

1 Principal Constraints and Challenges of Introducing Effective  
2 System of Corporate Governance in Emerging China By Sidaq

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7 **Abstract**

8 In this article, I examine the evolution of corporate governance reforms in the emerging  
9 economy of China. I first describe the importance of corporate governance for development  
10 and driving forces behind governance reforms in china. After summarizing the evolution of  
11 governance reforms in china ,I identify major obstacles that impede their implementation in  
12 china namely (A)Highly Concentrated Ownership Structure (B) Lack of Incentives (C) Power  
13 of the dominant shareholder (D) Lack of Independence among Directors (E)Underdeveloped  
14 external monitoring systems (F) Corruption (G) Frequent Insider Trading (H)Falsification and  
15 Fabrication of Financial Data (I) Immature Capital Market (J) Shortage of qualified  
16 independent directors (K) Insider Control of Corporate Affairs (L) Weak Supervisory Board  
17 (M) Weak Auditing Profession

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19 **Index terms**— china, corporate governance, emerging economies.

20 **1 Introduction**

21 orporate governance describes the structure of rights and responsibilities among the parties that have a stake in  
22 a firm. Research to date on corporate governance has mainly focused on (Western) developed economies.  
23 Thus, relatively little research effort has been devoted to corporate governance issues in emerging economies  
24 such as China. These economies, however, provide unique opportunities and challenges for governance practices  
25 and research.

26 **2 II.**

27 **3 Why Corporate Governance Matters for Development?**

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

31 From the perspective of local firms, there is evidence that firms in emerging economies (compared with their  
32 counterparts in developed countries) are discounted in financial markets because of their weak governance As  
33 such, improvements in corporate governance can enhance investor confidence in firms in emerging economies and  
34 increase these firms' access to capital.

35 **4 III.**

36 **5 Driving Forces ehind Corporate**

37 Governance Reforms in China

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

## 12 A) HIGHLY CONCENTRATED OWNERSHIP STRUCTURE

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

## 45 6 China's Corporate Governance Reforms

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

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

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

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

## 58 7 A

## 59 8 B

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

62 V.

## 63 9 China's Corporate Governance Model

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

## 75 10 VI.

## 76 11 Challenges of Corporate Governance Reforms in China

77 "Even in misfortune there is fortune".

78 -An old Chinese adage.

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

## 84 12 a) Highly Concentrated Ownership Structure

85 Key problem in China's corporate governance is the highly concentrated ownership structure in Chinese  
86 companies. A 2007 annual report from Shanghai Stock Exchange shows that 65 percent of the listed companies are  
87 state enterprises. Currently only individual shares are traded on the securities markets. The fact that state shares  
88 and legal person shares are not traded on the securities markets means that more than 60% of the outstanding  
89 shares have been excluded from the market. This has reduced the liquidity of the secondary market and has  
90 become the main obstacle of operating the market efficiently. The size, share, and scope of China's institutional  
91 investors are still very small. For example, Kim, Ho, and St Giles (2003) estimate about 10 percent of the  
92 shares in China's equity markets are controlled by institutional owners, compared with about 60 percent in the  
93 United States (The Conference Board, 2007). Thus the important factor that has seriously hindered the impact

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94 of institutional investors on monitoring corporate governance is the large chunk of non-tradable shares controlled  
95 by the state.

## 96 **13 b) Lack of Incentives**

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

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

## 106 **14 c) Power of the Dominant shareholder**

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

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

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

## 119 **15 Year ( )**

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

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

## 128 **16 d) Lack of Independence among Directors**

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

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

## 140 **17 e) Underdeveloped External Monitoring Systems**

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

150 **18 f) Corruption**

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

156 **19 g) Frequent Insider Trading**

157 There is frequent insider trading, self dealings, and collusions in market manipulations. Tomasic and Andrews  
158 (2006) attributed the rampant insider trading in China to two factors: the lack of concept for fiduciary duty and  
159 inefficient enforcement. China has not reached a commonly agreed translation of the legal concept "fiduciary  
160 duty." With neither common law precedents nor civil law definitions in place, many Chinese shareholders and  
161 managers are not fully aware of the necessity of avoiding conflicts of interest in corporate context. Another reason  
162 why insider trading remains uncurbed could be the absence of class actions in China.

163 **20 h) Falsification and Fabrication of Financial Data**

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

169 **21 i) Immature Capital Market**

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

177 **22 j) Shortage of qualified independent directors**

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

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

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

189 **24 k) Insider Control of Corporate Affairs**

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

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

197 **25 l) Weak Supervisory Board**

198 Given the overwhelming dominance of the government's influence on boards of directors, the supervisory board  
199 in China has not yet played a significant and effective governance role. Since bureaucrats in charge of the  
200 company nominate and remove directors and supervisors alike, members of the supervisory board have little say  
201 in the major corporate decisions, particularly when their role of overseeing the board of directors has been only

202 vaguely defined in China's Company Law. No law gives supervisors the right to take civil litigation against board  
203 directors or senior managers when they detect company misconduct.

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

## 207 **26 m) Weak Auditing Profession**

208 Another key problem in China's corporate governance is the weak auditing profession. Li (2001), an official with  
209 the Chinese Institute of Certified Public Accountants (CICPA), stated that Chinese accounting firms are lagging  
210 behind international standards regarding qualifications, services, and management. Many Chinese CPAs do not  
211 have enough knowledge about international accounting practices and are not well equipped with computer skills,  
212 due to a lack of proper training. Moreover, Chinese CPA firms have many problems in their operations because  
213 of lack of sound supervision mechanisms, which gives rise to serious fraud cases in the securities market.

## 214 **27 VII.**

## 215 **28 Conclusion**

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

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

225 Such a strengthening of corporate governance will play a vital role in ensuring that China's economic reforms  
226 lead to it becoming a major international economic superpower. "Governance reform is an important (part) Of  
227 the agenda (of many Asian countries)?.. But saying it is much less difficult than doing it. Implementation and  
enforcement are key" ~Chanhong Rhee, Chief Economist, Asian Development Bank <sup>1 2</sup>



Figure 1: 2 Global

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<sup>2</sup>Principal Constraints and Challenges of Introducing Effective System of Corporate Governance in Emerging China

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