large proportion of the
Corporate governance in China has evolved greatly during the transition process. However, the mechanisms that have evolved along with the current political environment suggest that problems still exist that make the overall corporate governance system in China not conducive to achieving high standards. The present governance system in China has a number of inbuilt weaknesses and is on some levels ineffective, as discussed in the following section (6.4). Through continued State control however, China has been able to successfully develop its economy with a high and steady rate of growth and avoided the ‘transition recession’ experienced by many other transition economies. The approach taken by China has a number of advantages which could be argued are more important than the insufficiencies observed by many researchers and illustrated in the following section.

Fundamental governance improvements of Chinese listed companies cannot be achieved without the restructuring of the SOE sector, and reducing the State control rights over listed companies. In order to address this, China has been considering different mechanisms for liquidating State assets. After several previous attempts, in 2005 the CSRC approved the “Administrative Measures on the Split Share Structure Reform” designed to facilitate the conversion of large blocks of non-tradable shares into tradable shares, with the aim of gradually relinquishing control. This in turn promotes increased accountability, reduced political influence and increased liquidity in the stock markets. This reform can be regarded as a critical process in improving corporate governance in China. All SOE’s will eventually become privatised and thus, listed companies will be relieved of their political goals and can be operated with a value maximising objective. Reducing the large blocks of non-tradable shares will also encourage more M&A activity and create a functioning market for corporate control. Private investors will also gain more power and are likely to exert pressure in areas such as information disclosure and transparency, board functions and auditor independence.

6.4.1 Development barriers

The key shortfalls identified in China’s present corporate governance system include the need for restructuring former SOE’s and simultaneously strengthening the legal system and enforcement
environments in order to protect the rights of minority shareholders. High levels of ownership concentration, compounded through pyramidal type ownership structures often exist due to weaknesses in minority shareholder protection.

The introduction of a robust legal and regulatory system with strong enforcement mechanisms in the corporate sector is recognised as a key factor in achieving an improved system of protection for minority shareholders. Laws and institutions must be developed in order to protect shareholders rights, provide open disclosure, address poor accounting practices and halt stock market manipulation.

At the annual general shareholders meetings, minority shareholders are often unable to make use of their voting rights, as either they do not have access to all relevant company information, or the controlling shareholders manipulate or ‘capture’ the meeting due to their higher proportion of shares. This situation typifies the type II problem between majority and minority shareholders that is common in many developing and transition countries. Chinese listed companies should focus both on clarifying and enforcing the fiduciary duties of large controlling shareholders, and strengthening the rights of minority shareholders.

In order to address the problem of large shareholders controlling the shareholder meetings, a quorum requirement may be able to protect the interests of minority shareholders. Under the current system, a qualified majority of shareholders present at the shareholder meeting is required to pass a resolution, which significantly strengthens the position of the controlling shareholders. Legally the general shareholder meeting is a powerful body in China, however in reality the meeting is often just a ‘rubber stamp’ assembly for the wishes of the largest shareholders. A quorum requirement could ensure a minimum percentage of outstanding shares are required to attend in order to pass resolutions at the general shareholders meeting.

One of the key issues voted on at the general shareholder meeting is the election/replacement of directors and their remuneration. Appointments to the management board are presently made by largest shareholders, resulting in a lack of independence and boards that are relatively weak. Furthermore, the confusion over the role of the supervisory board forms another complication. The 2002 code in China states that the management boards of listed companies must have one-third (minimum two) independent directors; however in reality many of these appointments are
not truly independent. Furthermore, whilst boards may have independent representation, these independent directors are rarely expected to contribute or be involved, if they attend board meetings at all (Economist, 2001c).

In an effort to address the problem of poor accounting standards, and promote full information and disclosure amongst Chinese listed companies, the Chinese authorities introduced the “Regulations on Information Disclosure of Listed Companies” in February 2007. However, the accounting industry in China is still under-developed and characterised by fierce competition with an abundance of profit-driven accounting firms. This situation previously leading to the poor overall quality of the accounting practice is likely to improve as a result of the 2007 regulations, although the lack of qualified accounting professionals in China remains an obstacle to the implementation of stricter accounting standards. Increased investment in the education and training of accounting professionals, combined with the influence of large International accounting firms such as the big four in China are also likely to have a positive effect in promoting better accounting standards.

Product market competition can be a very effective corporate governance mechanism as management must work hard to make the company more efficient and thus avoid bankruptcy. Bankruptcy laws have now been strengthened in China through the ‘Enterprises Bankruptcy Law of the People Republic of China’ in 2007, making it a more market-driven process. It should however be noted that, a strong regulatory and enforcement environment is also necessary in more competitive business environments. Without this, the presence of ‘guanxi’ in China may result in insider-based decision making or the use of unethical business practices in order to make the firm more efficient.

Chinese authorities appear to recognise executive compensation as an incentive mechanism and consider it an important part of enterprise reform. In order to fully resolve the incentive problem it is critical that managers are transferred from the role of being agents of the State, to being professional managers with their interests aligned to the performance of the firm. This fundamental problem is only likely to be resolved once there is a clear separation of ownership and control in former SOE’s.
The linkage between executive compensation and firm performance appears to have lead to improved performance. This is due to long term incentive packages being better designed to fully motivate the managers and align their interests with those of shareholders, and the maturity of the managerial market introducing a competitive mechanism that also acts as an incentive. In this respect, executive compensation might therefore form a more decisive parameter in respect of the firm performance than ownership structures. China’s immature legal system however may also facilitate the abuse of equity based compensation and in this way provide biased conclusions in respect of their importance in increasing firms’ performance.

Improving the quality of corporate governance is a task that must be undertaken both the firm level, and at the macro-level through market reform and institutional development. Internal governance mechanisms are likely to depend on the individual company’s effort, whilst external mechanisms must be promoted and developed by the State. The State must place itself in the role of economic legislator and market supervisor. It is becoming clear that the current Chinese State dominated governance model will eventually develop into a more market-orientated one.

China appears to still have some way to go in implementing a system conducive to good corporate governance practices, in which a collective effort between practitioners and the State, and a good balance of various mechanisms are essential. However, it has come a long way in the past few years in restructuring the SOE’s and strengthening its legal and enforcement environments, both key elements in developing a functioning system of corporate governance. A framework of laws and regulations was originally established in the 2002 code, followed by a series of new laws and regulations designed to increase minority shareholder protection, strengthen institutions, develop capital markets and facilitate the transfer of ownership from the State to private investors.

Reform of SOE’s will allow more foreign institutional investors. Increased foreign investment in China, especially foreign direct investment and M&A activity, helps introduction of Western-style best practices that emphasise transparency and accountability to shareholders. Chinese managers also face stricter monitoring from the non State-appointed board members. More foreign institutional investors are now being permitted to buy and sell Chinese ‘A’ shares under the Qualified Foreign Institutional Investor (QFII) system, although the scheme remains tightly regulated. This is due to a number of issues such as the control and pricing of State assets and the
role SOE’s play in social security. However, the gradual increase in participation by foreign institutional investors in China is likely to bring about positive changes in terms of corporate governance practice.

It is undeniable that corporate governance reform is occurring in China; however it is important to note that this economic reform is occurring in the context of a ‘socialist-market economy’ in a country governed by one party that is ideologically opposed to private ownership. As such it is unlikely that the full privatisation and the establishment of a market economy will occur in China without being accompanied also by political change.

6.5 Limitations to the study

Certain limitations have become apparent during the writing of this thesis, both of a general nature and specifically relating to the empirical work. The thesis has been written entirely without the benefit of field research, and it is conceivable that it may have benefited from using interviews or surveys to gather information relating to certain internal governance mechanisms (for example executive compensation and the board of directors). The use of such field research however was considered impractical due to the costs and time involved.

In relation to the empirical work, the study was limited to the information that was able to be gathered from publicly available sources. As such it was only possible to sub-divide ownership structure into two broad groups, State-owned and Private. The analysis of ownership structures may have provided more insight if more ownership groups could have been quantified, such as employee, manager or legal person holdings. Certain limitations pertaining to the use of Tobin’s Q as a performance measure also existed. The use of Q usually requires efficient capital markets, however as with many emerging and transition economies, Chinese stock markets suffer from a lack of liquidity and an absence of functioning debt markets. As such, proxies have been used in the paper (section 5.6.1), and thus it cannot be considered perfect estimation of Q. However, the authors’ intention was to provide a forward looking performance measure in conjunction with the backward looking ‘firm-based’ performance measure ROE, as such the use of Q in a proxy form was considered acceptable in this case.
Chapter 7 Conclusion

Corporate governance in China has evolved greatly during the transition process, whilst it has developed the economy with a high and steady rate of growth. Even though many corporate governance mechanisms have been implemented and developed as part of the Chinese corporate governance system, the road ahead is still long and further improvements are required. The study of effects of ownership concentration and structure on the performance of Chinese listed companies provided mixed results, and was therefore inconclusive. In terms of the accounting measure of performance (ROE), the study found no significant relation; however in terms of the market measure (Tobin’s Q) the study found that both ownership concentration and structure did help explain the performance of Chinese listed companies. These results point to a difference between the actual influence, and perceived influence.

A collective effort and balance of various mechanisms are necessary from both the State and the evolving private sector to foster a system conducive to a high standard of corporate governance. The continued restructuring of China’s large sector of SOE’s and the separation of government and enterprise management is fundamental to economic reform and must continue through the conversion of large blocks of non-tradable State shares to tradable shares. The rights of minority shareholders however must continue to be strengthened and protected. Reformed SOE’s are likely to have increased accountability and reduced political influence, as well as providing increased liquidity in the stock markets. Removing the large blocks of non-tradable shares and increasing liquidity in the stock markets will allow the market for corporate control to play a greater role as a governance mechanism in the future. The role of information disclosure and transparency as a governance tool is also likely to be strengthened, both through new regulations and the accounting practices imported by foreign firms operating in China. However, greater investment is needed in education and training for the Chinese accounting industry in the longer term. Overall, China has made significant progress in its pursuit of a functioning corporate governance system. However, considering the traditionally important social role SOE’s play in China, and the CCP’s ideological opposition to private property rights, the State may not be willing to relinquish control easily. It is therefore important to note that conflicting interests are likely to persist in Chinese listed companies so long as the State maintains any degree of ownership and control rights.
References


• OECD, (2004), The OECD Principles of Corporate Governance.


• Stefan, VoB., and Yi, W., (2006), Corporate Governance of Listed Companies in China, Track 8, International Corporate Governance.


Appendix 1 Results of the Ownership Concentration study

Results for the regression analysis of the effects of ownership concentration (T1) on the performance dependent variable ROE, expressed as:

\[ ROE = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T1) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

### Model Summary

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<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
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<td>.023</td>
<td>.564617</td>
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</tbody>
</table>


### ANOVA\(^b\)

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<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
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<td>Total</td>
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<td>8555</td>
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<td></td>
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b. Dependent Variable: Return on Equity
<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
<th>t</th>
<th>Sig.</th>
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<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
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<td>-546</td>
<td>0.077</td>
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<td>0.007</td>
<td>0.078</td>
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<td></td>
<td>Revenue Growth</td>
<td>0.010</td>
<td>0.003</td>
<td>0.043</td>
</tr>
<tr>
<td></td>
<td>Ownership Concentration T1</td>
<td>0.017</td>
<td>0.039</td>
<td>0.005</td>
</tr>
<tr>
<td>Industry 2</td>
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<td>0.018</td>
<td>0.556</td>
</tr>
<tr>
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a. Dependent Variable: Return on Equity
Results for the regression analysis of the effects of ownership concentration (T10) on the performance dependent variable ROE, expressed as:

\[ 2) \quad ROE = \alpha + \beta_1 SIZE + \beta_2 GRW + \beta_3 (T10) + \beta_4 IND + \beta_5 TIME + \varepsilon \]

### Model Summary

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b. Dependent Variable: Return on Equity
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a. Dependent Variable: Return on Equity
Results for the regression analysis of the effects of ownership concentration (T1) on the performance dependent variable Tobin’s Q, expressed as:

\[ Q = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T1) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \epsilon \]

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b. Dependent Variable: Tobins Q
## Coefficients

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a. Dependent Variable: Tobins Q
Results for the regression analysis of the effects of ownership concentration (T10) on the performance dependent variable Tobin’s Q, expressed as:

4) \[ Q = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 (T10) + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

### Model Summary

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b. Dependent Variable: Tobins Q
## Coefficients

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a. Dependent Variable: Tobins Q
Appendix 2 Results of the Ownership Structure study

Results for the regression analysis of the effects of ownership structure (EO) on the performance dependent variable ROE, expressed as:

\[ 5) \quad ROE = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 \text{EO} + \beta_4 \text{IND} + \beta_5 \text{TIME} + \varepsilon \]

### Model Summary

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b. Dependent Variable: Return on Equity
Coefficientsa

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<td>0.094</td>
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<tr>
<td>2003</td>
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<td>0.082</td>
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<tr>
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<tr>
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<tr>
<td>2006</td>
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<td>0.082</td>
<td>-0.059</td>
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<td>0.083</td>
<td>-0.046</td>
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a. Dependent Variable: Return on Equity
Results for the regression analysis of the effects of ownership structure (EO) on the performance dependent variable Tobin’s Q, expressed as:

6) \[ Q = \alpha + \beta_1 \text{SIZE} + \beta_2 \text{GRW} + \beta_3 \text{EO} + \beta_4 \text{IND} + \beta_5 \text{TIME} + \epsilon \]

### Model Summary

<table>
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<tr>
<th>Model</th>
<th>R</th>
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<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
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<td>0.182</td>
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### ANOVA

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<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
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<td>294,783</td>
<td>91,452</td>
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<td>Residual</td>
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<td>Total</td>
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b. Dependent Variable: Tobins Q
### Coefficients

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<tr>
<th>Model</th>
<th>Unstandardised Coefficients</th>
<th>Standardised Coefficients</th>
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<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td>t</td>
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<td>1 (Constant)</td>
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<td>.303</td>
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<td>.050</td>
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<td>Industry 6</td>
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<td>Industry 9</td>
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<tr>
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<tr>
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<td>1.143</td>
<td>.301</td>
<td>.074</td>
<td>3.799</td>
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<td>.262</td>
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<td>1.175</td>
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<td>.262</td>
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<td>2006</td>
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<td>.262</td>
<td>.069</td>
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<tr>
<td>2007</td>
<td>2.031</td>
<td>.265</td>
<td>.395</td>
<td>7.651</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Tobins Q
Appendix 3 Standard Industry Classifications

A. **Division A: Agriculture, Forestry, And Fishing**
   - Major Group 01: Agricultural Production Crops
   - Major Group 02: Agriculture production livestock and animal specialties
   - Major Group 07: Agricultural Services
   - Major Group 08: Forestry
   - Major Group 09: Fishing, hunting, and trapping

B. **Division B: Mining**
   - Major Group 10: Metal Mining
   - Major Group 12: Coal Mining
   - Major Group 13: Oil And Gas Extraction
   - Major Group 14: Mining And Quarrying Of Non-metallic Minerals, Except Fuels

C. **Division C: Construction**
   - Major Group 15: Building Construction General Contractors And Operative Builders
   - Major Group 16: Heavy Construction Other Than Building Construction Contractors
   - Major Group 17: Construction Special Trade Contractors

D. **Division D: Manufacturing**
   - Major Group 20: Food And Kindred Products
   - Major Group 21: Tobacco Products
   - Major Group 22: Textile Mill Products
   - Major Group 23: Apparel And Other Finished Products Made From Fabrics And Similar Materials
   - Major Group 24: Lumber And Wood Products, Except Furniture
   - Major Group 25: Furniture And Fixtures
   - Major Group 26: Paper And Allied Products
   - Major Group 27: Printing, Publishing, And Allied Industries
   - Major Group 28: Chemicals And Allied Products
   - Major Group 29: Petroleum Refining And Related Industries
   - Major Group 30: Rubber And Miscellaneous Plastics Products
   - Major Group 31: Leather And Leather Products
   - Major Group 32: Stone, Clay, Glass, And Concrete Products
   - Major Group 33: Primary Metal Industries
   - Major Group 34: Fabricated Metal Products, Except Machinery And Transportation Equipment
   - Major Group 35: Industrial And Commercial Machinery And Computer Equipment
   - Major Group 36: Electronic And Other Electrical Equipment And Components, Except Computer Equipment
   - Major Group 37: Transportation Equipment
   - Major Group 38: Measuring, Analyzing, And Controlling Instruments; Photographic, Medical And Optical Goods
   - Major Group 39: Miscellaneous Manufacturing Industries

E. **Division E: Transportation, Communications, Electric, Gas, And Sanitary Services**
   - Major Group 40: Railroad Transportation
   - Major Group 41: Local And Suburban Transit And Interurban Highway Passenger Transportation
   - Major Group 42: Motor Freight Transportation And Warehousing
   - Major Group 43: United States Postal Service
   - Major Group 44: Water Transportation
   - Major Group 45: Transportation By Air
   - Major Group 46: Pipelines, Except Natural Gas
   - Major Group 47: Transportation Services
   - Major Group 48: Communications
   - Major Group 49: Electric, Gas, And Sanitary Services
F. Division F: Wholesale Trade
   Major Group 50: Wholesale Trade-durable Goods
   Major Group 51: Wholesale Trade-non-durable Goods

G. Division G: Retail Trade
   Major Group 52: Building Materials, Hardware, Garden Supply, And Mobile Home Dealers
   Major Group 53: General Merchandise Stores
   Major Group 54: Food Stores
   Major Group 55: Automotive Dealers And Gasoline Service Stations
   Major Group 56: Apparel And Accessory Stores
   Major Group 57: Home Furniture, Furnishings, And Equipment Stores
   Major Group 58: Eating And Drinking Places
   Major Group 59: Miscellaneous Retail

H. Division H: Finance, Insurance, And Real Estate
   Major Group 60: Depository Institutions
   Major Group 61: Non-depository Credit Institutions
   Major Group 62: Security And Commodity Brokers, Dealers, Exchanges, And Services
   Major Group 63: Insurance Carriers
   Major Group 64: Insurance Agents, Brokers, And Service
   Major Group 65: Real Estate
   Major Group 67: Holding And Other Investment Offices

I. Division I: Services
   Major Group 70: Hotels, Rooming Houses, Camps, And Other Lodging Places
   Major Group 72: Personal Services
   Major Group 73: Business Services
   Major Group 75: Automotive Repair, Services, And Parking
   Major Group 76: Miscellaneous Repair Services
   Major Group 78: Motion Pictures
   Major Group 79: Amusement And Recreation Services
   Major Group 80: Health Services
   Major Group 81: Legal Services
   Major Group 82: Educational Services
   Major Group 83: Social Services
   Major Group 84: Museums, Art Galleries, And Botanical And Zoological Gardens
   Major Group 86: Membership Organizations
   Major Group 87: Engineering, Accounting, Research, Management, And Related Services
   Major Group 88: Private Households
   Major Group 89: Miscellaneous Services

J. Division J: Public Administration
   Major Group 91: Executive, Legislative, And General Government, Except Finance
   Major Group 92: Justice, Public Order, And Safety
   Major Group 93: Public Finance, Taxation, And Monetary Policy
   Major Group 94: Administration Of Human Resource Programs
   Major Group 95: Administration Of Environmental Quality And Housing Programs
   Major Group 96: Administration Of Economic Programs
   Major Group 97: National Security And International Affairs
   Major Group 99: Non-classifiable Establishments

Source: United States Department of Labor
Appendix 4 Industry groups

Standard Industry Classification (SIC) at the single digit level for Chinese listed companies produced industry classifications A-I in Table 1.

Table 1

<table>
<thead>
<tr>
<th>Industry sector</th>
<th>Firms</th>
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</thead>
<tbody>
<tr>
<td>A</td>
<td>25</td>
</tr>
<tr>
<td>Agriculture, Forestry &amp; Fishing</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>32</td>
</tr>
<tr>
<td>Mining</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>50</td>
</tr>
<tr>
<td>Construction</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>963</td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>139</td>
</tr>
<tr>
<td>Transportation &amp; Communications</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>61</td>
</tr>
<tr>
<td>Wholesale trade</td>
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</tr>
<tr>
<td>G</td>
<td>96</td>
</tr>
<tr>
<td>Retail trade</td>
<td></td>
</tr>
<tr>
<td>H</td>
<td>122</td>
</tr>
<tr>
<td>Finance, Insurance &amp; Real Estate</td>
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</tr>
<tr>
<td>I</td>
<td>75</td>
</tr>
<tr>
<td>Services</td>
<td></td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>1563</strong></td>
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</tbody>
</table>

In order to provide a more equal basis for the analysis, the above industry classifications were reorganised by combining industries (A, B, C) (F, G) and (H, I). The largest classification Manufacturing (D) was also broken down to the SIC two-digit level, providing five manufacturing sub-groups. The final nine industry groups are shown below in Table 2.

Table 2

<table>
<thead>
<tr>
<th>Industry group</th>
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</tr>
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<td>Manufacturing group D (3)</td>
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</tr>
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<td>7</td>
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<tr>
<td>Industry group F, G</td>
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<td>8</td>
</tr>
<tr>
<td>Industry group H, I</td>
<td>197</td>
<td>9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1563</strong></td>
<td></td>
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</tbody>
</table>