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Corporate Governance in China: Recent Developments, Key Problems, and Solutions

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Abstract

China started its economic reform in 1978. By 1995, China had become the world's third largest economic powerhouse after the United States and Japan, with a total GDP of \$720 billion. The development of the securities market and a sound corporate governance system plays an important role in the progress of China's economic reform. Since 1992, China has made substantial progress in seven areas of corporate governance: (1) rights of shareholders and rules for shareholders' meetings, (2) duties and responsibilities of directors and independence of board of directors, (3) fiduciary duties, (4) performance assessments and incentive and disciplinary systems, (5) information disclosure and transparency, (6) insider information and related party transactions, and (7) the role of the auditor.

This paper describes the recent developments in China's corporate governance. In particular, it addresses nine key corporate governance problems in China: (1) highly concentrated ownership structure, (2) insider control of corporate affairs, (3) weak protection of shareholders' rights, (4) frequent insider trading, self dealings and collusions in market manipulations, (5) falsification and fabrication of financial data, (6) weak independent board of directors and specialized committees, (7) weak supervisory board, (8) weak auditing profession, and (9) weak external governance structure.

This paper also provides eleven suggested solutions to improve the quality of corporate governance in China: (1) gradually floating the un-tradable shares, (2) CEO certification, corporate governance guidelines, and code of business conduct and ethics, (3) improving disclosure and supervision of insider and related party transactions, (4) accelerating the reform of board of directors, (5) clearly defining the functions of the supervisory board, (6) improving internal controls, audit quality and independence, (7) requiring an independent audit committee and an internal audit function, (8) strengthening legal liabilities and enforcement, (9) strengthening shareholder rights, (10) developing a long-term focus incentive compensation system for directors and executives, and (11) improving the quality of the external governance structure.

1. Introduction

China is a giant country with a population of 1.2 billion people. In 1978, China's "paramount leader" Deng Xiaoping started a series of reforms in its economic system in order to stimulate economic growth and to raise the Chinese people's standard of living. By 1995, China had become the world's third largest economic powerhouse after the United States and Japan, with a total GDP of \$720 billion. China's securities market

Monograph Series

Corporate Governance in China: Recent Developments, Key Problems, and Solutions

and a sound corporate governance system play an important role in these economic reforms. The number of listed companies has risen from 14 in the year when China's two stock exchanges (Shanghai and Shenzhen) commenced operation in 1991 to 1,223 by the year 2002.

Corporate governance is commonly viewed as a system that delineates the rights and responsibilities of each major group of stakeholders in a company, and sets rules and procedures for making decisions about company affairs (OECD, 1998). It can also be viewed as the design of institutions and mechanisms that induce or control board directors and management to best serve the interests of shareholders and other stakeholders in a company and to resolve conflicts among them, subject to the constraints of economic, legal and ethical norms (Ho, 2002). Sound corporate governance is good for maximizing the shareholder value and productivity of companies. During the past decade, before and after China's entry into the World Trade Organization (WTO) in late 2001, the Chinese government has continued to improve its corporate governance policies to prepare Chinese companies to compete with their foreign competitors. However, there are still several areas that need improvement.

The objectives of this paper are to identify key corporate governance problems in China and to provide suggested solutions to improve the quality of China's corporate governance.

The remainder of this paper is organized as follows: Section 2 briefly describes the recent developments in China's corporate governance; Section 3 addresses China's key corporate governance problems; Section 4 discusses suggested solutions; Section 5 concludes the paper.

2. Recent Developments in China's Corporate Governance

Since the establishment of China's securities regulator, the China Securities Regulatory Commission (CSRC), in 1992, more than 300 laws and directives concerning the securities and futures market have been issued. The key legal framework for corporate governance in China consists of the Company Law promulgated in December 1993, the Securities Law promulgated in December 1998, and the Code of Corporate Governance for Listed Companies issued by the China Securities Regulatory Commission and State Economic and Trade Commission in January 2002.

Since 1992, China has made substantial progress in seven areas of corporate governance: (1) rights of shareholders and rules for shareholders' meetings, (2) duties and responsibilities of directors and independence of board of directors, (3) fiduciary duties, (4) performance assessments and incentive and disciplinary systems, (5) information disclosure and transparency, (6) insider information and related party transactions, and (7) the role of the auditor.

Rights of Shareholders and Rules for Shareholders' Meetings

The Code of Corporate Governance emphasizes the importance of shareholders' rights. It includes both rights of shareholders and rules of shareholders' meetings in Chapter 1 (CSRC, 2002).

For shareholders' rights, it states that all shareholders are to enjoy equal rights and to bear the corresponding duties based on the shares they hold. Shareholders shall have the right to know about and the right to participate in major matters of the company set forth in the laws, administrative regulations, and articles of association. In addition, shareholders shall have the right to protect their interests and rights through civil litigation or other legal means in accordance with laws and administrative regulations.

Regarding to rules for shareholders' meetings, it states that a listed company shall

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set out convening and voting procedures for shareholders' meetings in its articles of association, including rules governing such matters as notification, registration, review of proposals, voting, counting of votes, announcement of voting results, formulation of resolutions, recording of minutes and signatories, public announcements, etc. The shareholders can either be present at the shareholders' meetings in person or they may appoint a proxy to vote on their behalf, and both means of voting possess the same legal effect. In addition, institutional investors shall play a role in the appointment of company directors, the compensation and supervision of management, and major decision-making processes.

Directors and Board of Directors

The Company Law has the following rules relating to a company's board of directors: (1) limited liability companies and joint stock companies are required to set up a board of directors, (2) the number of directors should range from three to 13 for a limited liability company and five to 19 for a joint stock company, (3) the board of directors has the responsibility of appointing and removing management, (4) directors and managers must faithfully perform their duties, protect the company's interests, and ultimately answer to shareholders, (5) and a director's appointment should not exceed three years, subject to re-appointment for a further term.

Chapter 3 of the Code of Corporate Governance discusses directors and board of directors in six areas: (1) election procedures for directors, (2) the duties and responsibilities of directors, (3) duties and composition of the board of directors, (4) rules and procedures of the board of directors, (5) independent directors, and (6) specialized committees of the board of directors. The following are major rules relating to directors (CSRC, 2002):

- ◆ A company shall establish a standardized and transparent procedure for director election in its articles of association, so as to ensure the openness, fairness, impartialness, and independence of the election.
- ◆ The election of directors shall fully reflect the opinions of minority shareholders. A cumulative voting system shall be earnestly advanced in shareholders' meetings for the election of directors. Listed companies that are more than 30% owned by controlling shareholders shall adopt a cumulative voting system, and the companies that do adopt such a system shall stipulate the implementing rules for such a cumulative voting system in their articles of association.
- ◆ Appointment agreements shall be entered into by a listed company and its directors to clarify such matters as the rights and obligations between the company and the director, the term of the directorship, the director's liabilities in case of breach of laws, regulations or articles of association, and the compensation from the company in case of early termination of the appointment agreement for cause by the company.
- ◆ Directors shall faithfully, honestly, and diligently perform their duties for the best interests of the company and all the shareholders.
- ◆ Directors shall attend the board of directors meetings in a diligent and responsible manner, and shall express their clear opinion on the topics discussed. When unable to attend a board of directors meeting, a director may authorize another director in writing to vote on his behalf and the director who makes such authorization shall be responsible for the vote.
- ◆ Directors shall earnestly attend relevant trainings to learn about the rights, obligations, and duties of a director, to familiarize themselves with relevant laws and regulations, and to master relevant knowledge necessary for acting as directors.

Monograph Series

- ♦ The board of directors shall possess proper professional background. The directors shall possess adequate knowledge, skill, and quality to perform their duties.
- ♦ The board of directors shall be made accountable to shareholders. A listed company's corporate governance framework shall ensure that the board of directors can exercise its power in accordance with laws, administrative regulations, and the company's articles of association.
- ♦ A listed company shall formulate rules of procedures for its board of directors in its articles of association to ensure the board of directors' efficient function and rational decisions.
- ♦ A listed company shall introduce independent directors to its board of directors in accordance with relevant regulations. Independent directors shall be independent from the listed company that employs them and the company's major shareholders. An independent director may not hold any other position apart from independent director in the listed company.
- ♦ The board of directors of a listed company may establish a corporate strategy committee, an audit committee, a nomination committee, remuneration and appraisal committee, and other special committees in accordance with the resolutions of the shareholders' meetings. All committees shall be composed solely of directors. The audit committee, the nomination committee, and the remuneration and appraisal committee shall be chaired by an independent director, and independent directors shall constitute the majority of the committees. At least one independent director from the audit committee shall be an accounting professional.
- ♦ The main duties of the audit committee are: (1) to recommend the engagement or replacement of the company's external auditing institutions, (2) to review the internal audit system and its execution, (3) to oversee the interaction between the company's internal and external auditing institutions, (4) to inspect the company's financial information and its disclosure, and (5) to monitor the company's internal control system.

Fiduciary Duties

The Company Law requires directors, supervisors, and managers to execute their official duties and to protect the company's interests without exploiting their positions and power in the company. In particular, they must: (1) comply with the company's constitution, (2) perform their duties faithfully and uphold the interests of the company and must not use their position in the company to seek personal gain, (3) do not take bribes or misappropriate the company's property, (4) do not deposit the company's funds in their personal accounts or the accounts of other persons, and (5) do not use the company's assets as collateral for the personal debts of the shareholders or other persons.

Competition and self-dealing with the company are strictly prohibited under the Company Law: (1) directors are prohibited from engaging personally, or assisting others, in the business operation of another company carrying out the same business as the company in which he is serving a term; (2) directors are also prohibited from engaging in activities that may adversely affect the interests of the company in which they are serving, and must account to the company for the benefit so derived; (3) directors and managers are not permitted to enter into any contract or conduct any transaction with the company unless the constitution provides otherwise or unless shareholders' consent is obtained. Sanctions for breach of such duties range from compensating the company to criminal liability (Doe and Chan, 2001).

Monograph Series

Performance Assessments and Incentive and Disciplinary Systems

Chapter 5 of the Code of Corporate Governance discusses performance assessments and incentive and disciplinary systems in three areas: (1) performance assessment for directors, supervisors, and management personnel, (2) selection of management personnel, and (3) incentive and disciplinary systems for management. The following are major rules relating to these systems (CSRC, 2002):

- ♦ A listed company shall establish fair and transparent standards and procedures for the assessment of the performance of directors, supervisors, and management personnel.
- ♦ The evaluation of the directors and management personnel shall be conducted by the board of directors or by the remuneration and appraisal committee of the board of directors. The evaluation of the performance of independent directors and supervisors shall be conducted through a combination of self-review and peer review.
- ♦ The recruitment of management personnel of a listed company shall be conducted in strict observation with relevant laws and regulations and the company's articles of association. No institution or individual shall interfere with a listed company's normal recruiting procedure for management personnel.
- ♦ Employment agreements shall be entered into by a listed company and its management personnel to clarify each party's rights and obligations.
- ♦ The performance assessment for management personnel shall become a basis for determining the compensation and other rewarding arrangements for the person reviewed.
- ♦ The results of the performance assessment shall be approved by the board of directors, explained at the shareholders' meetings, and disclosed.

Information Disclosure and Transparency

The basic framework for information disclosure in the Chinese securities markets has been established with the efforts of the CSRC and other relevant authorities. These disclosure requirements are described in different government pronouncements ranging from securities legislation to detailed explanations addressing specific questions. The requirements can be divided into four levels (Liu and Zhang, 1996).

The first level of disclosure requirements involves the securities trading legislation. The second level of disclosure requirements involves the detailed rules and regulations implementing securities legislation. The third level of disclosure requirements involves the content, form, and criterion of disclosure. The fourth level of disclosure requirements involves the interpretation and explanation of those specific provisions in the laws and regulations related to the disclosure of information as well as the answers to the questions related to the implementation of disclosure requirements.

Chapter 7 of the Code of Corporate Governance discusses information disclosure and transparency in three areas: (1) listed companies' ongoing information disclosure, (2) disclosure of information regarding corporate governance, and (3) disclosure of controlling shareholders' interests. The following are major rules relating to these areas (CSRC, 2002):

- ♦ Information disclosure is an ongoing responsibility of listed companies. A listed company shall truthfully, accurately, completely, and timely disclose information as required by laws, regulations, and the company's articles of association.
- ♦ The secretary of the board of directors shall be in charge of information disclosure, including formulating rules for information disclosure, receiving visits, providing consultation, contacting shareholders, and providing publicly dis-

Monograph Series

closed information about the company to investors. The board of directors and the management shall actively support the secretary's work. No institutions or individuals shall interfere with the secretary's work.

- ◆ A listed company shall disclose information regarding its corporate governance in accordance with laws, regulations, and other relevant rules, including but not limited to: (1) the members and structure of the board of directors and the supervisory board, (2) the performance and evaluation of the board of directors and the supervisory board, (3) the performance and evaluation of the independent directors, including their attendance at board of directors' meetings, their issuance of independent opinions, and their opinions regarding related party transactions and appointment and removal of directors and senior management personnel, (4) the composition and work of the specialized committees of the board of directors, (5) the actual state of corporate governance of the company, the gap between the company's corporate governance and the Code, and the reasons for the gap, and (6) specific plans and measures to improve corporate governance.
- ◆ A company shall timely disclose detailed information about each shareholder who owns a comparatively large percentage of shares of the company, the shareholders who actually control the company when acting in concert, and the company's actual controllers in accordance with relevant regulations.

Insider Information and Related Party Transactions

Doe and Chan (2001) summarized the Securities Law rules on insider information and related party transactions as follows: persons with insider information relating to securities trading are prohibited to use such information to conduct securities trading activities. Company directors, supervisors, managers, shareholders holding 5% or more of the share capital of the company, and other officials who have participated in securities trading pursuant to their legal duties are deemed to be persons possessing insider information for the purpose of the law. When a person with insider information deals with the related securities, leaks the information, or encourages another person to purchase or sell the securities prior to the publication of the information, any illegal income generated will be confiscated, and a fine equal to five times the illegal income obtained may be levied. The relevant conduct may also constitute a criminal offense. When transactions are conducted between related parties, their nature, type, and other pertinent information (such as the amounts involved and the basis for determining the transfer/disposal price) must be disclosed in the financial statements. CSRC will require listed companies to publish supplementary public notices to make up for any underreporting.

Chapter 1 of the Code of Corporate Governance states the following three major points for related party transactions (CSRC, 2002):

- ◆ Written agreements shall be entered into for related party transactions among a listed company and its connected parties. Such agreements shall observe principles of equality, voluntarily, and fair payment for value received.
- ◆ In principle, the prices for related party transactions shall not deviate from an independent third party's market price or charging standard. The company shall fully disclose the basis for pricing for related party transactions.
- ◆ A listed company shall not provide financial guarantees for its shareholders or their affiliates.

Monograph Series

The Role of the Auditor

Since the promulgation of the Securities Law, auditors have been empowered to review the company's financial statements and records and to request the company's management to provide all relevant information as they consider appropriate. Auditors have the right under the law to attend shareholders' meetings and express their views on any audit — related matters to the shareholders at such meetings. Audit opinions are not only required to be disclosed to shareholders but auditors are also under a duty to report to CSRC the background and reasons for issuing such opinions (Doe and Chan, 2001).

Certified public accountants (CPAs) and their firms in China were historically affiliated with the government finance bureau, thereby seriously impairing their independence and clouding risk management concepts. In order to rectify these shortcomings, the CSRC and the Ministry of Finance started in 1993 to require CPA firms to be separate and independent from their former bosses, i.e., finance bureau or other governmental agencies, and to obtain licenses to provide independent audits and related services, as well as to improve the quality of information disclosed by companies.

3. Key Corporate Governance Problems in China

Although China's government and companies have made substantial progress in recent years to improve corporate governance, many problems still exist. This paper identifies the following nine key corporate governance problems in China: (1) highly concentrated ownership structure, (2) insider control of corporate affairs, (3) weak protection of shareholders' rights, (4) frequent insider trading, self dealings and collusions in market manipulations, (5) falsification and fabrication of financial data, (6) weak independent board of directors and specialized committees, (7) weak supervisory board, (8) weak auditing profession, and (9) weak external governance structure.

Highly Concentrated Ownership Structure

Corporate governance problems in the Western World originate from the agency problem of the separation of ownership and control within a company, which gives rise to information asymmetry and agency costs (Fama and Jensen, 1983a & b). Agency theory assumes that human behavior is opportunistic and self-serving in nature; therefore, the fundamental function of the board of directors is to control managerial behavior and ensure that top managers act in the interests of shareholders (Fama, 1980; Jensen and Meckling, 1976).

The first key problem in China's corporate governance is the highly concentrated ownership structure in Chinese companies (Cha, 2001; Doe and Chan, 2001; Lin and Tang, 2001; SSE, 2003; Tam, 2002; Tenev and Zhang, 2002; Wei, 2003). 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. For example, at the end of 2000, the total shares in both the Shanghai Stock Exchange and Shenzhen Stock Exchange were 374.628 billion shares, and only 35.62% belonged to individual shares while state shares and legal person shares were 37.35%, and 27.03% shares, respectively, with a total of 64.38% non-tradable shares (CCX International 2001). This has reduced the liquidity of the secondary market and has become the main obstacle of operating the market efficiently.

Insider Control of Corporate Affairs

The second key problem in China's corporate governance is the insider control of corporate affairs (Cha, 2001; Doe and Chan, 2001; Guan, 1998; Lin and Tang, 2001;

Monograph Series

SSE, 2003; Tam, 2002; Wei, 2003; Zhang, 1998). 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. The controlling authorities have no incentives to select the best managers or to ensure companies are efficiently and profitably operated. As a result, these managers run the business as usual to produce poor operating performance.

The Chinese government and the party organization can exert a critical influence on company affairs. Documented abuses by controlling shareholders include soft loans from listed companies on a long-term basis; the use of listed companies as guarantors to borrow money from banks; and the sale of assets to listed companies at unfair prices, usually without an appraisal by an independent evaluator (Tenev and Zhang, 2002).

Weak Protection of Shareholders Rights

The third key problem in China's corporate governance is the weak protection of shareholders' rights (Cha, 2001; Lin, 2001; Schipani and Liu, 2001; SSE, 2003; Tam, 2002; Tenev and Zhang 2002).

In Chinese companies, majority shareholders are typically very strong and individual minority shareholders are extremely weak to counter the influence of the majority shareholders. Related party transactions between controlling shareholders or a group company and the listed company are often detrimental to minority shareholders. 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.

Frequent Insider Trading, Self Dealings and Collusions in Market Manipulations

The fourth key problem in China's corporate governance is the frequent insider trading, self dealings, and collusions in market manipulations (Lin and Tang, 2001; Tam, 2002).

Although the Chinese government promulgated against insider trading, cases are still reported in the news media. The spread of inside information is not uncommon; it has been the object of speculators to gain windfall profit. One security company was severely punished by the CSRC in 2001 because it made use of inside information concerning an intended takeover. The punishment included confiscation of all profit from the trading and a fine for the insider trading. That security company was suspended from operation for several months. The deterrent effects of the case are obvious but great efforts still need to be made in order to regulate inside trading in the Chinese Securities Market (Lin and Tang 2001).

Tam (2002) reported a famous fraud case from the Beijing Securities Times (1999) as follows: During a 9-month period from March 1997, a listed property development company in Shanghai was reported in China's premier business newspaper to have utilized 46 individual investors' accounts to engage in self dealings and insider trading in

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shares of a related company. By December 1997, the company was alleged to have employed over 180 million Yuan to acquire 29% of the target company's stocks, manipulating the latter's share price from 9.50 Yuan per share at the beginning of this period to 18.97 Yuan.

The BBC News (2001) also reported that in 2001, the CSRC found that half of the 56 companies that issued shares on the Shenzhen Stock Exchange misled shareholders; these companies advertised new shares to raise funds to expand their businesses, and then ploughed the money into stock market speculation.

Falsification and Fabrication of Financial Data

The fifth key problem of China's corporate governance is the falsification and fabrication of financial data by listed firms (Doe and Chan, 2001; Lin, 2001; SSE, 2003; Tam, 2002). Although Chinese laws on corporate governance appear to generally follow international standards on paper, mandatory disclosure of company information does not necessarily result in greater transparency, since investors cannot be assured of the truthfulness and accuracy of company reports. Information disclosure are in many cases not timely and accurate, and not easily understandable by investors.

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 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. This weak link permits some companies to hide their inefficiencies and mismanagement as well as dubious dealings by somehow overlooking the mandatory disclosure requirements.

Tam (2002) cited a major illegal incident reported in the Beijing Youth Daily on November 11, 2000 as follows: An established state owned television manufacturer planned to modernize with new injection of funds and sought successfully to obtain listing in May 1997. In its application for listing, the company was alleged to have falsely reported an annual profit of 54 million Yuan while in fact it had incurred a loss of 103 million Yuan. It raised 410 million Yuan in the IPO. After its listing, it was reported that the company had again falsified its income statements by claiming a profit when there was a loss, and reporting a much lower loss than was the actual figure. The company was alleged to have utilized only 16.5% of the raised capital according to its share prospectus, with 34% being diverted to speculating on the stock market through 200 personal investor accounts.

The BBC News (2001) also reported that in 2001 the Finance Ministry ordered checks on the accounts of listed companies after a tour operator admitted reporting 128 million Yuan (\$15.47 million U.S.) of non-existent profits over a three-year period.

Weak Independent Board of Directors and Specialized Committees

The sixth key problem of China's corporate governance is the weak independent board of directors and specialized committees in listed firms (Tam, 2002; Schipani and Liu, 2001; Tenev and Zhang, 2002). Company law stipulates that the shareholders' general meeting is responsible for selecting and removing directors, but it does not state who is responsible for nominating directors. Schipani and Liu (2001) cited a report from the China Daily (1999) that a survey in early 1999 revealed that most company officials were still nominated by government departments instead of the board of directors. Zhang (2000) also reported that many company directors found it difficult to exert any substantial influence, other than symbolic, on the board. Tenev and Zhang (2002) reported a 1999 survey result that only 3.1 percent of all directors had some

Monograph Series

degree of independence.

CSRC overhauled insider-controlled board structure by promulgating a regulation in August 2001 requiring each listed company to have at least one-third of the board to be independent directors by June 2003. CSRC's regulations require that independent directors must spend enough time on the companies they hold directorship; one person cannot hold more than 5 directorship positions concurrently. But according to a 1999 survey conducted by the OECD, the average percentage of independent directors on companies' board of directors was 62% in the U.S. Therefore, China needs to increase its percentage of independent directors.

The Code of Corporate Governance states that the board of directors may establish special committees. But Tenev and Zhang (2002) reported a 1999 survey result that only 5.4 percent of the companies have established special committees and only 14 percent plan to set up such committees.

Weak Supervisory Board

The seventh key problem in China's corporate governance is the weak supervisory board in listed firms (Cha, 2001; Doe and Chan, 2001; Schipani and Liu, 2001; Tam, 2002; Tenev and Zhang, 2002). In the Chinese system, companies operating under the country's Company Law have a two-tier board. In addition to the board of directors, Chinese companies also have a supervisory board. The supervisory board usually has labor union, party, and major shareholder representation. However, it only has a loosely defined monitoring role over the board of directors and managers. Cheng (2000) reported a 1999 survey that showed that board of supervisors in some companies had difficulty performing their supervisory duties.

The supervisory board in China has so far not played any effective governance role. Supervisors are not involved in the selection of directors and managers and have no means of disciplining them. In many companies, the supervisory board duplicates the authority of the board of directors but without corresponding responsibilities.

Weak Auditing Profession

The eighth key problem in China's corporate governance is the weak auditing profession (Lin and Tang, 2001). 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.

Management is accountable for fair presentation of financial information while the independent auditors are accountable for their audit report. However, the CPA's responsibility is not defined clearly. The only place where the CPA's legal liability is prescribed is in the decision of the People's Congress on the implementation of the Company Law. According to the decision, criminal charges could be imposed if auditors intentionally provide false documents concerning asset valuation, capital verification, and examination that resulted in serious consequences. The punishment could be imprisonment for up to five years and fines for up to 200,000 Yuan.

Several empirical studies found some unique auditing situations in China. For example, Abdel-Khalik et al.'s (1999) study found that independence and social acceptance of auditing in China appeared to be making slow progress due to government controlled domestic CPA firms. DeFond et al.'s (2000) study found a surprising situation in China's audit market, i.e., the increase in modified audit reports in recent years is followed by a

Monograph Series

decline in audit market share among large audit firms. Xiao et al. (2000) illuminated some major features of the Chinese audit market, such as the lack of audit independence, the shortage of well-qualified auditors, and an environment of massive corruption.

Weak External Governance Structure.

The ninth key problem in China's corporate governance is the weak external governance structure (Lin, 2001; SSE, 2003; Tam, 2002; Tenev and Zhang, 2002). This paper identifies four areas of weakness in the external governance structure: (1) the market for corporate control is weak due to the lack of professional management and its market, obstacles in regulations, and lack of information transparency; (2) the legal enforcement is weak due to the lack of an independent judiciary in China, weak legal culture, and weak enforcement system, (3) weak or absence of monitoring role by banks, professional organizations, and the mass media, and (4) small and insignificant number of institutional investors that do not play a major role to improve corporate governance.

4. Suggested Solutions

To solve these problems, the following eleven suggestions are proposed: (1) gradually floating the un-tradable shares, (2) implementing CEO certification, corporate governance guidelines, and code of business conduct and ethics, (3) improving disclosure and supervision of insider and related party transactions, (4) accelerating the reform of the board of directors, (5) clearly defining the functions of the supervisory board, (6) improving internal controls, audit quality, and independence, (7) requiring an independent audit committee and internal audit function, (8) strengthening legal liabilities and enforcement, (9) strengthening shareholder rights, (10) developing a long-term focus incentive compensation system for directors and executives, and (11) improving the quality of the external governance structure.

In 2001 and 2002, the exposure of several corporate scandals in America such as Enron and WorldCom led the U.S. Congress to pass the Sarbanes-Oxley Act of 2002, and the SEC to approve the New York Stock Exchange's (NYSE) proposed New Rules to Strengthen Corporate Governance Standards for Listed Companies in 2003. These two sets of new rules and regulations have strengthened the corporate governance of U.S. firms. Some of these new rules and regulations can be applied to Chinese companies to improve the quality of their corporate governance.

Gradually Floating the Un-Tradable Shares

The first suggestion is to gradually release state shares and legal person shares to be traded in the market (Lin and Tang, 2001; SSE, 2003; Tenev and Zhang, 2002; Wei, 2003). One method is to sell off the un-tradable shares to existing owners of tradable shares at proper prices. The second method is to transfer state shares to trusts administered by trust investment companies. The third method is to transform government equity claims into preferred nonvoting shares. These three methods can be combined with a ten-year, three-phase timetable to implement.

Implementing CEO Certification, Corporate Governance Guidelines, and Code of Business Conduct and Ethics

CSRC can learn from the recent U.S. Sarbanes-Oxley Act (2002) and NYSE (2003) corporate governance rules to require CEOs of listed companies to attest to the accuracy, completeness, and understandability of information provided to investors, and mandate that listed companies adopt and publish corporate governance guidelines as well as

Monograph Series

a code of business conduct and ethics.

The Sarbanes-Oxley Act (2002) requires that the CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the “appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respect, the operations and financial condition of the issuer.”

The NYSE (2003) requires the CEO of each listed company to certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE’s corporate governance listing standards. It also requires each listed company to adopt and disclose corporate governance guidelines, and to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, as well as to promptly disclose any waivers of the code for directors or executive officers.

Improving Disclosure and Supervision of Insider and Related Party Transactions

The following Sarbanes-Oxley Act (2002) rules can be modified and used to improve the quality of China’s company corporate governance:

- ♦ “Each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions” and “other relationships” with “unconsolidated entities” that may have a material current or future effect on the financial condition of the listed company.
- ♦ Directors, officers, and owners of 10% or more must report designated transactions by the end of the second business day following the day on which the transaction was executed.
- ♦ Prohibit the purchase or sale of stock by officers and directors and other insiders during blackout periods. Any profits resulting from sales in violation of this section “shall inure to and be recoverable by the issuer.” If the issuer fails to bring suit or prosecute diligently, a suit to recover such profit may be instituted by “the owner of any security of the issuer.”

Accelerating the Reform of the Board of Directors

A survey of 145 U.S. CFOs by PricewaterhouseCoopers (2002) showed that company board of directors plan to have more input in the following areas: identifying and managing risk (57%), the company’s business structure and transactions (55%), auditor independence (55%), and the code of conduct (47%). These areas are also important for Chinese company boards to focus on.

The following NYSE (2003) rules can be modified and used in China to improve the quality of its listed company boards’ operations:

- ♦ Require the board of directors of each listed company to consist of a majority of independent directors.
- ♦ Require each listed company to have a nominating/corporate governance committee composed entirely of independent directors. It also requires such a committee to have a written charter that addresses, among other items, the committee’s purpose and responsibilities, and an annual performance evaluation of the nominating/corporate governance committee. In addition, the committee would be required to identify individuals qualified to become board members, consistent with the criteria approved by the board.
- ♦ Require each listed company to have a compensation committee composed entirely of independent directors.
- ♦ Require the non-management directors of each listed company to meet at

Monograph Series

regularly scheduled executive sessions without management.

- ◆ Require listed companies to disclose a method for interested parties to communicate directly with the presiding director of such executive sessions, or with the non-management directors as a group.

Shultz (2003) suggested the following ten common mistakes to avoid when choosing board members: (1) failure to recruit strategically for board members to add value to the company, (2) too many inside directors, (3) too many members who have some previous association with the company, (4) too many friends and colleagues, (5) too much like a family, (6) getting the money wrong by either rewarding mediocrity or hiring board members to give management a blank check, (7) fear of diversity in board members, (8) information block between board and management, (9) passive boards, and (10) failed leadership by the board.

Epstein and Roy (2004) suggested that companies use a balanced scorecard to measure and improve corporate board performance. They showed an example of a board's strategic objectives as: (1) financial dimension: long-term financial success, short-term financial success, and long-term success of major organizational changes; (2) shareholders dimension: high level of ethical behavior and legal compliance, high level of corporate governance and accountability, and successful identification and management of various stakeholders' needs; (3) internal process dimension: effective risk and crisis management, effective performance evaluation systems, effective review of strategic plans, structures, and major investments, and effective functioning of the board; and (4) learning and innovation dimension: strong succession for CEO and senior management, improving board's information system, and improving board's skills and knowledge.

Clearly Defining the Functions of the Supervisory Board

The board of supervisors was created to monitor insiders and management. However, in reality, most Chinese companies have strong management but weak and non-independent supervisory boards. Starting in June 2003, all listed companies have at least one-third of board of directors are independent directors due to the new CSRC rule. There are some duplicated functions between independent directors of the board of directors and supervisors of the supervisory board. Therefore, a new rule is needed to clearly define supervisors' functions and increase a supervisor's independence (SSE, 2003).

Improving Internal Controls, Audit Quality, and Independence

It is imperative to upgrade the Chinese auditing profession such as to establish the auditor's independent status, to increase the professional competency of CPAs, and to focus on the importance of Chinese CPA's professional ethics (Lin and Tang, 2001).

The following Sarbanes-Oxley Act (2002) rules can be modified and used in China to improve internal controls, audit quality, and independence:

- ◆ Require each annual report of a listed company to contain an internal control report.
- ◆ It shall be "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert

Monograph Series

services unrelated to the audit.

- ♦ Prohibit relationships between independent auditors and their clients that would affect the fairness and objectivity of audits.
- ♦ Grant the audit committee sole authority to hire and fire independent auditors and to approve any significant non-audit work by the auditors.
- ♦ Establish an annual or periodic independent review of all public accounting firms.
- ♦ The lead audit or coordinating partner and the reviewing partner must rotate off of the audit every 5 years.
- ♦ Auditors are required to maintain “all audit or review work papers” for five years.

Requiring an Independent Audit Committee and an Internal Audit Function

CSRC can learn from the recent U.S. Sarbanes-Oxley Act (2002) and NYSE (2003) corporate governance rules to require each listed company to have an independent audit committee and an internal audit function.

The Sarbanes-Oxley Act (2002) states that the audit committee of a listed company shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that company.

The NYSE (2003) requires each listed company to have a minimum three-person audit committee composed entirely of directors. It also requires the audit committee of each listed company to have a written audit committee charter that addresses: (1) the committee’s purpose; (2) an annual performance evaluation of the audit committee; and (3) the duties and responsibilities of the audit committee. In addition, at least one member of the audit committee would be required to have accounting or related financial management expertise.

The NYSE (2003) also requires each listed company to have an internal audit function.

A survey of 145 U.S. CFOs by PricewaterhouseCoopers (2002) showed that companies have or will make changes in their audit committees in these ways: more-frequent audit committee meetings (32%) longer audit committee meetings (31%), and additional education of audit committee members (26%). These areas are also important for Chinese company boards to focus on.

Strengthening Legal Liabilities and Enforcement

China’s government needs to strengthen legal liabilities and enforcement.

Especially, the enforcement of laws and regulations must be effective enough to deter irregularities (Lin and Tang, 2001).

The following rules from the Sarbanes-Oxley Act (2002) can be modified and used to improve the quality of China’s company corporate governance:

- ♦ Lengthen the statute of limitations on securities fraud to five years.
- ♦ Prevent company executives from receiving company loans unavailable to outsiders.
- ♦ Prevent chief executive officers from selling stock during “blackout periods.”
- ♦ Make securities fraud a crime subject to a 25-year jail term.
- ♦ Make it easier for whistleblowers to sue.
- ♦ Permanently bar officers and directors of public companies from holding office again after violating their duties to shareholders.

Monograph Series

Strengthening Shareholder Rights

To improve corporate governance, efforts are needed to strengthen the mechanism for shareholders to enforce their rights (Lin, 2001; Schipani and Liu, 2001; SSE, 2003; Tenev and Zhang, 2002). Several measures can be implemented: (1) enhancing shareholders' voting mechanism; (2) entitling shareholders to seek answers from the board of directors, the board committees, the board of supervisors, and the senior management; (3) lowering the minimum requiring number of shares for shareholders to raise proposals; (4) safeguarding the interests of minority, outside shareholders; and (5) increasing legal obligation of controlling shareholders.

Developing a Long-term Focus Incentive Compensation System for Directors and Executives

It is essential to improve the current fixed and relation-based compensation mechanism, and develop a long-term focus incentive compensation system for directors and executives (Lin, 2001; Schipani and Liu, 2001; SSE, 2003; Wei, 2003). This new system should have a close linkage between compensation and performance, and at least 50 percent should be in the form of stock options or performance shares based on the company's long-term performance.

Improving External Corporate Governance Structure

It is imperative to improve the quality of the external governance structure in China (Gillan and Starks, 2003; Lin, 2001; Lin and Tang, 2001; SSE, 2003; Tenev and Zhang, 2002; Wei, 2003). The following areas of the external governance structure should be improved: (1) developing the market for corporate control by introducing foreign and private capital to acquire state shares, and improving the legal environment for mergers & acquisitions; (2) improving and promoting an independent judiciary and legal culture in China; (3) strengthening the regulations and improve administration efficiency, as well as enforcing punishment for illegal trades; (4) accelerating reforms in banks and professional organizations, and the mass media; (5) increasing the number and size of institutional investors, and improving related regulations; (6) promoting the market for professional managers; (7) allowing the civil class action lawsuits; and (8) establishing a nationwide training center and conduct training programs for professionals in the securities market and investors at large.

5. Summary and Conclusion

China started its economic reform in 1978. By 1995, China had become the world's third largest economic powerhouse after the United States and Japan, with a total GDP of \$720 billion. China's securities market as well as corporate governance structure and rules play an important role in these economic reforms. Since 1992, China has made substantial progress in specifying rights of shareholders, duties and responsibilities of directors and independence of board of directors, and emphasizing the importance of information disclosure and transparency and the role of the auditor, as well as providing guidelines to guard against insider information and related party transactions.

Although there are already rules governing many aspects of the corporate behavior of companies, there is a great deal to be done. This paper has identified nine key problems and suggested eleven solutions to improve the quality of China's corporate governance. All parties involved, such as the CSRC, listed companies, auditors, investors, and banks, other creditors, and public media, should cooperate to speed up the changes and reforms in China's securities market and corporate governance structure, as well as to improve the standard of living for all Chinese people.

Monograph Series

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