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# Principal Constraints and Challenges of Introducing Effective System of Corporate Governance in Emerging China

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## I. INTRODUCTION

Corporate governance describes the structure of rights and responsibilities among the parties that have a stake in a firm. Research to date on corporate governance has mainly focused on (Western) developed economies.

Thus, relatively little research effort has been devoted to corporate governance issues in emerging economies such as China. These economies, however, provide unique opportunities and challenges for governance practices and research.

## II. WHY CORPORATE GOVERNANCE MATTERS FOR DEVELOPMENT?

Well-functioning corporate governance mechanisms in emerging economies are of crucial importance for both local firms and foreign investors that are interested in pursuing the tremendous opportunities for investment and growth that emerging economies provide.

From the perspective of local firms, there is evidence that firms in emerging economies (compared with their counterparts in developed countries) are discounted in financial markets because of their weak governance. As such, improvements in corporate governance can enhance investor confidence in firms in

emerging economies and increase these firms' access to capital.

## III. DRIVING FORCES BEHIND CORPORATE GOVERNANCE REFORMS IN CHINA

While many factors have contributed to governance reforms in China, the most important are arguably privatization and globalization.

Another factor impacting on corporate governance in China, in common with other transition economies, is the relatively underdeveloped market and legal institutions and processes which in advanced market economies act as powerful complementary, external mechanisms for corporate governance. Many of the shortcomings in the actual practice of corporate governance in China derive from weaknesses in the policy and institutional environment as well as from peculiar cultural and political governance

## IV. CHINA'S CORPORATE GOVERNANCE REFORMS

China's Company Law is an important starting point in the evolution of China's corporate governance reforms. Passed in December 1993 and effective July 1, 1994, the law was subsequently amended in 1999. China's Securities Law, which became effective in December 1998, regulates capital market issuance, trading activities, and related matters. According to this law, all stock exchanges, securities houses, securities clearing houses, and securities regulators must file regular reports with the State Statistics Bureau for auditing purposes.

It was, however, the corporate scandals and capital flight cases that emerged in mid-2001 (e.g., Caijing Magazine's exposé of an RMB745-million fraud in YingGuangXia [a publicly listed company], the largest economic scandal in mainland China's history) that prompted officials of the China Securities Regulatory Commission (CSRC) and other state regulatory bodies to further improve Chinese firms' governance.

In January 2002, the CSRC released its Code of Corporate Governance for Listed Companies in China, which follows the US regulatory system.

According to PRC Company Law, the basic organizational structure of listed companies comprises

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of three tiers of control, namely the shareholder's meeting, the board of directors and supervisory board. In addition the stock company is legally required to have a management team.

## V. CHINA'S CORPORATE GOVERNANCE MODEL

There is little controversy that china's existing corporate governance concepts and institutions were mainly borrowed from the west, emulating certain important characteristics of both Anglo-American Model and the Germanic- Japanese model. China has adopted the two-tier board structure consisting of a board of directors and a supervisory board. It is for this reason that we observe both the supervisory board from the German-Japanese model and independent directors from the Anglo-American model being brought into China's corporate governance system. However, unlike the German structure of the supervisory board, the Chinese board does not have the right to appoint and dismiss executive board directors. Also, in contrast with the Anglo-American system, there is no majority control by independent directors on the board of directors in Chinese listed companies. On Kit Tam presented an exhaustive comparison of the two stylized models and Chinese corporate governance arrangements and concluded that the merits of the Anglo-American and the German-Japanese systems did not dominate, either separately or jointly, in the Chinese model.

## VI. CHALLENGES OF CORPORATE GOVERNANCE REFORMS IN CHINA

"Even in misfortune there is fortune".  
-- An old Chinese adage.

The regulatory bodies of China have advocated comprehensive and rigorous corporate governance reforms which emphasize the importance of the credibility and integrity of listed companies, the responsibilities of directors and management, the protection of minority shareholders, and the necessity for information disclosure. Over-regulation and under enforcement are common themes that characterize china's governance system. Many factors that impede progress in the implementation of governance reforms in China are:

### a) *Highly Concentrated Ownership Structure*

Key problem in China's corporate governance is the highly concentrated ownership structure in Chinese companies. A 2007 annual report from Shanghai Stock Exchange shows that 65 percent of the listed companies are state enterprises. Currently only individual shares are traded on the securities markets. The fact that state shares and legal person shares are not traded on the securities markets means that more than 60% of the outstanding shares have been excluded from the

market. This has reduced the liquidity of the secondary market and has become the main obstacle of operating the market efficiently. The size, share, and scope of China's institutional investors are still very small. For example, Kim, Ho, and St Giles (2003) estimate about 10 percent of the shares in China's equity markets are controlled by institutional owners, compared with about 60 percent in the United States (The Conference Board, 2007). Thus the important factor that has seriously hindered the impact of institutional investors on monitoring corporate governance is the large chunk of non-tradable shares controlled by the state.

### b) *Lack of Incentives*

Despite the encouraging changes in China's governance laws, key parties (e.g., regulatory bodies, boards of directors/supervisors, management) do not yet possess compelling incentives to implement these changes. Management does not have strong incentives to implement governance reforms unless they help them accomplish their immediate objectives; for example, the need to gain access to foreign capital has prompted proactive governance practices among some large Chinese firms. Further, outside directors often do not have strong incentives to implement governance reforms. In emerging economies, outside directors are often political allies (in the case of privatized SOEs) or friends and relatives of the senior managers/owners (in the case of family controlled businesses). These directors may represent a dominant interest group but not all shareholders.

The compensation in china is far less than developed country like US.

### c) *Power of the Dominant shareholder*

A closer scrutiny of the governance challenges in China suggests that the central problem in this context is not goal conflicts between management and owners, but rather unaddressed conflicts between the dominant shareholders and the minority shareholders. Because the board derives its power mostly from the dominant shareholder, it is not practical to expect the board to discipline or punish the dominant shareholder; this, in turn, contributes to the ineffectiveness of boards of directors in the Chinese context. There are at least two types of dominant shareholders in the Chinese context.

The first type is state ownership, which is manifested in China's broad range of strategically important industries. When the state dominates a firm, it is obvious that the state can use its influence to achieve the objectives of politicians, rather than protecting the interests of investors and shareholders.

The second type of dominant shareholder is evident in large, often family owned or controlled, business groups. Using social mechanisms, dominant shareholders appoint allies, friends, and family members to top management positions, and these managers may then have incentives to disregard minority shareholders'

interests. There is weak protection of shareholders' rights. Minority shareholders are often regarded as speculators expecting to gain a "free ride" on the company's performance. Chinese Criminal Law, Company Law, and Securities Law relatively neglect civil liability and compensation, and have not provided a procedure and specific clauses for enforceable civil actions. In addition, there is no provision for a class action lawsuit under Chinese law and it is very cumbersome for an individual shareholder to sue a listed company for fraud.

In summary, the dual challenge of governance reforms in emerging economies is how to simultaneously resolve the traditional agency problem between shareholders and management, and the unique agency problem between dominant shareholders and minority shareholders.

#### d) *Lack of Independence among Directors*

A direct result of ownership concentration is the lack of independence among board directors. According to the 1993 Company Law, the shareholders' general meeting holds the right to elect or remove board directors; however, the law doesn't specify the nomination process. In the absence of legal specification, it is easy for the dominant owner, often the Chinese government, to nominate all the directors for a company. With strong government involvement, the chosen directors could be symbolic figures chosen to meet the legal requirement for a listed company.

In a 1999 survey of listed companies, Tenev and Zhang (2002) found that only 3.1 percent of all directors had some degree of independence; the vast majority of directors remain under the dominant influence of the government. Without director independence, the call for fiduciary duty and duty of care will be ineffective. Thus before directors can effectively carry out their duties, a fundamental change in the power structure of company boards needs to take place.

#### e) *Underdeveloped External Monitoring Systems*

So far, China's corporate governance reforms have mainly focused on internal mechanisms, emphasizing the responsibilities of directors and management and the necessity to disclose information. It is important to note, however, that effective governance is contingent upon the existence and efficient operation of other (external institutional) regulatory, legal, and financial frameworks. The external monitoring system in China is still in its infancy, and this can prohibit the effective implementation of governance reforms in these countries. For example, the Chinese government controls about 70% of the stakes of publicly listed companies in the Shenzhen and Shanghai Stock Exchanges. The extremely high ownership concentration in these countries makes hostile takeovers and leveraged buyouts unlikely to occur, which means that

as long as a firm's management can appease the dominant shareholder(s), it is unlikely to be challenged.

#### f) *Corruption*

Effective government reforms also require determined efforts by government to clamp down on corruption. Over several decades of a centrally controlled and socialist economy, a large parallel black-market economy developed in China in which transactions were carried out in cash and typically not recorded in accounting and financial statements. Most businessmen in China believe that corruption (e.g., kickbacks and "red envelopes") is a necessary condition and a norm for conducting business.

#### g) *Frequent Insider Trading*

There is frequent insider trading, self dealings, and collusions in market manipulations. Tomasic and Andrews (2006) attributed the rampant insider trading in China to two factors: the lack of concept for fiduciary duty and inefficient enforcement. China has not reached a commonly agreed translation of the legal concept "fiduciary duty." With neither common law precedents nor civil law definitions in place, many Chinese shareholders and managers are not fully aware of the necessity of avoiding conflicts of interest in corporate context. Another reason why insider trading remains uncurbed could be the absence of class actions in China.

#### h) *Falsification and Fabrication of Financial Data*

Doe and Chan (2002) cited a Ministry of Finance survey reported in the China Reform Daily on May 5, 2001, that alarmingly indicated approximately 98.7% of Journal of Accounting and Corporate Governance Chinese companies falsified their earnings in annual reports for the past accounting year. This demonstrates how a company's management usually enjoys a high degree of autonomy and often operates outside the confines of the government and CSRC.

#### i) *Immature Capital Market*

China's immature capital market is characterized by the Chinese banks' preferential treatment of state-owned enterprises, the difficulty in issuing corporate bonds, and the lack of preferred shares. The absence of over-the-counter trading and bond trading, coupled with a strict quota for company listing, has both limited capital supply for the Chinese companies not listed in the stock market and twisted the performance evaluation for the Chinese companies that are. In recent years, the difficulty of obtaining permission for an IPO in the Chinese stock market has led high-tech Chinese enterprises to the NASDAQ, although they incur additional costs associated with the cross-cultural information asymmetry.

#### j) *Shortage of qualified independent directors*

The governance reforms of China have emphasized the importance of independent directors,



and the governance laws in china define the minimum number, and the roles and responsibilities, of these directors. A major obstacle to implementing the governance reforms in China, however, is that there are few qualified candidates; that is, individuals who understand and can carry out the role of an independent director. China needs to fill over 3000 independent director positions in its listed companies.

An even more important issue is that most directors view their directorships as sinecures, without real responsibilities. Most independent directors are government officials, university professors, and nominee directors from large financial institutions who have traditionally shown little interest in monitoring the actions of management.

#### k) *Insider Control of Corporate Affairs*

Another problem in China's corporate governance is the insider control of corporate affairs. The resulting lack of separation between ownership and management, together with the potential for conflicts of interest, make it even more problematic to establish a high level of corporate governance.

Despite its majority ownership, the state does not exercise effective control over its companies. The control of China's companies rests primarily with the insider-managers who are often in turn controlled and supported in various forms by their Communist Party and ministerial associates, who do not always act in the interest of the shareholders.

#### l) *Weak Supervisory Board*

Given the overwhelming dominance of the government's influence on boards of directors, the supervisory board in China has not yet played a significant and effective governance role. Since bureaucrats in charge of the company nominate and remove directors and supervisors alike, members of the supervisory board have little say in the major corporate decisions, particularly when their role of overseeing the board of directors has been only vaguely defined in China's Company Law. No law gives supervisors the right to take civil litigation against board directors or senior managers when they detect company misconduct.

Statistics show that on average, members of the board of supervisors are significantly less educated than members of the board of directors, and most of the supervisors are not experienced enough in accounting and management to perform checks and balances vis-à-vis the board of directors and senior managers.

#### m) *Weak Auditing Profession*

Another key problem in China's corporate governance is the weak auditing profession. Li (2001), an official with the Chinese Institute of Certified Public Accountants (CICPA), stated that Chinese accounting firms are lagging behind international standards

regarding qualifications, services, and management. Many Chinese CPAs do not have enough knowledge about international accounting practices and are not well equipped with computer skills, due to a lack of proper training. Moreover, Chinese CPA firms have many problems in their operations because of lack of sound supervision mechanisms, which gives rise to serious fraud cases in the securities market.

## VII. CONCLUSION

Effective corporate governance is crucial to China's development. It involves many issues and has profound policy and practical implications. In the process of transition from a centrally planned economy to a market oriented economy, China has at least embraced the concept of corporate governance and its underlying principles. However, serious deficiencies may be observed in the current system, such that corporate governance problems arising from China's transitional emerging economy have arisen to engage the attention of policymakers, regulators and corporate players.

Further studies of international experience in corporate governance need to be conducted so that China can follow new developments and improve existing practices, and devise the best system of corporate governance to facilitate the efficient development of its growing capital markets.

Such a strengthening of corporate governance will play a vital role in ensuring that China's economic reforms lead to it becoming a major international economic superpower.

"Governance reform is an important (part)  
Of the agenda (of many Asian countries).....  
But saying it is much less difficult than doing it.  
Implementation and enforcement are key"

~ Chanhyong Rhee, Chief Economist, Asian Development Bank

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