Corporate Governance Research on Listed Firms in China: Institutions, Governance and Accountability

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Contents

Abstract

The objective of this monograph is to review prior studies and propose new research directions for the corporate governance of Chinese listed firms. The focus of this monograph is to investigate the underlying relation between China's institutional environment and its listed firms' corporate governance, and to show how formal and informal governance mechanisms actually work within these firms. A top-down institutional framework is adopted to integrate prior research and guide us in identifying first-order factors that shape the corporate governance practice in China. Following this institutional framework, I propose a number of research directions that study the formal and informal governance approaches unique to China's environment.

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Introduction

China has experienced a phenomenal growth in of the gross domestic product (GDP) at an average annual rate of 10% for the past 20 years. In October 2015, China had the second largest GDP in the world at current prices and was ranked first in the world in Purchasing Power Parity terms, according to the IMF Economic Outlook Report. Together with Hong Kong, Shanghai and Shenzhen combined, China's stock market was ranked third in the world in 2014, only after NYSE and Nasdaq. Despite the rapid growth in the number of firms and market capitalization in the domestic stock markets, the fledging market is plagued with a number corporate governance challenges facing the listed firms, including opaque accounting, expropriation by controlling shareholders, and political intervention by the government.

These challenges are in conflict with the original intention of the Chinese government to list the state-owned enterprises (SOEs) in Hong Kong and the domestic stock markets in Shanghai and Shenzhen, and to reform the SOEs through efficiently allocating capitals to these firms and improve their corporate governance by using Anglo-American style governance mechanisms such as instating board of directors, listing regulations, company laws, accounting and auditing standards, and information and financial intermediaries. Allen et al. [2015] argue that these governance issues are part of the key contributing factors, and explain that the stock price performance of the firms listed in China's domestic markets has failed to reflect the stellar performance of the country's GDP in the past 20 years. Thus, research that can shed light on the underlying factors that explain a firm's choices in corporate governance design and whether there are alternative corporate governance approaches that can substitute or complement the Anglo-American model would be invaluable to its SOE reform and its stock markets' capital allocation efficiency.

The objective of this monograph is to review prior studies and propose new research directions on the corporate governance of Chinese listed firms. The focus is on investigating the underlying relation between China's institutional environment and its listed firms' corporate governance and study how formal and informal governance mechanisms actually work within these firms. A top-down institutional framework is adopted to integrate prior research and guide us in identifying first-order factors that shape the corporate governance practice in China. Following this institutional framework, I propose a number of research directions that study the formal and informal governance approaches unique to China's environment.[1]

The top down approach allows us to trace the chain of effects from institutions at the country level to the corporate governance mechanisms practiced at the firm level. Identifying the institutional factors and understanding the paths through which these institutions impact corporate governance is an essential first step for researchers. The reason for a firm in China to adopt a governance system that is different from that of the United States (U.S.) is not necessarily because the managers of the firm behave opportunistically, it may be that such a

[1]In this review, I have primarily selected papers from top U.S. accounting and finance journals that are relevant to China's corporate governance research and the top-down institutional framework. A large body of corporate governance and accounting papers published in China's academic journals are excluded in this paper. A review of these governance and accounting papers can be found in Li and Sun [2009].

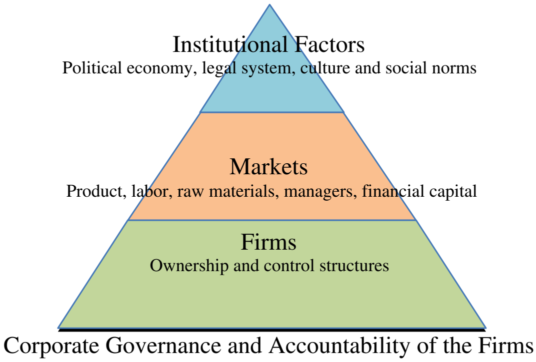

Figure 1.1: Layers of factors that shape corporate governance.

system is optimal to the institutional environment in which the firm is operating.

As shown in Figure 1.1, the corporate governance mechanisms adopted by a firm are determined by key institutional factors, which are at the top of the pyramid, and layers of intermediate factors below the apex. The bottom layer of the pyramid, which has the most direct impact on the corporate governance of a firm, is the corporate and ownership structures of the firm. Compared to U.S. firms, a typical Chinese listed firm is not diffusely owned, but controlled by a large shareholder such as the state, family, or an entrepreneur. In addition, the listed firm often belongs to a corporate group that is under the control of the same large shareholder. The group typically comprises of firms that are vertically integrated or belonging to a diversified portfolio of industries or both. In most cases, the group of firms is structured in a stock pyramid, with the large shareholder controlling the holding company, which in turn, holds shares of another group company and so on. Figure 1.2 illustrates how a listed firm in China is ultimately controlled by the large shareholder at the top of a stock pyramid. Past research has shown that firms' corporate and ownership structures can have a significant impact on their corporate governance, firm performance, and accounting properties [Fama and Jensen, 1983, Morck et al., 1988, La Porta et al., 1999, Fan and Wong, 2002].

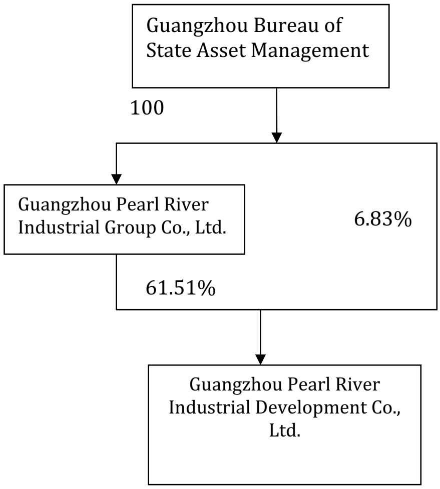

Figure 1.2: A listed company controlled by a local government through a two-layer pyramid.
Source: This figure was reproduced from Fan et al. [2013].
Description: Guangzhou Pearl River Industrial Development Co., Ltd., a listed company, is controlled by Guangzhou Pearl River Industrial Group Co., Ltd., its parent company, with 61.51% ownership. This parent state-owned firm is ultimately controlled by the Guangzhou Bureau of State Asset Management with 100% ownership. Thus, Guangzhou Pearl River Industrial Development Co., Ltd. is ultimately controlled by the government asset management bureau via a two-layer stock pyramid.

The underdevelopment of market institutions is one of the reasons why Chinese listed firms have a high concentration of ownership and/or belong to a corporate group that is either vertically integrated or diversified into various industries. In China, access to natural and financial resources is heavily controlled by the state. Corporate groups are formed because in the absence of private markets for these scarce resources, such structure could create internal markets for accessing and allocating these resources. Large shareholders such as a local government or an entrepreneur with strong political connections can access these state-controlled resources and channel them to members of the corporate group via an internal market. The group can form internal labor markets for member firms when the market for talents is underdeveloped, and achieve a vertical integration that secures the contractual relationships of suppliers and customers, which are otherwise difficult to maintain; especially when the market and legal institutions for many products and services are not yet established (See La Porta et al. [1999], Claessens et al. [2000], and Khanna and Yafeh [2005] for prior research on stock pyramids and corporate groups).

Ultimately, it is the country's institutions that shape the development of markets, which in turn, determines the corporate and ownership of the listed firms. According to the property rights literature, the three key institutional factors in a country that have a significant effect on markets, corporate and ownership structures, and corporate governance are political economy, law and social norms.[2] As a communist state adopting market socialism, the state's influence on the economy is still ubiquitous. As argued earlier, the markets for natural resources, managerial talents and financial capital are not well developed because access to these resources are still heavily controlled by the state. Even in some markets where the state has given up control, the transactions are carried out not at arms-length but through private networks. One important reason is that the legal system is not well established in China. Contracting parties therefore use their social networks to enforce contracts, rather than relying on the courts [Granovetter, 1985]. The dependence on social networks, termed *guanxi* in China, for business transactions is especially prevalent in China because its society is traditionally structured in webs of personal ties. Instead of using formal and universal rules and regulations that govern individual behaviors, members in a social group rely on rituals and mutual obligations that are informal and situation specific [Fei et al., 1992, Faure, 2006]. Therefore, the weak legal system and the traditional practice of *guanxi*-based transactions will further constrain business transactions from being at arms-length, further slowing down the market development.

These country institutional factors sometimes have direct effects on the lower tiers of the pyramid in Figure 1.1. For example, the

[2] The body of property rights literature provides a general framework for analyzing the determinants of corporate ownership structures. This literature was pioneered by Coase [1960], Demsetz [1964], Alchian [1965, 1977], Cheung [1970, 1983]. Interested readers are referred to Eggertsson [1990] for a survey of the literature.

development of legal institutions can shape a firm's ownership structure directly. As argued by La Porta et al. [1999], firms that operate in economies with weak investor protection tend to have high ownership concentration because investors that fear expropriation by corporate insiders will avoid buying shares of such companies, and vice versa. Similarly, the political economy and social norms in China also shape its firms' ownership structure. As China is still transitioning from a state-controlled economy to a market-based economy, many of the listed state firms are still under majority control by the state. Even for entrepreneurial firms, establishing political ties that allow them to access scarce resources would be essential for the firms' growth or even survival. To facilitate rent-seeking activities with the government, which require the ability to build clandestine and long-term relationship with the politicians, entrepreneurs maintain a high concentration of ownership and even form stock pyramids [Fan and Wong, 2002].

Using this institutional framework for analyzing China's corporate governance offers a number of advantages. By identifying China's institutional features that determine its firms' corporate governance, we can gain a better understanding of the differences in governance practice between China and more developed economies such as the U.S. This allows policy setters and researchers to observe the reasons why one size does not always fit all. That is, not all U.S. governance mechanisms are appropriate in China due to the differences in the institutional environment. An undesirable governance arrangement in the U.S. may well be optimal in China. Also, many agency conflicts and governance challenges in China cannot be fixed with simple solutions such as the appointment of a few independent directors, adopting new accounting standards, or introducing pay-for-performance compensation schemes. Many of the problems are deeply rooted in the institutions that cannot be remedied by quick-fix solutions.

Another benefit of using the institutional perspective to study China is that it points us to possible alternative governance systems that are suitable for its environment. One key institutional difference of listed SOEs compared to the U.S., is that the government still retains control in the appointment of senior executives, who are government bureaucrats rather than professional managers. Another important distinction from the U.S. is that *guanxi* is often used as an informal governance mechanism. In this monograph, I propose to examine how the bureaucratic management system, compared to the professional managerial market in the U.S., serves its corporate governance role in the listed SOEs. I also argue that more efforts should be devoted to understanding what roles social networks play in the corporate governance and transfer of information of Chinese listed firms. As will be discussed in Section 2, since there are institutional constraints that prevent the formation of formal governance systems in China, *guanxi* will continue to be a crucial informal substitute. Stakeholders such as business partners, suppliers, customers, creditors, and investors will extensively use network ties to engage in business transactions with the firms. Policy setters should get a better understanding of the values of these network ties and not to be too quick to restrict the usage of such informal contracting and governance mechanisms.

Finally, the corporate governance research of Chinese listed firms offers researchers a rare opportunity to study how a country's institutions can fundamentally change the way firms establish their governance and accounting systems. For instance, the government's retention in the ownership control rights and the rights to appoint senior executives of the listed firms leads to serious agency conflicts between the government as the controlling shareholder and the politicians and bureaucrats who have management control over the firms. These conflicts allow us to examine the direct effect of politicians' incentives on firm behaviors. Other institutional features that have first order effects on the firms are China's legal system and social norms. These institutional factors shape the way firms contract, the formation of markets in which the firms operate and the ownership and corporate structures of the listed firms. This, in turn, will affect the firms' corporate governance and accounting systems. By applying this institutional framework to the China setting, we can identify fundamental conditions or constraints, which are embedded in China's institutions, that cause its governance practice to be different from that of the U.S. and other developed economies.

Also, by carefully mapping the relations between these institutional factors and firms' corporate governance, we can expand our theoretical understanding of the endogenous relations between the firms' operating environment and their governance practice. Having the knowledge of these latent factors will enable us to identify first-order effects and omitted variables in corporate governance research in China. In contrast, without this institutional perspective, our research models will guide us towards inappropriate governance solutions by focusing on the wrong fundamental factors. Also, not considering the right set of underlying determinants of corporate governance will lead to endogeneity or correlated omitted variable problems in the analysis.

This institutional approach to researching China offers new insights in corporate governance research that uses cross-country data or focuses on a single economy. The unique institutional conditions and constraints identified in China are likely to be weaker in more developed economies and stronger in similar emerging economies. Cross-country research can examine whether and how the fundamental institutional factors identified in China also apply in other emerging economies, whereas a different set of institutional features are shaping corporate governance in developed economies. Likewise, the findings of this research could guide cross-country studies in identifying and comparing formal and informal governance mechanisms practiced in certain countries, and analyzing how they differ from those in other countries because of their institutional differences. Although the institutional features and informal governance mechanisms documented in China are not dominant factors in the developed economies, they could play an important role in certain industries or during a particular stage in the life cycle of the firms within those economies. The corporate governance research discussed in this monograph could potentially provide new insights on these research areas.

The remainder of the monograph is organized as follows. Section 2 provides a discussion of the key unique institutional features in China. Section 3 reviews prior research on the effects of government ownership and control on firm performance, managerial turnover and compensation, and accounting. I propose a number of research directions in Section 4, and conclude in Section 5.

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